

INTERVIEW WITH JAVIER BIANCHI ¹

Let us start with monetary policy implementation. In a paper with Saki Bigio you argue that the way monetary policy is implemented matters for the macroeconomy. Could you explain why?

My paper with Saki Bigio provides a unified framework to study the implementation and the transmission of monetary policy. One of the things we find is that the pass-through from the policy rates to the banks' lending rate depends on the overall liquidity in the interbank market. To the extent that it is the lending rate that matters for the level of aggregate demand, this implies that to understand how monetary policy ultimately affects economic activity, it is therefore essential to consider the financial plumbing of the banking system.

The standard New Keynesian model, which is widely used to discuss monetary policy, excludes this plumbing from its setup. Should central bank economists move away from basic New Keynesian models and think more about the functioning of interbank markets?

Let me give you a concrete example of how the implementation of monetary policy matters. Imagine a central bank that wishes to raise the target for the interbank market rate by 1%. Suppose it implements the tightening with open market operations. We find that in this case, the increase in the banks' lending rate is lower compared to a situation where the central bank raises the corridor rates. And so the choice of the target for the interbank market rate must be considered jointly with the choice of how to implement the target. This is unlike what we typically see in central bank policy discussions, where these decisions are disconnected for the most part.

So to answer your question, I would not say that central banks should move away from New Keynesian models. I would argue, however, that it is essential that models used at central banks incorporate interbank market frictions if we want to gain a better understanding of how monetary policy decisions will affect economic activity.

Pressures on bank funding usually appear first in the interbank market. In a recent paper with Manuel Amador, you show that the competitive equilibrium has too few bank failures relative to the optimum. Could you explain the mechanics of this surprising result, and does it mean that we should get

rid of the lender of last resort (and/or deposit insurance) so that banks would fail more often?

Indeed, in my paper with Manuel Amador the competitive equilibrium may feature too few bank failures. This occurs when financial crises are driven by fundamentals. The mechanism has to do with a cleansing effect. When more banks fail, this keeps asset prices low and helps those banks that survive a crisis because they are net buyers of assets. Because surviving banks have a high valuation of funds, higher bank failures turn out to improve overall banks' utility. In this context, policies aimed at preventing bank failures are a bad idea.

However, the opposite happens when defaults are driven by self-fulfilling runs. In this case, defaults are inherently inefficient in the sense that a bank's default results from a coordination problem, and so policies oriented at making banks less fragile are welfare improving. These findings highlight that the financial stability implications of central bank policies depend crucially on whether financial crises are driven by fundamentals or self-fulfilling runs.

In that same paper you also study the consequence of "credit easing" — that is, asset purchases by the government that are debt financed — on financial stability. What are the main insights from your analysis, and what are the main lessons we can learn for the current post-COVID situation where governments have been purchasing private debt to support the economy?

There is a prevalent view that in a financial crisis, central banks should engage in credit easing, purchasing private assets in secondary markets. The idea is that this can mitigate financial disruptions and the potential negative consequences in the real economy. This view was notably articulated by former Chairman Ben Bernanke in the speech "The Crisis and the Policy Response" in January 2009. More recently, during the COVID crisis, we've seen central banks following this policy recipe. Our analysis, however, shows that credit easing is not desirable or effective when a crisis is driven by fundamentals. The logic is that asset purchases lower the return on private assets and crowd out banks, reducing their incentives to repay. Credit easing therefore turns out to backfire, leading to more banks defaulting. Moreover, under the plausible assumption that the return on assets held by the central bank is not higher than on those

held by investors, we demonstrate that credit easing generates welfare losses.

When a crisis is driven by self-fulfilling runs instead, credit easing is effective at reducing financial fragility. Asset purchases increase asset prices and, in effect, provide liquidity to a bank facing a run. The key idea is that higher asset prices allow a bank facing a run to obtain higher revenues from selling assets to service the maturing bonds. In equilibrium, investors have fewer incentives to run because they anticipate that the bank will not default even if it faces a run. If the intervention is large enough, the banking system may become run-proof.

Going forward, do you think that the ballooning public debt due to COVID will affect monetary policy considerations differently in advanced and emerging economies? And will there be different monetary and fiscal responses in those two types of economy?

I think that the monetary-fiscal interactions highlighted by Sargent and Wallace's unpleasant monetarist arithmetic 40 years ago will be central going forward. This is especially the case for many emerging markets that have been increasingly issuing debt in domestic currency. The temptation to inflate away the debt will certainly be an issue if they see sudden increases in sovereign spreads. In addition, concerns about fiscal dominance may complicate the use of monetary policy to stabilize macroeconomic fluctuations. Managing these trade-offs will be more challenging for countries with more limited credibility regarding their fiscal and monetary frameworks. So to answer your question, my conjecture would be that even though advanced economies have experienced a more substantial increase in public debt, it is probably emerging markets that would be more on the hook.

In this context, the European Commission is discussing a reform of the fiscal framework that can help provide more space to use fiscal policy for macroeconomic stabilization in times of downturns. Similarly, the IMF has been pushing for the adoption of fiscal rules. In my work with Pablo Ottonello and Ignacio Presno, we show that a government that lacks commitment to repay the debt has incentives to follow a procyclical fiscal

¹ These are the views of Javier Bianchi and do not necessarily reflect the views of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.



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policy. Facing higher sovereign spreads in a recession, the government finds it optimal to resort to more austere policies at the expense of a deeper contraction in economic activity. The challenge going forward is to develop a fiscal framework that is both credible and flexible. This is not easy to do.

Also, what will be the implications for economies in a monetary union, like the ones in the eurozone? Usually, economies can inflate their debt away, but economies opting for a monetary union relinquished that option. In a recent paper with Mondragon, you show that the cost for the Spanish economy of sacrificing monetary independence is a sixfold increase in the likelihood of rollover default. Could you explain the mechanism leading to such a large effect? For the eurozone, is the result in your paper speaking in favour of a "euro bond"?

In my paper with Jorge Mondragon, we argue that the lack of monetary independence has made countries in Southern Europe more vulnerable to a rollover crisis. However, the reason is not the inability to inflate away the debt—in fact, we abstract from this force by considering a model with real debt. The logic of our result is as follows. When creditors fear others will stop lending to the government, they refuse to roll over the government bonds, forcing it to tighten spending or raise fiscal revenues. In the absence of an independent monetary policy (i.e., in the presence of a monetary union), a demand-driven recession unfolds and defaulting becomes more tempting for the government. As a result, a country within a monetary union becomes more vulnerable to a rollover crisis. By contrast, a government that has a flexible exchange rate can respond to the investors' panic by letting the exchange rate depreciate and mitigate the recession. Because investors anticipate that the government will respond with monetary policy, this reduces the region of vulnerability to a rollover crisis.

Regarding the question on euro bonds, I think that instrument can help with other issues regarding the broad circulation of a liquid asset. The main lesson from our analysis is that governments in the euro area need the ECB to be a lender of last resort.

Relatedly, the SNB is purchasing euro-denominated assets in order to counter appreciation pressure on the Swiss franc. In a paper with Amador, Bocola, and Perri, you show that such interventions may be costly at the zero lower bound. Could you explain why?

My paper with Amador, Bocola, and Perri is concerned with a situation in which a central bank cannot counter appreciation pressures by using conventional monetary policy because of the effective lower bound—a situation that the SNB has recently experienced. It is well-known that with perfect capital markets, there is little the central bank could do to resist the appreciation because the interest parity condition places strong restrictions on the path of the exchange rate. In an environment featuring limits to international arbitrage, we argue that purchases of international reserves can help to resist the appreciation pressures on the exchange rate but that this intervention is costly.

The mechanism is that accumulating reserves leads to an increase in the real rate on domestic currency bonds. This is because households try to offset the increase in reserves by borrowing more, but investors have limited pockets to lend. So when the central bank accumulates reserves, it opens up a deviation from the interest parity condition. Given the nominal rate, this leads to a temporary depreciation of the exchange rate. Critically, the expected appreciation implies that foreign investors end up obtaining profits at the expense of the central bank. We then show in the paper that the costs of the FX intervention can be computed as

the stock of international reserves times the deviation from covered interest parity. For the case of SNB, we find that these costs peaked at about 0.6% of monthly gross domestic product.

In a broader context, you analysed foreign reserves holdings and accumulation in a paper with Cesar Sosa-Padilla, arguing that a government that increases its debt, while accumulating reserves at the same time, may not face increasing borrowing costs. Given public debt increased in most countries, what are the implications for the optimal foreign reserves management going forward?

My paper with Cesar Sosa-Padilla provides a theory of a macro-stabilization hedging role for international reserves. The idea is that when a country faces a negative shock and spreads increase, the availability of liquid assets allows the government to manage the recession better without the need to borrow at high interest rates. Moreover, the availability of reserves in these circumstances reduces the temptation to default on the debt. It is because of this reason that a country that issues debt to accumulate reserves may see very limited increases in sovereign spreads.

Given these findings and the previous discussions, I find it a bit puzzling that countries in the eurozone hold almost no international reserves. My view is that ongoing reforms of the fiscal framework in the European Union should pay more attention to portfolio considerations.

Thank you very much Javier for this interview.

Cyril Monnet conducted this interview.