Dynamic Rawlsian Policy

Charles Brendon, Martin Ellison

Abstract
A well-known time-inconsistency problem hinders optimal decision-making when policymakers are constrained in their present choices by expectations of future outcomes. The time-inconsistency problem is caused by differences in the preferences of policymakers who exist at different points in time. Adapting the arguments of Rawls (1971), we propose that these differences can be eliminated if policy is set from behind a ‘veil of ignorance’, without knowledge of when the policy will be implemented. We set up a well-defined choice problem that captures this normative perspective. The policies that it generates have a number of appealing properties.

Universal Banking, Asymmetric Information and the Stock Market

Sanjay Banerji and Parantap Basu

Abstract
The paper shows that attempts to sell stocks of borrowing firms by the universal banks upon private information result in: (i) discounting of stock prices, (ii) a higher fraction of ownership in the borrowing firm and a greater loan size, (iii) an increase in consumption risk and precautionary savings of households. Hence, the size of the commercial banking activity increases under asymmetric information at the expense of a higher consumption risk borne by the households. The magnitude of the resulting risk premium is shown to be highly sensitive to the probability of an aggregate negative shock perceived by the market.

Leaning against the wind, but how? Monetary policy versus macroprudential measures

F. Gulcin Ozkan and D. Filiz Unsalz

Abstract
This paper derives welfare-maximizing monetary and macro-prudential policy rules in an open-economy by utilizing a New Keynesian general equilibrium model with financial frictions. We consider optimal Taylor-type interest rate rules, where the policy rate is set as a function of inflation, output, and credit growth; and macro-prudential instrument is set as a function of credit growth. We find that responding to credit growth through the monetary instrument improves macroeconomic stability and hence welfare. Interestingly, this holds true even when monetary policy is strongly anti-inflationary. However, in the presence of macro-prudential measures, there is no significant welfare gains from monetary policy also reacting to credit growth. Our results therefore suggest delegating "lean against the wind" squarely to macro-prudential policy.
Liquidity, Term Spreads and Monetary Policy
Yunus Aksoy, Henrique Basso

Abstract
We propose a model that delivers endogenous variations in term spreads driven primarily by banks’ portfolio decision and their appetite to bear the risk of maturity transformation. We first show that fluctuations of the future profitability of banks’ portfolios affect their ability to cover for any liquidity shortage and hence influence the premium they require to carry maturity risk. During a boom, profitability is increasing and thus spreads are low, while during a recession profitability is decreasing and spreads are high, in accordance with the cyclical properties of term spreads in the data. Second, we use the model to look at monetary policy and show that allowing banks to sell long-term assets to the central bank after a liquidity shock leads to a sharp decrease in long-term rates and term spreads. Such interventions have significant impact on long-term investment, decreasing the amplitude of output responses after a liquidity shock. The short-term rate does not need to be decreased as much and inflation turns out to be much higher than if no QE interventions were implemented. Finally, we provide macro and micro-econometric evidence for the U.S. confirming the importance of expected financial business profitability in the determination of term spread fluctuations.

What causes banking crises? An empirical investigation
Vo Phuong Mai Le, David Meenagh and Patrick Minford

Abstract
We add the Bernanke-Gertler-Gilchrist model to a modified version of the Smets-Wouters model of the US in order to explore the causes of the banking crisis. We test the model against the data on HP-detrended data and re-estimate it by indirect inference; the resulting model passes the Wald test on output, inflation and interest rates. We then extract the model’s implied residuals on US unaltered data since 1984 to replicate how the model predicts the crisis. The main banking shock tracks the unfolding sub-prime shock, which appears to have been authored mainly by US government intervention. This shock worsens the banking crisis but traditional shocks explain the bulk of the crisis; the non-stationarity of the productivity shock plays a key role. Crises occur when there is a run of bad shocks; based on this sample they occur on average once every 40 years and when they occur around half are accompanied by financial crisis. Financial shocks on their own, even when extreme, do not cause crises provided the government acts swiftly to counteract such a shock as happened in this sample.
Macro-Prudential Instruments: Lessons from a US Bank Panel
Jagjit S. Chadha and Christoffer Koch

Abstract
Historically, regulators were concerned with the failure of individual institutions whilst monetary policy makers focussed on systemic risks by the provision of emergency liquidity to otherwise solvent institutions. A new toolkit of macro-prudential instruments may mitigate the role of leverage and credit in amplifying the business cycle. What is the potential impact of macro-prudential instruments (MPIs) on financial stability, allocative efficiency and the transmission channel of monetary policy? How have monetary policy and the aggregate state of the banking system interacted historically? Can we construct counterfactuals using historical episodes - like the adjustment to the Basel accords in the early 1990s - by examining panel data on individual banks? The empirical bank level literature on the lending channel tends to emphasize the role of individual bank level characteristics and explores heterogeneity in bank level lending in terms of capitalization, liquidity and bank size. Little emphasis thus far has been paid to the overall state of the banking system that is the objective of MPIs. In particular, the banking system’s response to regulatory shifts that could be interpreted in terms of potential MPIs. Using a unique historical, quarterly bank level data set that spans a number of different monetary policy regimes and regulatory changes since 1959 we explore appropriate historical counterfactuals in order to get an understanding of workings of MPIs qualitatively and quantitatively.

Diana Lima, Paul Levine, Joe Pearlman and Bo Yang

Optimal Macroprudential policy and Monetary Policy

Abstract
There is now convergence to a consensus in favour of a unified institutional regime that promotes cooperation between both monetary policy and macroprudential tools. In particular there is a view that central banks should have such tools, since monetary policy decisions have potential implications for leverage and risk taking. In addition, central banks monitor macroeconomic developments, so they can use this expertise to analyse financial trends. Moreover, during a crisis, the combination of functions would enable the central bank to utilize the synergies between the two while avoiding most of the costs of organizational coordination. In addition, the role of lender of last resort is a function that is related with macroprudential (as opposed to microprudential) supervision. This study therefore aims at examining the implications of financial frictions, embedded in a New Keynesian DSGE model, for the conduct of welfare-optimal monetary policy. Secondly, it studies the role of a macroprudential policy for improving welfare outcomes.
Richard Werner

Macroprudential policy and the debate about a new role and function for central banks

Abstract

Tony Yates, Gabor Pinter and Kostas Theodoridis [RBNZ]

Risk news shocks and the business cycle

Abstract

This paper identifies risk news shocks in a VAR, shocks which do not affect today’s proxy for risk, Bloom’s VIX series, but contribute to explaining it at some horizon in the future. It then quantifies its contribution to recent business cycles and fits a SW model with BGG frictions to this risk news shock, where the shock is interpreted to be a shock to the future value of the parameter that controls the distribution of entrepreneur’s returns via accumulated physical capital. It then shows that provided interest rates can move, the shock does little damage, but does considerable damage if they cannot e.g. at the ZLB.

Ray Barrell and Dilly Karim

Macro Prudential Policy and Credit; the right question but the wrong answer

Arnab Bhattacharjee and Rosenazad Chowdhury

The transition into financial crisis: Fundamentals, path dependence or institutions?

Abstract

Debt crises, currency crises and banking crises - the three components of financial crises - are in most cases interrelated and are frequently evidenced both for developing and developed countries. Obviously, the frequency and timing of their occurrence depends on economic fundamentals - mainly, current account, external debt and macroeconomic performance. However, countries with similar fundamentals often have very different experiences of financial crises. This suggests that other factors
are also important - stages of economic development, the economic scenario leading up to a crisis (path dependence), contagion effects across countries, and institutional quality. We analyse the Reinhardt-Rogoff data on banking and currency crises, placing this within the context of current economic models, to understand the relative importance of all of these factors. We find that each of these issues is important. However, while difficult to measure and therefore often ignored in the empirical literature, institutional quality is of critical importance. Most importantly, such institutional features are very stable over time, and macroeconomic and financial reforms would have impacts on institutional quality only in the long run. This finding has important implications for economies with substantial risk of financial crises.

**Stephen Wright**

**The Predictive Space or Why Economists are so Bad at Predicting the Macroeconomy**

**Abstract**

This paper is primarily an exercise in econometric theory, but it also sheds light on economists' longstanding difficulties in forecasting the macroeconomy. We show that the univariate properties observed in a wide range of macro processes mean that a) it may be very hard for even the best possible predictive model to beat an ARMA model; and b) even those models that can do so must live within a tightly restricted parameter space. We illustrate using Stock and Watson's (2007) univariate representation of inflation, and show that predictors of inflation that beat the ARMA must have properties that we do not observe in commonly used observable predictors.