Financial Vulnerability and Monetary Policy

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Overview

- Data: tight fin. conditions predict lower, more volatile output gap
  - both effects shift down lower tail of output distribution

    (in near term, reverses over longer horizon: vol. paradox)
- Model: Standard NK model + banks with VAR constraint
  - banks finance intermediate goods sector, collect profits,

    decide how much dividends to pay out, s.t. preference shock
  - no fundamental risks: first best is constant output
  - binding VAR constraint $\Rightarrow$ bank shocks transmit to real economy
- Optimal monetary policy: limit preference shock pass through
  - how? adjust tightness of VAR constraint through

    bank borrowing cost and MP equilibrium effects

Preference shock transmission

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  - do not consume dividends, but pass on to households
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- Alternative setup 2: banks consume dividends
  - model becomes two agent NK framework
  - preference shocks become actual demand shocks
  - pass-through to real economy even absent VAR constraint

Preference shock transmission contd.

- Clever here: two agents, but hh's consume aggregate output
  - household SDF driven by aggregate consumption
  - frictionless financial markets can undo any dividend policy
  - when VAR constraint binds: distorted asset prices, limited undoing

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- Key idea: monetary policy can loosen/tighten VAR constraint
  - how? $\frac{dX_t}{X_t} = ((1-\theta_t)R_t - f_t + \theta_t\tilde{\mu}_t)dt + \theta_t\sigma_t dB_t$
  - monetary policy directly affects R_t (emphasis of paper)
  - in equilibrium also affects $\tilde{\mu}_t$, σ_t, f_t and θ_t (a bit obscure in paper)

Wealth dynamics and monetary policy

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  - paper focuses discussion on future wealth dynamics (LHS VAR)
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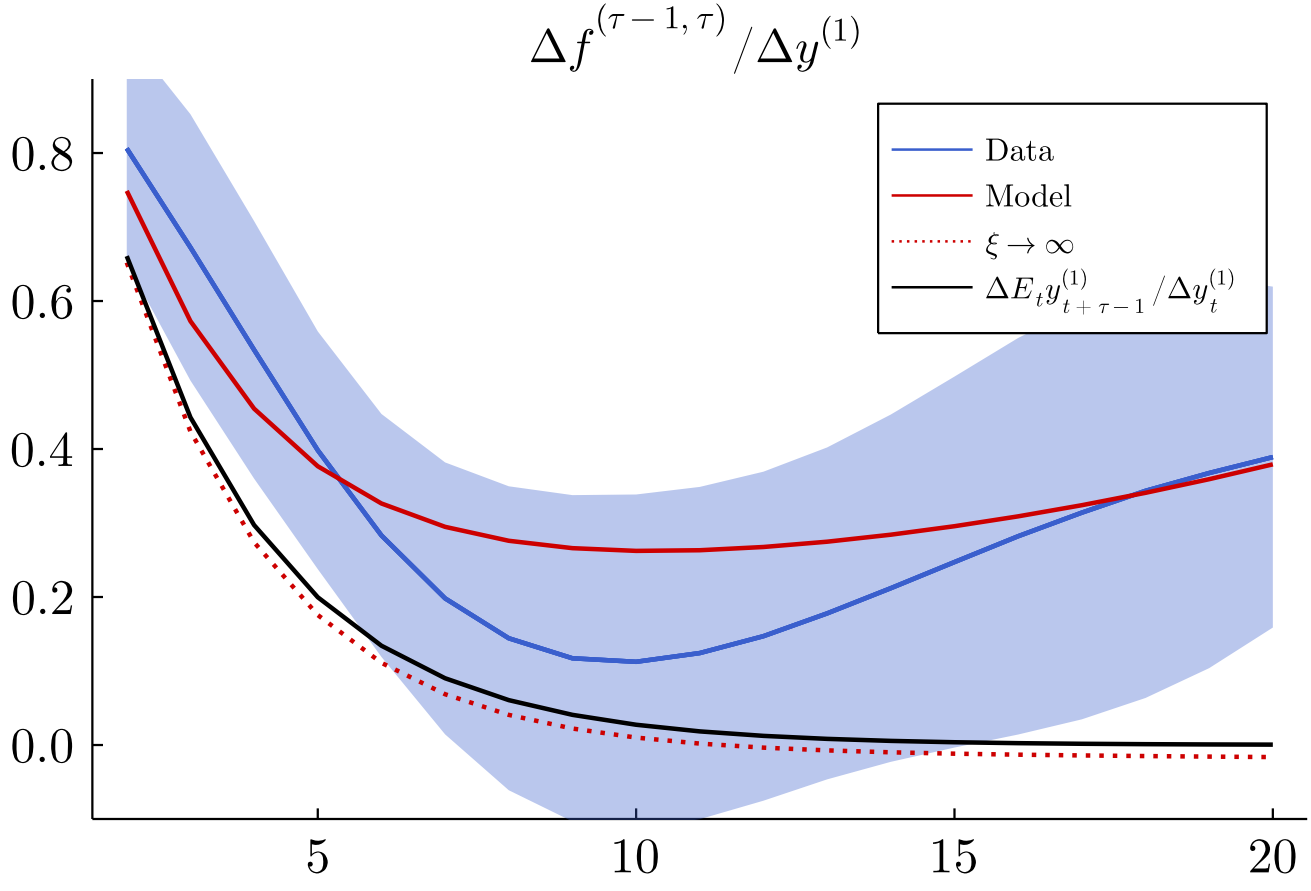
- Kekre-Lenel: Monetary Policy, Redistribution, & Risk Premia
  - focus on wealth revaluation effects of MP
  - key: expansionary monetary policy redistributes to agents with high marginal propensity to bear risk (MPR)

    $\Rightarrow$ lowers risk-premia and amplifies real effects
  - MPR summarizes differences in portfolio choice (risk-aversion differences, leverage constraints, belief differences, ...)

Wealth dynamics and monetary policy contd.

- Kekre-Lenel: Monetary Policy, Segmentation & Term Structure
  - $\Rightarrow$ expansionary monetary increases wealth of intermediaries
  - $\Rightarrow$ increases their risk-bearing capacity and lowers term premia



Final comments

- First order question: financial stability and monetary policy
  - simple but rich framework: NK + banking sector with VAR
  - solve for optimal policy (!): augmented Taylor rule

  $\Rightarrow$ easier monetary policy when financial conditions tight

  $\Rightarrow$ tighter policy when financial conditions at risk to become tight
- Focus on forward looking VAR constraint novel and relevant
  - underlying economic mechanisms complex
  - hopefully room to ease understanding for reader
  - change of variables to GDP-at-risk connects to empirics,
    not sure whether it makes analysis more approachable
- Important and insightful paper, thanks to authors and organizers!