Optimal Macro-Financial Stabilization in a New Keynesian Preferred Habitat Model

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Motivation

Motivation

Bernanke: “QE works in practice but not in theory”

- By now the gap between practice and theory is small
- But what do we mean by *QE works*?
  - Obvious: reduce long-term yields
  - Less obvious: stimulate the economy
  - Even less obvious: improve social welfare
  - Reis: “QE’s original sin”
- Especially relevant today now that central banks are implementing QT while increasing short rates
- Question: what is the optimal QE policy, and how does this interact with short rate policy?

Our Model

- This paper: develops a tractable general equilibrium model with market segmentation, nominal frictions, and household heterogeneity
- Arbitrageurs with imperfect risk-bearing capacity absorb supply and demand shocks in bond markets
- Clientele investors introduce a degree of market segmentation
  - Bonds of different maturities traded by specialized investors (pension funds, MMMF)
  - Arbitrageurs (hedge funds, broker-dealers) partly overcome segmentation
- Households have differentiated access to bond markets
  - Introduces imperfect risk-sharing, consumption and labor dispersion across households
- Formally: embed a Vayanos-Vila model in a New Keynesian model, where households are heterogeneous in access to financial markets

Findings: Policy Transmission

- Key mechanisms of conventional monetary policy:
  - Changes in the short rate affect required rates of return of all assets
  - Interaction of arbitrageurs and investor clienteles leads to portfolio rebalancing
  - Implies variation in risk premia, imperfect transmission to households
- Key mechanisms of balance sheet policy:
  - Imperfect arbitrage breaks QE neutrality
  - Central bank asset purchases induce portfolio rebalancing and hence reduce risk premia
  - Vice versa for central bank asset sales (QT)
- Thus, short rate and balance sheet policies are substitutes when targeting aggregate borrowing rates
  - A fall in aggregate borrowing rates is stimulative for the usual NK reasons

Findings: Welfare Consequences

- If the policymaker only cares about macroeconomic stabilization, conventional and unconventional policies are essentially equivalent
  - Nominal rigidities $\implies$ welfare losses due to inflation volatility
  - Policy stabilizes inflation by keeping aggregate borrowing rates at some "natural" rate
  - Even with short rate constraints, QE is equally effective
- However, both policies imply variation in risk premia
  - Excess fluctuations in risk premia lead to dispersion in borrowing rates
- Social welfare depends not only on macroeconomic fluctuations:
  - Imperfect risk sharing $\implies$ welfare losses from consumption dispersion
  - Labor market inefficiencies $\implies$ welfare losses from labor dispersion

Findings: Optimal Policy

- Hence, when policy is unconstrained we derive an **optimal separation result**:
  - Conventional policy targets macroeconomic stability
  - Unconventional policy targets financial stability
- However, when policy constraints bind, policy must balance trade-offs:
  - Balance sheet constraints: short rate must be less reactive in order to minimize financial disruptions (at the cost of macroeconomic stability)
  - Short rate constraints: QE must be used to offset macroeconomic shocks (at the cost of financial stability)
- With full commitment, forward guidance is welfare-improving (short rate and QE)
  - Policymaker uses the entire expected path of borrowing rates to minimize macroeconomic volatility
  - But reduces short-run fluctuations to keep risk premia volatility low
  - However, dynamics are complicated and suffer from time-inconsistency
- General message: implementation matters for welfare

Related Literature

- Preferred habitat models
  - Vayanos & Vila (2009, 2021), Ray, Droste, & Gorodnichenko (2023), Greenwood & Vayanos (2014), Greenwood et al (2016), King (2019, 2021) , Kekre, Lenel, & Mainardi (2024), ...
- Empirical evidence: QE and preferred habitat
  - Krishnamurthy & Vissing-Jorgensen (2012), D'Amico & King (2013), Li & Wei (2013), Cahill et al. (2013), King (2019), Fieldhouse et al (2018), Di Maggio et al (2020), Gali, Debortoli, & Gambetti (2020) , ...
- Macroeconomic QE models
  - Andres, Lopez-Salido, & Nelson (2004), Gertler & Karadi (2011), Curdia & Woodford (2011), Chen et al (2012), Gertler & Karadi (2013), Sims & Wu (2020), Karadi & Nakov (2020), Iovino and Sergeyev (2023), Carlstrom et al (2017), Ippolito et al (2018) , ...
- Market segmentation, macro-prudential monetary policy
  - Cui & Sterk (2021), Auclert (2016), Collard et al (2017), Kaplan et al (2017), Debortoli & Gali (2017) , ...
- International
  - Itskhoki & Mukhin (2022), Greenwood et al (2023), Gourinchas, Ray, & Vayanos (2022) , ...

Set-Up

Model Set-Up

- Continuous time New Keynesian model with embedded Vayanos-Vila bond markets
- **Agents**:
  - Firms: monopolistic competitors produce using labor, face nominal pricing frictions
  - Households: supply differentiated labor, consume, save via habitat bond funds
  - Arbitrageurs: imperfect risk-bearing capacity, conduct bond carry trades
  - Habitat funds: buys and sell bonds of a specific maturity
- **Policymakers**:
  - Central bank: conducts short rate and balance sheet (QE) policy
  - Government: optimal production subsidy, otherwise passive
- **Bond markets**:
  - Continuum of zero coupon bonds with maturity $0 \leq \tau \leq T \leq \infty$
  - Bond price $P_t^{(\tau)}$ with yield to maturity $y_t^{(\tau)} = -\log P_t^{(\tau)}/\tau$
  - Nominal short rate: in equilibrium, $i_t = \lim_{\tau \to 0} y_t^{(\tau)}$

Firms

- Continuum of intermediate goods $j \in [0,1]$ (and CES final good with elasticity ϵ)
- Linear production in differentiated labor $Y_t(j) = Z_t L_t(j)$:

$$\mathrm{d}z_t = -\kappa_z z_t \,\mathrm{d}t + \sigma_z \,\mathrm{d}B_{t,z}\,, \quad L_t(j) = \left[\int_{h\in\mathcal{H}} L_t(j,h)^{\frac{\epsilon_W - 1}{\epsilon_W}} \,\mathrm{d}h\right]^{\frac{\epsilon_W}{\epsilon_W - 1}}$$

- Face Rotemberg costs $\Theta(\pi_t(j)) = \frac{\theta}{2}\pi_t(j)^2 P_t Y_t$ when setting prices $\frac{\mathrm{d}P_t(j)}{P_t(j)} = \pi_t(j)\,\mathrm{d}t$
- Firms choose $\pi_t(j)$ in order to solve

$$U_0 \equiv \max \mathbb{E}_0 \int_0^\infty e^{-\rho t} Q_t^{\mathcal{H}} \frac{\mathcal{F}_t}{P_t} \,\mathrm{d}t$$

  - Take as given CES demand, wage index, price index
  - Profits are discounted by HH sector real SDF $Q_t^{\mathcal{H}}$

Key takeaway: inefficiencies due to pricing frictions, differentiated labor

Households

- Continuum of HH members $h \in \mathcal{H}$, differentiated by access to bond markets τ
- Mass $\eta(\tau)$ of each $h = (i, \tau)$ HH where $\int_0^T \eta(\tau)\,\mathrm{d}\tau = 1$ (otherwise identical)
- A τ-type HH chooses consumption and labor $C_t(\tau), N_t(\tau)$ in order to solve

$$V_0(\tau) \equiv \max \mathbb{E}_0 \int_0^\infty e^{-\rho t} \left(\frac{C_t(\tau)^{1-\varsigma} - 1}{1-\varsigma} - \frac{N_t(\tau)^{1+\varphi}}{1+\varphi} \right) \mathrm{d}t$$

$$\text{s.t.} \;\; \mathrm{d}A_t(\tau) = [(1+\tau^W)\mathcal{W}_t(\tau)N_t(\tau) - P_t C_t(\tau)]\,\mathrm{d}t + A_t(\tau)\frac{\mathrm{d}P_t^{(\tau)}}{P_t^{(\tau)}} + \mathrm{d}F_t^{(\tau)}$$

- $A_t(\tau)$ is nominal wealth earning $\frac{\mathrm{d}P_t^{(\tau)}}{P_t^{(\tau)}}$ and $\mathrm{d}F_t\,(\tau)$ are (flow) nominal transfers
- $\mathcal{W}_t(\tau)$ is the nominal (differentiated) wage and

Key takeaway: consumption/labor choices differ when bond returns not equalized

Arbitrageurs

- Mean-variance optimization

$$\max \mathbb{E}_t \, \mathrm{d}\omega_t - \frac{a}{2} \mathbb{V}\mathrm{ar}_t \, \mathrm{d}\omega_t$$

$$\text{s.t. } \mathrm{d}\omega_t = \omega_t i_t \, \mathrm{d}t + \int_0^T X_t^{(\tau)} \left(\frac{\mathrm{d}P_t^{(\tau)}}{P_t^{(\tau)}} - i_t \, \mathrm{d}t \right) \mathrm{d}\tau$$

- Arbitrageurs invest $X_t^{(\tau)}$ in bond carry trade of maturity τ
- Remainder of wealth ω_t invested at the short rate
- Risk-return trade-off governed by a
    - Formally: risk aversion coefficient, but proxies for any limits to risk-bearing capacity
    - Arbitrageurs transfer gains/losses to HHs, so a represents any frictions which hinder ability to trade on behalf of HHs

Key takeaway: risk averse arbitrageurs' holdings increase with expected return

Preferred Habitat Funds

- Habitat bond demand for maturity τ:

$$Z_t^{(\tau)} = -\alpha(\tau) \log P_t^{(\tau)} - \theta(\tau)\beta_t^{(\tau)}$$

- $\alpha(\tau)$: demand elasticity for τ fund
- $\beta_t^{(\tau)}$: additional time-varying ("noise") demand factor
    - Noise demand $\beta_t^{(\tau)}$ follows a factor structure across habitat funds, eg

$$\mathrm{d}\beta_t = -\kappa_\beta \left(\beta_t - \bar{\beta}\right) \mathrm{d}t + \sigma_\beta \, \mathrm{d}B_{\beta,t}$$

    - $\theta(\tau)$: mapping from demand factor β_t to τ-habitat demand

Key takeaway: price movements require portfolio rebalancing

Government

- Central bank chooses policy rate i_t and bond holdings $S_t^{(\tau)}$
- Potentially subject to costs:

$$Y_t \Psi_t^S \equiv Y_t \int_0^T \frac{\psi^{(\tau)}}{2} \left(S_t^{(\tau)}\right)^2 \mathrm{d}\tau \,, \quad Y_t \Psi_t^i \equiv Y_t \frac{\psi^i}{2} \left(i_t - \bar{i}_t\right)^2$$

- In the background: fiscal authority chooses production/labor subsidies τ^y, τ^w, balances the budget period by period
- Optimal policy: maximize social welfare

$$\max \mathbb{E}_0 \int_0^\infty e^{-\rho t} \left(\int_0^T \eta(\tau) u\left(C_t(\tau), N_t(\tau)\right) \mathrm{d}\tau \right) \mathrm{d}t$$

Key takeaway: policy attempts to undo frictions:

1. Nominal pricing frictions $\Longrightarrow$ deadweight loss
2. Differentiated labor $\Longrightarrow$ production inefficiencies
3. Market segmentation $\Longrightarrow$ consumption dispersion, imperfect risk-sharing

Equilibrium

Aggregation

- Firms, arbitrageurs, and funds transfer profits equally to HHs
- Symmetric firm equilibrium $Y_t(j) = Y_t, P_t(j) = P_t, \pi_t(j) = \pi_t, \frac{\mathrm{d}P_t}{P_t} = \pi_t \,\mathrm{d}t$
- Clearing in production and goods markets:

$$Y_t = Z_t L_t \equiv Z_t \left[\int_0^T \eta(\tau) N_t(\tau)^{\frac{\epsilon_W - 1}{\epsilon_W}} \,\mathrm{d}\tau \right]^{\frac{\epsilon_W}{\epsilon_W - 1}}$$

$$C_t \equiv \int_0^T \eta(\tau) C_t(\tau) \,\mathrm{d}\tau = Y_t \left(1 - \frac{\theta}{2} \pi_t^2 - \Psi_t^S - \Psi_t^i \right)$$

- Bond market clearing implies

$$X_t^{(\tau)} + Z_t^{(\tau)} + \eta(\tau) A_t(\tau) + S_t^{(\tau)} = 0$$

Optimality Conditions

- Equilibrium bond price dynamics:

$$\frac{\mathrm{d}P_t^{(\tau)}}{P_t^{(\tau)}} \equiv \mu_t^{(\tau)}\,\mathrm{d}t + \boldsymbol{\sigma}_t^{(\tau)}\,\mathrm{d}\mathbf{B}_t$$

  - $\mathbf{B}_t$ collects innovations to risk factors (technology, noise demand, ...)
- Arbitrageur optimality conditions:

$$\mu_t^{(\tau)} - i_t = \boldsymbol{\sigma}_t^{(\tau)}\boldsymbol{\Lambda}_t, \quad \boldsymbol{\Lambda}_t^\top = a\int_0^T X_t^{(\tau)}\boldsymbol{\sigma}_t^{(\tau)}\,\mathrm{d}\tau$$

  - Term premia depend on risk aversion a and equilibrium holdings $X_t^{(\tau)}$
- HH optimality conditions (log-linearized) :

$$w_t = \varsigma c_t(\tau) + \phi n_t(\tau) + \frac{1}{\epsilon_w}\left(n_t(\tau) - \ell_t\right), \quad \mathbb{E}_t\,\mathrm{d}c_t(\tau) = \varsigma^{-1}\left(\mu_t^{(\tau)} - \pi_t - \rho\right)\mathrm{d}t$$

- Firm optimality conditions (log-linearized):

$$\mathbb{E}_t\,\mathrm{d}\pi_t = \left(\rho\pi_t - \delta_w w_t\right)\mathrm{d}t$$

Simplifying Assumptions

- Tractability assumption: a "head of HH" sets transfers such that in equilibrium, wealth is equalized: across τ HH groups, $A_t(\tau) \equiv A_t$
    - Pros: clear focus on the role market segmentation plays on consumption dispersion
    - Cons: ignores the impact of market segmentation on wealth inequality
- Approximation: around a limiting case: risk $\boldsymbol{\sigma}_t^{(\tau)} \to \mathbf{0}$ but arbitrageur risk aversion $a \to \infty$ such that $a^{1/2} \cdot \boldsymbol{\sigma}_t^{(\tau)} \equiv \tilde{\boldsymbol{\sigma}}_t^{(\tau)}$ remains non-zero and bounded
    - Pros: clear focus on the idea of "imperfect arbitrage"
    - Cons: less realistic risk premia (particularly in first-best)
- Allows us to derive simple first-order approximations of dynamics and second-order approximations for welfare and focus on analytical results

Aggregate Dynamics

- The first-best (natural) allocation obtained when $\theta = 0$ and $a = 0$. Output gap:

$$X_t \equiv \frac{Y_t}{Y_t^n}$$

- Output gap evolves according to modified aggregate Euler equation:

$$\mathrm{d}x_t = \varsigma^{-1} \left(\tilde{\mu}_t - \pi_t - r_t^n \right) \mathrm{d}t$$

- $r_t^n \equiv -\kappa_z z_t$ is the usual natural rate and $\tilde{\mu}_t$ is the effective borrowing rate:

$$\tilde{\mu}_t = \int_0^T \eta(\tau) \mu_t^{(\tau)} \, \mathrm{d}\tau$$

- We recover a standard NKPC:

$$\mathrm{d}\pi_t = \left(\rho \pi_t - \delta x_t \right) \mathrm{d}t$$

- $\implies$ to a first-order, our model is essentially the same as Ray, Droste, & Gorodnichenko (2023)

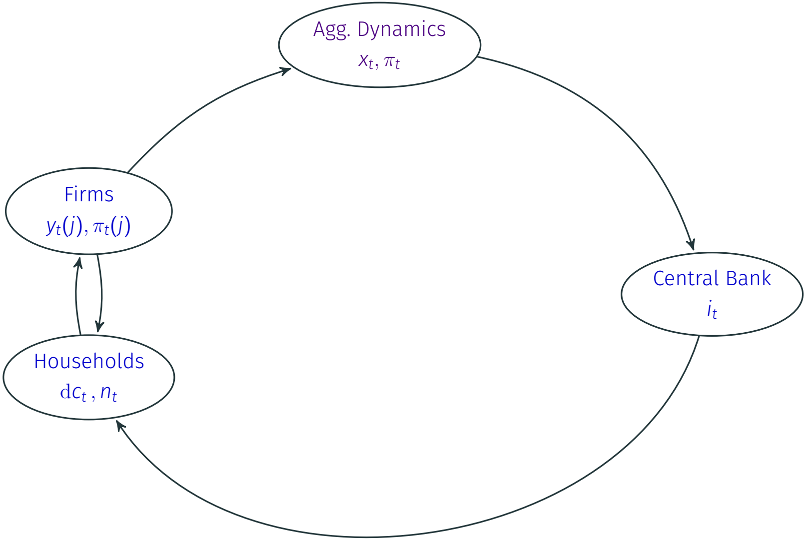
Social Welfare

- Social welfare loss (second-order expansion relative to first-best):

$$
\begin{aligned}
\mathcal{L}_t \equiv (\varsigma + \varphi)x_t^2 + \theta\pi_t^2 \\
&+ \frac{\varsigma}{\varphi}\left(\varphi + \varsigma\left[\frac{\varphi\epsilon_w}{1+\varphi\epsilon_w}\right]^2\right)\mathbb{V}\mathrm{ar}_\tau\, c_t^{(\tau)} + \epsilon_w\,\mathbb{V}\mathrm{ar}_\tau\, w_t^{(\tau)} \\
&+ \int_0^T \psi^{(\tau)}\left(s_t^{(\tau)}\right)^2 \mathrm{d}\tau + \psi^i\left(i_t - \bar{i}_t\right)^2
\end{aligned}
$$

- First line: losses from nominal rigidities (same as in textbook RANK)
- Next line: losses also depends on consumption and wage dispersion *across* HHs
- Final line: losses from policy frictions (when $\psi^i > 0, \psi^{(\tau)} > 0$)

Equilibrium and Welfare Illustration: Standard Model



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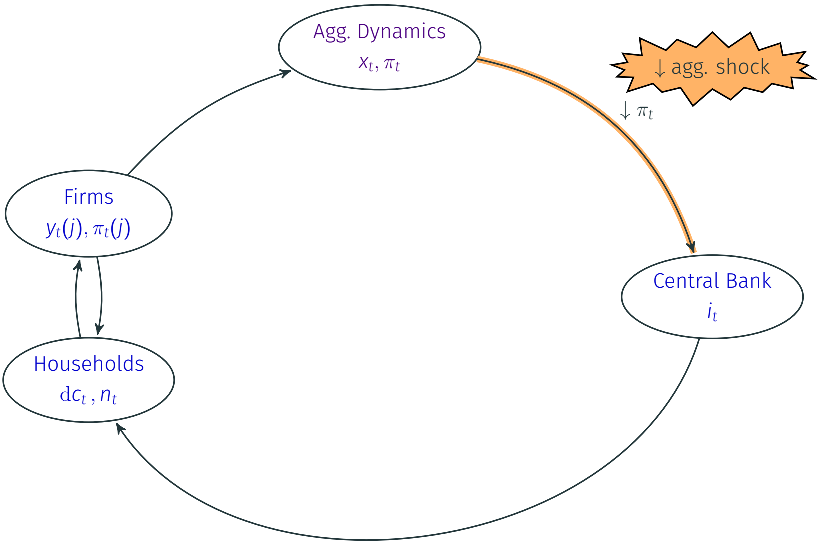

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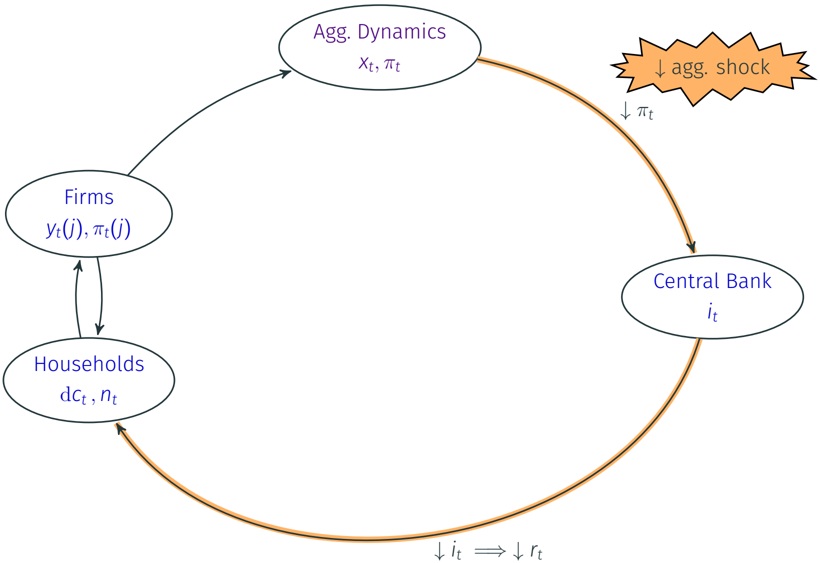

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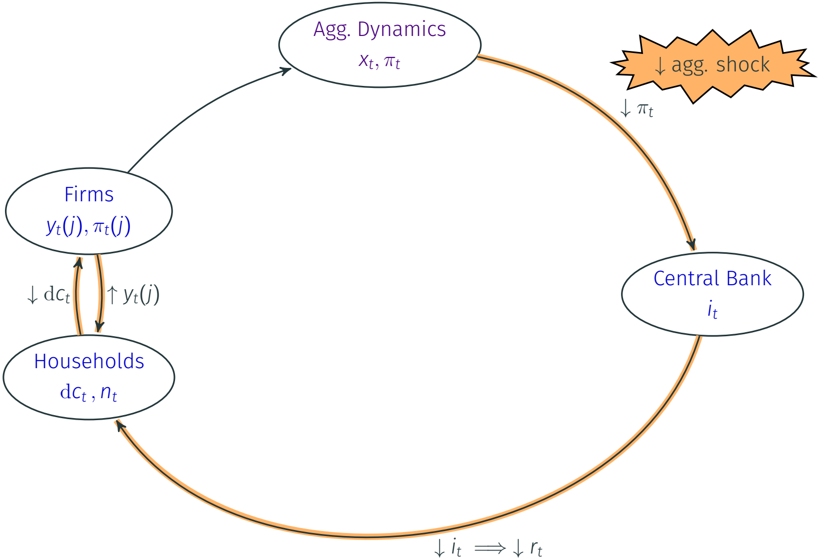

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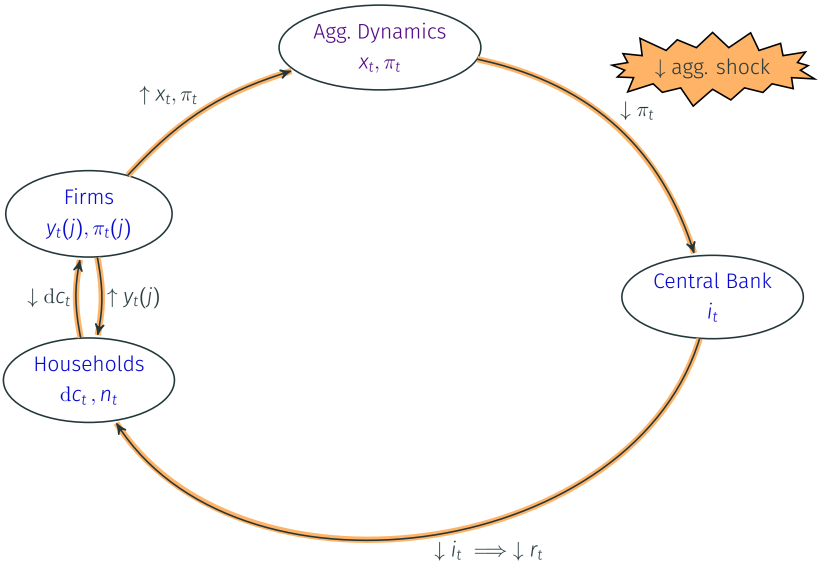

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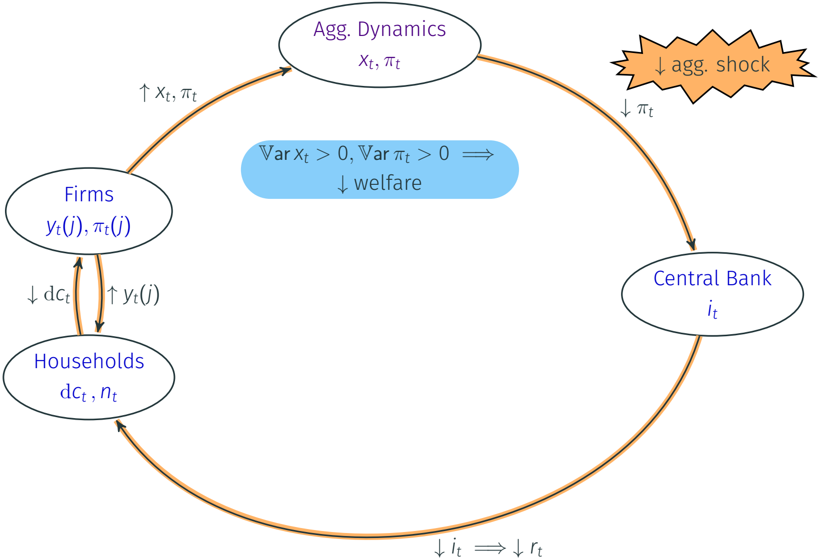
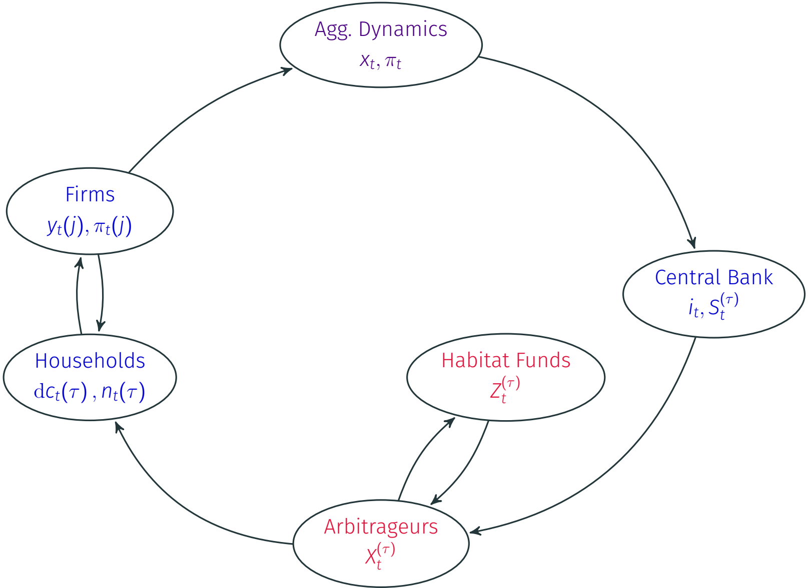


Equilibrium and Welfare Illustration: Imperfect Arbitrage



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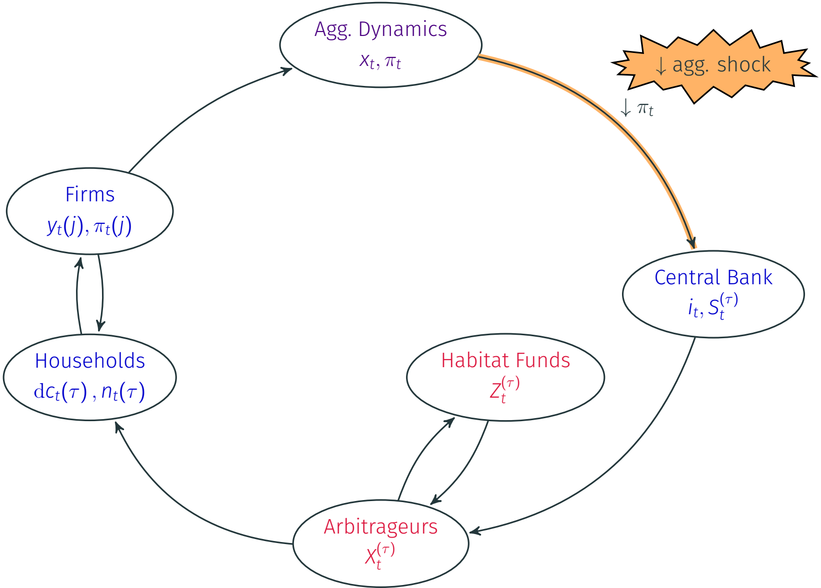

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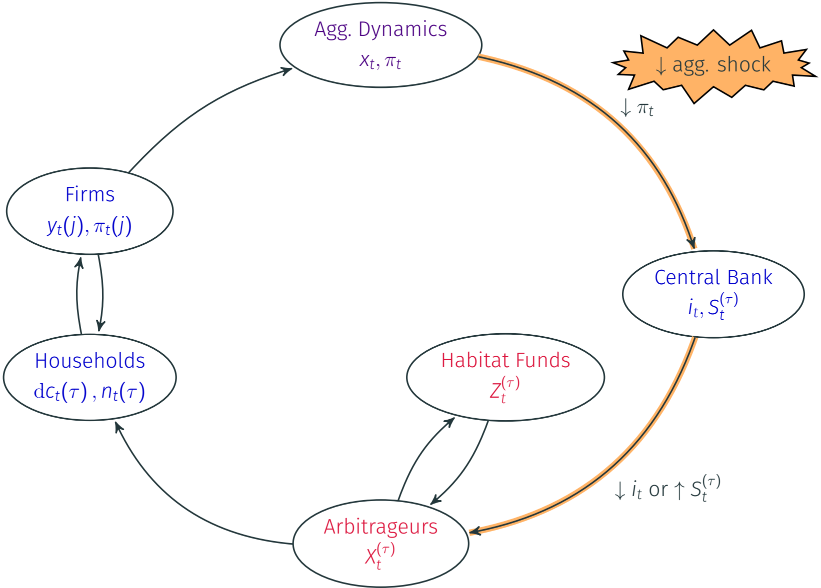

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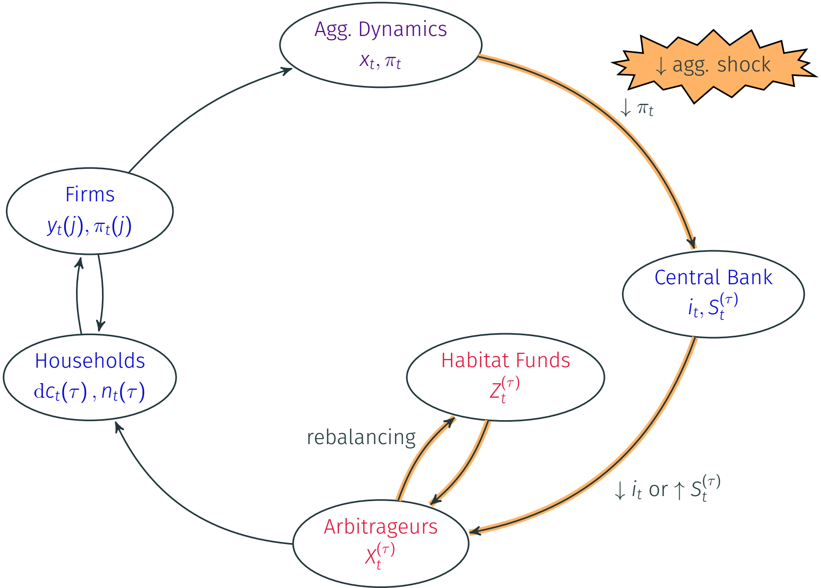

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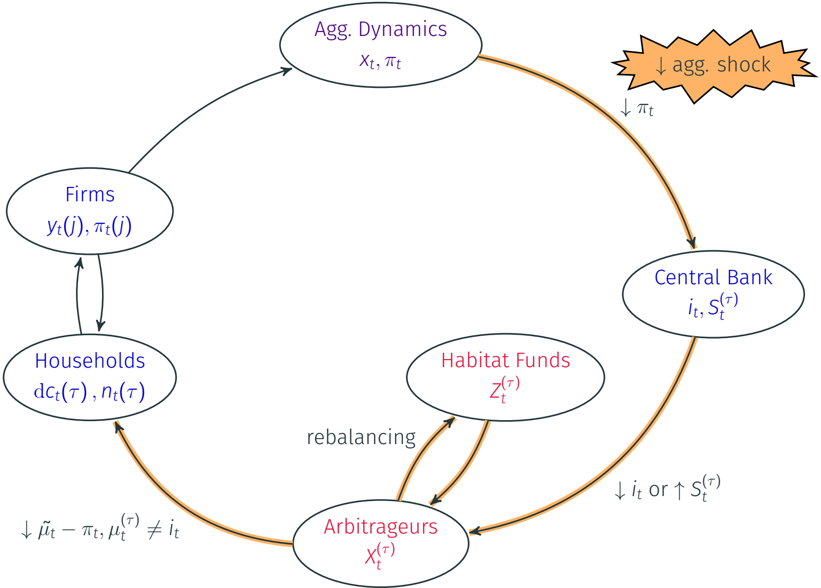

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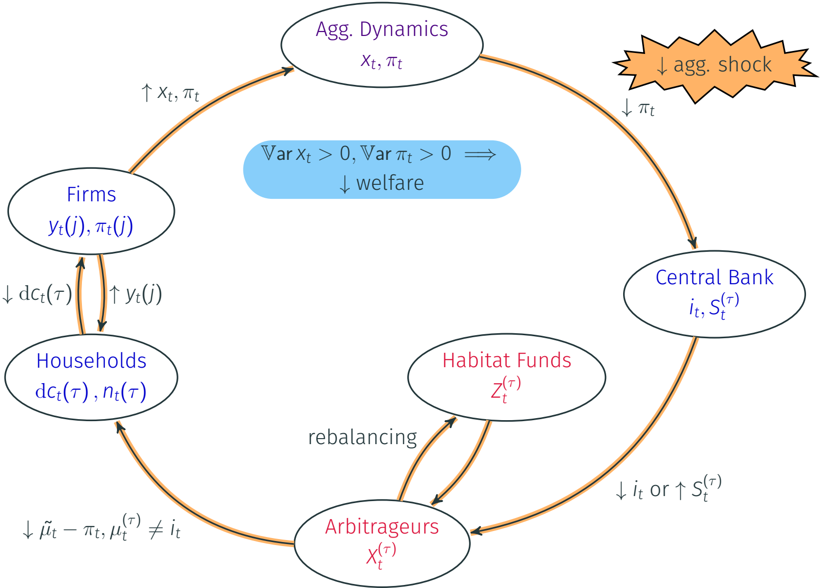

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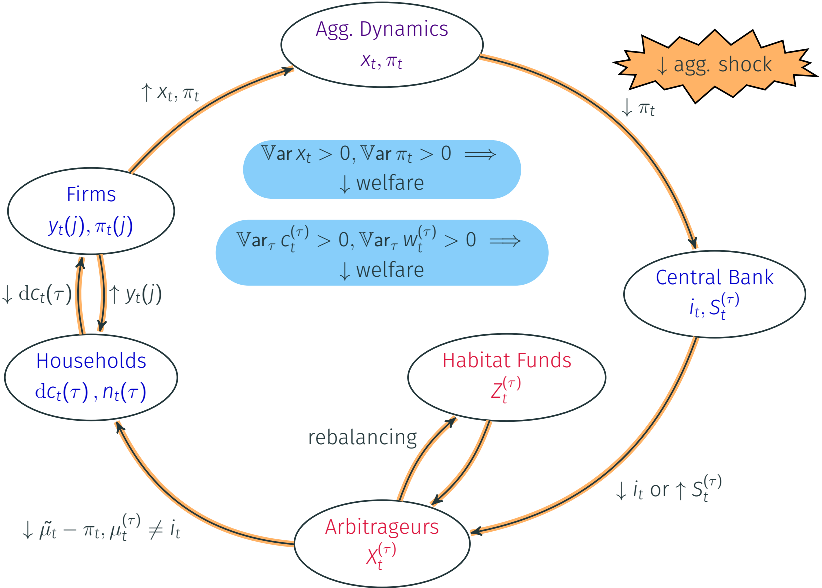


Aggregate and Welfare Consequences: Simple Policy Rules

- In order to better understand the model, simplify to a version of the model which only includes natural rate shocks r_t^n

$$\mathrm{d}r_t^n = -\kappa_z r_t^n \, \mathrm{d}t + \sigma_r \, \mathrm{d}B_{z,t}$$

- Consider policy rules which implement

$$i_t = \chi_i r_t^n$$
$$S_t^{(\tau)} = \chi_S^{(\tau)} r_t^n$$

- Simple policy rules: function of natural state variables only
  - Time-consistent: policymaker seeks to minimize unconditional social welfare loss
- We will examine the outcome of these policies in different versions of the model

Risk Neutral Arbitrageur

Benchmark: Risk Neutral Arbitrageur (“Standard Model”)

- Consider the benchmark case of a risk neutral arbitrageur: $a = 0$
- The expectations hypothesis holds: $\mu_t^{(\tau)} = i_t \implies$ model collapses to RANK

$$\mathbb{V}\text{ar}_\tau\, c_t^{(\tau)} = 0, \quad \mathbb{V}\text{ar}_\tau\, w_t^{(\tau)} = 0$$

- Recover the standard QE neutrality result: balance sheet policies do not affect bond prices (and therefore have no aggregate effects)
- Divine coincidence holds: conventional policy can achieve first-best

$$\chi_i = 1 \implies \mu_t^{(\tau)} = r_t^n \implies x_t = \pi_t = 0$$

- ‘Woodford-ian’ equivalence: the role of policy on aggregate dynamics and welfare is fully summarized by policy rate i_t

Imperfect Arbitrage

Imperfect Arbitrage

- Now assume $a > 0$ and the central bank continues to implement $i_t = r_t^n$

Proposition (Imperfect Arbitrage and Ad-hoc Policy)

Assume risk aversion $a > 0$ and price elasticities $\alpha(\tau) > 0$

Bond markets: bond carry trade return $\mu_t^{(\tau)} - i_t$

- Decreases with the short rate i_t
- Decreases with QE shocks $S_t^{(QE)}$

Aggregate dynamics: output gaps x_t and inflation π_t

- Not identically zero: $\mathbb{V}\text{ar}\, x_t \neq 0$ and inflation $\mathbb{V}\text{ar}\, \pi_t \neq 0$;
- QE increases the output gap and inflation

Dispersion: consumption and wage dispersion $\mathbb{V}\text{ar}_\tau\, c_t^{(\tau)} \neq 0, \mathbb{V}\text{ar}_\tau\, w_t^{(\tau)} \neq 0$

Imperfect Arbitrage Intuition: Policy Pass-Through

- Consider a fall in the natural rate inducing a cut in the policy rate:
  - When $\downarrow i_t$, bond arbitrageurs want to invest more in the BCT
  - $\implies$ bond prices increase $\uparrow P_t^{(\tau)}$
  - As $\uparrow P_t^{(\tau)}$, price-elastic habitat bond investors $(\alpha(\tau) > 0)$ reduce their holdings: $\downarrow Z_t^{(\tau)}$
  - Bond arbitrageurs increase their holdings $\uparrow X_t^{(\tau)}$, which requires a larger BCT return

- Now consider a QE shock
  - QE purchases: $\uparrow S_t^{(\tau)}$
  - Bond arbitrageurs reduce holdings $\downarrow X_t^{(\tau)}$, reducing risk exposure and pushing down yields

Imperfect Arbitrage Intuition: Aggregate Effects

- Therefore, a shock to the natural rate does not fully pass through to the effective borrowing rate $\tilde{\mu}_t \neq i_t$
  - Thus aggregate borrowing demand changes, and hence $x_t \neq 0$
  - Through the NKPC, $\pi_t \neq 0$
- On the other hand, a QE shock stimulates the economy
  - QE reduces borrowing rates $\downarrow \tilde{\mu}_t$ and therefore stimulates aggregate consumption $\uparrow x_t$
  - Through the NKPC, inflation $\uparrow \pi_t$
- Additionally, in general $\mu_t^{(\tau)} \neq \mu_t^{(\tau')}$
  - Hence individual Euler equations differ
  - $\implies c_t^{(\tau)} \neq c_t^{(\tau')}, n_t^{(\tau)} \neq n_t^{(\tau')}$ and therefore $\mathbb{V}\mathbf{ar}_\tau\, c_t^{(\tau)} \neq 0, \mathbb{V}\mathbf{ar}_\tau\, w_t^{(\tau)} \neq 0$

Optimal Policy

Imperfect Arbitrage and Macroeconomic Stabilization

- Can conventional policy alone close the output gap?
- Yes but the short rate must react more than one-for-one with the natural rate:

$$\exists\, \chi_i^n > 1 : \; i_t = \chi_i^n r_t^n \implies \tilde{\mu}_t = r_t^n$$

- However, this does not achieve first-best since $\mathbb{V}\mathrm{ar}_\tau\, c_t^{(\tau)} \neq 0, \mathbb{V}\mathrm{ar}_\tau\, w_t^{(\tau)} \neq 0$
- In fact, relative to the policy $i_t = r_t^n$, in general we have $\uparrow \mathbb{V}\mathrm{ar}_\tau\, c_t^{(\tau)}, \uparrow \mathbb{V}\mathrm{ar}_\tau\, w_t^{(\tau)}$
  - Short rate is more volatile, hence $\uparrow$ term premia volatility
  - This implies higher dispersion across borrowing rates $\mu_t^{(\tau)}$ and therefore an increase in consumption/labor dispersion
- Optimal short rate policy: if $\psi^{(\tau)} \to \infty$, then optimal policy implements

$$i_t = \chi_i^* r_t^n, \quad \chi_i^* < \chi_i^n \implies \frac{\partial \tilde{\mu}_t}{\partial r_t^n} < 1$$

- With access to frictionless balance sheet policies, we obtain the following

Proposition (Optimal Policy Separation Principle)

Assume risk aversion $a > 0$ and price elasticities $\alpha(\tau) > 0$, and policy costs $\psi^i = \psi^{(\tau)} = 0$. Suppose the central bank implements short rate and balance sheet policy according to

$$i_t = r_t^n$$

$$S_t^{(\tau)} = \alpha(\tau) \log P_t^{(\tau)}$$

Then first-best is achieved:

- Macroeconomic stabilization: $x_t = \pi_t = 0 \ \forall t$
- Financial stabilization: $\mu_t^{(\tau)} = \tilde{\mu}_t \ \forall \tau$
- Consumption and wage equalization: $\mathbb{V}\mathrm{ar}_\tau \, c_t^{(\tau)} = 0, \mathbb{V}\mathrm{ar}_\tau \, w_t^{(\tau)} = 0 \ \forall t$

Optimal Policy Separation Principle: Intuition

- The results follow naturally from our findings regarding ad-hoc policy
- QE policy stabilizes shocks to bond markets by offsetting all habitat portfolio rebalancing shocks:

$$S_t^{(\tau)} = -Z_t^{(\tau)} \implies \boldsymbol{\sigma}_t^{(\tau)} \boldsymbol{\Lambda}_t = 0$$

- This equalizes borrowing rates across HHs: $\mu_t^{(\tau)} = \tilde{\mu}_t$
- Hence the model collapses to a standard RANK model, in which case divine coincidence implies $i_t = r_t^n$ is optimal

Separation principle for optimal policy:

- Optimal balance sheet policy stabilizes financial markets
- Optimal short rate policy stabilizes macroeconomic aggregates

Financial Stabilization Policy with Short Rate Constraints

- Suppose that short rate policy is constrained, and implements

$$i_t = \tilde{\chi}_i r_t^n, \quad 0 < \tilde{\chi}_i < 1$$

  - Formally: assume costs $\psi^i \left(i_t - \tilde{\chi}_i r_t^n\right)$ and take $\psi^i \to \infty$
- If the central bank continues to implement the balance sheet policy derived above, then borrowing rates are still equalized $\mu_t^{(\tau)} = \tilde{\mu}_t$
- However, $\tilde{\mu}_t \neq r_t^n$ and hence this policy does not achieve macroeconomic stabilization

$$x_t \neq 0, \pi_t \neq 0$$

Macroeconomic Stabilization with Short Rate Constraints

- Can balance sheet policy alone close the output gap?
- Yes but must sacrifice equalizing borrowing rates:

$$\mu_t^{(\tau)} = i_t + \sigma_t^{(\tau)} \lambda_t$$

$$\lambda_t \equiv a \int_0^T \left[\alpha(\tau) \log P_t^{(\tau)} - S_t^{(\tau)} \right] \sigma_t^{(\tau)} \, \mathrm{d}\tau$$

- Hence, can always choose $\left\{ S_t^{(\tau)} \right\}$ such that

$$\lambda_t^* = \frac{r_t^n - i_t}{\int_0^T \eta(\tau) \sigma_t^{(\tau)} \, \mathrm{d}\tau} \implies \tilde{\mu}_t = r_t^n$$

- However, because $\sigma_t^{(\tau)} \neq \sigma_t^{(\tau')}$ this necessitates

$$\mu_t^{(\tau)} = i_t + \sigma_t^{(\tau)} \left(\frac{r_t^n - i_t}{\int_0^T \eta(\tau') \sigma_t^{(\tau')} \, \mathrm{d}\tau'} \right) \neq r_t^n \qquad (\text{unless } i_t = r_t^n)$$

Stabilization with Short Rate Constraints: Intuition

- Balance sheet policy works by affecting term premia through changes in the market price of risk
- Although arbitrage is imperfect in this model, arbitrageurs still enforce tight restrictions between between market price of risk and term premia across maturities
- Hence, while in principle the central bank has a continuum of policy tools $\left\{S_t^{(\tau)}\right\}$, in practice it can only manipulate λ_t
- Related to localization results in Vayanos & Vila (2021) and Ray, Droste, & Gorodnichenko (2023)
  - In the one-factor model considered here, the effects of QE are fully global
  - Even with more complicated risk structure, localization is not strong enough to allow balance sheet policy alone to achieve first-best

Extensions

Extensions: “Noise” Demand Shocks

- We obtain identical results when allowing for shocks to habitat demand $\beta_t^{(\tau)}$
- Optimal separation principle still holds with $\psi^{(\tau)} = 0$, but QE must be more reactive:

$$S_t^{(\tau)} = \alpha(\tau) \log P_t^{(\tau)} + \beta_t^{(\tau)}$$

- Optimal short rate policy still implements $i_t = r_t^n$
- Additional result: if noise demand dynamics are such that $\uparrow\uparrow \beta_t^{(\tau)}$ in response to $\uparrow r_t^n$, then it is optimal to expand the balance sheet $\uparrow S_t^{(\tau)}$ while hiking rates $\uparrow i_t$
- Intuition:
  - Suppose during a hiking cycle and in the absence of QE we have an increase in term premia
  - Then the optimal balance sheet policy is to conduct additional QE purchases in order to offset spike in term premia
  - $\implies$ conventional and unconventional policy seem to be at odds with one another
  - Otherwise, short rate policy and balance sheet policy tend to be reinforcing

Extensions: Cost-Push Shocks

- What if divine coincidence does not hold? Eg, wage rigidity in labor markets
- More generally, introduce cost-push shocks u_t in NKPC:

$$\mathrm{d}\pi_t = (\rho\pi_t - \delta x_t - u_t)\,\mathrm{d}t$$

- Unfortunately, our separation principle still holds:
    - Optimal QE stabilizes term premia
    - Short rate policy must contend with the output gap/inflation trade-offs
- Intuition: despite multiple policy instruments, (un)conventional policy only affects aggregate outcomes through changes in effective borrowing rate $\tilde{\mu}_t$
    - Take any feasible path $\{x_t, \pi_t, \tilde{\mu}_t\}_t$ from an implementation implying policies $\left\{\hat{i}_t, \hat{S}_t^{(\tau)}\right\}_t$
    - Can also be achieved with $i_t = \tilde{\mu}_t, S_t^{(\tau)} = \alpha(\tau)\log P_t^{(\tau)} + \beta_t^{(\tau)}$
    - This guarantees $\mathbb{V}\mathrm{ar}_\tau\, c_t^{(\tau)} = \mathbb{V}\mathrm{ar}_\tau\, w_t^{(\tau)} = 0$ and hence strictly dominates

Extensions: Non-Zero First-Best Carry Trade Returns

- Our approximation approach implies that in the first-best, expected carry trade returns are zero
- This simplifies our analytical results but of course is an extreme assumption
- Suppose instead that first-best BCT returns are $\nu^{(\tau)} \neq 0$
- Our separation principle still holds when $\nu^{(\tau)}$ is achievable but optimal short rate policy is a function of $\nu^{(\tau)}$
- Intuition: combination of previous results
  - Aggregate outcomes through changes in effective borrowing rate $\tilde{\mu}_t$ (as before)
  - Optimal QE policy guarantees $\mu_t^{(\tau)} - i_t \equiv \nu^{(\tau)}$ and hence $\tilde{\mu}_t = i_t + \int_0^T \eta(\tau)\nu^{(\tau)}\, \mathrm{d}\tau \equiv i_t + \tilde{\nu}$
  - Thus, optimal short rate policy implements $i_t = r_t^n - \tilde{\nu}$

Monetary Policy with Commitment

- When policy frictions bind, simple policy rules fail to achieve first-best
- Instead suppose the policymaker chooses policy tools u_t as a function of entire history of predetermined and nonpredetermined variables $\mathsf{y}_t, \mathsf{x}_t$
- Minimizes conditional social loss

$$
\begin{aligned}
\mathcal{W}_0 &= \mathbb{E}_0 \int_0^\infty \frac{1}{2} e^{-\rho t} \mathcal{L}_t \,\mathrm{d}t \\
&= \frac{1}{2} \mathbb{E}_0 \int_0^\infty e^{-\rho t} \left(\mathsf{Y}_t^\top \mathsf{R} \mathsf{Y}_t + \mathsf{u}_t^\top \mathsf{Q} \mathsf{u}_t \right) \mathrm{d}t \,, \quad \mathsf{y}_0 \text{ given}
\end{aligned}
$$

- By setting policy in a history-dependent manner, full commitment policies can improve on simple policy rules

Characterizing Optimal Policy with Commitment

Theorem (Optimal Policy with Commitment)

Given $\mathbf{y}_0$, the policymaker minimizes $\mathcal{W}_0$ by choosing $\mathbf{u}_t = \mathbf{F}\mathbf{Y}_t$, which induce equilibrium dynamics $\mathrm{d}\mathbf{Y}_t = -\boldsymbol{\Upsilon}(\mathbf{F})\mathbf{Y}_t\,\mathrm{d}t + \mathbf{S}(\mathbf{F})\,\mathrm{d}\mathbf{B}_t$. Necessary conditions are given by

$$\mathbf{y}_0^\top \left(\partial_i \mathbf{P}_{11} - \partial_i \mathbf{P}_{12}\mathbf{P}_{22}^{-1}\mathbf{P}_{21} - \mathbf{P}_{12}\mathbf{P}_{22}^{-1}\partial_i \mathbf{P}_{21} + \mathbf{P}_{12}\left(\mathbf{P}_{22}^{-1}\partial_i \mathbf{P}_{22}\mathbf{P}_{22}^{-1}\right)\mathbf{P}_{21}\right)\mathbf{y}_0 = 0$$

where $\rho\mathbf{P} = \mathbf{R} + \mathbf{F}^\top\mathbf{Q}\mathbf{F} - \mathbf{P}\boldsymbol{\Upsilon} - \boldsymbol{\Upsilon}^\top\mathbf{P}$. Dynamics are given by $\mathbf{q}_0 = \begin{bmatrix}\mathbf{y}_0 & \mathbf{0}\end{bmatrix}^\top$ and

$$\mathrm{d}\mathbf{q}_t = -\begin{bmatrix}\mathbf{I} & \mathbf{0}\\ \mathbf{P}_{21} & \mathbf{P}_{22}\end{bmatrix}\boldsymbol{\Upsilon}\begin{bmatrix}\mathbf{I} & \mathbf{0}\\ -\mathbf{P}_{22}^{-1}\mathbf{P}_{21} & \mathbf{P}_{22}^{-1}\end{bmatrix}\mathbf{q}_t\,\mathrm{d}t + \begin{bmatrix}\mathbf{I} & \mathbf{0}\\ \mathbf{P}_{21} & \mathbf{P}_{22}\end{bmatrix}\mathbf{S}\,\mathrm{d}\mathbf{B}_t \equiv -\boldsymbol{\Gamma}\mathbf{q}_t\,\mathrm{d}t + \boldsymbol{\sigma}\,\mathrm{d}\mathbf{B}_t$$

Bond prices are affine in $\mathbf{A}(\tau)^\top\mathbf{q}_t$ with $\mathbf{A}(\tau) = \left[\mathbf{I} - e^{-\mathbf{M}\tau}\right]\mathbf{M}^{-1}\mathbf{e}_i$ and

$$\mathbf{e}_i^\top\mathbf{q}_t = i_t, \quad \mathbf{M} = \boldsymbol{\Gamma}^\top - \int_0^T \left[-\alpha(\tau)\mathbf{A}(\tau) + \boldsymbol{\Theta}(\tau)\right]\mathbf{A}(\tau)^\top\,\mathrm{d}\tau\,\tilde{\boldsymbol{\Sigma}}$$

Monetary Policy with Commitment: Intuition

- Policymaker chooses tools i_t, $\left\{S_t^{(\tau)}\right\}$ which:
  - Directly affect optimality conditions of arbitrageurs
  - Indirectly affect HHs through changes in equilibrium borrowing rates
  - Indirectly affect firms through changes in marginal costs
- Trade-off: more aggressive policy reactions to shocks:
  - Greater pass-through to HHs
  - Larger and more volatile term premia
- Commitment partially relaxes this link:
  - HH decisions depend on entire expected path of borrowing rates $\int_0^\infty \mu_t^{(\tau)} \, \mathrm{d}\tau$
  - Arbitrageur risk compensation depends on volatility of short-run fluctuations $\mathrm{d}i_t$, $\mathrm{d}S_t^{(\tau)}$
- Characterizing dynamics of optimal policy with commitment is difficult
  - Ongoing work studies optimal policy numerically
  - Suffers from time inconsistency; simple rules may be more practical

Measuring Balance Sheet Objectives: Return Predictability

- Fama-Bliss regression:

$$\frac{1}{\Delta\tau}\log\left(\frac{P_{t+\Delta\tau}^{(\tau-\Delta\tau)}}{P_t^{(\tau)}}\right) - y_t^{(\Delta\tau)} = a_{FB}^{(\tau)} + b_{FB}^{(\tau)}\left(f_t^{(\tau-\Delta\tau,\tau)} - y_t^{(\Delta\tau)}\right) + \varepsilon_{t+\Delta\tau}$$

- Measures how the slope of the term structure predicts excess returns
- In our model, when the central bank does not use balance sheet policies:

$$\bar{b}_{FB}^{(\tau)} > 0$$

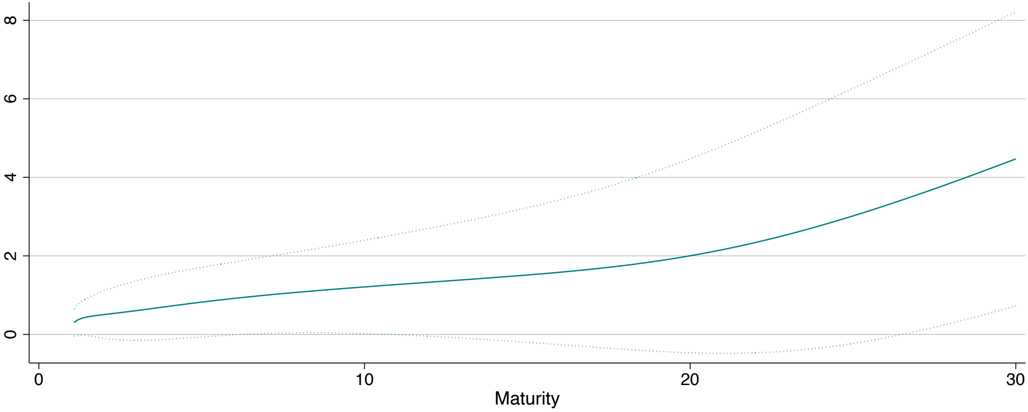
- If balance sheet policy is pursuing financial stabilization:

$$\bar{b}_{FB}^{(\tau)} > b_{FB}^{(\tau)} \to 0$$

- Instead, if balance sheet policy is pursuing macroeconomic stabilization:

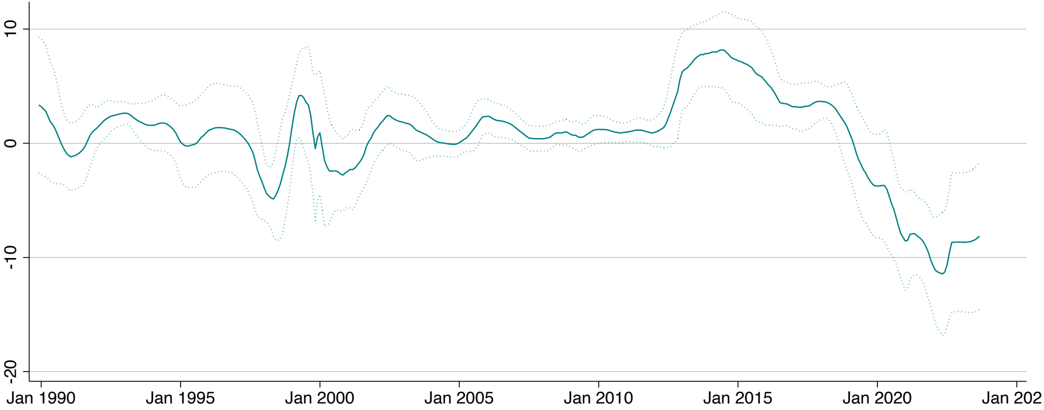
$$b_{FB}^{(\tau)} > \bar{b}_{FB}^{(\tau)}$$

Fama-Bliss Coefficients: Treasuries, Full Sample



FB coefficients are non-zero (and increasing across maturities)

Fama-Bliss Coefficients: 10-year Treasuries, Rolling Sample



FB coefficients increase during initial QE regime, but have fallen and even become negative in recent years

Concluding Remarks

- This paper develops a tractable general equilibrium model with market segmentation, nominal frictions, and household heterogeneity
- We find that optimal short rate and balance sheet policy is characterized by a sharp **optimal separation result**:
  - Conventional policy targets macroeconomic stability
  - Unconventional policy targets financial stability
- Optimal policy removes excess volatility of risk premia and hence improves risk-sharing across households, while reducing excess macroeconomic volatility
  - Policy constraints on either the short rate or balance sheets imply trade-offs between these two policy objectives
- When considering social welfare, cannot abstract from the policy tools used to conduct monetary policy

Thank You!