

Discussion of 'Optimal monetary
policy in a model of credit
frictions', by de Fiore and Tristani

Tony Yates

Main messages of this paper

- Exogenous rise in spreads warrants looser monetary policy
- Credit friction modifies response to other shocks, but not much
- Credit friction dampens business cycles, so recession warrants less loosening than otherwise

Vlieghe (2005)

- Puts sticky prices into Kiyotaki (1998)
- Recession raises premium entrepreneurs pay; reduces borrowing by productive agents; output shrinks, net worth falls
- Optimal policy is to tolerate a little inflation in response to productivity shock
- Exogenous hit to net worth of entrepreneurs warrants looser policy

Aikman and Paustian (2006)

- AP put sticky prices into Chen (2001)
- Recession raises premium entrepreneurs pay; reduces borrowing; economy less productive
- Optimal policy response to technology shock is to tolerate a little inflation
- Exogenous fall in bank capital warrants looser policy

Carlstrom, Fuerst, Paustian (2008)

- Sticky prices into Carlstrom and Fuerst style model
- Optimal policy response to technology shock is to tolerate a little inflation

BGG

- Quick exercise: ad-hoc optimal policy in BGG: optimal policy response to technology shock is to allow a little inflation
- Gilchrist and Leahy (2002), Faia and Monacelli (2006)

Key finding that price stability is dominant motive

- Echoes in other contexts, e.g. Collard and Dellas (2005); Khan et al (2003)
- Mildness of effect of credit frictions on cycles
- Cost of varying the inflation tax
- Small 'bang for buck', though Vlieghe (2005) shows that efficiency of inflation tax increased by having nominal rather than real debt

Mildness of amplification

- Mildness despite 'rigging' in favour of amplification (Cordoba and Ripoll (2002), Kocherlakota (2000))...
 - e.g. forcing firms to sign risky debt contracts in BGG
 - risk neutrality of entrepreneurs in CF, KM and BGG
- Krusell and Smith(1998) – agents self-insure and credit constraints don't bind often

Mildness of amplification

- Overriding message: credit frictions don't matter for business cycles
- Diagnosis on the models?
- Diagnosis on the prevailing view amongst policymakers which is that credit conditions severely amplify credit crisis?

Dampening vs amplification: theory

- BGG (1999) and others: net worth falls in a recession, raising equilibrium cost of finance.
- dFT(2008): net worth channel shut off
- Recession shrinks size of loan relative to capital endowment: reduces prob of default and eqm spreads

Dampening vs amplification: theory

- BGG (1999) and others: net worth falls in a recession. That raises equilibrium cost of finance.
- dFT(2008): net worth channel small or shut off entirely.
- Recession shrinks size of loan relative to capital endowment: reduces prob of default and eqm spreads

Dampening vs amplification: evidence

- Levin et al (2006)
- Gilchrist and Zakrajsek (2008)
- CKM investment wedge falls during Great Depression

CKM on investment wedges vs efficiency wedges

- Investment wedge: distortion to investment and capital accumulation (BGG, KM, CF)
- Efficiency wedge: distortion to finance of other non-accumulating intermediate inputs (Faia, dFT, CFP)
- Investment wedges do not account for business cycle movements, e.g. recessions of 1929, 1982
- Efficiency wedges important
- Adjudicates in favour of financial frictions that generate efficiency wedges

Monetary or fiscal policy?

- Abstracts from fiscal policy
- Other sufficiently non-distorting tax instruments would reduce monetary policy response further
- SG and U (2005): optimal policy is for labour income taxes and capital taxes vary too
- Collard and Dellas: don't use inflation tax to eliminate distortions from other taxes
- Echoes response of governments to current crisis