

A Quantitative Analysis of Countercyclical Capital Buffers

Miguel Faria-e-Castro *

FRB St. Louis

March 2019

Abstract

This paper analyzes the effects of countercyclical capital buffers (CCyB) in a non-linear DSGE model with a financial sector that is subject to occasional panics. The model is combined with data to estimate sequences of structural shocks and study policy counterfactuals. First, I show that lowering capital buffers during a crisis can moderate its intensity. Second, I show that raising capital buffers during leverage expansions can reduce the frequency of crises by more than half. A quantitative application to the 2008 financial crisis shows that CCyB in the $\pm 2\%$ range (as in the Fed's current framework) could have potentially avoided the financial crisis in 2007Q4-2008Q4 (but not the Recession). These findings suggest that CCyB are a useful policy tool both ex-ante and ex-post.

*The views expressed here are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of St. Louis or the Federal Reserve System. Contact: miguel.fariaecastro@stls.frb.org

1 Introduction

The 2008-2009 financial crisis and subsequent Great Recession triggered a large debate among academics and policy makers that eventually led to large-scale reforms and policy recommendations in terms of financial regulation. Of particular concern were the (previously overlooked) links between the financial sector and the macroeconomy. This renewed interest on the design and implementation of so-called macroprudential policies: a series of policy tools that were aimed at preventing the build-up of fragilities in the financial system that could then trigger crises with severe macroeconomic consequences.

One of the pillars of the new global framework for financial regulation, the Third Basel Accord, is a discretionary counter-cyclical capital buffer (known as CCyB) that allows regulators to raise capital requirements during periods of credit expansion, or when the buildup of vulnerabilities is perceived. According to the basic guidelines provided by the Bank of International Settlements (BIS), as of January 2019, banks that are subject to the Basel rules are required to maintain a minimum common equity tier 1 capital ratio of 7% (of risk-weighted assets). National regulators possess the discretion to require up to an additional 2.5% ([Basel Committee on Banking Supervision, 2010](#)). The basic idea is to force financial institutions to hold more capital when vulnerabilities are detected, so as to allow them to enter any potential downturns with a sufficiently high capital buffer. This buffer increases their distance to default and prevents other institutional and market-based constraints from binding, that could trigger fire sales along with other situations that can potentially deepen downturns.

The CCyB framework was formally introduced in the US in September 2016, and is set by the Board of Governors of the Federal Reserve System, who votes at least once a year on its level.¹ The Fed Board reserves the right to activate the CCyB when “[...] systemic vulnerabilities are meaningfully above normal [...]”, and “[...] expects to remove or reduce the CCyB when the conditions that led to its activation abate or lessen and when the release of CCyB capital would promote financial stability.” So far, the Board has voted once on the level of CCyB, deciding to leave it at zero on December 2017. More recently, and in face of surging financial markets, several prominent policymakers and academics have advocated an increase of the CCyB — including members of the Federal Open Market Committee² — but this decision ultimately rests with the members of the Board of Governors.³

¹Formally, the Fed Board sets it for banking organizations with greater than \$250 billion in total assets or \$10 billion in on-balance-sheet foreign exposure ([Federal Reserve Board, 2016](#)).

²These include the Presidents of the Federal Reserve Banks of Cleveland, Boston, and Minneapolis (see <https://www.ft.com/content/ec8e07ee-ab08-11e8-94bd-cba20d67390c>).

³See also [Liang \(2017\)](#) and [Furman \(2018\)](#) for notable arguments for CCyB.

This paper provides a positive and quantitative analysis of the effects of CCyB. The starting point is a New Keynesian model with an explicit financial sector: impatient borrowers take on mortgages to purchase houses. These mortgages are originated by banks, and are subject to endogenous default risk. Banks are subject to a financial friction (they cannot issue equity) and to a regulatory constraint in the spirit of a Basel-capital requirement. Banks fund themselves using retained earnings, and deposits that are lent by savers. Due to costly liquidation, banks are subject to runs on their deposits as in [Gertler et al. \(2018\)](#). Periods of high bank leverage give rise to run equilibria on the banking sector, which can then materialize via a coordination device (such as a sunspot). The final key ingredient in the model are nominal rigidities: runs destroy the banking sector, which triggers the collapse of intermediation between borrowers and savers. As borrowers have a higher marginal propensity to consume than savers, and cannot borrow from a delapidated financial system, their consumption falls; this fall in aggregate consumption then transmits itself to a fall in GDP due to nominal rigidities.

In the model, CCyB can be used for two important purposes. First, they can be used as instrument ex-post: during a run, the capital of the banking sector is depleted, leading to a large rise in spreads and contraction of amounts that are lent. Regulatory constraints such as capital requirements make the problem worse due to the traditional financial accelerator effect ([Bernanke et al., 1996](#)) that is compounded by endogenous default ([Faria-e-Castro, 2018](#)). Lowering capital requirements helps relax these constraints, helping reduce spreads and increase lending during periods when these constraints bind. These are the periods when the marginal propensity to consume of borrowers is the highest (as credit is scarce). Lowering capital requirements helps then resume the intermediated flow of credit and contributed to attenuate potentially large falls in GDP.

Second, CCyB also play a more traditional role as an ex-ante instrument: by committing raising capital requirements when the economy approaches the run region, the regulator can keep the economy away from that region. This reduces lending, and raises spreads and net interest margins. These forces, in turn, help build bank capital and prevent the economy from even entering the run region. I show that, by committing to raise capital requirements when bank leverage is sufficiently high, the regulator can almost avoid runs altogether in this model. A global stochastic solution to the model is crucial to generate the nonlinearities inherent to this result.

I calibrate the model to the U.S. economy in the pre-2008 period, and combine it with macrofinancial data to study historical policy counterfactuals. First, I use the basic model without CCyB as a measurement device, and use a particle filter to estimate sequences of structural shocks for the U.S. economy around this period. Then, I use these estimated

sequences of shocks to ask the following question: what would the 2008-2009 financial crisis have looked like if CCyB were deployed? I also decompose the relative contribution of *raising* capital buffers before the crisis (the ex-ante benefits) and that of *lowering* them during the crisis (the ex-post benefits). I find that the benefits of lowering capital requirements ex-post amount to 9.20% of real aggregate consumption between 2007Q1 and 2010Q4. The benefits of raising capital requirements ex-ante are larger, and amount to 31.17% of aggregate consumption, and comprise most of the benefit of using these two policies together. Last but not least, my model-based estimates imply that raising capital requirements before the crisis could have basically prevented the financial crisis altogether, but not a subsequent recession.

Relation to the Literature From a modeling perspective, this paper combines the non-linear New Keynesian model with long-term risky mortgages and a constrained banking sector of [Faria-e-Castro \(2018\)](#) with endogenous financial crises and bank runs as in [Gertler et al. \(2018\)](#). This is a model of endogenous financial crises where aggregate demand externalities are crucial for the transmission of financial shocks to real activity, consistent with the empirical findings of [Mian et al. \(2017\)](#).⁴

A significant body of literature on macroprudential policy and optimal capital requirements has emerged in the wake of 2008-2009 financial crisis that is too large to be reviewed here. [Admati and Hellwig \(2013\)](#) provide a comprehensive overview of the post-crisis debate on bank regulation. Closer in spirit to the present paper are works that study optimal capital requirements in the context of dynamic stochastic general equilibrium models.

A first generation of such models studies the optimal *level* of capital requirements, typically in a setting where the regulator trades-off investment growth or the benefits of liquidity provision, and the likelihood of financial crises. Examples of such analyzes include [Nguyen \(2014\)](#), [Martinez-Miera and Suarez \(2014\)](#), [Begenau \(2015\)](#), [Landvoigt and Begenau \(2016\)](#).

A second generation of models tries to study how should capital requirements *optimally change* depending on current economic and financial conditions. [Karmakar \(2016\)](#) studies the effects of countercyclical capital requirements in the context of a real DSGE model, and finds that raising CR's reduces volatility and raises welfare. [Davydiuk \(2017\)](#) shows that countercyclical capital requirements arise as the optimal Ramsey policy in a setting where the social planner tries to curb off excessive lending while ensuring liquidity provision by banks. [Elenev et al. \(2018\)](#) study capital requirements in a model where banks can engage in excessive lending to the corporate sector; as in other papers, they find that an increase

⁴Other treatments of endogenous financial panics include [Paul \(2017\)](#). Like in [Gertler et al. \(2018\)](#), the transmission of financial shocks to the real sector occurs mainly via the production side of the economy.

in CR curbs lending/the size of the financial sector, while reducing financial fragility. They also look at the redistributive effects of CR's, and find that an increase in CR redistributes resources away from depositors, towards bankers. Finally, they find that current CR's seem to be close to optimal. Empirically, [Jiménez et al. \(2017\)](#) confirm the benefits of CCyB for the case of Spain. [Mendicino et al. \(2018\)](#) who study the setting of optimal capital charges in a triple-decker model of default calibrated to the Euro Area.

[Poeschl and Zhang \(2018\)](#) also study a nonlinear DSGE model with anticipated banking panics, but focus on the unintended consequences of tightening capital requirements on retail banks, which can lead to intermediation to shift to the shadow banking sector and reduce financial stability.

I contribute to this literature by (i) highlighting that CCyB can have both ex-ante and ex-post benefits, and (ii) performing a quantitative analysis of CCyB in the U.S. economy. In particular, I estimate the model-implied probabilities of a systemic bank run in the U.S. during the financial crisis of 2008-2009, and provide model-based estimates for the potential benefits of CCyB both before and during financial crises.

2 Model

The model extends [Faria-e-Castro \(2018\)](#) to include anticipated banking panics as in [Gertler et al. \(2018\)](#). The model is set up in discrete and infinite time, $t = 0, 1, 2, \dots$. The economy is populated by four types of agents: households, who can be either borrowers or savers; commercial banks; a corporate sector consisting of intermediate goods producers and final goods retailers; and a central bank.

The structure of the model is summarized in Figure 1: borrowers differ from savers to the extent that they derive utility from housing services and can finance housing purchases by borrowing in long-term debt contracts. Banks intermediate funds between savers and borrowers, originating long-term loans and borrowing in short-term deposits. Both borrowers and savers supply their labor to monopolistically competitive producers of intermediate goods, who in turn supply a representative retailer of final goods. Borrowers can default on their payments to the bank, and banks are potentially subject to runs on their deposits. The central bank sets the policy rate using a standard Taylor rule.

There are three exogenous shocks in the model: a total factor productivity (TFP) shock to the production function, a shock to the monetary policy rule, and a sunspot that selects the equilibrium when the economy enters a region where bank runs are possible. Markets are incomplete, and all financial contracts take the form of risky debt.

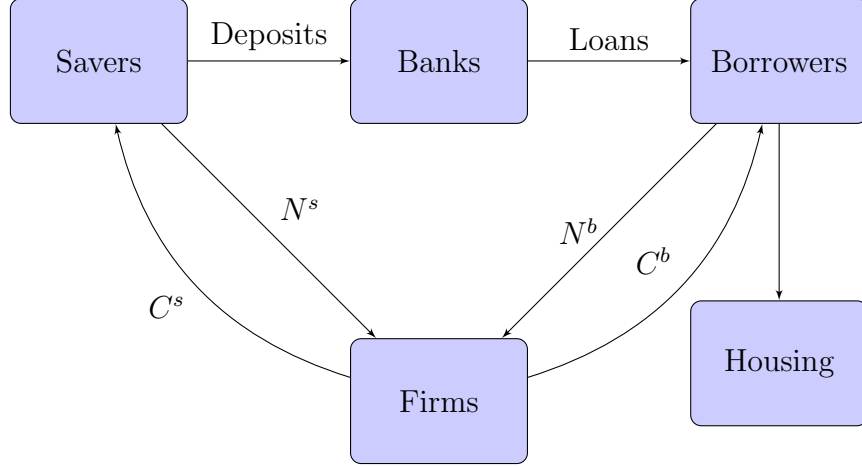


Figure 1: Structure of the model.

2.1 Environment

2.1.1 Household Preferences

There are two types of households, borrowers and savers, indexed by $i = \{b, s\}$ and in measures χ and $1 - \chi$, respectively. Households differ in terms of the preferences and the type of financial assets they have access to. Savers invest in short-term bank deposits, while borrowers can own houses and borrow in long-term debt contracts. Savers own all firms and banks in the economy.

Both borrowers and savers seek to maximize the present discounted sum of utility flows,

$$V_t^i = u_t^i + \beta_i \mathbb{E}_t(V_{t+1}^i) \quad (1)$$

Household preferences differ in two dimensions: borrowers derive utility from houses, and are more impatient $\beta_b < \beta_s$. Instantaneous utility is defined over streams of consumption C_t^i , labor N_t^i , and housing h_t^i , and is given by

$$u_t^i = \log(C_t^i) - \frac{(N_t^i)^{1+\varphi}}{1+\varphi} + \xi^i \log(h_t^i)$$

Logarithmic preferences over consumption implicitly set the elasticity of intertemporal substitution to 1; φ is the inverse of the Frisch elasticity of labor supply, and ξ^i is the preference parameter for housing. I assume that $\xi^b > 0 = \xi^s$, so that savers do not derive any utility from housing services. This is not a crucial assumption and is made for simplicity.⁵

⁵All results hold as long as the housing markets in which borrowers and savers participate are fragmented.

2.1.2 Savers

Savers maximize utility (1) subject to a sequence of budget constraints of the type,

$$P_t C_t^s + Q_t^d P_t D_t + Q_t P_t B_t^g = P_t w_t N_t^s + Z_t^d P_{t-1} D_{t-1} + P_{t-1} B_{t-1}^g + \Gamma_t$$

where P_t is the price level, D_t are real deposits, B_t^g are risk-free bonds in zero net supply, Q_t is the inverse of the nominal interest rate, w_t is the real wage, and Γ_t are net profits and transfers from the corporate and financial sectors. Savers own all firms and banks in this economy. Z_t^d is the payoff per unit of deposits, only realized at t due to the possibility of bank failure and liquidation as explained below. Saver first-order conditions are standard and consist of asset-pricing conditions for deposits and for government debt (the Euler equation) as well as an intratemporal labor supply condition.⁶ It is useful to define the saver's stochastic discount factor for real payoffs:

$$\Lambda_{t,t+1}^s \equiv \beta \frac{C_t^s}{C_{t+1}^s} \quad (2)$$

2.1.3 Borrowers

Borrowers derive utility from housing services and borrow in long-term debt contracts to finance house purchases.

Debt Contracts, Default, and Foreclosures Banks offer long-term debt contracts to borrowers: each contract has a face value of \$1 and a market price of Q_t^b . These contracts are geometrically decaying perpetuities with a coupon/decay rate of $\gamma \in [0, 1]$, as in [Woodford \(2001\)](#). To obtain partial default in equilibrium while keeping the model environment tractable, I assume a family construct for the borrower.⁷ The borrower family enters period t with an outstanding nominal debt balance $P_{t-1} \bar{B}_{t-1}^b$ and a total stock of housing h_{t-1} .⁸

At the beginning of the period, the borrower family is split into a continuum of members indexed by $i \in [0, 1]$, each receiving an equal share of the debt balance and housing stock $(P_{t-1} \bar{B}_{t-1}^b, h_{t-1})$. Each of these members is then subject to two idiosyncratic shocks: first, they receive a *moving* shock with probability m , which determines whether they have to sell their house and move or not. After the moving shock is realized, each member i receives a *housing quality* shock $\nu_t(i)$, drawn from some distribution $F^b[0, +\infty)$ and satisfying $\mathbb{E}_t[\nu_t(i)] = 1, \forall t$.

⁶All equilibrium conditions, including the saver's optimality conditions, are reported in Appendix [A.1](#).

⁷As in [Landvoigt \(2016\)](#) or [Ferrante \(2015\)](#).

⁸I use the upper bar to denote per capita variables. Since there is a mass χ of borrowers, the aggregate level of debt is $B_{t-1}^b = \bar{B}_{t-1}^b / \chi$.

Family members who do not move (a fraction $1 - m$) simply fulfill their debt payment in the current period $\gamma \times P_{t-1}\bar{B}_{t-1}^b$. Household members that move (a fraction m) decide whether to prepay their debt balance and sell their home or to default on the mortgage and walk away from their home. The debt balance prepayment is worth $P_{t-1}\bar{B}_{t-1}^b$, and the market value of their house is $P_t p_t^h \times \nu_t(i) h_{t-1}$ given the quality adjustment. Upon default, the lender seizes the housing assets that serve as collateral; i.e., the house gets foreclosed.

Given the resale value of housing, each family member chooses to repay her maturing debt balance or default and let the bank seize her housing assets. The cost of default is the loss of housing collateral. Let $\iota(\nu) \in \{0, 1\}$ denote the default choice by a member with house quality shock ν . This indicator function is equal to 1 if this member defaults on her debt repayments, and zero otherwise. After default and repayment decisions are made, members reconvene in the borrower household, who then takes all relevant decisions for the current period (including the values of the states for the following period). End-of-period debt balances for the borrower family equal new borrowings L_t plus non-prepaid balances net of the current coupon:

$$P_t \bar{B}_t^b = P_t L_t + (1 - m)(1 - \gamma) P_{t-1} \bar{B}_{t-1}^b \quad (3)$$

Budget and Borrowing Constraints Once individual members have made their default decisions, they are regrouped in the borrower household, who chooses all control variables: consumption, labor supply, new borrowing, and new housing as well as the default rules for each individual member.⁹ The budget constraint written in real terms is

$$\begin{aligned} C_t^b + \frac{\bar{B}_{t-1}^b}{\Pi_t} \left[(1 - m)\gamma + m \int [1 - \iota_t(\nu)] dF^b \right] + p_t^h h_t^* \\ = w_t N_t^b + Q_t^b L_t + p_t^h h_{t-1} m \int \nu [1 - \iota_t(\nu)] dF^b \end{aligned} \quad (4)$$

where h_t^* are new housing purchases. New borrowing L_t is defined by (3). The law of motion for the stock of housing is

$$h_t = h_t^* + (1 - m) h_{t-1} \quad (5)$$

The borrower family is subject to a loan-to-value constraint on new borrowing: new debt balances contracted this period cannot exceed a fraction of the value of new housing

⁹This arrangement is thus implicitly equivalent to one where borrower family members are identical agents with access to a full set of contingent claims that allow them to hedge any idiosyncratic risks within the group.

purchases,

$$L_t \leq \theta^{LTV} p_t^h h_t^* \quad (6)$$

Optimality The borrower household chooses $(C_t^b, L_t, N_t^b, h_t, \{\nu_t(\nu)\}_{\nu \in [0, +\infty)})$ to maximize (1) subject to (3)-(6). It can be shown that the optimal default decision is static and given by a threshold rule: the borrower optimally defaults on all debt prepayments for which $\nu < \nu_t^*$, where this threshold satisfies

$$\nu_t^* = \frac{\bar{B}_{t-1}^b}{\Pi_t p_t^h h_{t-1}} \quad (7)$$

Basically, a “moving” member of the borrower household behaves as having limited liability when it comes the time to prepay and defaults if the remaining debt balance exceeds the market value of the house. In equilibrium, default is positive and partial and the default rate fluctuates with household leverage, which in turn depends on equilibrium objects such as the house price. Another relevant optimality condition is the asset-pricing equation for housing, which takes the form

$$p_t^h = \frac{\frac{\xi}{h_t} C_t^b + \mathbb{E}_t \{ \Lambda_{t,t+1}^b p_{t+1}^h [(1-m)(1-\lambda_{t+1}^b \theta^{LTV}) + m \Psi^b(\nu_{t+1}^*)] \}}{1 - \lambda_t^b \theta^{LTV}} \quad (8)$$

where λ_t^b is the Lagrange multiplier on the borrowing constraint (6) and $\Lambda_{t,t+1}^b$ is the borrower’s stochastic discount factor for real payoffs, defined analogously to (2). $\Psi^b(\nu_{t+1}^*)$ is a partial expectation term for the house quality shock, defined as

$$\Psi^b(\nu_t^*) \equiv \int_{\nu_t^*}^{\infty} \nu dF^b(\nu)$$

Condition (8) highlights that changes in borrower consumption have a first-order effect on house prices, both through the current utility dividend from housing services and through the stochastic discount factor that is applied to the continuation value.

2.1.4 Corporate Sector

The corporate sector consists of final goods retailers and intermediate goods producers. Final goods retailers are perfectly competitive and employ a continuum of intermediate goods varieties indexed by $k \in [0, 1]$ to produce the final good using a Dixit-Stiglitz aggregator with constant elasticity of substitution ε

$$Y_t = \left[\int_0^1 Y_t(k)^{\frac{\varepsilon}{\varepsilon-1}} dk \right]^{\frac{\varepsilon-1}{\varepsilon}}$$

There is a continuum of intermediate goods producers, each producing a different variety k . All firms are owned by the savers and have access to a linear production technology in labor,

$$Y_t(k) = A_t N_t(k)$$

where A_t is an exogenous aggregate TFP shock. Given the constant elasticity of substitution assumption, each of these firms faces a demand schedule of the type

$$Y_t(k) = \left[\frac{P_t(k)}{P_t} \right]^{-\varepsilon} Y_t$$

I assume that firms are subject to menu costs as in [Rotemberg \(1982\)](#), with a standard quadratic functional form of the type

$$d[P_t(k), P_{t-1}(k)] \equiv \frac{\eta}{2} Y_t \left[\frac{P_t(k)}{P_{t-1}(k)} \Pi^{-1} - 1 \right]^2$$

where Π is the inflation target set by the central bank (so that it is free to adjust to keep up with trend inflation) and η is the menu cost parameter. It can be shown that the first-order condition for an individual price-setting firm k combined with the assumption of a symmetric equilibrium yields a standard (nonlinear) Phillips curve that relates inflation to aggregate output:

$$\eta \frac{\Pi_t}{\Pi} \left(\frac{\Pi_t}{\Pi} - 1 \right) + \varepsilon \left(\frac{\varepsilon - 1}{\varepsilon} - \frac{w_t}{A_t} \right) = \eta \mathbb{E}_t \left[\Lambda_{t,t+1}^s \frac{Y_{t+1}}{Y_t} \frac{\Pi_{t+1}}{\Pi} \left(\frac{\Pi_{t+1}}{\Pi} - 1 \right) \right] \quad (9)$$

2.1.5 Financial Sector

Banks borrow in short-term deposits and hold long-term mortgages. I assume that banks hold perfectly diversified portfolios of household debt, so that credit risk is systemic. I assume that liquidation of bank assets is costly, which potentially exposes banks to runs on their portfolios.

There is a continuum of banks indexed by $j \in [0, 1]$, wholly owned by savers. Bank j enters the period with a portfolio of debt securities $b_{j,t-1}$ and deposits $d_{j,t-1}$. Each deposit entitles its owner to a unit repayment, while each debt security yields an aggregate payoff of Z_t^b . Nominal earnings at the beginning of the period are equal to

$$P_t e_{j,t} = Z_t^b P_{t-1} b_{j,t-1} - P_{t-1} d_{j,t-1} \quad (10)$$

Bank Runs and Failures If $e_{j,t} < 0$, bank j defaults, and its assets are liquidated to provide pro-rata payments to depositors. I assume that liquidation is costly, and entails a deadweight cost equal to a fraction λ^d of the value of the assets, hence the recovery rate is equal to $1 - \lambda^d$. These liquidation costs create a region of the state space where bank runs can be an equilibrium. In particular, consider the situation where

$$\begin{aligned} Z_t^b b_{j,t-1} - d_{j,t-1} &\geq 0 \\ (1 - \lambda^d) Z_t^b b_{j,t-1} - d_{j,t-1} &< 0 \end{aligned}$$

This is a situation where the bank is solvent as the market value of its assets exceeds the value of repayments on its liabilities, but is illiquid: if it were to liquidate all of its assets, it would not be able to repay all of its depositors. From the point of view of an individual depositor, there is an incentive to force early liquidation if all other depositors intend to do so.¹⁰ It is useful to define the following variables

$$\begin{aligned} u_{j,t}^F &= \frac{d_{j,t-1}}{Z_t^b b_{j,t-1}} \\ u_{j,t}^R &= \frac{d_{j,t-1}}{(1 - \lambda^d) Z_t^b b_{j,t-1}} \end{aligned}$$

Note that $u_{j,t}^R > u_{j,t}^F$ (as long as $\lambda^d > 0$). Whenever $u_{j,t}^R > 1$, bank j becomes exposed to a run equilibrium. For simplicity, I use a sunspot as a selection device for banks that are in this “run region”: ω_t triggers a run whenever it takes a value of 1, which happens with probability p . With probability $1 - p$, we have that $\omega_t = 0$ and no run takes place banks with $u_{j,t}^R > 1$. Whenever $u_{j,t}^F > 1$, bank j becomes insolvent and fails with probability one. The conditional probability of bank failure next period is therefore given by

$$\begin{aligned} \mathbb{P}_t(\text{failure}_{j,t+1}) &= \mathbb{P}_t(u_{j,t+1}^F > 1 \vee [u_{j,t+1}^F \leq 1 \wedge u_{j,t+1}^R > 1 \wedge \omega_{t+1} = 1]) \\ &= \mathbb{P}_t(u_{j,t+1}^F > 1) + \mathbb{P}_t(u_{j,t+1}^F \leq 1 < u_{j,t+1}^R \wedge \omega_{t+1} = 1) \\ &= \mathbb{P}_t(u_{j,t+1}^F > 1) + p \times \mathbb{P}_t(u_{j,t+1}^F \leq 1 < u_{j,t+1}^R) = \mathbb{E}_t x_{j,t+1} \end{aligned}$$

where $x_{j,t}$ is an indicator that is equal to one when the bank defaults. Importantly, this probability depends not only on the realizations of aggregate shocks next period, but also on endogenous decisions that are taken today (the ratio of assets to liabilities, bank leverage).

¹⁰While I do not microfound the depositor problem, it is straightforward to do so using existing models of coordination-based bank runs.

Financial Frictions I assume that due to contractual frictions that are left unmodeled, banks are forced to pay out a constant fraction $1 - \theta$ of their earnings as dividends every period. Thus $\theta \in [0, 1]$ is the fraction of earnings that are retained as (book) capital. To fund their assets, banks need to use either retained earnings or new deposits. This gives rise to a flow of funds constraint, expressed in real terms as

$$Q_t^b b_{j,t} = \theta e_{j,t} + Q_t^d d_{j,t} \quad (11)$$

The bank also faces a leverage constraint, which constrains the market value of its assets not to exceed the ex-dividend market value of the bank. Let $V_{j,t}(e_{j,t})$ denote the real market value of the bank at the beginning of the period, before dividends are paid. The ex-dividend value of the bank is then given by

$$\Phi_{j,t}(e_{j,t}) \equiv V_{j,t}(e_{j,t}) - (1 - \theta)e_{j,t}$$

The constraint imposes that this value must always exceed a fraction κ_t of the market value of the bank's assets,

$$\Phi_{j,t}(e_{j,t}) \geq \kappa_t Q_t^b b_{j,t} \quad (12)$$

This constraint effectively caps the amount of lending that banks can offer every period. Banks seek to maximize the present discounted value of their dividends. The bank's problem, conditional on not having defaulted this period, is then

$$V_{j,t}(e_{j,t}) = \max_{b_{j,t}, d_{j,t}} \left\{ (1 - \theta)e_{j,t} + \mathbb{E}_t \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} (1 - x_{j,t+1}) V_{j,t+1}(e_{j,t+1}) \right\} \quad (13)$$

Banks solve (13) subject to the law of motion for earnings (10), the flow of funds constraint (11), and the capital requirement (12). A detailed derivation of the bank's problem may be found in Appendix A.2. In the appendix, I show that $\Phi_{j,t}(e_{j,t}) = \Phi_{j,t} \theta e_{j,t}$, where $\Phi_{j,t}$ can be interpreted as the marginal value of a dollar of earnings for the bank. Letting $\mu_{j,t}$ denote the Lagrange multiplier on the leverage constraint, we can write the solution to the bank's problem as

$$\mathbb{E}_t \left\{ \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} (1 - x_{j,t+1}) (1 - \theta + \theta \Phi_{j,t+1}) \left[\frac{Z_{t+1}^b}{Q_t^b} - \frac{1}{Q_t^d} \right] \right\} = \kappa \mu_{j,t} \quad (14)$$

This asset-pricing condition highlights three potential sources of excess returns: current binding constraints via $\mu_{j,t}$; bank default/limited liability via $x_{j,t+1}$; and future binding

constraints via $\Phi_{j,t+1}$. This last term comes from the envelope condition and is given by

$$\Phi_{j,t} = \frac{\mathbb{E}_t \left\{ \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} (1 - x_{j,t+1})(1 - \theta + \theta \Phi_{j,t+1}) \right\}}{Q_t^d(1 - \mu_{j,t})} \quad (15)$$

Aggregation and Bank Entry Note that condition (15) does not depend on any bank specific variable. This means that $\Phi_{j,t} \equiv \Phi_t, \forall j$. The appendix shows that the bank's problem is homogeneous of degree 1 in the level of current earnings $e_{j,t}$. Thus all banks take decisions that are proportional to their level of current earnings. Since all banks take proportional portfolio decisions, and the sunspot is an aggregate shock that coordinates run equilibria for *all* banks, this also means that $(u_{j,t}^R, u_{j,t}^F, \mu_{j,t}) \equiv (u_t^R, u_t^F, \mu_t), \forall j$. This allows for simple aggregation of the banking system and, in particular, allows us to focus the analysis on a representative bank whose earnings correspond to aggregate earnings for the banking system net of defaults.

Aggregate earnings $P_t E_t$ are comprised of retained earnings of surviving banks $P_t E_t^s$ plus earnings of new banks $P_t E_t^n$. Retained earnings for surviving banks are given by

$$P_t E_t^s = P_{t-1}(1 - x_t)\theta[Z_t^b b_{j,t-1} - d_{j,t-1}]$$

I assume that, every period, savers inject an amount of equity equal to ϖ in the banking system. During a run, this corresponds to starting equity for new banks. This implies that

$$P_t E_t^n = P_t \varpi$$

and thus real aggregate bank earnings evolve as

$$E_t = \frac{(1 - x_t)}{\Pi_t} \theta(Z_t^b B_{t-1}^b - D_{t-1}) + \varpi$$

Asset Returns Let λ^b denote liquidation costs of default on household debt. Consider a bank that enters the period with a stock of debt securities worth B_{t-1}^b . Every period, a fraction equal to $1 - m$ of these mortgages holders pay their coupon γ and the remaining principal can be sold at price Q_t^b . Out of the remaining fraction m , a fraction $1 - F^b(\nu_t^*)$ prepay in full. The remaining mortgages are foreclosed and liquidated by the banks (who immediately resell these houses to borrowers in the housing market). The payoff per dollar of debt securities is therefore given by

$$Z_t^b \equiv (1 - m)[(1 - \gamma)Q_t^b + \gamma] + m \left[1 - F^b(\nu_t^*) + (1 - \lambda^b) \frac{1 - \Psi^b(\nu_t^*)}{\nu_t^*} \right]$$

Similarly, for bank deposits, we define the unit return as Z_t^d , which can be written as

$$Z_t^d = 1 - x_t + \frac{x_t}{u_t^R}$$

2.1.6 Housing

I assume that the housing market is segmented: borrowers are the only agents that derive utility from housing services and the only agents that are allowed to hold housing assets intertemporally. This implies that house prices are fully determined with the borrower's stochastic discount factor. Movements in house prices are important in determining equilibrium default rates and generate pecuniary externalities through the borrowing constraint.¹¹ Foreclosed houses that are acquired by the banks are immediately resold back to the borrowers. For simplicity, I also assume that the supply of housing is fixed and normalized to 1, $h_t = 1, \forall t$. This assumption, coupled with the fact that $\mathbb{E}_t(\nu) = 1 \forall t$, means that the total, quality-adjusted supply of housing in the economy is equal to 1 at every point in time, $h_t \int \nu dF^b(\nu) = 1 \forall t$.¹²

2.1.7 Central Bank and Monetary Policy

The central bank conducts conventional monetary policy by following a standard Taylor rule through which the policy rate Q_t^{-1} responds to deviations of GDP and inflation from their targets:

$$Q_t^{-1} = \bar{Q}^{-1} \left[\frac{\Pi_t}{\bar{\Pi}} \right]^{\phi_\pi} \left[\frac{GDP_t}{\bar{GDP}} \right]^{\phi_Y} \mu_t$$

where \bar{GDP}, \bar{Q} are the steady-state values of output and the nominal interest rate, and μ_t is a monetary policy shock. I define $GDP_t \equiv C_t + G_t$, that is, output net of resource costs.

2.2 Equilibrium

Equilibrium is defined in the standard way: it consists of allocations, prices, and policies such that (i) all agents choose allocations and optimize given prices and policies, (ii) prices clear markets given allocations and policies, and (iii) policies satisfy the government's budget constraint. A full list of the model's equilibrium conditions is provided in Appendix A.1.

¹¹This assumption of market segmentation has also been used by [Garriga et al. \(2015\)](#) and [Greenwald \(2016\)](#), for example.

¹²This normalization is chosen to simplify algebra and the derivation of the aggregate resource constraints but is easily relaxed — the model can be easily extended to handle aggregate shocks to the average quality of housing.

For reference, the aggregate resource constraint is given by

$$C_t + G_t + \lambda_t^b m \chi p_t^b [1 - \Psi^b(\nu_t^*)] + \lambda^d Z_t^b \frac{B_{t-1}^b}{\Pi_t} x_t = Y_t \left[1 - \frac{\eta}{2} \left(\frac{\Pi_t}{\bar{\Pi}} - 1 \right)^2 \right]$$

where $Y_t \equiv A_t N_t$ is gross output, $C_t \equiv \chi C_t^b + (1 - \chi) C_t^s$ is aggregate consumption, and $N_t \equiv \chi N_t^b + (1 - \chi) N_t^s$ are aggregate hours. Throughout, I focus on the fiscal multiplier of fiscal policies over GDP, which I define as total consumption by the private and public sectors,

$$GDP_t = C_t + G_t$$

3 Model Results

This section describes the calibration and characterizes the behavior of the model.

3.1 Calibration

The period in the model is a quarter. Most parameters are chosen so that the model's stochastic steady-state matches moments of the US economy and financial system in the early 2000s, prior to the 2007 financial crisis. The model has several parameters, which I group into four broad categories. The calibration is summarized in Table 1.

Standard Macro Parameters The discount factor is set at $\beta = 0.9951$ to generate an annualized real interest rate of 2% at the deterministic steady-state. The inverse Frisch elasticity of labor supply is set to be $\varphi = 0.5$, which is standard in macroeconomic models. The elasticity of substitution across varieties is set at $\varepsilon = 6$, implying an average markup of 20% at the steady-state. To choose the Rotemberg menu cost parameter, I set η such that the slope of a linearized Phillips curve would coincide with that of a Calvo-type model where the probability of readjusting the price every period is equal to 20%. This procedure yields $\eta = 98.06$.

I assume standard values for the Taylor rule parameters, $\phi_\Pi = 1.5$ and $\phi_Y = 0.5/4$. I assume that the central bank pursues an annualized inflation target of 2%.

Productivity and monetary policy shocks follow AR(1) processes in logs:

$$\begin{aligned} \log A_t &= \rho_a \log A_{t-1} + \sigma_a \epsilon_t^a \\ \log \mu_t &= \rho_\mu \log \mu_{t-1} + \sigma_\mu \epsilon_t^\mu \end{aligned}$$

The shock parameters are jointly calibrated to match the persistence and volatility of aggregate consumption and nominal interest rates during the pre-crisis period.

Household Finance The model features a set of non-standard parameters related to household finance that I choose in order to match pre-crisis moments of the US economy. Maximum loan-to-value (LTV) at origination, which determines how binding is the constraint for the borrower, is set at a standard value of 85%. The fraction of agents that move every period m is set to match an aggregate LTV of 60%. The housing preference parameter ξ is jointly chosen to generate a ratio of household debt to GDP of 70% at the stochastic steady-state, the value in the early 2000s. The coupon rate $\gamma = 0.05$ is chosen to match a payment-to-income ratio of 35% for borrowers, consistent with the micro data. This rate implies an effective debt maturity of 5 years, close to the effective duration of mortgage contracts in the US once prepayment risk is taken into account.

The credit risk distribution F^b is assumed to be beta, with a constant mean equal to 1. The distribution is thus characterized by a single time-varying parameter, σ^b . The beta assumption implies that we have closed-form expressions for the distribution function and partial expectations that appear in the equilibrium conditions:

$$F^b(\nu_t^*) = \left[\frac{\sigma^b \nu_t^*}{\sigma^b + 1} \right]^{\sigma^b}$$

$$\Psi^b(\nu_t^*) = 1 - \left[\frac{\sigma^b \nu_t^*}{\sigma^b + 1} \right]^{\sigma^b + 1}$$

Fraction of Borrowers I pick the fraction of borrowers χ to be 0.475, a middle-of-the-ground estimate that is consistent with common estimates in the literature. [Broda and Parker \(2014\)](#) estimate that around 40% of households in the US are liquidity constrained, based on Nielsen survey data. [Elenev et al. \(2016\)](#) use several waves of the SCF to estimate the fraction of the population with negative fixed income positions and arrive at 47%, a number very close to mine. It should be noted that while the fraction of borrowers is larger than the share of constrained agents that is used in the heterogeneous agents literature ([Kaplan and Violante, 2014](#)), the borrowers in this model are only *occasionally* constrained. During expansions, the constraint may not bind, in which case the aggregate marginal propensity to consume may fall. Thus, while the fraction of borrowers is constant, the fact that borrowers are only occasionally constrained implies that the aggregate MPC fluctuates with the business cycle, as in a model where the percentage of constrained agents is endogenous.

Banking Banking parameters are jointly calibrated to match a series of targets. The retained earnings parameter $\theta = 0.9179$ and set-up transfer $\varpi = 0.005$ are jointly chosen to match bank leverage at the stochastic steady state of around 8, and a mortgage spread of 2% annualized. These imply an average annual payout rate of 9%, which is close to the value for large US commercial banks. κ is set to 0.08, the standard Basel III level for capital requirements in the US. The loss given default $\lambda^d = 0.10$ and probability of the sunspot $\Pr(\omega = 1) = 0.10$ are chosen to match an unconditional frequency of financial crises of about 2.5%.

Parameter	Description	Value	Target
<i>Standard Parameters</i>			
β	Discount factor	0.9951	Annualized real interest rate of 2%
φ	Frisch elasticity	0.5	Standard
ε	Elasticity of subst.	6	20% markup in SS
η	Rotemberg Menu Cost	98.06	Prices adjusted once every five quarters
<i>Policy Parameters</i>			
Π	Trend Inflation	$1.02^{0.25}$	2% for the US
ϕ_Π	Taylor rule: Inflation	1.5	Standard
ϕ_Y	Taylor rule: Output	0.5/4	Standard
<i>Borrower Parameters</i>			
χ	Fraction of borrowers	0.475	Response of consumption to ESA'08 in Parker et al. (2013)
θ^{LTV}	Maximum LTV at origination	0.85	Greenwald (2016)
m	Fraction of movers	0.116	Aggregate LTV of 55%
ξ	Housing preference	0.1418	Debt to GDP of 70%
σ^b	House quality distr.	4.3513	Annual default rate of 0.5%
λ^b	Loss given default	0.30	FDIC data
γ	Maturity of debt	0.05	payment-to-income of 35%
<i>Banking Parameters</i>			
θ	Retained earnings	0.9179	Leverage equal to 8
κ	Leverage constraint	0.08	Basel III
ϖ	Transfer to new banks	0.005	Annual lending spread of 2%
λ^d	Liquidation costs	0.10	Frequency of financial crises of 2.5%
<i>Shock Parameters</i>			
ρ_a	Persistence of TFP	0.900	Pre-crisis persistence of detrended consumption
σ_a	SD of TFP Innovations	0.005	Pre-crisis volatility of detrended consumption
ρ_μ	Persistence of MP shock	0.800	Pre-crisis persistence of FFR
σ_μ	SD of MP Innovations	0.002	Pre-crisis volatility of FFR
p	Sunspot probability	0.10	Frequency of financial crises of 2.5%

Table 1: Summary of the calibration.

3.2 Solution Method

The model features three main sources of nonlinearities: two occasional binding constraints (the capital requirement for banks and the LTV constraint for borrowers), as well as inherently nonlinear endogenous bank runs. Due to these three features, the model cannot be solved with traditional methods, such as log-linear approximations around the steady state.

I solve the model using a global solution method that consists of a combination of time iteration [Judd et al. \(2002\)](#), and parametrized expectations [den Haan and Marcet \(1990\)](#). The global solution method allows me to capture the nonlinearities that are inherent to the aforementioned features, as well as important precautionary motives and risk premia: bank runs in the model are akin to a “large disaster”. The computational details of the solution method as well as robustness and accuracy checks regarding the numerical solution can be found in [Appendix B](#).

3.3 Financial Crises

A crisis in the model is a period with a bank run: when $u_t^R \geq 1$ and the sunspot shock realizes $\omega_t = 1$. Note that crises have both an endogenous and an exogenous component: while the crisis is associated to the realization of an exogenous shock (the sunspot), it can only occur if the economy endogenously moves to the “crisis region”, a region of the state space where $u_t^R \geq 1$. In this sense, the endogeneity of crises is reminiscent of that that is present in standard models of sovereign default ([Cole and Kehoe, 2000](#); [Arellano, 2008](#)).

3.3.1 Crisis Regions

Recall that

$$u_t^R = \frac{D_{t-1}}{Z_t^b B_{t-1}}$$

where D_{t-1}, B_{t-1} are pre-determined, endogenous states, and Z_t^b is an equilibrium object that is a function of both endogenous and exogenous states at t . This suggests that the economy will be closer to a crisis the higher is leverage in the banking sector, defined as $\text{lev}_{t-1} = \frac{D_{t-1}}{B_{t-1}}$.¹³ Figure [3.3.1](#) plots the different regions in the state space of the model: the horizontal axis is lev , a measure of bank leverage, and the vertical axis is B , a measure of household leverage. There are three regions in the state space: a “safe region” (blue), where $u_t^R < 1$ and no crisis occurs; a “run region” (green), where $u_t^R \geq 1, u_t^D < 1$, and the economy is subject to a crisis depending on the realization of the sunspot; and a “insolvency region” (yellow), where $u_t^D \geq 1$, and a crisis occurs with probability one. The figures shows us several things: (i) crises are more likely when bank leverage is high, which comes almost directly from the definition of u_t^R ; (ii) crises are more likely when the face value of bank assets is relatively low (holding leverage constant); (iii) crises are more likely when TFP is low. All of these “comparative statics” are consistent with a large empirical literature on

¹³This definition of leverage consists of total liabilities cum interest payments divided by the “face value” of assets.

facts related to financial crises ([Jordà et al., 2016](#)).

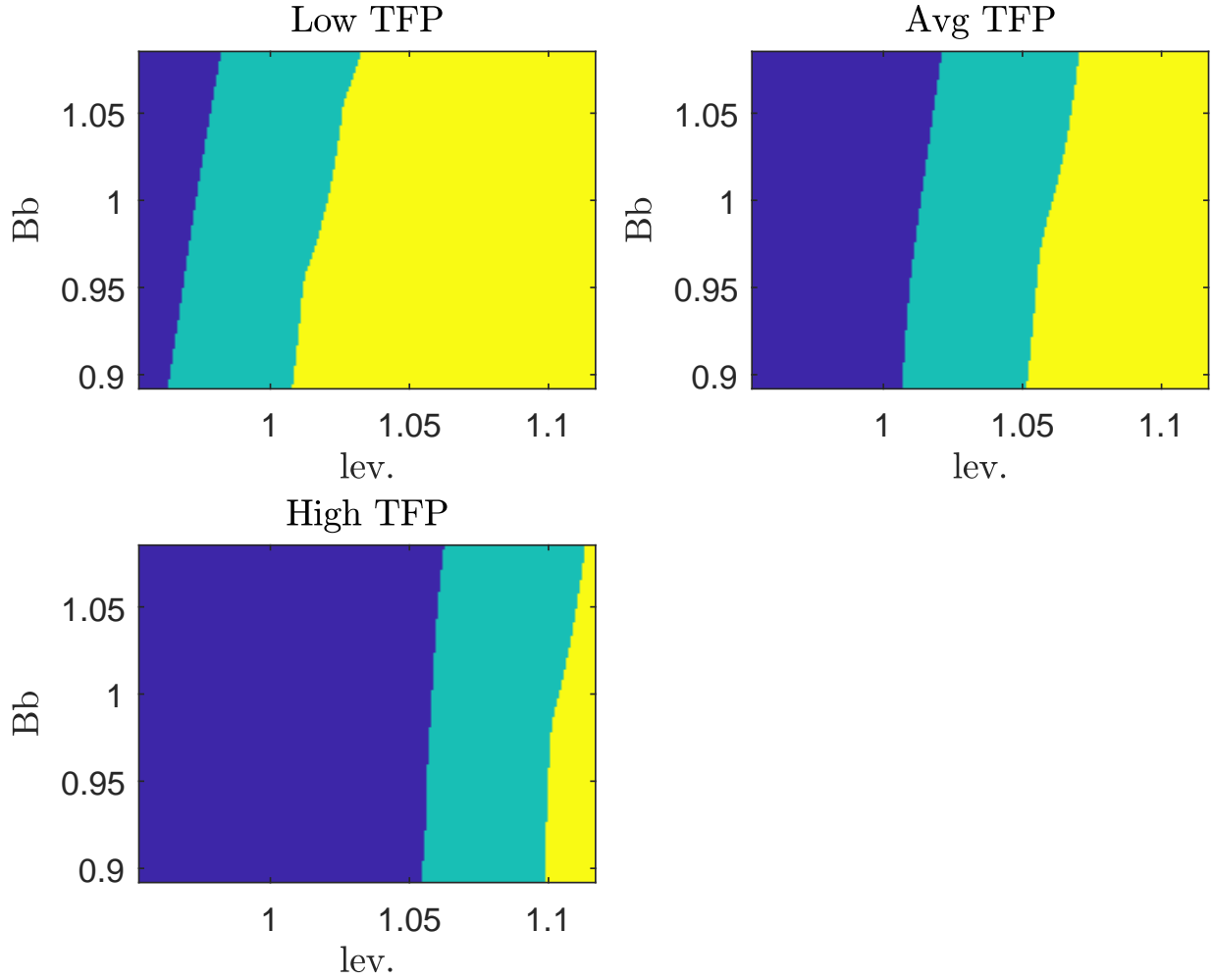


Figure 2: Model state space for different realizations of the TFP shock. The horizontal axis corresponds to $\text{lev} = \frac{D}{B}$, while the vertical axis is B . The blue area corresponds to the “safe region”, where $u^R < 1$; the green area is the “illiquidity region”, where $u^R \geq 1$ but $u^D < 1$; the yellow area is the “insolvency region”, where $u^D \geq 1$.

Figure 3.3.1 illustrates the state space of the model, but does not tell us much regarding the actual behavior of the model: it could be, for example, that agents are sufficiently risk averse such that the economy never actually exits the blue region. Figure 3.3.1 plots the distribution of states across the state space from a long simulation of the model, and shows that this is not the case. The horizontal and vertical axes are the same (the endogenous states), and each point is a period in the simulation. Blue points correspond to non-crisis periods, while orange points are periods when a run has happened, $x_t = 1$.

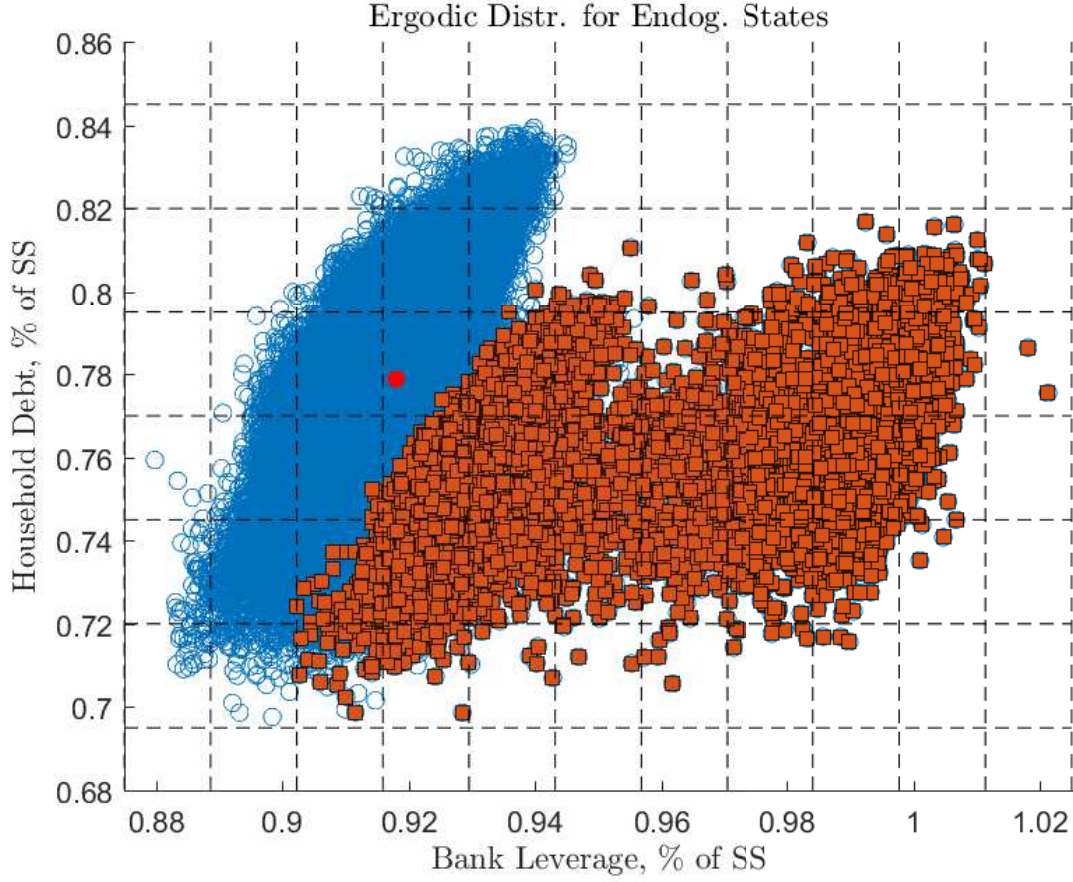


Figure 3: Joint-distribution of endogenous states from a long simulation of the model. Blue points correspond to normal periods, orange squares correspond to financial crises. The red dot is the stochastic steady state of the model.

3.3.2 The Macroeconomic Effects of a Crisis

To study the endogenous behavior of the model during a financial crisis, I simulate the model for a large number of periods, and focus on the behavior of the economy when it enters into a bank run. Figure 3.3.2 plots the median behavior of GDP, borrower consumption, house prices, and mortgage spreads in such events, along with 95% confidence bands. Financial crises correspond to sharp contractions of GDP, consumption, and house prices, as well as large increases in credit spreads.



Figure 4: The blue line plots the median path of selected endogenous variables around the time the economy enters a financial crisis ($t = 0$). The red lines correspond to 95% confidence bands.

The mechanism that underlies the financial crisis is analogous to the default-collateral channel of [Faria-e-Castro \(2018\)](#): when a crisis starts, bank equity collapses, hampering their ability to intermediate. Lending to borrowers falls, and interest rates rise sharply as the banking sector struggles to satisfy capital requirements. If this drop in lending and rise in spreads is large enough, borrowers are pushed to their LTV constraint and effectively become hand-to-mouth. Since lending has fallen and interest rates have risen, disposable income falls, making borrower consumption fall almost one-for-one. Since borrower consumption has a first-order effect on house prices via marginal utility and the stochastic discount factor, this also causes a large collapse in house prices. This fall in house prices, in turn, raises LTV rates, which in turn endogenously lead to an increase in default rates. This further reduces bank profits, contributing to a further tightening of the constraint. This bank-borrower “doom-

loop” is a high-powered version of the classic financial accelerator mechanism (Bernanke et al., 1996), compounded by the endogenous default of the borrowers and the rise in deposit spreads for banks.¹⁴ The combination of incomplete markets and demand externalities (via nominal rigidities) means that a fall in borrower consumption translates into a fall in output, throwing the economy into a recession.

3.3.3 The Macroeconomic Effects of an *Almost-Crisis*

More interestingly, the probability that a crisis might occur may also trigger a recession, even if such crisis never materializes. Figure 3.3.3 plots the median path of the economy along with 95% confidence bands for periods when the economy enters the crisis region, but manages to exit this region without a crisis ever occurring (that is, $u_t^R \geq 1$ and $\omega_t = 0$ for some periods). While the effects are more modest than those of a full blown crisis, the possibility of a crisis does cause a noticeable drop in GDP and house prices, as well as a significant rise in credit spreads. Importantly, all of these effects arise from the anticipation of a crisis: the economy is transitioning from a set of states where the probability of a crisis was zero (or at least very low) to another where the probability of a crisis rises considerably. The anticipation of crises can trigger a recession, even if those crisis never occur ex-post.

¹⁴Depending on the constellation of endogenous states that helps trigger the crisis, the crisis can last for more than one period, in which case this mechanism is further compounded by a rise in bank deposit rates that contributes to raising their leverage.



Figure 5: The blue line plots the median path of selected endogenous variables around the time the economy enters the run region ($t = 0$), but exits it with no crisis ever occurring. The red lines correspond to 95% confidence bands.

4 Countercyclical Capital Buffers

I now turn to the analysis of the effects of CCyB. I proceed in two steps: first, I show that CCyB can be an useful instrument *ex-post*, and that lowering them during a crisis lowers the severity of these events; second, I show that CCyB can also be an useful *ex-ante*, and that raising them during periods of high leverage can greatly reduce the probability of a crisis event.

4.1 Design of CCyB

I assume that the government, via its macroprudential regulator, can steer the leverage of the banking sector via the adjustment of κ_t , the parameter in the leverage constraint. In particular, I assume that macroprudential policy is as follows,

$$\kappa_t = \begin{cases} \kappa_{\text{hi}}, & \text{for } u_t^R \geq 1, \omega_t = 0 \\ \kappa_{\text{med}}, & \text{for } u_t^R < 1 \\ \kappa_{\text{low}}, & \text{for } u_t^R \geq 1, \omega_t = 1 \end{cases} \quad (16)$$

where $\kappa_{\text{hi}} \geq \kappa_{\text{med}} \geq \kappa_{\text{lo}}$. That is, the macroprudential regulator can set three levels of capital requirements. The baseline level, when the economy is in the safe region, is κ_{med} . When the economy enters the run region, but no crisis has materialized, the regulator raises capital requirements in order to lower bank leverage and make the economy exit the run region. If, however, a run occurs, the regulator can lower capital requirements below their standard level in order to relax bank constraints and help break the collateral-default financial accelerator that was described in the previous section.

It should be noted that this specification for macroprudential policy is slightly different and richer than what is prescribed by Basel III. In particular, the current implementation framework for CCyB in the US is a particular case of the above framework, where $\kappa_{\text{low}} = \kappa_{\text{med}}$. That is, the Fed can raise capital requirements over and above standard levels, but does not have the authority to lower them beyond standard levels during periods of distress. A potential critique of the proposed policy is that it requires real-time knowledge of what u_t^R is. On the other hand, this is the only variable that the regulator needs to keep track of, and therefore becomes a sufficient statistics for the setting of macroprudential policy. Consistent with the current US framework, and from a baseline level of $\kappa_{\text{med}} = 8\%$, I set $\kappa_{\text{hi}} = 10\%$, and $\kappa_{\text{low}} = 6\%$.

4.2 Ex-post effects of CCyB

I first focus on an economy where $\kappa_{\text{hi}} = \kappa_{\text{med}}$. That is, the regulator can lower capital requirements during a crisis but cannot raise them ex-ante. This exercise is useful to isolate the ex-post benefits of the proposed CCyB policy. These effects are shown on Figure 4.2: by relaxing capital requirements in the banking sector, the regulator contains the rise in credit spreads, which means that disposable income for borrowers falls by less. This results in a lower drop in consumption and GDP: while the recession is still deep, it is about one third smaller.

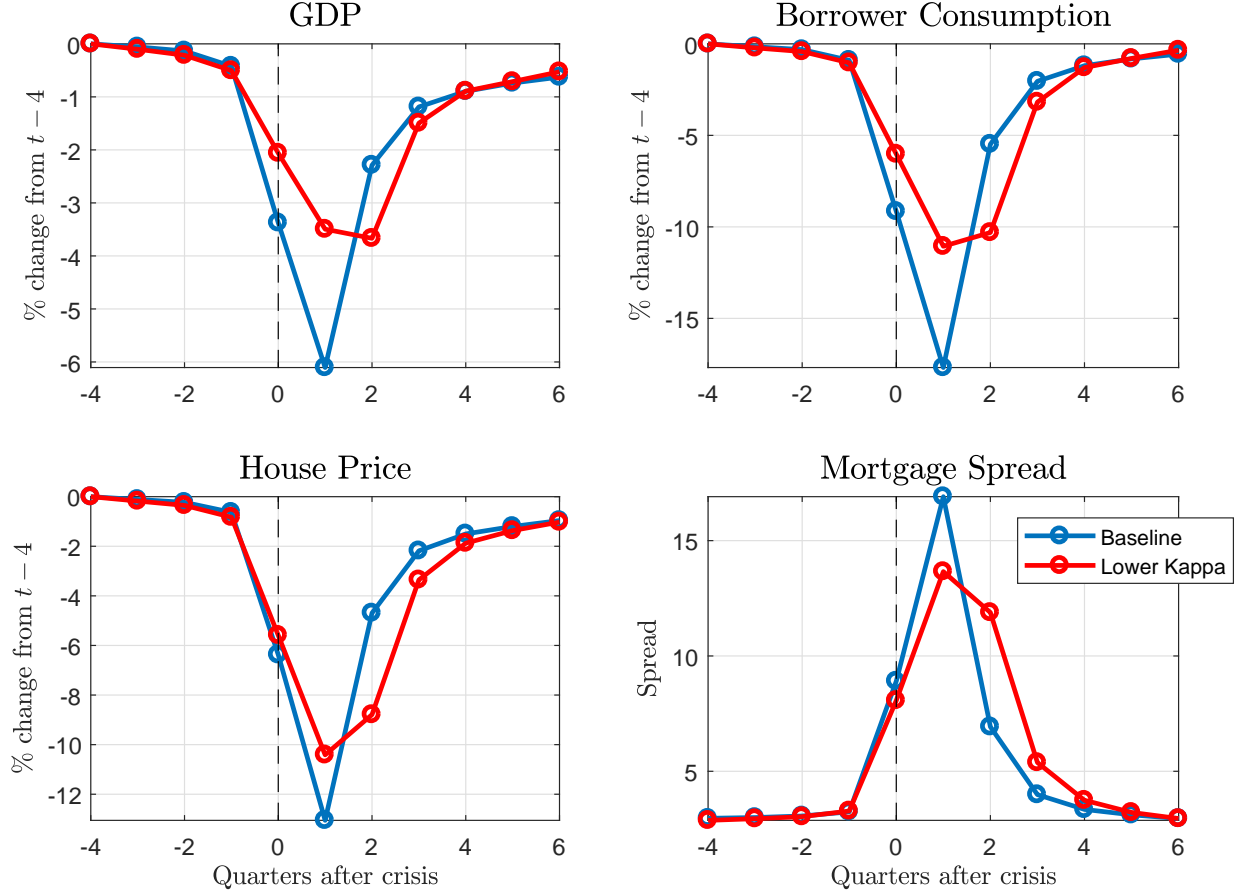


Figure 6: The blue line plots the median path of selected endogenous variables around a crisis, in the absence of macroprudential policy. The red line plots the median path of selected endogenous variables when capital requirements are lowered during a crisis.

4.3 Ex-ante effects of CCyB

Now, I consider an economy where $\kappa_{lo} = \kappa_{med}$: that is, the regulator cannot lower capital requirements below their baseline value, but can raise them when bank leverage is high, $u_t^R \geq 1$. While this does not offer much benefit should a crisis actually occur, it can help the economy exiting this region faster, or even avoiding it altogether. To see this, table XXX shows how this type of policy reduces the frequency of crises, but does not contribute to changing their severity.

The mechanism, in this case, is precautionary: banks try to stay away from the constraint. The threat of tightening the constraint if leverage is high therefore induces the banking sector to further deleverage in the first place. This is visible in Table 2, which summarizes certain moments from model simulations: ex-ante policy reduces the unconditional probability of a crisis by more than half, from 2.41% to 0.89%. The last line shows that ex-post policy can

reduce the severity of crises on GDP by almost half, while ex-ante policy also helps moderate crises somewhat. This is mostly due to the fact that both banks and households tend to be less leveraged when a crisis erupts.

Variable	No Policy (Baseline)	Ex-post policy	Ex-ante policy	Both policies
$100 \times \Pr(x_t = 1)$	2.24	2.08	0.89	0.88
Median Δ GDP in Crisis	-5.54	-2.97	-4.10	-3.62

Table 2: Model moments. The probability of a crisis and GDP contraction are based on model simulations. Bank leverage and the Lagrange multiplier for the borrower are based on the stochastic steady state of each model.

4.4 Combined policies

The last column of Table 2 contains results for the combination of the two policies. There, we can see that the policy combination offers primarily the benefits of the ex-ante policy, and substantially reduces the risk of a run. The ex-post benefits seem to be smaller than in the case with only ex-post policy, and the reason is that these benefits are measured *conditional* on a run taking place. Under ex-ante policy, the runs that are not avoidable are the “worst” ones, i.e. the ones that are generated by combinations of large negative shocks. Under ex-post policy, there are more runs, including “avoidable” ones that tend to be less severe. What is important is that, in terms of ex-post benefits, the combined set of policies does improve over both the baseline and the model with ex-ante policy only.

5 Quantitative Exercise

I now combine the calibrated model with US data to perform a quantitative exercise, and ask the following question: what would the Great Recession have looked like if CCyB had been deployed? To this end, I use the baseline model without CCyB as a measurement device to estimate structural shocks for the US economy, and then feed the same sequences of shocks to different specifications of the model: one where the regulator can lower capital requirements during crises, one where the regulator can raise them during periods of financial fragility, and one where the regulator can do both.

5.1 Measurement and Particle Filter

Let the vector of endogenous variables in the model be denoted by \mathbb{X}_t , the vector of endogenous states be \mathbb{S}_t , and the vector of exogenous shocks be \mathbb{Z}_t . As this is a standard

rational expectations model, we can write its solution as a set of (nonlinear) state transition equations, and a set of (nonlinear) observation equations:

$$\begin{aligned}\mathbb{S}_t &= f(\mathbb{S}_{t-1}, \mathbb{Z}_t) \\ \mathbb{X}_t &= g(\mathbb{S}_{t-1}, \mathbb{Z}_t)\end{aligned}$$

where f, g are the state transition and observation functions, respectively. Our goal is estimate paths for $\{\mathbb{S}_t, \mathbb{Z}_t\}_{t=0}^T$ (where $t = 0, \dots, T$ is the sample period). To this end, we can choose up to three data observables and back out the implied paths for states and exogenous shocks from the above system. This is, in some sense, “inverting” the model to back out model-implied estimates for the paths of the endogenous states and shocks. Since neither f nor g are necessarily invertible, this procedure can be accomplished via simulation, using the particle filter as in [Fernández-Villaverde and Rubio-Ramírez \(2007\)](#).

The spirit of this exercise is to assume that the baseline model without CCyB corresponds to the true model of the US economy in the 2000-2015 period, as the CCyB policy was not in place. Then, the estimated paths of the shocks can be fed to the alternative models with different CCyB specifications, to tell us what the historical effects of these policies would have looked like.

5.2 Observables

The model features three shocks: the TFP shock, the monetary policy shock, and the sunspot shock. I estimate sequences of shocks that allow the model to match the path of two observables: detrended aggregate consumption, and a measure of bank borrowing costs (the TED spread), and the federal funds rate.

Consumption Since there is no investment in the model, I focus on matching the path of aggregate consumption instead of GDP. The path of aggregate consumption is informative of the path of TFP innovations. Real aggregate consumption is the data counterpart of $C_t = \chi C_t^b + (1 - \chi)C_t^s$. I use quarterly real personal consumption expenditures (PCE) from the Federal Reserve Bank of St. Louis FRED database (series code: PCECC96). I detrend this series using the approach proposed by [Hamilton \(Forthcoming\)](#), which involves

estimating the following OLS regression

$$\log C_{t+8} = \alpha + \sum_{i=0}^4 \beta_i \log C_{t-i} + \epsilon_t$$

and obtain detrended consumption as \hat{c}_t .

Credit Spreads The credit spread in the model is simply the difference between the price of the one-period deposit and that of a risk-free bond,

$$\text{spread}_t^d = \log Q_t - \log Q_t^d$$

Outside of financial crises, the credit risk of deposits is very low and their price mostly tracks the risk-free rate. When the financial shock hits, however, a wave of mortgage defaults can trigger large jumps in the deposit spread. For that reason, I use the data counterpart to the deposit spread — the TED spread — as the observable that allows me to identify financial shocks. The series is taken from FRED (series code: TEDRATE) and consists of the spread between the 3-month LIBOR and the yield on the 3-month Treasury bill. It is a common measure of the cost of wholesale funding for large banks.

Policy Rate Q_t is measured directly as the current federal funds rate (series code: FEDFUNDS). All these series are plotted in Figure 7.

5.3 Results

Figure 8 and 9 show the model-implied (median) behavior for the targeted observables, as well as the data series. Other variables are plotted in the estimation appendix; the model predicts that the US economy entered a financial crisis in 2007Q4, and exited it in 2008Q4.¹⁵

5.3.1 Counterfactual Experiment

Figures 10 and 11 plot the counterfactual scenarios in which the regulator has access to ex-post, and ex-ante policies, respectively. The ex-post figure shows that while lowering capital requirements could have had contributed to lowering credit spreads at certain points during the crisis, the effects are not very large. More interestingly, Figure 11 shows that raising capital requirements before the crisis could have prevented a large drop in output and a large increase in credit spreads. Eventually, the economy would have entered a recession anyway,

¹⁵That is, the median value for the run indicator is equal to 1 for these dates.

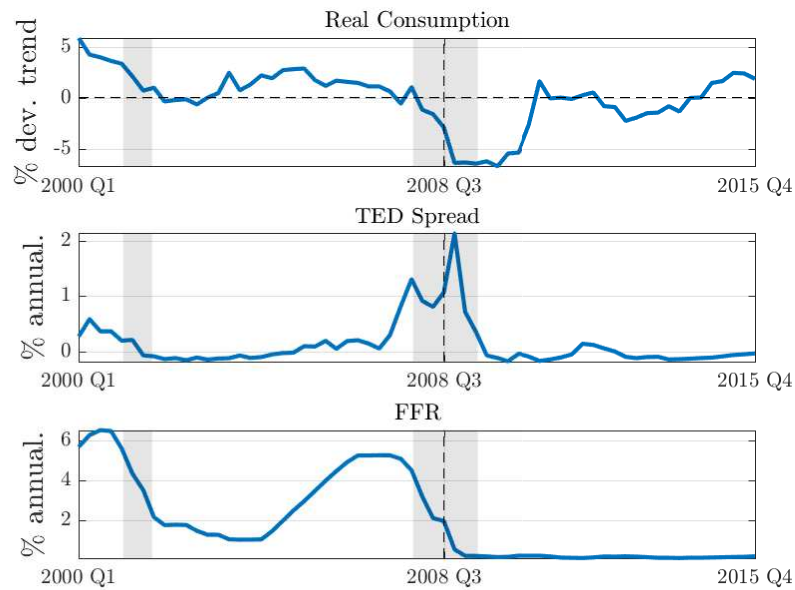


Figure 7: Detrended real consumption, annualized TED spread, and annualized Federal Funds Rate. Sample: 2000Q1-2015Q4. Lehman Brothers failure highlighted (2008Q3). Source: Federal Reserve Bank of St. Louis FRED.

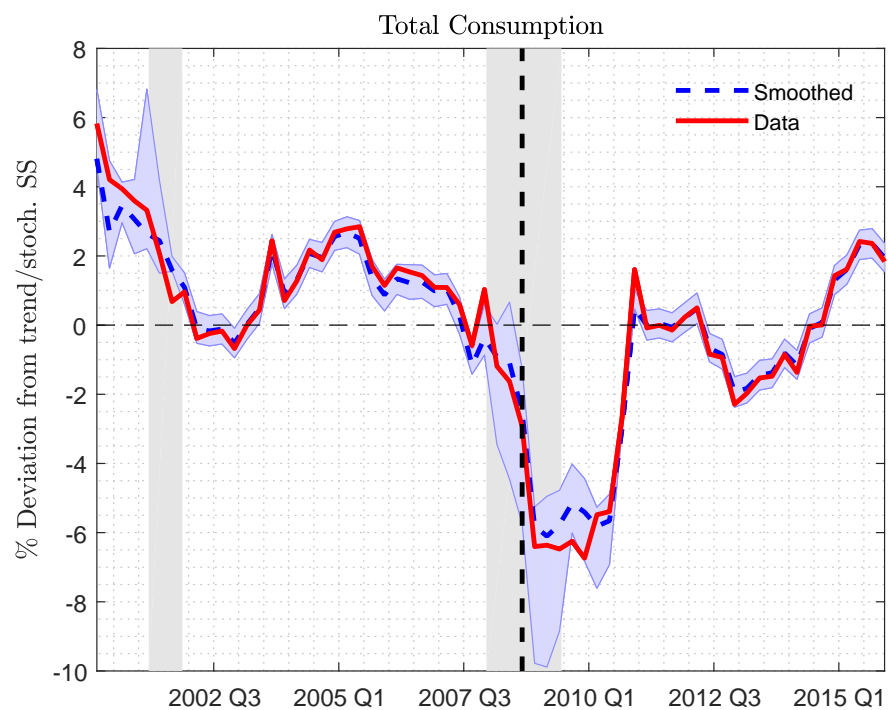


Figure 8: Estimated path for smoothed consumption vs. data, with 95% confidence bands.

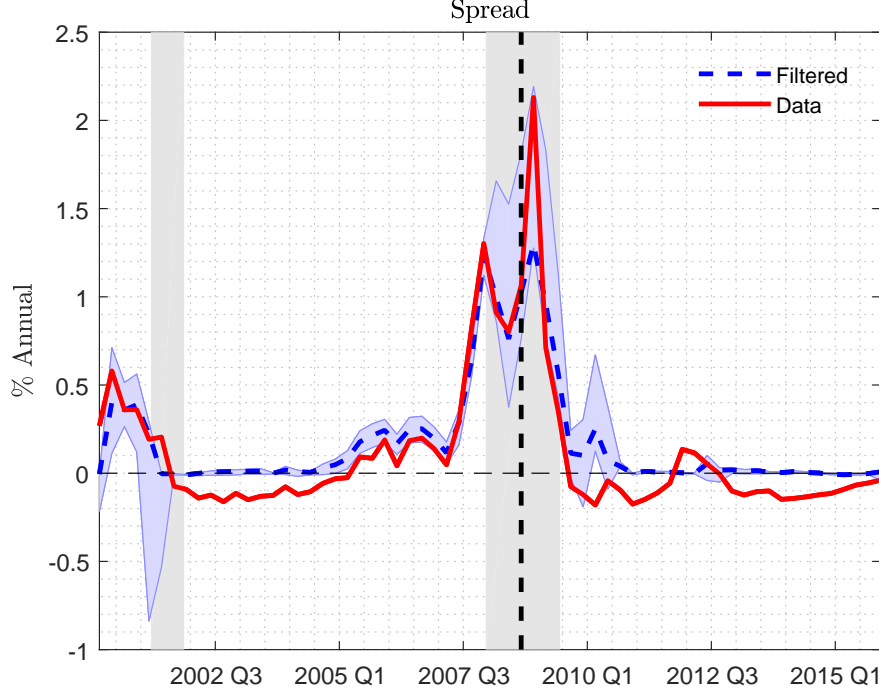


Figure 9: Estimated paths for smoothed spread vs. data, with 95% confidence bands.

as the model estimates that the latter part of the recession is mostly attributable to other types of shocks, but the landing would have been much “softer”.

To understand the magnitude of these gains, let us conduct the following simple, back-of-the-envelope calculation: real PCE consumption in 2007Q1 was about \$ 10,566.6 bn. The cumulative gap between deviations from trend from lowering capital requirements vis-a-vis no policy equals 9.20% between 2007Q1 and 2010Q4, or about \$ 972.3 bn. For ex-ante policy, the gap is 31.18%, or \$ 3,294.2 bn. Finally, 12 shows the counterfactual when the regulator has access to both ex-ante and ex-post policies; the overall picture is very similar to the ex-ante policy one, confirming that the ability to raise capital requirements is responsible for most of the gains. The consumption gap in this case is equal to 31.71%, or \$ 3,351 bn.

6 Conclusion

Countercyclical capital buffers were one of the pillars of post-crisis financial regulation reform. This paper investigates the effects of these regulations in the context of a nonlinear dynamic stochastic general equilibrium model where the financial sector is subject to occasional financial panics and these are transmitted to real activity via aggregate demand. In the context of this model, I show that CCyB can offer benefits ex-post, as lowering them during a crisis moderates the fall in output and consumption, as well as more traditional

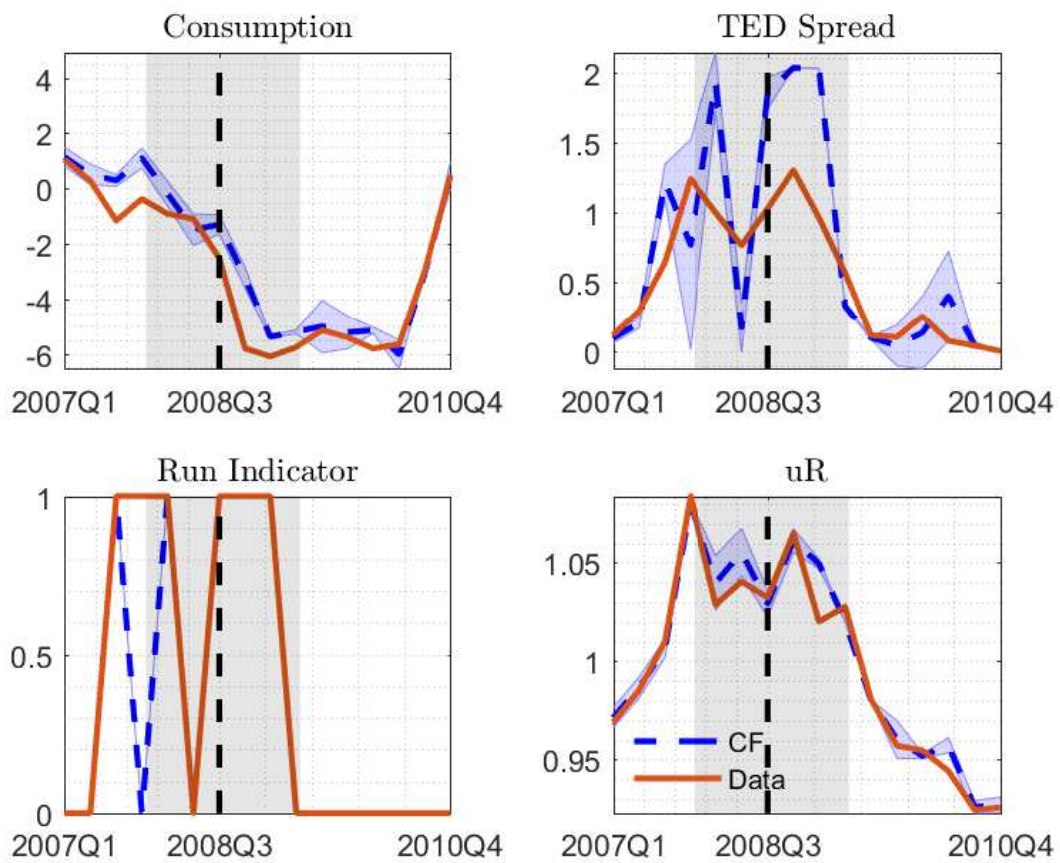


Figure 10: Data (orange solid line) vs. counterfactual where regulator lowers capital requirements during the crisis (dashed blue line)

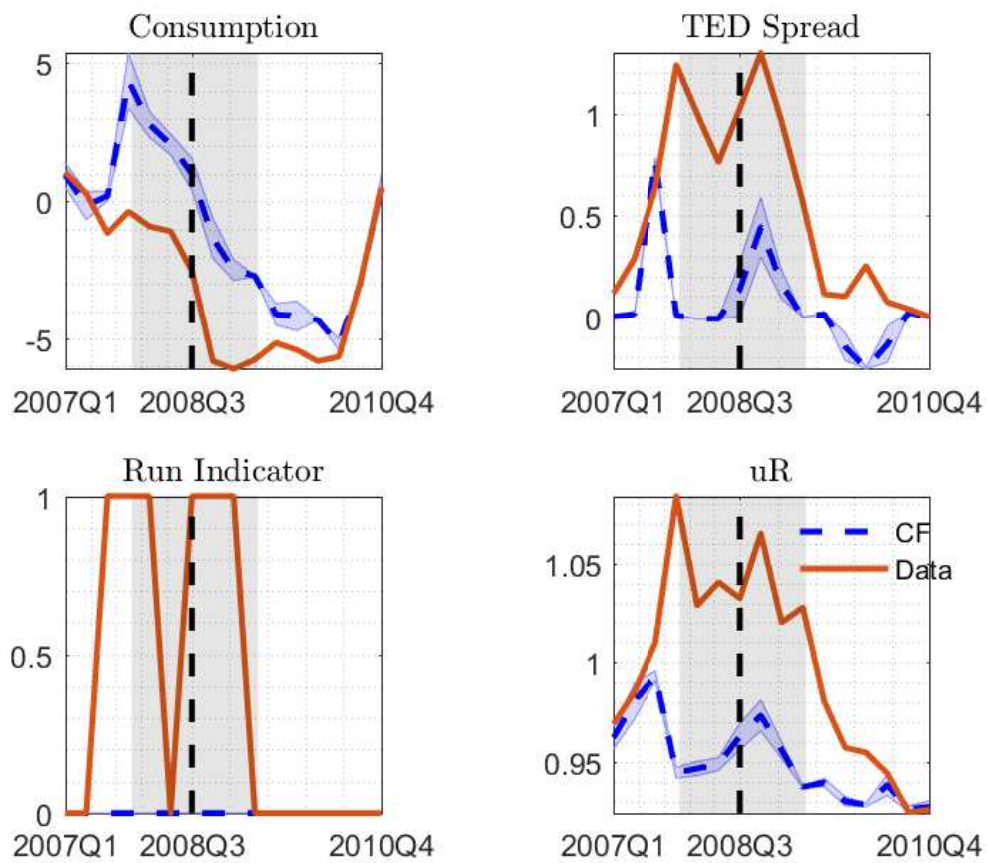


Figure 11: Data (orange solid line) vs. counterfactual where regulator raises capital requirements before the crisis (dashed blue line)

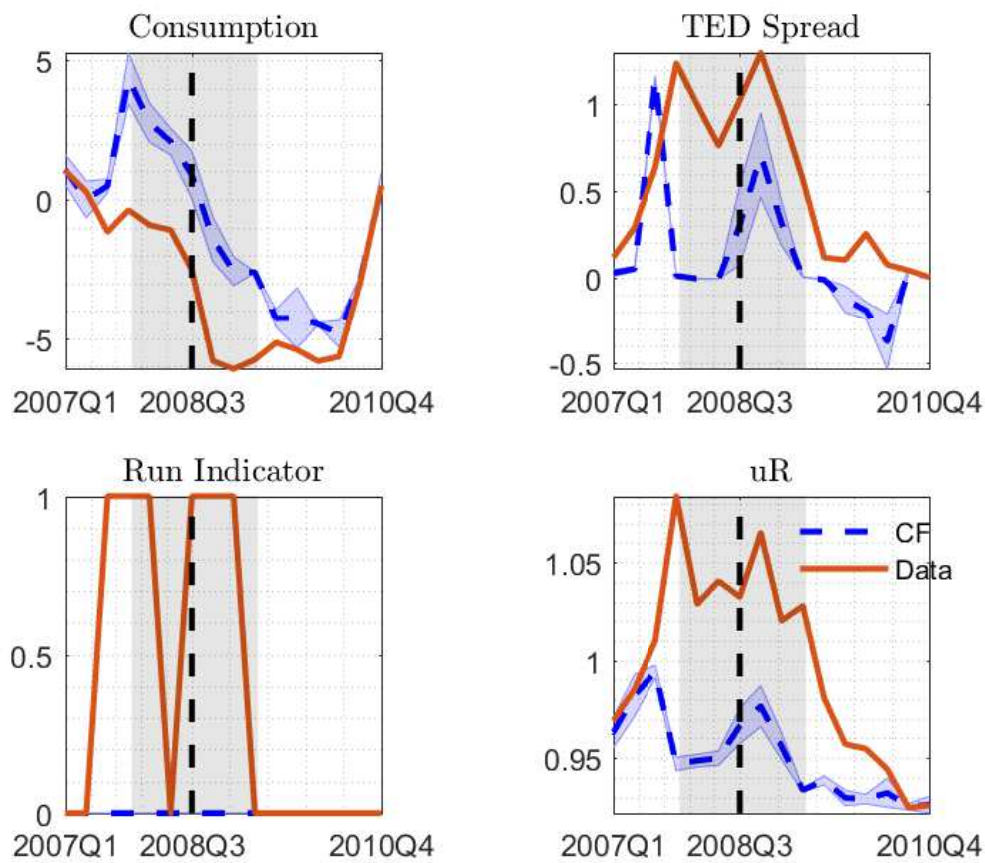


Figure 12: Data (orange solid line) vs. counterfactual where regulator can both raise and lower capital requirements (dashed blue line)

ex-ante benefits, as raising them during periods of leverage growth can greatly reduce the frequency of crises.

In a quantitative application to the 2008-09 Great Recession, I find that the ex-post benefits of CCyB would have been quantitatively significant, with a cumulative gain of almost 10% in aggregate consumption. However, the main benefits would have arisen from the macroprudential use of these tools, as they would have allowed regulators to avoid most of the financial crisis, avoiding a cumulative fall of over 30% of aggregate consumption. In sum, I find that the benefits of this type of policy can be quantitatively very large, especially ex-ante.

In the current model, the real effects of financial panics are transmitted purely via aggregate demand. The model does not feature investment nor a link between the financial and production sectors. For this reason, and since the single component of output that fell the most was aggregate investment, it is likely that the model underestimates the true historical benefits of CCyB. Since consumption tends to be the least volatile component of private expenditure, these numbers can be seen as a lower bound for the fall in GDP that could have been avoided. The inclusion of a more traditional investment channel could also offer potentially interesting interactions with the aggregate demand channel and is left as an avenue for future research.

References

- ADMATI, A. AND M. HELLWIG (2013): *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, Princeton University Press, 1 ed.
- ARELLANO, C. (2008): "Default Risk and Income Fluctuations in Emerging Economies," *American Economic Review*, 98, 690–712.
- BASEL COMMITTEE ON BANKING SUPERVISION (2010): "Basel III phase-in arrangements," .
- BEGENAU, J. (2015): "Capital Requirements, Risk Choice, and Liquidity Provision in a Business Cycle Model," 2015 Meeting Papers 687, Society for Economic Dynamics.
- BERNANKE, B., M. GERTLER, AND S. GILCHRIST (1996): "The Financial Accelerator and the Flight to Quality," *The Review of Economics and Statistics*, 78, 1–15.
- BRODA, C. AND J. A. PARKER (2014): "The Economic Stimulus Payments of 2008 and the aggregate demand for consumption," *Journal of Monetary Economics*, 68, S20–S36.
- COLE, H. L. AND T. J. KEHOE (2000): "Self-Fulfilling Debt Crises," *The Review of Economic Studies*, 67, pp. 91–116.
- DAVYDIUK, T. (2017): "Dynamic Bank Capital Requirements," 2017 Meeting Papers 1328, Society for Economic Dynamics.
- DEN HAAN, W. J. AND A. MARCET (1990): "Solving the Stochastic Growth Model by Parameterizing Expectations," *Journal of Business & Economic Statistics*, 8, 31–34.
- ELENEV, V., T. LANDVOIGT, AND S. V. NIEUWERBURGH (2018): "A Macroeconomic Model with Financially Constrained Producers and Intermediaries," NBER Working Papers 24757, National Bureau of Economic Research, Inc.
- ELENEV, V., T. LANDVOIGT, AND S. VAN NIEUWERBURGH (2016): "Phasing out the GSEs," *Journal of Monetary Economics*, 81, 111–132.
- FARIA-E-CASTRO, M. (2018): "Fiscal Multipliers and Financial Crises," Working Papers 2018-23, Federal Reserve Bank of St. Louis.
- FEDERAL RESERVE BOARD (2016): "Regulatory Capital Rules: The Federal Reserve Board's Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer," 12 CFR Part 217, Appendix A, available online at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160908b.htm>.

- FERNÁNDEZ-VILLAVERDE, J. AND J. F. RUBIO-RAMÍREZ (2007): “Estimating Macroeconomic Models: A Likelihood Approach,” *Review of Economic Studies*, 74, 1059–1087.
- FERRANTE, F. (2015): “Risky Mortgages, Bank Leverage and Credit Policy,” FEDS Working Paper 2015-110, Federal Reserve Board of Governors.
- FURMAN, J. (2018): “The Fed Should Raise Rates, but Not the Ones You’re Thinking,” Opinion Column on the Wall Street Journal, <https://www.wsj.com/articles/the-fed-should-raise-rates-but-not-the-ones-youre-thinking-1534803795>.
- GARRIGA, C., F. E. KYDLAND, AND R. SUSTEK (2015): “Mortgages and Monetary Policy,” Working Papers 2015-33, Federal Reserve Bank of St. Louis.
- GERTLER, M., A. PRESTIPINO, AND N. KIYOTAKI (2018): “A Macroeconomic Model with Financial Panics,” 2018 Meeting Papers 113, Society for Economic Dynamics.
- GREENWALD, D. L. (2016): “The Mortgage Credit Channel of Macroeconomic Transmission,” Unpublished, MIT Sloan.
- HAMILTON, J. D. (Forthcoming): “Why you should never use the Hodrick-Prescott filter,” *The Review of Economics and Statistics*.
- JIMÉNEZ, G., S. ONGENA, J.-L. PEYDRO, AND J. SAURINA (2017): “Macroprudential Policy, Countercyclical Bank Capital Buffers, and Credit Supply: Evidence from the Spanish Dynamic Provisioning Experiments,” *Journal of Political Economy*, 125, 2126 – 2177.
- JORDÀ, O., M. SCHULARICK, AND A. M. TAYLOR (2016): “The great mortgaging: housing finance, crises and business cycles,” *Economic Policy*, 31, 107–152.
- JUDD, K., F. KUBLER, AND K. SCHMEDDERS (2002): “A solution method for incomplete asset markets with heterogeneous agents,” Available at SSRN.
- KAPLAN, G. AND G. L. VIOLANTE (2014): “A Model of the Consumption Response to Fiscal Stimulus Payments,” *Econometrica*, 82, 1199–1239.
- KARMAKAR, S. (2016): “Macroprudential regulation and macroeconomic activity,” *Journal of Financial Stability*, 25, 166 – 178.
- LANDVOIGT, T. (2016): “Financial Intermediation, Credit Risk, and Credit Supply during the Housing Boom,” Unpublished, available at SSRN.

- LANDVOIGT, T. AND J. BEGENAU (2016): “Financial Regulation in a Quantitative Model of the Modern Banking System,” 2016 Meeting Papers 1462, Society for Economic Dynamics.
- LIANG, N. (2017): “Financial Regulations and Macroeconomic Stability,” Keynote address at the International Finance and Banking Society, Hutchins Center on Fiscal and Monetary Policy at Brookings.
- MARTINEZ-MIERA, D. AND J. SUAREZ (2014): “Bank’s endogenous systemic risk-taking,” Unpublished, CEMFI.
- MENDICINO, C., K. NIKOLOV, J. SUAREZ, AND D. SUPERA (2018): “Optimal Dynamic Capital Requirements,” *Journal of Money, Credit and Banking*, 50, 1271–1297.
- MIAN, A., A. SUFI, AND E. VERNER (2017): “How do Credit Supply Shocks Affect the Real Economy? Evidence from the United States in the 1980s,” NBER Working Papers 23802, National Bureau of Economic Research, Inc.
- NGUYEN, T. T. (2014): “Bank Capital Requirements: A Quantitative Analysis,” Working Paper Series 2015-14, Ohio State University, Charles A. Dice Center for Research in Financial Economics.
- PARKER, J. A., N. S. SOULELES, D. S. JOHNSON, AND R. MCCLELLAND (2013): “Consumer Spending and the Economic Stimulus Payments of 2008,” *American Economic Review*, 103, 2530–53.
- PAUL, P. (2017): “A Macroeconomic Model with Occasional Financial Crises,” Working Paper Series 2017-22, Federal Reserve Bank of San Francisco.
- POESCHL, J. AND X. ZHANG (2018): “Bank Capital Regulation and Endogenous Shadow Banking Crises,” Unpublished.
- ROTEMBERG, J. (1982): “Sticky Prices in the United States,” *Journal of Political Economy*, 90, 1187–1211.
- WOODFORD, M. (2001): “Fiscal Requirements for Price Stability,” NBER Working Papers 8072, National Bureau of Economic Research, Inc.

A Model Appendix

A.1 Full List of Equilibrium Conditions

Savers,

$$C_t^s (N_t^s)^\varphi = w_t \quad (17)$$

$$Q_t = \mathbb{E}_t \left(\frac{\Lambda_{t+1}^s}{\Pi_{t+1}} \right) \quad (18)$$

$$Q_t^d = \mathbb{E}_t \left(\frac{\Lambda_{t+1}^s}{\Pi_{t+1}} Z_{t+1}^d \right) \quad (19)$$

$$\Lambda_{t+1}^s = \beta \frac{C_t^s}{C_{t+1}^s} \quad (20)$$

Banks,

$$E_t = \frac{(1 - x_t)}{\Pi_t} \theta (Z_t^b B_{t-1}^b - D_{t-1}) + \varpi Q_t^b \frac{B_{t-1}^b}{\Pi_t} \quad (21)$$

$$Q_t^b B_t^b = E_t + Q_t^d D_t \quad (22)$$

$$\kappa Q_t^b B_t^b \leq \Phi_t E_t \perp \mu_t \geq 0 \quad (23)$$

$$\Lambda_{t+1}^k = \frac{\Lambda_{t+1}^s}{\Pi_{t+1}} (1 - \theta + \theta \Phi_{t+1}) (1 - x_{t+1}) \quad (24)$$

$$\mu_t \kappa = \mathbb{E}_t \left\{ \Lambda_{t+1}^k \left[\frac{Z_{t+1}^b}{Q_t^b} - \frac{1}{Q_t^d} \right] \right\} \quad (25)$$

$$\Phi_t = \frac{\mathbb{E}_t \{ \Lambda_{t+1}^k \}}{Q_t^d (1 - \mu_t)} \quad (26)$$

$$u_t^D = \frac{D_{t-1}}{Z_t^b B_{t-1}^b} \quad (27)$$

$$u_t^R = \frac{D_{t-1}}{(1 - \lambda^d) Z_t^b B_{t-1}^b} \quad (28)$$

$$x_t = \mathbb{1}[(u_t^D \geq 1) \vee (u_t^D < 1 \wedge u_t^R \geq 1 \wedge \omega_t = 1)] \quad (29)$$

Borrowers,

$$C_t^b(N_t^b)^\varphi = w_t \quad (30)$$

$$B_t^b \leq \chi m \theta^{LTV} p_t^h + B_{t-1}^b \frac{1-\gamma}{\Pi_t} (1-m) \perp \lambda_t^b \geq 0 \quad (31)$$

$$\nu_t^* = \frac{B_{t-1}^b}{\chi \Pi_t p_t^h} \quad (32)$$

$$p_t^h = \frac{\xi(C_t^b)^\sigma + \mathbb{E}_t \left\{ \Lambda_{t+1}^b p_{t+1}^h [(1-m)(1-\theta^{LTV} \lambda_{t+1}^b) + m \Psi^b] \right\}}{1 - \lambda_t^b \theta^{LTV}} \quad (33)$$

$$Q_t^b - \lambda_t^b = \mathbb{E}_t \left\{ \frac{\Lambda_{t+1}^b}{\Pi_{t+1}} \left\{ (1-m) [(1-\gamma)(Q_{t+1}^b - \lambda_{t+1}^b) + \gamma] + m [1 - F^b(\nu_{t+1}^*)] \right\} \right\} \quad (34)$$

$$w_t N_t^b + \frac{Q_t^b B_t^b}{\chi} = C_t^b + \frac{B_{t-1}^b}{\chi \Pi_t} \left\{ m [1 - F^b(\nu_t^*)] + (1-m) [(1-\gamma) Q_t^b + \gamma] \right\} + m p_t^h [1 - \Psi^b(\nu_t^*)] \quad (35)$$

$$\Lambda_{t+1}^b = \beta \frac{C_t^b}{C_{t+1}^b} \quad (36)$$

Asset payoffs,

$$Z_t^b = (1-m) [Q_t^b (1-\gamma) + \gamma] + m \left[1 - F^b(\nu_t^*) + (1-\lambda_t^b) \frac{1 - \Psi^b(\nu_t^*)}{\nu_t^*} \right] \quad (37)$$

$$Z_t^d = 1 - x_t + \frac{x_t}{u_t^R} \quad (38)$$

Phillips curve, resource constraint, and production function

$$\eta \mathbb{E}_t \left\{ \Lambda_{t+1}^s \frac{Y_{t+1}}{Y_t} \frac{\Pi_{t+1}}{\Pi} \left(\frac{\Pi_{t+1}}{\Pi} - 1 \right) \right\} - \varepsilon \left(\frac{\varepsilon - 1}{\varepsilon} - \frac{w_t}{A_t} \right) = \eta \frac{\Pi_t}{\Pi} \left(\frac{\Pi_t}{\Pi} - 1 \right) \quad (39)$$

$$C_t + G_t + \lambda_t^b m \chi p_t^h [1 - \Psi^b(\nu_t^*)] + \lambda^d Z_t^b \frac{B_{t-1}^b}{\Pi_t} (1 - x_t) = Y_t \left[1 - \frac{\eta}{2} \left(\frac{\Pi_t}{\Pi} - 1 \right)^2 \right] \quad (40)$$

$$Y_t = A_t N_t \quad (41)$$

Monetary policy and GDP,

$$\frac{1}{Q_t} = \frac{1}{\bar{Q}} \left[\frac{\Pi_t}{\Pi} \right]^{\phi_\pi} \left(\frac{GDP_t}{G\bar{D}P} \right)^{\phi_Y} \quad (42)$$

$$GDP_t = C_t + G_t \quad (43)$$

Cumulative distribution functions and partial expectations for risk shocks,

$$F^b(\nu_t^*) = \left[\frac{\sigma^b \nu_t^*}{\sigma^b + 1} \right]^{\sigma^b} \quad (44)$$

$$\Psi^b(\nu_t^*) = 1 - \left[\frac{\sigma^b \nu_t^*}{\sigma^b + 1} \right]^{\sigma^b + 1} \quad (45)$$

A.2 Bank Optimality and Aggregation

To solve the bank's problem, we start by writing the bank's franchise/continuation value as

$$\begin{aligned} \Phi_{j,t}(e_{j,t}) &\equiv \mathbb{E}_t \left[(1 - x_{t+1}) \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} V_{j,t+1}(e_{j,t+1}) \right] \\ &= \mathbb{E}_t \left\{ (1 - x_{t+1}) \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} [(1 - \theta)e_{j,t+1} + \Phi_{j,t+1}(e_{j,t+1})] \right\} \end{aligned}$$

I assume throughout that the bank takes the possibility of a run as given. We now guess, to later verify, that the bank's franchise value is linear in current earnings,

$$\Phi_{j,t}(e_{j,t}) = \Phi_{j,t} \theta e_{j,t}$$

Under this assumption, we can reformulate the bank's problem as

$$\Phi_{j,t} \theta e_{j,t} = \max_{b_{j,t}, d_{j,t}} \mathbb{E}_t \left\{ (1 - x_{t+1}) \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} (1 - \theta + \theta \Phi_{j,t+1}) e_{j,t+1} \right\}$$

subject the law of motion for earnings, the balance sheet constraint, and the leverage constraint. Replacing for the first two, we can write the bank's Lagrangian as

$$\begin{aligned} \Phi_{j,t} \theta e_{j,t} &= \max_{b_{j,t}} \mathbb{E}_t \left\{ (1 - x_{t+1}) \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} (1 - \theta + \theta \Phi_{j,t+1}) \left[\left(\frac{Z_{t+1}^b}{Q_t^b} - \frac{1}{Q_t^d} \right) Q_t^b b_{j,t}^b + \frac{\theta e_{j,t}}{Q_t^d} \right] \right\} \\ &\quad + \mu_{j,t} [\Phi_{j,t} \theta e_{j,t} - \kappa_t Q_t^b b_{j,t}^b] \end{aligned}$$

The first-order condition with respect to $b_{j,t}$ is then

$$\mathbb{E}_t \left\{ (1 - x_{t+1}) \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} (1 - \theta + \theta \Phi_{j,t+1}) \left(\frac{Z_{t+1}^b}{Q_t^b} - \frac{1}{Q_t^d} \right) \right\} = \mu_{j,t} \kappa_t$$

Applying the envelope theorem and rewriting the Lagrangian then yields

$$\Phi_{j,t} = \frac{\mathbb{E}_t \left\{ \frac{\Lambda_{t,t+1}^s}{\Pi_{t+1}} (1 - \theta + \theta \Phi_{j,t+1}) (1 - x_{t+1}) \right\}}{Q_t^d (1 - \mu_{j,t})}$$

thus confirming our conjecture that the value was linear in earnings.

A.3 Standard Shocks (TFP and Monetary Policy)

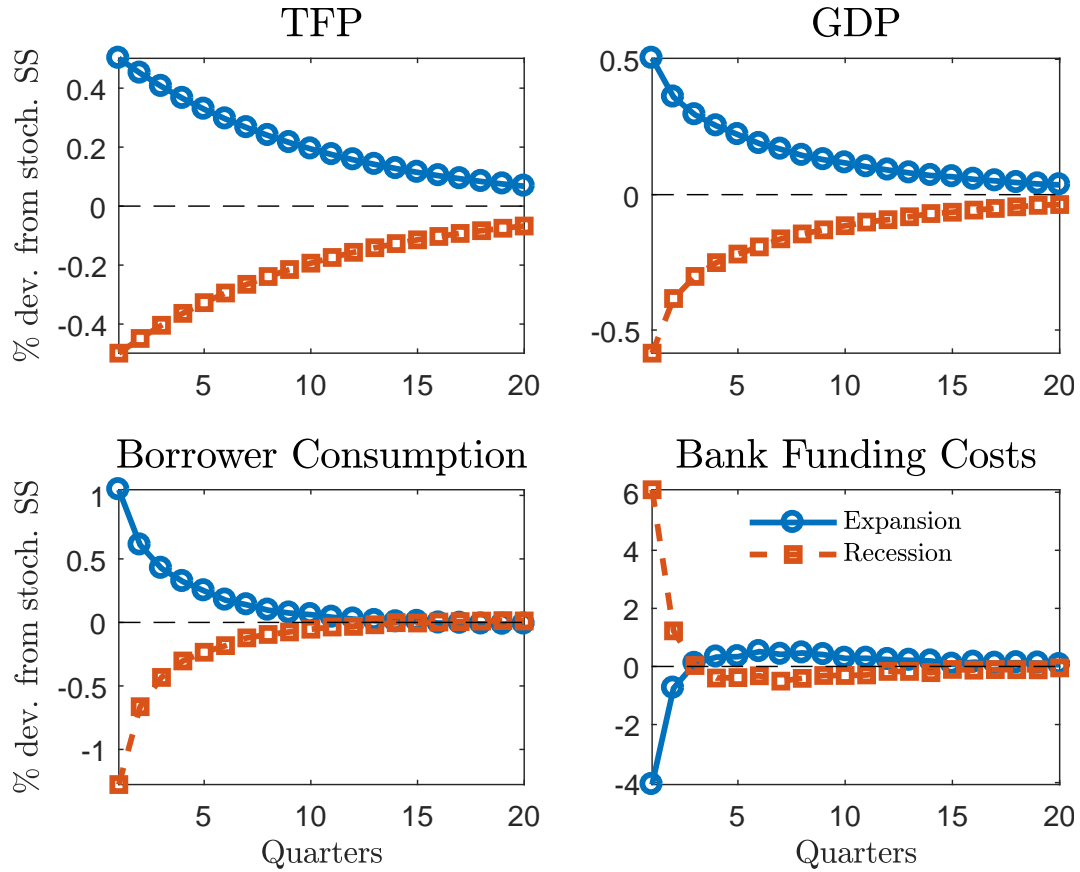


Figure 13: Response of selected variables to a one-standard deviation TFP shock.

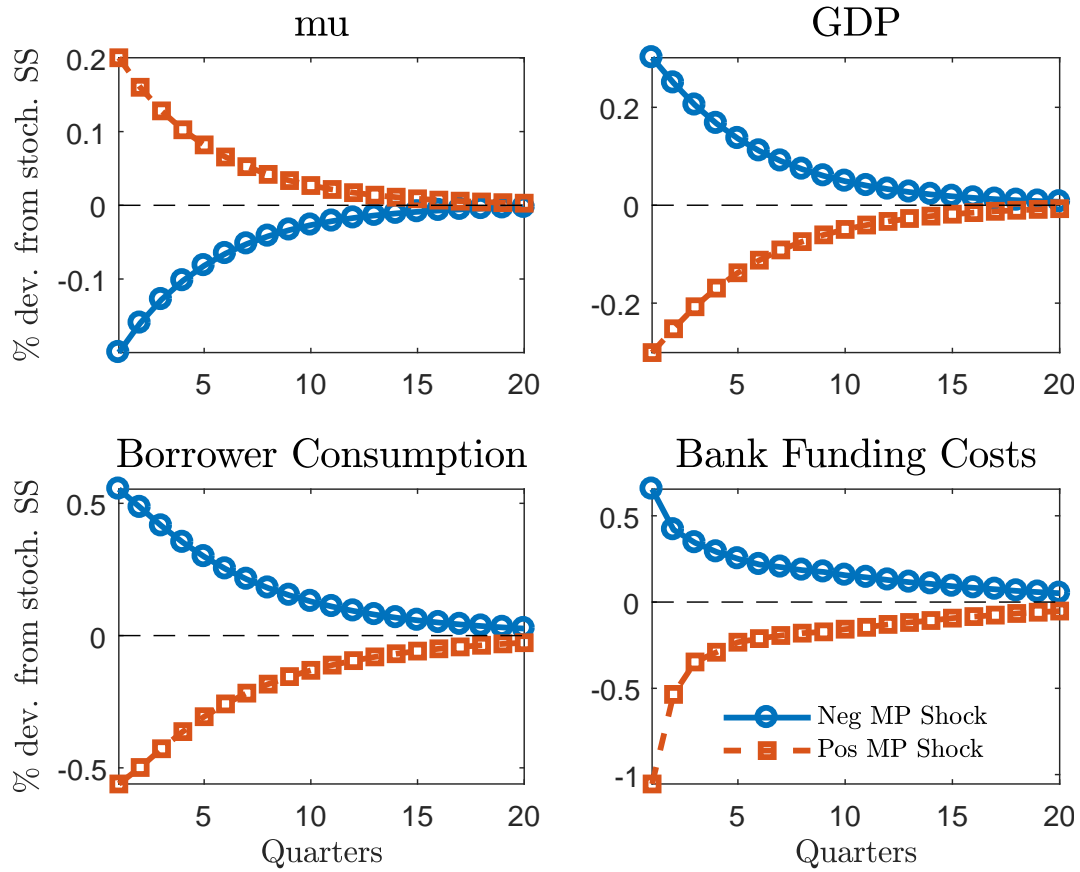


Figure 14: Response of selected variables to a one-standard deviation monetary policy shock.

B Computational Appendix

.

[TO BE COMPLETED]

C Estimation Appendix

[TO BE COMPLETED]

D Additional Figures

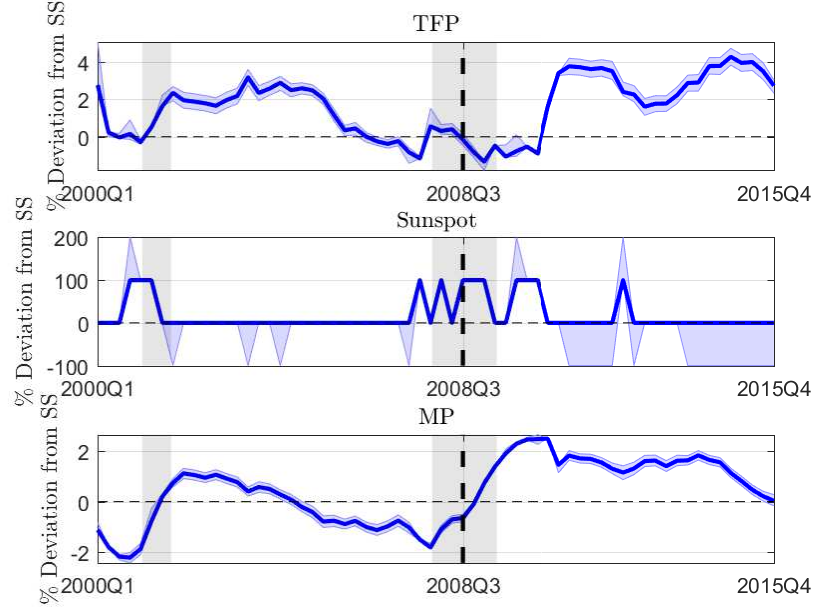


Figure 15: Estimated paths for structural shocks.

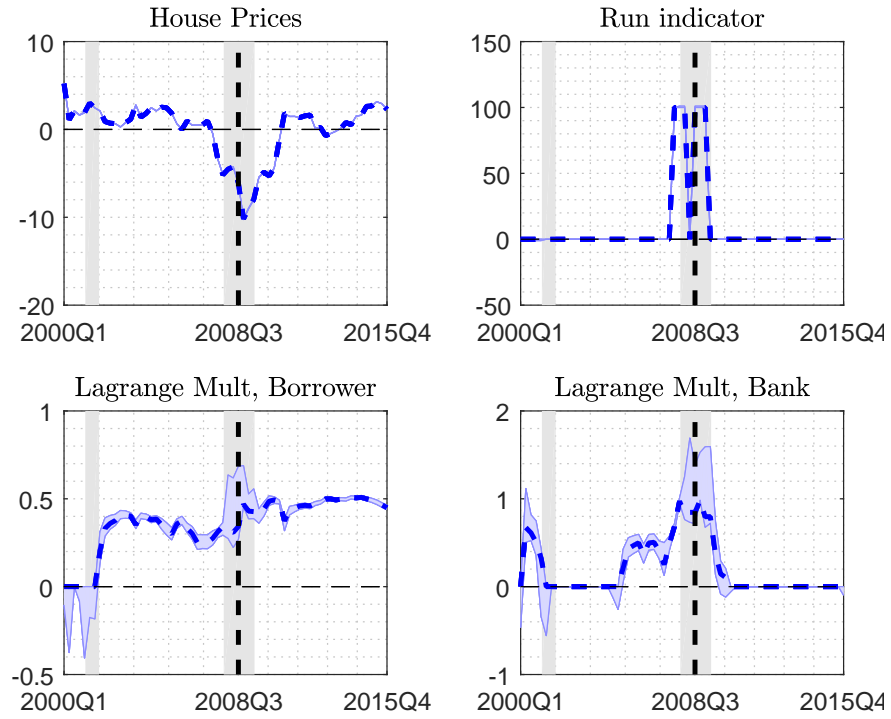


Figure 16: Estimated paths for other endogenous variables.