Bornstein and Lorenzoni's "Moral Hazard Misconceptions: the Case of the Greenspan Put"

Olivier Jeanne, Johns Hopkins University

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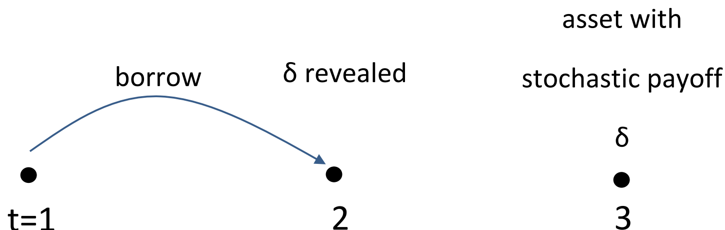
A moral hazard misconception:

- Venture capital insures entrepreneurs against risk (debtors' prison)
- Hence venture capital encourages risk-taking
- This is moral hazard: let's ban venture capital!

- Two classes of agents in the economy: A and B
- B agents borrow against risky future income with non-contingent debt



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- Central bank can stabilize the price of the asset in $t = 2$ using the interest rate (Greenspan put)
- This insures B agents (substitute to complete markets)
- B agents borrow more, **which is good**

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Stabilizing asset price with monetary policy generally not first-best because of another (macro) distortion: nominal stickiness

firms

set prices

t=1

firms produce

with agents A labor

2

3

Changing the interest rate may distort production, which hurts agents A

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Three policy regimes:

1. "Rigid" regime: the real interest rate is set before the realization of δ
2. "Output gap targeting": the real interest rate is set contingent on δ to reproduce the flexible-price allocation (new-Keynesian approach)
3. "Flexible regime": the real interest rate is set contingent on δ to maximize total welfare (A+B)

What does the "rigid' regime correspond to in the real world?

Questions we would like to have answers for:

How do the regimes differ in terms of:

- activism (responsiveness of r to δ)?
- need for macroprudential policy?
- welfare?

Activism

- In the new-Keynesian regime r is adjusted to δ in a way that is consistent with insurance
- "Divine coincidence" if utility is log: the new-Keynesian and flexible regimes coincide
- The flexible regime is more activist than the new-Keynesian regime only if the elasticity of intertemporal substitution is larger than 1

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Macroprudential policy

- The new-Keynesian regime does not need macroprudential policy
  - ex-post equilibrium does not depend on aggregate debt
- Macroprudential debt reduction is required in flexible regime if it is more activist than the new-Keynesian regime
  - but a debt subsidy is required if the flexible regime is less activist
  - intuition?

Welfare

- Which regime is better?
- Nothing in the paper on that
- My hunch: flexible regime+macroprudential policy dominates new-Keynesian regime

Conclusions

- Very stimulating paper
- Perhaps the paper would benefit from being less about "moral hazard misconceptions" and more about whether monetary policy should stabilize asset prices
- The paper offers an interesting departure from new conventional wisdom that given macroprudential policy, monetary policy can continue to focus on macro-objectives