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
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

- 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

- 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