Preventive monetary and macroprudential policy response to anticipated shocks to financial stability

CONFERENCE NAME

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Aug, 2021

Motvation

- Recent Crises (2008 and Covid-19) have prompted active rethinking about banking regulation and the coordination between monetary and macroprudential policies
- Increased number of macroprudential measures, especially in EMEs (Cerutti et al., 2017)
- Monetary policy is well studied in economic literature (Clarida et al., 1999; Kaplan et al., 2018) ...
- ... and macroprudential policy as well (Bianchi & Mendoza, 2018; Kara & Ozsoy, 2016; Stavrakeva, 2020; Woodford, 2003)
- What's about their combination or coordination?
  - Coordination during recurrent boom-bust cycles (Van der Ghote, 2021)
  - Integrated Policy Framework (Adrian et al., 2020; Basu et al., 2020)
  - How does monetary policy affect the transmission of macroprudential measures and vice versa? (Cozzi et al., 2020)

What Question We Ask

This paper: Characterize *optimal coordination between monetary and macroprudential policies* with inefficient pecuniary and aggregate demand externalities in economies with financial frictions

Our approach: rationalize the use of both monetary and macroprudential policies

- Agents do not internalize effects of their decisions
  - Aggregate demand externalities (Farhi & Werning, 2016; Korinek & Simsek, 2016; Schmitt-Grohé & Uribe, 2016)
    - ⋆ nominal rigidities
  - Pecuniary externalities / fire-sales (Dávila & Korinek, 2017; Lorenzoni, 2008)
    - ⋆ aggregate assets price movements

Question:

- How do monetary and macroprudential policies interact?

→ Will this interaction be like substitutes or complements?

How We Contribute

How we differ from other articles:

1. Endogenous capital accumulation under sticky prices (Basu et al., 2020; Stavrakeva, 2020)
   - previous papers: either no capital accumulation but sticky prices or capital accumulation without sticky prices
   - Study credit booms – overaccumulation of debt

$\rightarrow$ Study the transmission of macroprudential policy through two channels:

1. Effect on aggregate capital accumulation
2. Effect on re-distribution of capital between agents in the pre-crisis period

2. Study interactions between monetary and macroprudential policies (Dávila & Korinek, 2017; Farhi & Werning, 2016)
3. We use global methods to solve (non-linear solution) (Bianchi & Mendoza, 2018; Clerc et al., 2015)
4. We are not restricted by three-period framework (for policy experiments)

Preview of the results

- Policy intervention (both monetary and macroprudential) can improve allocations by restricting borrowing ex-ante (during the accumulation of risks and imbalances) and stimulating the economy ex-post (during the implementation of risks).
- We find a complementarity relation between ex-ante monetary policy and preventive macroprudential policy.
- We also compare this result with a flexible prices model and conduct several sensitivity analysis exercises.

What We Do

- Standard NK model with nominal rigidities
- $t = 0; 1; 2...$ starting from $t = 3$ the economy is in flexible price steady state
- Final goods prices are fixed in $t = 0; 1$
- Cobb-Douglas technology for final goods: labor and raw inputs
- Raw inputs are produced using capital by firms using two technologies
- Firms with linear technology (superior) which might be constrained at $t = 1$
- Firms with concave technology (inferior) and always unconstrained
- Uncertainty $s \in \{High(good), Low(bad)\}$, realized at date 1
- Assume that in "bad" state borrowing constraint binds
- Capital is created in $t = 0$ (by HHs from a final good), is traded with price q_t and used with a lag
- Available policy instruments: preventive θ_1 for macropru and i_1, and ex-post $i_{2,L}, i_{2,H}$ for monetary policies (actually, we can add ex-post macropru)

Timing

- $t \geq 2$ – all prices are flexible and no borrowing constraint and all capital in hands of firms with linear (superior) technology
- $t = 1$ – financial shock comes with probability π_L and borrowing constraint is binding – firms with linear technology are forced to deleverage – fire sales

$$d_{2,L}^{linear} = \kappa q_{1,L} k_{1,L}^{linear}\text{: L is for low (crisis) state}$$
$$d_{2,H}^{linear} < \kappa q_{1,H} k_{1,H}^{linear}\text{:H is for high (no crisis) state}$$

- $t = 0$ – agents know distribution of uncertainty, physical capital produced – in the absence of taxes firms with linear technology buy all capital

Model and Environment

- **Households:** consume final good, provide labor for final good production, produce capital with quadratic costs at $t = 0$, own concave technology, finance firms with linear technology

$$\mathbb{E}\sum_{t=0}^{\infty}\beta^t[\log(c_{t,s}) - h_{t,s}] \qquad c_0 + inv_0(1 + \frac{\phi}{2}\frac{inv_0}{k_{-1}}) = y_0$$

- **Capital firms:** use capital (k_t^f) at a price q_t to produce inputs (x_t) for production of final good y_t

$$x_{t,s} = \underbrace{log(1 + k_{t,s}^{concave})}_{\text{concave tech}} + \underbrace{k_{t,s}^{linear}}_{\text{linear tech}} \qquad K = k_{t,s}^{linear} + k_{t,s}^{concave} = k_{-1} + inv_0$$

- **Final goods producer:** combine labor and capital inputs. Fixed at $t = 0; 1$ and fully flexible at $t \geq 2$

$$y_t = \underbrace{h_{t,s}^{\alpha}}_{\text{labor}}\ \underbrace{x_{t,s}^{1-\alpha}}_{\text{raw good}} \qquad \underbrace{1 = \frac{\epsilon}{\epsilon - 1}\left(\frac{w_{t,s}}{\alpha}\right)^{\alpha}\left(\frac{p_{x,t,s}}{1-\alpha}\right)^{1-\alpha}}_{\forall t \geq 2}$$

Macroprudential and Monetary polcies

- Ex-ante macroprudential policy

$$q_0 = \frac{\beta c_0}{1+\theta_1} \sum_s \left[\frac{\pi_s}{c_{1,s}} (p_{x,1,s} + q_{1,s}) \right]$$

- Ex-ante monetary policy

$$\frac{1}{c_0} = \beta(1+i_1) \sum_s \left[\pi_s \frac{1}{c_{1,s}} \right]$$

- Ex-post monetary policy

$$q_{1,H} = \frac{p_{x,2,H} + q_{2,H}}{1+i_{2,H}}$$

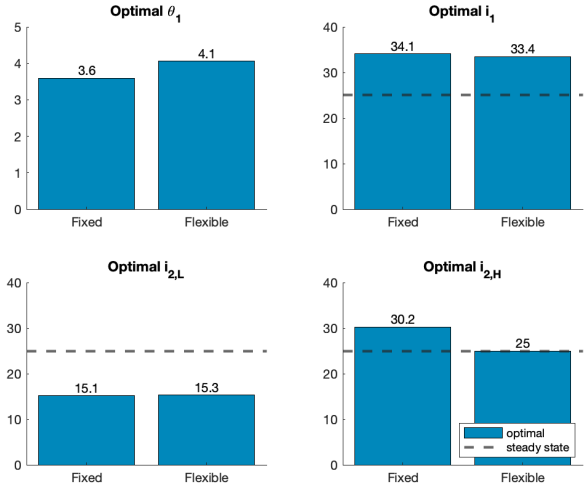
$$q_{1,s} = \frac{p_{x,2,s} + q_{2,s}}{(1+k_1^{concave})(1+i_{2,s})}$$

Solving the Model and Constrained Social Planner

- **Decentralized equilibrium**
- Numerically solve problem for some fixed $\bar{\theta}_1, \bar{i}_1, \bar{i}_{2,H}, \bar{i}_{2,L}$.
- **Social Planner**
- SP internalizes adverse effects of the fire-sales externalities on aggregate prices and allocations
- SP maximizes households expected utility for every combination of $\theta_1, i_1, i_{2,H}, i_{2,L}$
- Therefore we numerically maximize expected utility function varying $\theta_1, i_1, i_{2,H}, i_{2,L}$

Result 1: Complementarity in static

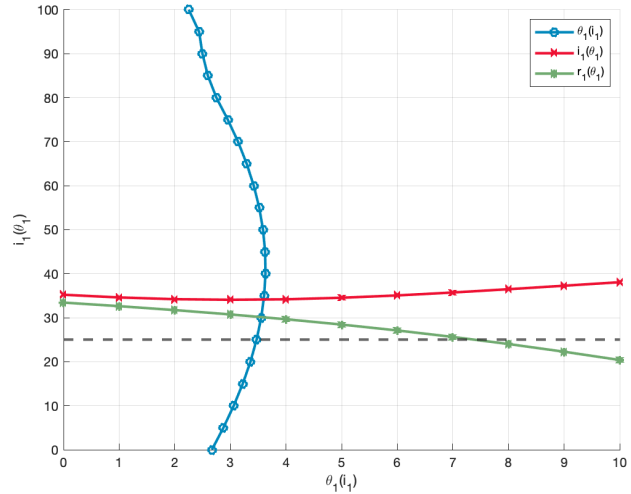
Tightening both ex-ante monetary and macroprudential policy



- Optimal to tighten both ex-ante macroprudential and monetary policies, continue tightening if a crisis does not occur, while if a crisis occurs it is optimal to soften ex-post monetary policy
- This tightening happens for both fixed and flexible prices.
- This result also highlights the importance of assessing the degree of price rigidity in the economy to better understand the behaviour of the economy during a crisis and the speed of recovery after the crisis.

Result 2: Semi-complementarity in dynamic

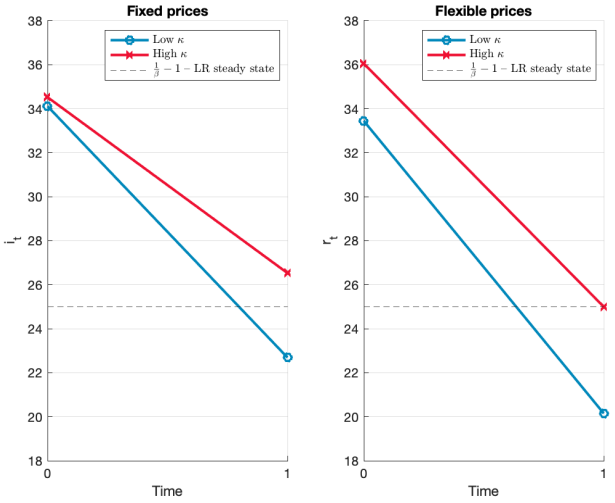
Macroprudential policy shows an inverse U-shape curve



- Optimal ex-ante monetary policy is almost insensitive to changes in θ_1.
- Optimal macroprudential shows a U-shape curve, i.e. θ_1 grows when i_1 is small but with higher values of i_1 it declines.
- In dynamics these policy policies only partly complement.

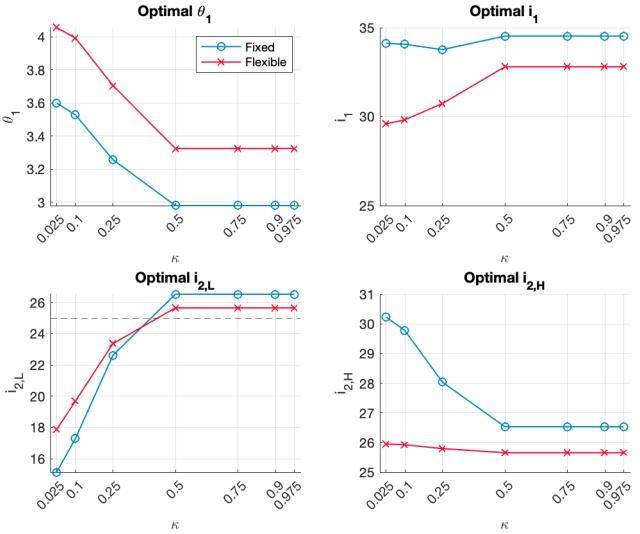
Result 3: Ex-ante vs ex-post policies

Tightening monetary policy in the absence of crisis and to loosen monetary policy in a crisis



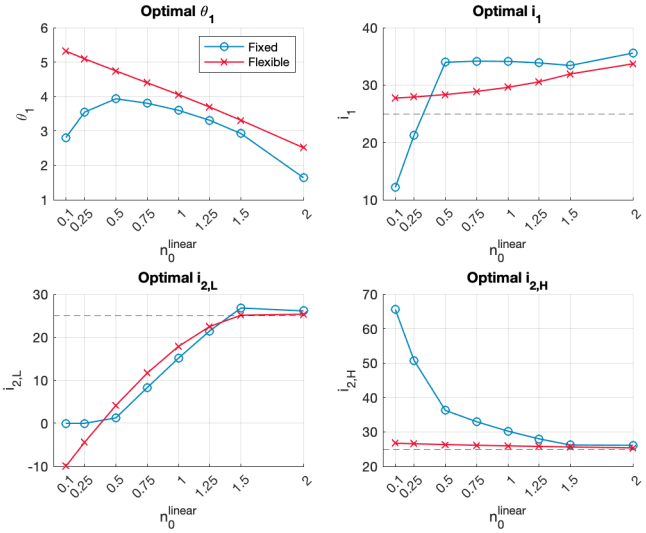
- In the pre-crisis ($t = 0$) monetary policy tightening period is almost the same for both κ's (fixed prices), while in the model with flexible prices monetary policy tightening for high κ is stronger.
- In the crisis period ($t = 1$): for high κ easing is smaller than for low κ.
- The "size" of a crisis matters only ex-post.

Tightening of the restrictions (κ)



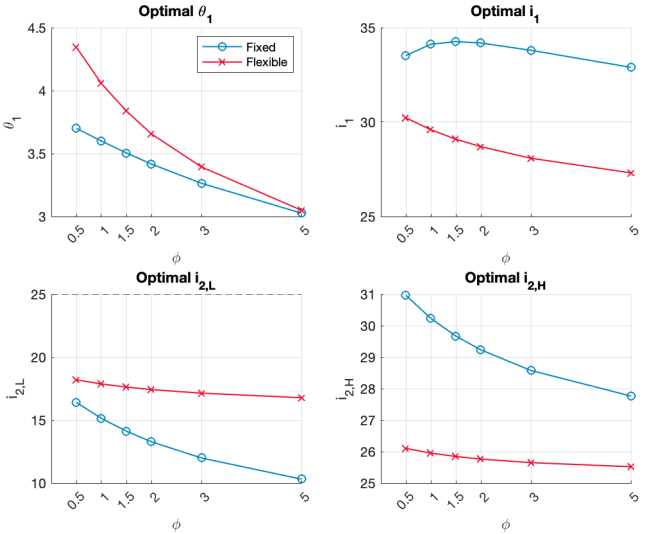
- There is an upper limit in κ after which all policies do not react.
- If the debt limit is not tough, then the financial constraint does not bind because firms with linear technology are willing to take less debt and so do not meet this financial constraint.

Initial firms' financing (n_0)



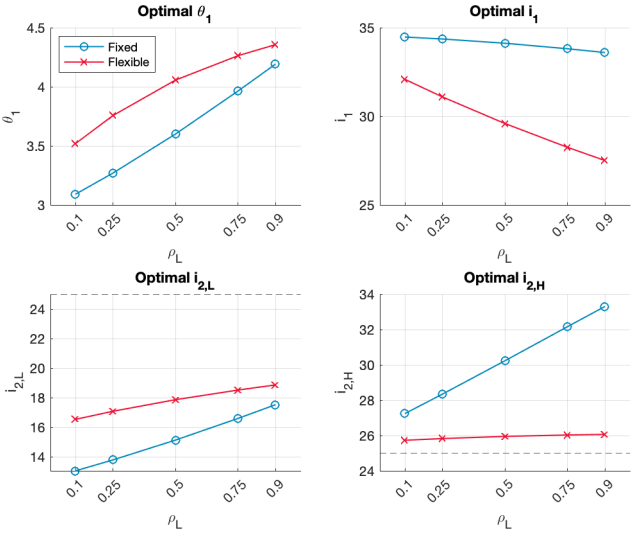
- Depending on n_0^{linear}, optimal θ_1 is non-linear.
- It rises when n_0^{linear} is low and it decreases when n_0^{linear} becomes higher.
- Also there is an upper limit for interest rates.
- If the economy consists of "rich" firms then monetary policy could be a constraint in either ex-ante and ex-post.

Tightening of capital production (ϕ)



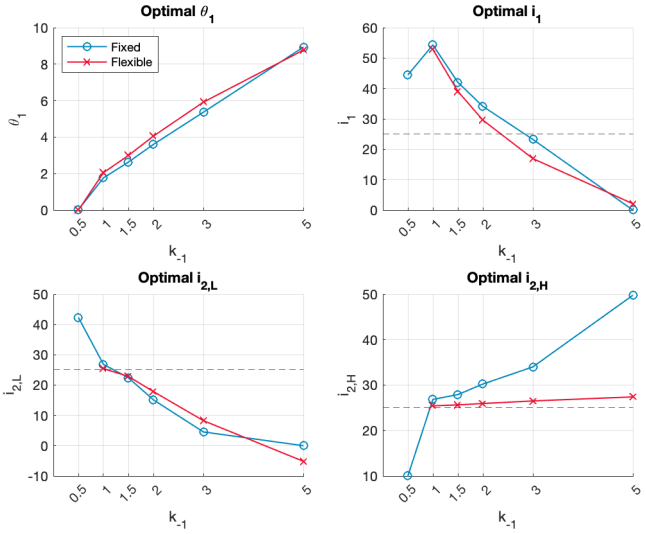
- With larger ϕ it is more difficult to create a new unit of capital, thus, agents accumulate less capital and it requires a smaller amount of intervention from a policymaker.
- The tightening of i_1 and $i_{2,H}$ is much stronger for fixed prices model, while for θ_1 and $i_{2,L}$ the result is the opposite.

Change in probability of a crisis (ρ_L)



- When the probability of a crisis ρ_L rises, a policymaker tightens macroprudential policy but slightly loosens ex-ante monetary policy and tightens ex-post monetary policy.
- Loosening ex-ante monetary policy with a growing probability of a crisis looks counter-intuitive because it seems that if a crisis is imminent, a policymaker needs to make every effort to reduce the severity of the crisis.

Initial HHs' endowment (k_{-1})



- The initial households capital endowment is important when a policymaker use macroprudential policy and monetary policy to soften the severity of a crisis.
- If households are richer initially (have more k_{-1}), then a policymaker have to set quite a high ex-ante macroprudential policy, θ_1 and ex-post monetary policy, $i_{2,H}$.
- While it have to set ex-ante monetary policy i_1 and ex-post monetary policy, $i_{2,L}$ quite low.

Conclusion

Question:

- How do monetary and macroprudential policies interact?
  - In response to financial shock, it is optimal to tighten both policies

→ Will this interaction be like substitutes or complements?

  - Thus, policies behave like complements

- For a policymaker it is important to understand/estimate an initial household endowment, and the amount of financing of firms with linear technology.
- Both of these variables indicate households' or firms resources but the optimal policy response is diametrically opposite.
- It is important to correctly estimate the severity of a crisis.
- If the debt limit is not so tight, then it may be possible that the financial consultant does not bind.
- We highlight that price rigidity matters both especially ex-ante to prevent a crisis.
- While with fully fixed prices the "size" of a crisis does not matter
- The difference in optimal policies in the model with flexible prices is large.

Thank you for your attention!

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Aug, 2021

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