Discussion of
“Prudential Policy with Distorted Beliefs ”
by Eduardo Davila and Angus Walther

2021 AEA Meetings

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Overview

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Very interesting results

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Paper also looks at case with bailouts and monetary policy

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★ Two practical questions:

- Paper's characterization is for *any* beliefs, but which ones should social planner use?
- How to empirically assess agents' beliefs?

Internalities and/or Externalities

Alternative approach to fin. regulation is based on externalities

- Induce agents to choose what is right for them individually vs. what is wrong for them individually but socially desirable

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- Bianchi-Boz-Mendoza 2012 prudential tax with pecuniary externalities and non-RE beliefs

$$\tau = \underbrace{\frac{E_t^P[u'(t+1)]}{E_t^I[u'(t+1)]} - 1}_{\text{internality}} + \underbrace{\frac{E_t^I[\kappa'\mu' Q' u''_{t+1}] - E_t^P[\kappa'\mu' Q' u''_{t+1}]}{E_t^I\left[u'_{t+1}\right]}}_{\text{interaction}} + \underbrace{\frac{E_t^I[-\kappa'\mu' Q' u''_{t+1}]}{E_t^I\left[u'_{t+1}\right]}}_{\text{externality}}$$

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- Interaction term is larger if investors are more optimistic
    - Investors belief of μ' is lower

Study of Monetary Policy

Monetary policy is modelled, in effect, as a tax/subsidy on lending rebated lump sum & a deadweight loss $\mathcal{L}(r - r^*) \geq 0$

- An increase in r reduces debt, leverage and k
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★ Does monetary policy still have prudential role in more explicit monetary model?

- *Monetary policy would affect the marginal benefits from investment*

Final Remarks

Interesting and important paper

- Very clean analytical and intuitive results
- Potentially a building block in exciting research agenda

Avenues for fruitful future work

- Interaction between externalities and internalities
- More explicit monetary considerations