Discussion of

‘’Risk Channel of Monetary Policy”

by Oliver de Groot

Javier Bianchi

University of Wisconsin & NBER

“Inflation Targeting and Its Discontents”, IJCB

Narodowy Bank Polski, September 6-7, 2013

Overview

- This paper investigates the effects of monetary policy on the composition of banks funding
- Key result: Countercyclical monetary policy provides insurance → increase the reliance of banks on non-state contingent debt finance
- Overall, modest quantitative effects from monetary policy in composition of banks funding
- Interesting and well executed paper

Overview

- This paper investigates the effects of monetary policy on the composition of banks funding
- Key result: Countercyclical monetary policy provides insurance $\rightarrow$ increase the reliance of banks on non-state contingent debt finance
- Overall, modest quantitative effects from monetary policy in composition of banks funding
- Interesting and well executed paper

Overview

- This paper investigates the effects of monetary policy on the composition of banks funding
- Key result: Countercyclical monetary policy provides insurance → increase the reliance of banks on non-state contingent debt finance
- Overall, modest quantitative effects from monetary policy in composition of banks funding
- Interesting and well executed paper

Overview

- This paper investigates the effects of monetary policy on the composition of banks funding
- Key result: Countercyclical monetary policy provides insurance $\rightarrow$ increase the reliance of banks on non-state contingent debt finance
- Overall, modest quantitative effects from monetary policy in composition of banks funding
- Interesting and well executed paper

Overview (ctd)

- Extends Gertler, Kiyotaki and Queralto (2012) with sticky prices and various interest-rate rules
- Complex problem (incomplete markets, portfolio choice, sticky prices)
- Portfolio problem is solved using a "risky adjusted steady state" and perturbation methods

  –Devereux/Sutherland, Tille/Van Wincoop, Coeurdacier/Rey/Winant

Overview (ctd)

- Extends Gertler, Kiyotaki and Queralto (2012) with sticky prices and various interest-rate rules
- Complex problem (incomplete markets, portfolio choice, sticky prices)
- Portfolio problem is solved using a “risky adjusted steady state” and perturbation methods

  –Devereux/Sutherland, Tille/Van Wincoop, Coeurdacier/Rey/Winant

Basics of the Model

- Banks obtain funding from households (outside equity versus non-state contingent debt)
- Banks face an always binding leverage constraint
- Outside equity assumed to make constraint tighter
- Asset side: banks hold equity of firms
- Monopolistically competitive final goods firms with convex menu costs
- Central Bank sets follows a Taylor-type rule

Basics of the Model

- Banks obtain funding from households (outside equity versus non-state contingent debt)
- Banks face an always binding leverage constraint
- Outside equity assumed to make constraint tighter
- Asset side: banks hold equity of firms
- Monopolistically competitive final goods firms with convex menu costs
- Central Bank sets follows a Taylor-type rule

Basics of the Model

- Banks obtain funding from households (outside equity versus non-state contingent debt)
- Banks face an always binding leverage constraint
- Outside equity assumed to make constraint tighter
- Asset side: banks hold equity of firms
- Monopolistically competitive final goods firms with convex menu costs
- Central Bank sets follows a Taylor-type rule

Summary of Mechanism

- Debt pays a fixed amount regardless of the state
- Banks pay little to outside equity holders in bad times

  $\rightarrow$ good hedge

  $\Rightarrow$ Risk/Return Tradeoff: equity is more costly but offers better hedge

- Monetary policy can stabilize economy ex-post
- This may cause banks to increase reliance on debt financing ex-ante

Summary of Mechanism

- Debt pays a fixed amount regardless of the state
- Banks pay little to outside equity holders in bad times

  $\rightarrow$ good hedge

  $\Rightarrow$ Risk/Return Tradeoff: equity is more costly but offers better hedge
- Monetary policy can stabilize economy ex-post
- This may cause banks to increase reliance on debt financing ex-ante

Summary of Mechanism

- Debt pays a fixed amount regardless of the state
- Banks pay little to outside equity holders in bad times

  → good hedge

  ⇒ Risk/Return Tradeoff: equity is more costly but offers better hedge
- Monetary policy can stabilize economy ex-post
- This may cause banks to increase reliance on debt financing ex-ante

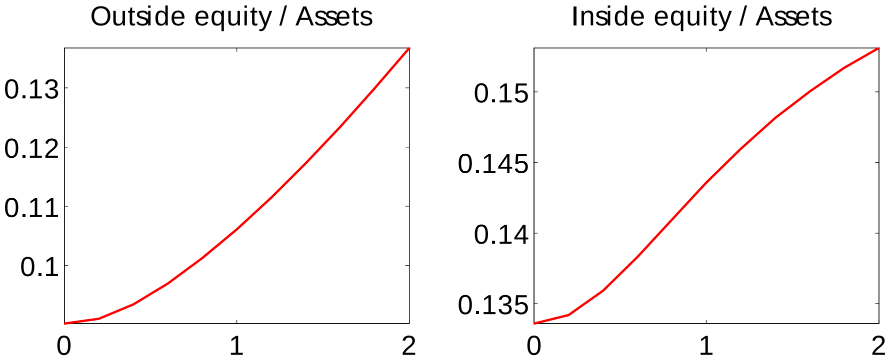
Summary of Mechanism

- Debt pays a fixed amount regardless of the state
- Banks pay little to outside equity holders in bad times

  $\rightarrow$ good hedge

  $\Rightarrow$ Risk/Return Tradeoff: equity is more costly but offers better hedge
- Monetary policy can stabilize economy ex-post
- This may cause banks to increase reliance on debt financing ex-ante

Effects of Monetary Policy Uncertainty



Comments/Questions

Why are effects of policy so small?

- Conjecture 1: Conventional MP does not have big effects on crisis ex-post in the first place
- Conjecture 2: Paper focuses on long-run averages.
  - Perhaps, there are big changes in support of the distribution causing big effects on crises dynamics (Bianchi and Mendoza)
  - Challenge to capture these effects with log-linearized solution around risky-steady state
- Conjecture 3: Numerical inaccuracies from solution method
  - Rabitsch-Stepanchuk-Tsyrennikov (2013): Credit constraints can strongly compromise the performance of the local portfolio solution method

Why are effects of policy so small?

- Conjecture 1: Conventional MP does not have big effects on crisis ex-post in the first place
- Conjecture 2: Paper focuses on long-run averages.
  - Perhaps, there are big changes in support of the distribution causing big effects on crises dynamics (Bianchi and Mendoza)
  - Challenge to capture these effects with log-linearized solution around risky-steady state
- Conjecture 3: Numerical inaccuracies from solution method
  - Rabitsch-Stepanchuk-Tsyrennikov (2013): Credit constraints can strongly compromise the performance of the local portfolio solution method

Why are effects of policy so small?

- Conjecture 1: Conventional MP does not have big effects on crisis ex-post in the first place
- Conjecture 2: Paper focuses on long-run averages.
  - Perhaps, there are big changes in support of the distribution causing big effects on crises dynamics (Bianchi and Mendoza)
  - Challenge to capture these effects with log-linearized solution around risky-steady state
- Conjecture 3: Numerical inaccuracies from solution method
  - Rabitsch-Stepanchuk-Tsyrennikov (2013): Credit constraints can strongly compromise the performance of the local portfolio solution method

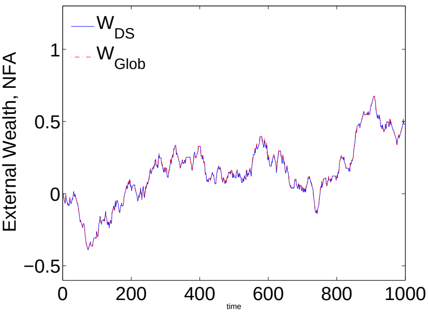
Why are effects of policy so small?

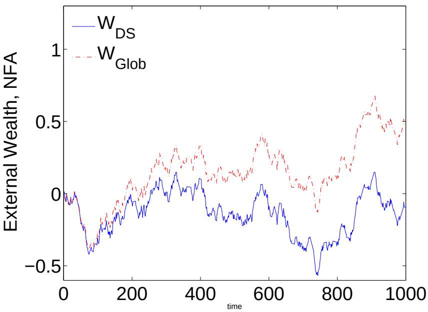
- Conjecture 1: Conventional MP does not have big effects on crisis ex-post in the first place
- Conjecture 2: Paper focuses on long-run averages.
  - Perhaps, there are big changes in support of the distribution causing big effects on crises dynamics (Bianchi and Mendoza)
  - Challenge to capture these effects with log-linearized solution around risky-steady state
- Conjecture 3: Numerical inaccuracies from solution method
  - Rabitsch-Stepanchuk-Tsyrennikov (2013): Credit constraints can strongly compromise the performance of the local portfolio solution method

Why are effects of policy so small?

- Conjecture 1: Conventional MP does not have big effects on crisis ex-post in the first place
- Conjecture 2: Paper focuses on long-run averages.
  - Perhaps, there are big changes in support of the distribution causing big effects on crises dynamics (Bianchi and Mendoza)
  - Challenge to capture these effects with log-linearized solution around risky-steady state
- Conjecture 3: Numerical inaccuracies from solution method
  - Rabitsch-Stepanchuk-Tsyrennikov (2013): Credit constraints can strongly compromise the performance of the local portfolio solution method

Local vs Global Approx



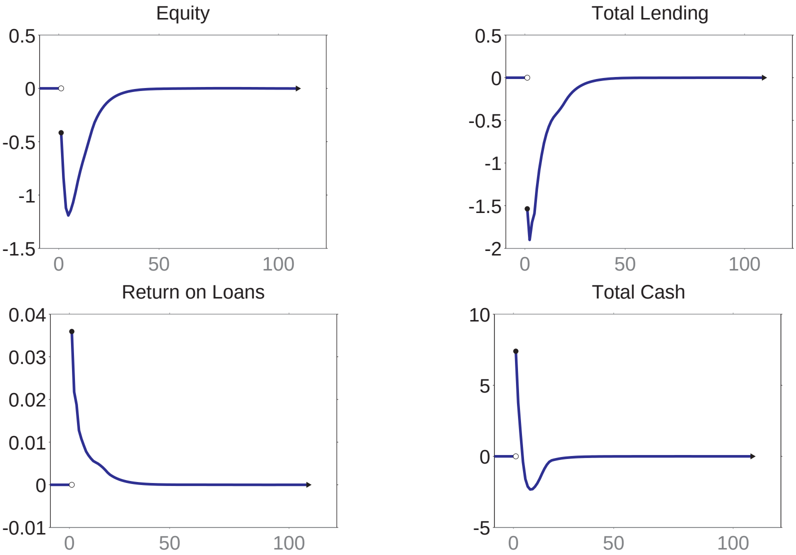


Rabitsch-Stepanchuk-Tsyrennikov (2013)

- Related Papers with large effects of monetary policy on risk-taking
  - Depreciating the nominal exchange rate ex-post reduces precautionary savings ex-ante. $\rightarrow$ significant increase in non-state contingent debt
  - Fornaro (2012) via increases in labor supply that reduces fire sales during systemic crises
  - Schmitt-Grohe and Uribe (2012) via reductions in real wages mitigating downward wage rigidity
- This paper: rich portfolio decision for bank funding
- My view: Important also to enrich the asset portfolio (market liquidity)

- Related Papers with large effects of monetary policy on risk-taking
    - Depreciating the nominal exchange rate ex-post reduces precautionary savings ex-ante. $\rightarrow$ significant increase in non-state contingent debt
    - Fornaro (2012) via increases in labor supply that reduces fire sales during systemic crises
    - Schmitt-Grohe and Uribe (2012) via reductions in real wages mitigating downward wage rigidity
- This paper: rich portfolio decision for bank funding
- My view: Important also to enrich the asset portfolio (market liquidity)

Bank Liquidity Management



Bianchi and Bigio (2013): Rise in Bank-Run Risk

Normative Implications

- What should be the optimal monetary policy regime? Not fully articulated analysis so far.
- Does the fact that MP has small effects on bank funding suggest that inflation targeting is still the right objective?
  - Is reliance on debt excessive?
  - Availability of macroprudential instruments
- Potential trade-offs between insurance benefits of countercyclical monetary policy and moral hazard effects
- Insurance benefits of ex-post policies during systemic crises appear to outweigh moral hazard effects (Bianchi, 2012)

Normative Implications

- What should be the optimal monetary policy regime? Not fully articulated analysis so far.
- Does the fact that MP has small effects on bank funding suggest that inflation targeting is still the right objective?
  - Is reliance on debt excessive?
  - Availability of macroprudential instruments
- Potential trade-offs between insurance benefits of countercyclical monetary policy and moral hazard effects
- Insurance benefits of ex-post policies during systemic crises appear to outweigh moral hazard effects (Bianchi, 2012)

Normative Implications

- What should be the optimal monetary policy regime? Not fully articulated analysis so far.
- Does the fact that MP has small effects on bank funding suggest that inflation targeting is still the right objective?
  - Is reliance on debt excessive?
  - Availability of macroprudential instruments
- Potential trade-offs between insurance benefits of countercyclical monetary policy and moral hazard effects
- Insurance benefits of ex-post policies during systemic crises appear to outweigh moral hazard effects (Bianchi, 2012)

Normative Implications

- What should be the optimal monetary policy regime? Not fully articulated analysis so far.
- Does the fact that MP has small effects on bank funding suggest that inflation targeting is still the right objective?
  - Is reliance on debt excessive?
  - Availability of macroprudential instruments
- Potential trade-offs between insurance benefits of countercyclical monetary policy and moral hazard effects
- Insurance benefits of ex-post policies during systemic crises appear to outweigh moral hazard effects (Bianchi, 2012)

Normative Implications

- What should be the optimal monetary policy regime? Not fully articulated analysis so far.
- Does the fact that MP has small effects on bank funding suggest that inflation targeting is still the right objective?
  - Is reliance on debt excessive?
  - Availability of macroprudential instruments
- Potential trade-offs between insurance benefits of countercyclical monetary policy and moral hazard effects
- Insurance benefits of ex-post policies during systemic crises appear to outweigh moral hazard effects (Bianchi, 2012)

Normative Implications

- What should be the optimal monetary policy regime? Not fully articulated analysis so far.
- Does the fact that MP has small effects on bank funding suggest that inflation targeting is still the right objective?
    - Is reliance on debt excessive?
    - Availability of macroprudential instruments
- Potential trade-offs between insurance benefits of countercyclical monetary policy and moral hazard effects
- Insurance benefits of ex-post policies during systemic crises appear to outweigh moral hazard effects (Bianchi, 2012)

Normative Implications (ctd)

- **Key issue:** Interaction between monetary and macroprudential policy
- How does macroprudential policy affect transmission mechanism of monetary policy?
- How does monetary policy regime affect the need of macroprudential regulation?
- Paper has some important ingredients to address these questions!

Normative Implications (ctd)

- **Key issue:** Interaction between monetary and macroprudential policy
- How does macroprudential policy affect transmission mechanism of monetary policy?
- How does monetary policy regime affect the need of macroprudential regulation?
- Paper has some important ingredients to address these questions!

Normative Implications (ctd)

- **Key issue:** Interaction between monetary and macroprudential policy
- How does macroprudential policy affect transmission mechanism of monetary policy?
- How does monetary policy regime affect the need of macroprudential regulation?
- Paper has some important ingredients to address these questions!

Normative Implications (ctd)

- **Key issue:** Interaction between monetary and macroprudential policy
- How does macroprudential policy affect transmission mechanism of monetary policy?
- How does monetary policy regime affect the need of macroprudential regulation?
- Paper has some important ingredients to address these questions!

Final Remarks

- Global financial crises has shown the importance to develop computable models of financial crises
- Doing so, requires models that incorporate systemic risk
- This paper is an important step towards this goal!