Discussion of Cost-Benefit Analysis of Leaning Against the Wind: Are Costs Larger Also with Less Effective Macroprudential Policy?

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Summary of discussion

• Svensson key assumption: Credit affects the probability of a crisis, but not severity

• But credit is a vulnerability and affects severity
  • Reinhart and Rogoff; Jorda, Schularik, Taylor (2013); Mian and Sufi (2014); Aikman, Lehnert, Liang, Modugno (2016)

• Two other assumptions:
  • Probability of crisis is low
  • Elasticity of p to policy is low

• Reasonable alternative assumptions can overturn net cost-benefit
Svensson Framework for Costs and Benefits of LATW

- Initial Expected Cost = \( p \cdot \Delta U \)
- Costs of LATW (relative to Initial): \( p, \Delta U_i, \Delta U_a \)
  - Key assumption: \( \Delta U_i = \Delta U_a \)
  - LATW does not reduce the increase in unemployment in a crisis
- Benefits of LATW (relative to Initial): \( \Delta \frac{p}{i}, \Delta U_i, \Delta U_a \)
  - LATW policy reduces \( \Delta \frac{p}{i} \)
- Welfare function is quadratic in \( \Delta U \)
- Will show for a range of smaller \( \Delta U_a \), Benefits > Costs
Cost and Benefit of LATW relative to Initial $\Delta U_i = 5$, $p=6$, $\Delta p/\Delta i = -.01$
Cost and benefit of LATW relative to Initial, for higher dp/di

* new relative to initial
Cost and benefit of LATW relative to Initial, for higher dp/di and p

* new relative to initial
Credit-to-GDP
Credit-to-GDP gap is a vulnerability - leads to contraction
Aikman, Lehnert, Liang, and Modugno (2016)
Monetary policy ineffective when credit gap is high — Debt overhang
Probability of a crisis is greater than crisis realizations

Peek, Rosengren, and Tootell (2015)
Alternative Framework

• Credit is a financial vulnerability, affects the severity of a recession

• Other possible vulnerabilities that monetary policy affects:
  • **Asset prices**: Bernanke and Gertler (1989); Lopez-Salido, Stein, Zakrajsek (2015); Jorda, Schularik and Taylor (2015)
  • **Financial intermediation**: Rajan (2005), Adrian and Shin (2010); Krishnamurthy and Vissing-Jorgensen (2015)

• Too early to conclude that monetary policy and financial stability objectives and tools should be separate
END
Cost and benefit of LATW relative to initial, for p=6 and p=12