Discussion of Kiley and Sim's

Optimal monetary and macro-pru policies

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Summary

- One of the first papers on a new macro topic: optimal monetary and macro-prudential policy

- "A quantitative model": need to provide guidance in discussions of specific macroprudential instruments

- Can simple rules approximate optimal policy?

Three questions/suggestions

- Why macro-prudential policy?

- Why dilution costs?

- Which results are useful from the applied policy perspective?

Why macroprudential policy

- To reduce the likelihood of new financial crises. An ex-ante response to risks (not expectations)

- Main concern: *excessive* (eg. due to deposit insurance) leverage/risk taking leading to fragility

- Macro-prudential tools better suited to reduce excessive risk taking. Monetary policy would face a trade-off

Why macroprudential policy

- To help set macroprudential tools, the paper should focus more on the ex-ante dimension: *Is leverage lower on average with the leverage tax? Is consumption volatility lower? Are there trade-offs without the leverage tax?*

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Why macroprudential policy

- No trade-off for monetary policy.

Table 2: Changes (%) in Welfare Under Alternative Optimal (Ramsey) Policies

	New Keynesian Calibration		Financial Shock Calibration	
Instrument	ΔC ($\lambda_0 = 0$)	ΔC ($\lambda_0 = \lambda_{ss}$)	ΔC ($\lambda_0 = 0$)	ΔC ($\lambda_0 = \lambda_{ss}$)
r_t	1.59	0.26	10.84	9.06
r_t and τ_t^m	3.52	0.29	12.53	8.31
τ_t^m	0.28	0.15	8.32	8.17

- Are welfare gains only ex-post?

Why macroprudential policy

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- In the model can leverage be excessive ex-ante?

- If not, promise ex-post credit policy?

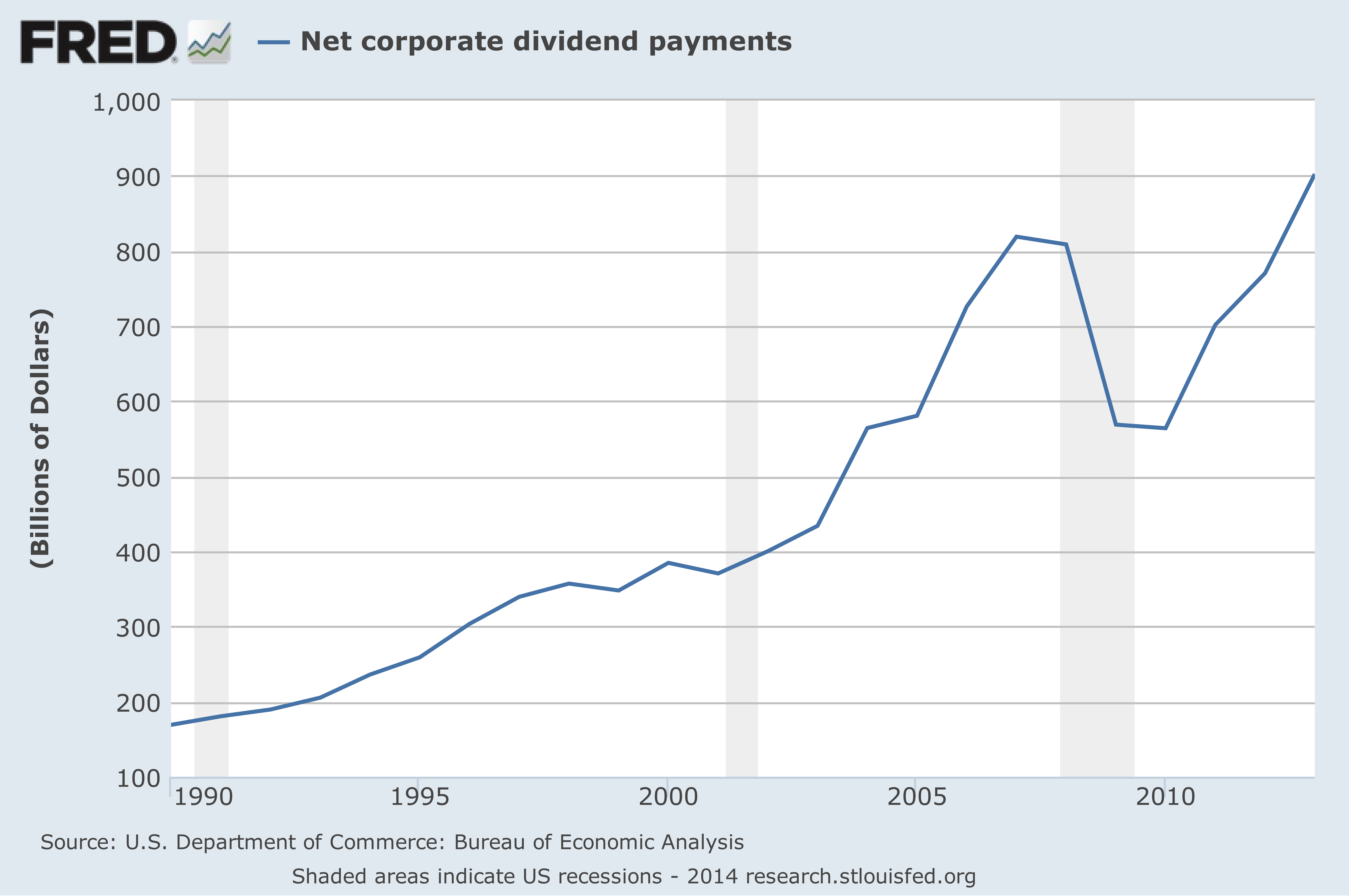
Why dilution costs?

- Kiley and Sim: no explicit leverage constrains, but cost to raise equity when needed. *Banks react ex-ante to risk of having to raise capital.* Compare to:
  - Gertler and Karadi: high leverage constrains banks' ability to borrow (deposits)
  - He and Krishnamurthy (also Dewachter and Wouters): high leverage constrains banks' ability to raise outside equity

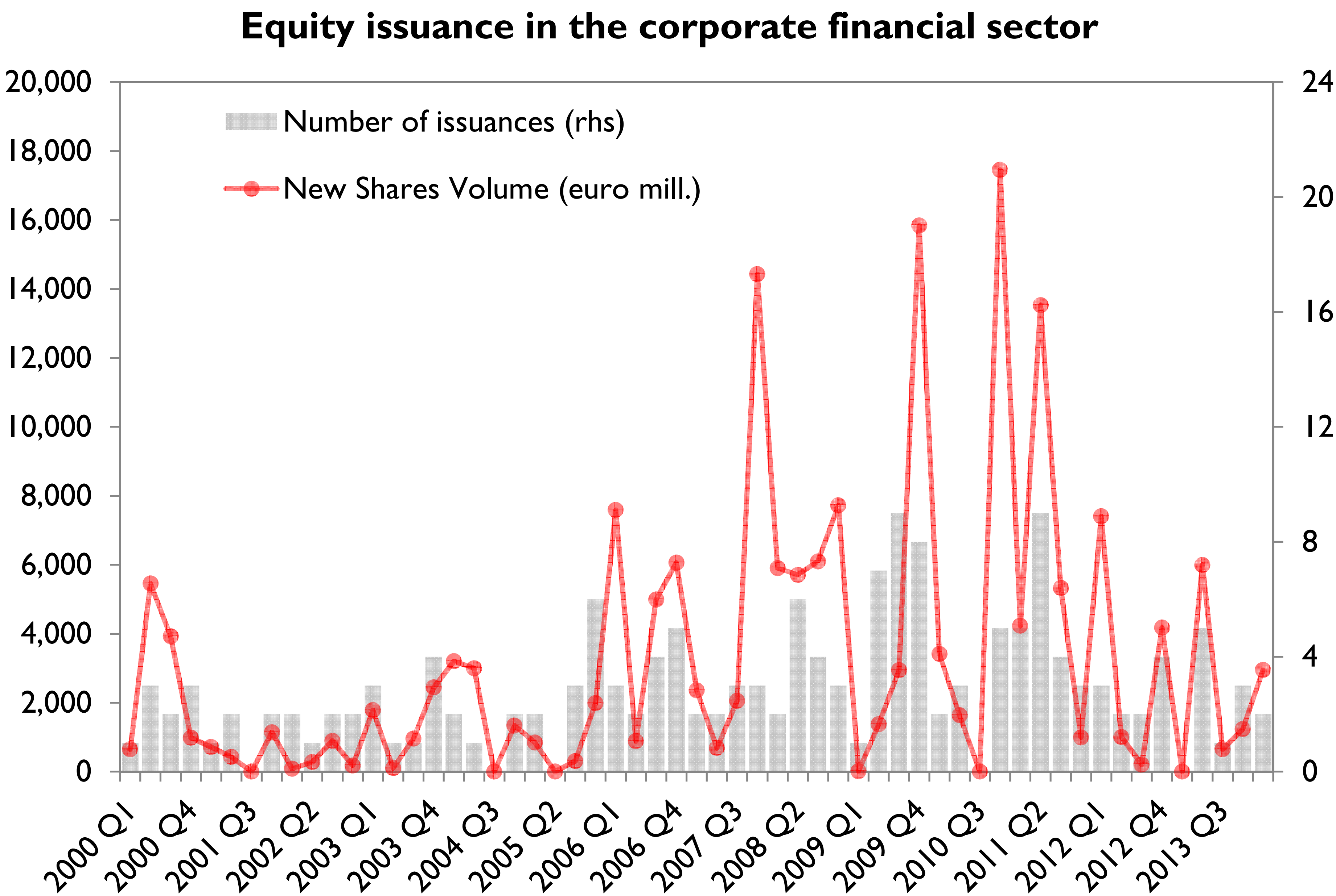
Why dilution costs?

- Some evidence in favour of the KS friction would be desirable.

  - Model has both time series and cross-sectional implications for banks' equity issuance and dividend payments. *E.g. banks should pay dividends also during recessions; dividends should fall after "financial recession"; equity issuance should increase at times of high funding uncertainty*



FRED
Net corporate dividend payments
1,000
900
800
700
600
500
400
300
200
100
(Billions of Dollars)
1990
1995
2000
2005
2010
Source: U.S. Department of Commerce: Bureau of Economic Analysis
Shaded areas indicate US recessions - 2014 research.stlouisfed.org


Equity issuance in the corporate financial sector
Number of issuances (rhs)
New Shares Volume (euro mill.)
20,000
18,000
16,000
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
24
20
16
12
8
4
0
2000 Q1
2000 Q4
2001 Q3
2002 Q2
2003 Q1
2003 Q4
2004 Q3
2005 Q2
2006 Q1
2006 Q4
2007 Q3
2008 Q2
2009 Q1
2009 Q4
2010 Q3
2011 Q2
2012 Q1
2012 Q4
2013 Q3

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  - Were dilution costs a key constraint during the recent crisis?

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- Some evidence in favour of the KS friction would be desirable.
  - Model has both time series and cross-sectional implications for banks' equity issuance and dividend payments
  - Were dilution costs a key constraint during the recent crisis?
  - Basic model properties: are lending spreads countercyclical? Is leverage pro-cyclical or counter-cyclical?

Why dilution costs?

- Dilution costs are realistic, but is the mechanism in the paper of first order importance for macro-dynamics?

- Is net worth a state variable? How long does high leverage last?

- No accelerator properties?

Constraints from the applied policy perspective

- Which tax/subsidy works best as a macroprudential tool?

- Specific macro-prudential tool taken as given here. But is the "realism constraint" too tight?

  - welfare penalty on interest rate changes

  - could the regulator not react to "changes in leverage judged to be excessive"?

Summary

- One of the first contributions to a new literature

- Focus more on the ex ante properties of optimal policy

- Clarify propagation mechanism and provide some evidence in support of the macro-relevance of dilution costs