Comments on “The Tradeoffs in Leaning Against the Wind” By Gourio, Kahyap, Sim

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The views presented are my own and do not necessarily reflect the views of the Federal Reserve Bank of San Francisco, or anyone else affiliated with the Federal Reserve System

Three parts to my discussion

1. Context for the question
2. Details (in search of the devil)
3. Result interpretation, implications, and going forward

Two questions folded into one:

1. Are credit booms undesirable?
    - If yes, there is room for policy to counteract them
2. Is monetary policy the right tool to counteract credit booms?

Are credit booms undesirable?

- Yes, because they may cause financial crises
  - They are frequently, but not always, followed by crises
    - Old literature: Kindleberger (1978); Minsky (1986) and more...
    - Literature following the crises of the 1990s: Gourinchas et al. 2001; Borio and Lowe 2002; Tornell and Westermann 2002 and more...
    - Literature revived by global financial crisis: Claessens et al. 2010; Schularick & Taylor 2012; Aikman et al. 2014 and more...

Are credit booms undesirable?

- Yes, because they tend to make recessions worse and recoveries slower
  - Series of papers by Jordà, Schularick, & Taylor; Reinhart and Rogoff 2009; Cerra and Saxena 2008
- Theoretically, financial market frictions can create credit booms that are *ex ante* inefficient
  - Strategic complementarities (Aiken 2014); limited commitment (Lorenzoni 2008); distortions favoring debt over equity (this paper) and more…

Therefore, room for policy

- Is monetary policy the right tool?
    - Old question of “leaning against the wind” - answer is no
        - Most recently: IMF Staff Report 2015; Svensson 2016 and more..
    - Sometimes formulated in terms of desirability of monetary policy reaction to asset prices - usually (not always) answer is no
        - Bernanke & Gertler 1999; Bordo & Jeanne 2002 and more…
    - This paper answer: “maybe”
- What are the alternatives?
    - Macroprudential regulation
    - “Mop-up” after the crisis

This paper makes a contribution

- Model allows to separate the effect of monetary policy on crisis probability from its effects before and after the crisis
- Extension with imperfect measurements
- Multitude of shocks:
  - Credit shocks
  - Financial crises (with exogenous or endogenous probability)
  - Productivity shocks
  - Demand shocks
- Welfare analysis and quantitative assessment

Details: Model Limitations

- Specific distortion: excessive debt financing (over equity)
    - Will results generalize to other financial market distortions more commonly used in the literature?
    - How empirically relevant?
- Limited set of monetary policy options:
    - Taylor (1999) rule
    - --- with credit gap in addition to or instead of output gap
    - Fixed coefficient on inflation gap
    - No macroprudential policy

Details: Model Limitations

- Exogenous crises
  - With possibility of endogenous probability (increasing with inefficient credit)
  - Reduce productivity, capital, and disutility of labor
  - Exogenous size of output drop in crisis state (crisis cost)
- Financial intermediation and financial crises are disconnected
  - Except for crisis probability
  - Intuition hard to grasp

Interpretation and implications

Authors say

- ✓ Not arguing macroprudential policy is not needed
  - It would be useful to consider it in the model
- IMF conclusion is too strong
- Simple model shows LAW could increase welfare
- ✓ Don't know enough about elasticities to properly calibrate
- LAW tradeoff: higher volatility of output and inflation to lower crisis risk

My understanding

- In theory LAW could be welfare improving, but model presented does not feel like to most natural one
- LAW tradeoff: higher volatility of output and inflation to lower crisis risk
  - Also cost of crisis can go up with LAW
- LAW can only be beneficial if it can lower crisis probability
  - Any evidence or theory that monetary policy can affect crisis risk?
- What about the alternatives to LAW?

Going forward

- More empirical work is needed to properly measure (calibrate) possible costs and benefits
- Perhaps a more relevant policy question is whether LAW is the best way to mitigate credit cycles
    - Model with multiple instruments: interest rate, macroprudential
        - Dagher et al. (2016) : find that higher capital ratios lower crisis probability; survey measures of impact on credit