Bornstein and Lorenzoni’s “Moral Hazard Misconceptions: the Case of the Greenspan Put”

Olivier Jeanne, Johns Hopkins University

IMF Annual Research Conference, November 3-4, 2016

Washington DC, November 2016
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
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**
Stabilizing asset price with monetary policy generally not first-best because of another (macro) distortion: nominal stickiness

\[ t=1 \]

firms produce with agents A labor

\[ t=1, 2, 3 \]

Changing the interest rate may distort production, which hurts agents A
Three policy regimes:

1. “Rigid” regime: the real interest rate is set before the realization of $\delta$

2. “Output gap targeting”: the real interest rate is set contingent on $\delta$ to reproduce the flexible-price allocation (new-Keynesian approach)

3. “Flexible regime”: the real interest rate is set contingent on $\delta$ 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 $\delta$)?
- need for macroprudential policy?
- welfare?
Activism

- In the new-Keynesian regime, $r$ is adjusted to $\delta$ 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.
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