Comments:
A Theory of Macroprudential Policies in the Presence of Nominal Rigidities

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Motivation

• Macroprudential policy
  – Regulations/taxes on financial variables to reduce the risk and the macroeconomic costs of financial instability

• Macroprudential vs. microprudential policy
  – Micro-prudential aimed at soundness of individual institutions
  – Macroprudential focus on macroeconomic system as a whole

• Lots of discussion following the crisis calling for much bigger role for macroprudential policy.

• Key theoretical underpinning of macroprudential policy
  – Externalities
Externalities and macroprudential policy

• Until now much of the work on macroprudential policy is focused on
  – Cancel each other under complete markets
  – Macroprudential policy justified when incomplete markets.

• My view: Does not really capture why people are asking for macro prudential policy.
  – Want it to avoid events like we see today: Big recession that can’t be cured by cutting nominal interest rates.
  – Perception this was triggered by problems in finance ... need more regulation/taxes on finance.
This paper: Demand Externalities

• These arise even when asset markets are complete.

• Key frictions: Prices are rigid and policy constrained for some reason.

• Demand externalities can also be used to justify “macro-prudential policy”.

• My suspicion: Much closer to the actual rationale people give for macroprudentials.
What is aggregate demand externality?

• My interpretation: If I buy stuff this increases the overall level of output for everybody in the economy beyond my private benefits which is good in a recession.

• Loosely speaking: My spending – your income and your spending – somebodies else income and spending ...... etc ...... old multiplier argument
What is aggregate demand externality? – and elegant formulation

With recession looming George Bush encourages people to go shopping more.

• As we to meet the challenges of the 21st century, we must also work together to achieve important goals for the American people here at home. **This work begins with keeping our economy growing. ... And I encourage you all to go shopping more.**
What is aggregate demand externality?

• Isn’t this just some old Keynesian fairytale?
• When does it apply in modern models?
Key contribution of paper

- Take aggregate demand externalities from a fairytale to series of propositions.
- Loosely speaking....
- Ex ante it matters a lot who has the money (MPC different) in a recession for aggregate output when policy constrained.
- This fact is not internalized by private agents when signing financial contracts.
- Contribution here: Show this has important implications for macro-prudential policy.
This paper

• Proposes a unified framework for analyzing demand externalities and macro prudential policy
• Ex ante people don’t take into account the positive (negative) externality their asset positions has on aggregate demand in the future.
• Authors provide formulas that precisely calculate those externalities and taxes to correct them.
• Show examples when they apply (and when not)
• Also compute ex post optimal policy.
Approach of paper

• Characterize optimal policy with certain set of tax instruments in an elegant abstract example.
  – Rule out commodity taxes that would do away with the inefficiencies associated with monetary policy.
• Show how these instruments are set so as to make agent internalize aggregate demand externalities.
• Show that these instruments imply active ex ante “macroprudential policy” in specific examples.
• Also show ex post optimal redistribution
• Outline: First general → Various examples
Synthesis of authors work

- Dealing with the Trilemma: Optimal Capital Controls and fixed Exchange Rates.
- Fiscal Unions
- Work on the zero bound.
Eggertsson-Krugman (2012) economy

\[ E_0 \sum_{t=0}^{\infty} \beta(i)^t \log C_t(i) \text{ with } i = s \text{ or } b \]

\[ D_t(i) = (1 + r_{t-1}) D_{t-1}(i) - \frac{1}{2} Y + C_t(i) \]

\[ (1 + r_t) D_t(i) \leq D^{\text{high}} > 0 \]

\[ \beta(s) = \beta \]
Experiment: “Deleveraging” shock

- Minsky Moment $\rightarrow$ A reduction (unexpected) in this limit.
- Need to deleverage: Unexpected exogenous drop in the debt limit the borrower *must* satisfy

\[ D_{high} \rightarrow D_{low} \]

- Debtor cuts down his spending.
- Real interest rate needs to drop to get saver to spend
- With nominal frictions, may not be possible (real interest rate stuck due to zero bound), can have serious macroeconomic consequences.
- Large demand side recession
• Suppose we consider period 0 when the agents contracted the debt
• Key point, debtors do not take into account the negative externality of deleveraging, even if they anticipate a “Minsky moment”.
• Policy: Want to impose a tighter cap on lending to have people internalize this.
• Show policy will choose lower D than given by model.
• Good example of “macro-prudential”.

Here: Add prior state
Intuition

• In a liquidity trap you want to borrowers to have more wealth because they have higher MPC.
• Macro prudential policy limits the their ability to borrow ex ante, hence they have more resources in recession → more spending → more output.
• Nice bottom-line
  – You want to use macro prudential policy in period 0
  – You don’t want to “curb the bubble” by raising rates at that time.
Only one examples of a general principle

• Demand externalities prevalent whenever monetary policy is constrained.
  – Zero bound in general
  – Currency pegs
    • Capital controls
  – Monetary Union
    • Large scope for for intervention
  – Insight even more general that this. Not crisis specific
Comment

• Can even take this further.
  – Any model with an inflation-output tradeoff and some agent heterogeneity.

→ Scope for corrective taxes on financial transactions.

→ Bottom-line: With demand externalities financial markets inefficient in general.

→ Somewhat disturbing and radical conclusion.
Comment: Practicalities

- Do we know enough to implement effective macro prudential policies?
- Example: What is the right “cap” on lending?
- How do we intervene in asset markets?
Conclusion

• There is role for macroprudential policy.
But.....

.....we know very little about how to do it.