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# Monetary and Macro-Prudential Policies: An Integrated Analysis

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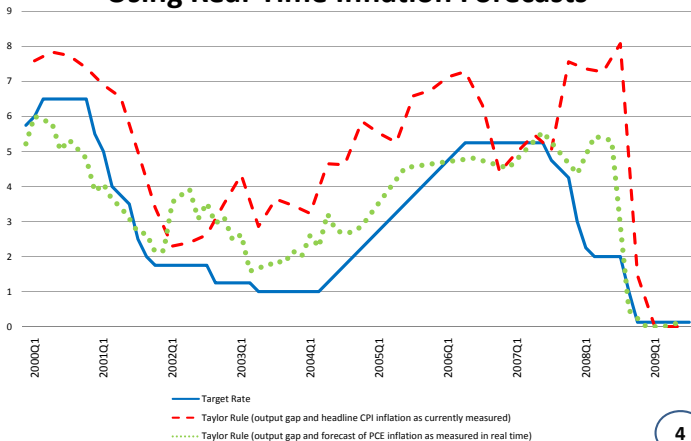
# Comments on Benigno et al “Monetary and Macro-Prudential Policies: An Integrated Analysis”

Olivier Jeanne, JHU and PIIE

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US monetary policy followed the Taylor rule before the crisis

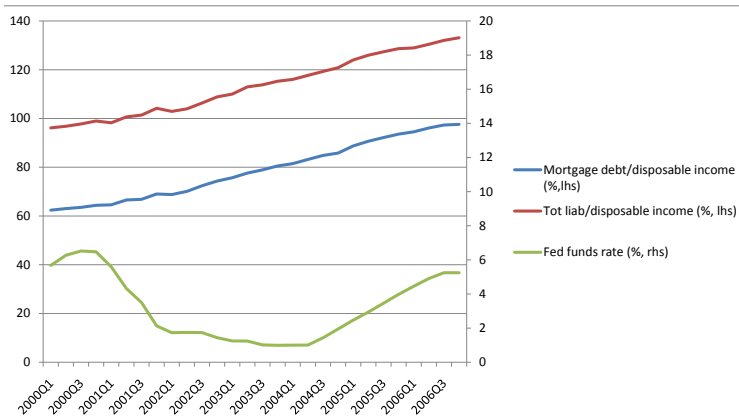
## The Target Rate and the Taylor Rule Prescriptions Using Real-Time Inflation Forecasts



Source: Federal Reserve Board, Bureau of Labor Statistics, Bureau of Economic Analysis, and Federal Reserve staff calculations.

# Introduction

But it did not respond to the boom in credit and asset prices



How should monetary policy respond to booms and busts in credit and asset prices?

## Two views

- View 1: the interest rate should be raised to lean against the boom in credit and asset prices (Issing, 2011)
- View 2: financial stability should be pursued by macroprudential policy, not monetary policy (Svensson, 2010)

## Structure of my comments

- Theoretical priors
- How are they challenged by this paper?

## Theoretical priors

This paper integrates two lines of literature

1) Neo-Keynesian analysis of monetary policy (Woodford, *Interest & Prices*, 2003)

- Friction is nominal stickiness
- The best that monetary policy can do is reproduce the frictionless equilibrium
- That means setting the real interest rate at the Wicksellian "natural level"

2) Neo-Fisherian analysis of credit booms and busts (Jeanne and Korinek, 2010; Bianchi and Mendoza, 2010; Benigno et al, 2010)

- Friction is credit constraint
- Feedback loop between asset prices and credit constraint, which magnifies booms and busts in credit and asset prices
- This calls for cyclical Pigouvian taxation of debt

What should we expect from putting those two approaches together?

- If the nominal interest rate is the only instrument to deal with both frictions, it should have a macro-prudential role
  - second-order loss and a first-order gain from a macro-prudential twist
- If there are two instruments (nominal interest rate and Pigouvian tax), then use the interest rate to take care of the nominal friction, and the tax to take care of the financial friction



## **This paper.** Assumptions

- Three periods
- Nominal stickiness and collateral constraint
- Open economy with debt denominated in foreign currency but collateral is in domestic currency
  - two prices are involved in the pecuniary externality (exchange rate and domestic currency price of collateral)
- One instrument: the nominal interest rate (no macroprudential policy)
- They compare a standard Taylor rule with a "macroprudentially augmented" Taylor rule

## Results

- Adding a macroprudential component to the Taylor rule *reduces welfare*
- Why? This increases foreign currency debt in period 0
  - the opposite of the intended effect
- In general, a macroprudential Taylor rule can have perverse effect in an open economy indebted in foreign currency
  - raising the interest rate in the boom can increase capital inflows
  - lowering the interest rate in the bust magnifies the currency mismatch problem
- Are these results applicable to a closed economy, to an advanced economy?

## Conclusion

- Important question
- Intriguing (preliminary) results
- The authors should clarify what type of economy their model is applicable to
- Perhaps one conclusion will be that emerging market countries need macroprudential instruments even more than advanced economies
  - given that monetary policy does not provide a good substitute