

Discussion of Faia "Optimal Monetary Policy with Credit Augmented Liquidity Cycles"

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Can financial frictions exacerbate MP's supply-side effects?



Do financial frictions influence MP trade-off?



Should MP respond to financial indicators?

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- Yes. MP should target asset prices in addition to inflation.

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- Credit Channel of Shock Transmission
 - Bernanke and Blinder (1988), Bernanke and Gertler (1989), Kiyotaki and Moore (1997), Carlstrom and Fuerst (1997), Bernanke et al., (1999), Christiano, Motto and Rostagno (2006), Faia and Monacelli (2007), and Curdia and Woodford (2008).

Modelling Financial Frictions (I)

MICRO-FOUNDATION OF FINANCIAL FRICTION

- Asymmetric information between Firms and External Financiers
 - Firms can costlessly observe idiosyncratic output
 - Households cannot observe firms' output
 - reason for no direct lending
 - Banks can observe output at a cost
 - Standard Costly State Verification
 - Justification for existence of financial intermediaries

$$efp_t \equiv \frac{G'(l_t)}{(1 + r_t^d)} = \rho \left(\frac{l_t^+}{G(l_t)} \right) \quad (1)$$

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- Financial frictions on financing working capital:
 - exacerbate cost-channel \implies supply-driven fluctuations.

- Phillips curve relationship:

$$0 = a_t \omega_t n_t^{1-\alpha} k_t^\alpha \left((1 - \varepsilon) + \varepsilon \left[-\frac{u_{n,t}}{u_{c,t}} \frac{(1 + (1 + r_t'))}{a_t \omega_t (1 - \alpha)} \left(\frac{n_t}{k_t} \right)^\alpha \right] \right) - \theta_p (\pi_t - 1) \pi_t + \beta \theta_p (\pi_{t+1} - 1) \pi_{t+1} \quad (2)$$

- MP Rule:

$$\begin{aligned} \ln \left(\frac{1 + r_t^n}{1 + r^n} \right) &= (1 - \phi_r) \left(\phi_\pi \ln \left(\frac{\pi_t}{\pi} \right) + \phi_y \ln \left(\frac{y_t}{y} \right) \right) \\ &+ (1 - \phi_r) \left(\phi_q \ln \left(\frac{q_t}{q} \right) + \phi_{lk} \ln \left(\frac{l_t/k_t}{l/k} \right) \right) \\ &+ \phi_r \ln \left(\frac{1 + r_{t-1}^n}{1 + r^n} \right) \end{aligned} \quad (3)$$

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 - would preclude analyzing nominal rigidity AND financial frictions in one same agent.

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