Discussion: The International Dimensions of Macro-prudential policies

Jorge Quintana

Goethe University Frankfurt

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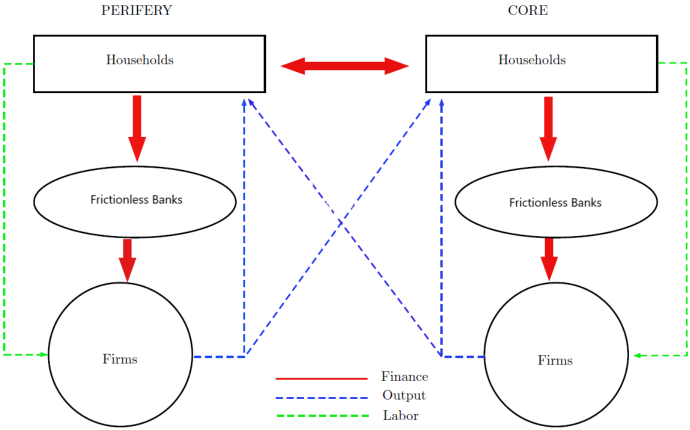
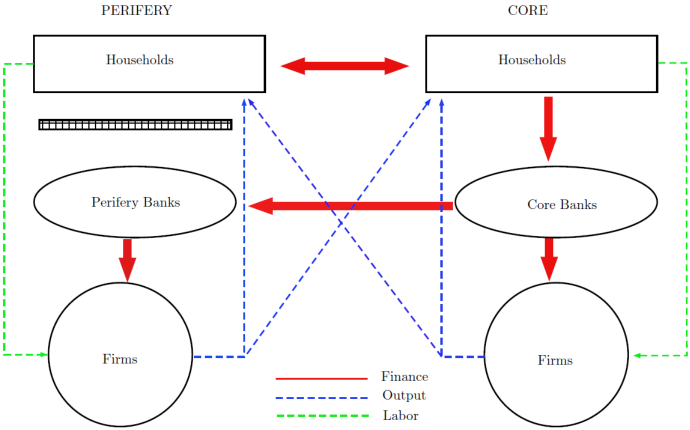
Overview

- Paper addresses the potential for international cooperation in the conduct macro-prudential (MaP) policies.
- The global economy is modelled within a core-periphery framework, emphasizing the role of international financial centers.
- Financial frictions give rise to a constructive role for MaP policy.
- Can MaP policies generate welfare gains in this context?
- Is it in the interest of the national authorities to cooperate toward achieving this goal?

Frictionless Model Economy



Financial Frictions Model Economy



Macro-prudential Policy

- Limited enforceability of contracts and financial dependency create a wedge, χ, between the return on capital, R_k, and the frictionless return, R.

$$\chi_t = E_t[\Lambda_{t+1}(R_{k,t+1} - R_t)] > 0$$

- MaP policy is modelled as a tax/subsidy, τ_k, on the gross return on capital:

$$\chi_t = E_t[\Lambda_{t+1}(R_{k,t+1}(\tau_{k,t+1}) - R_t)]$$

- MaP policy intervention costs generated through distortionary taxation.

Results

- MaP policies prove to be effective in mitigating the inefficiencies linked to financial frictions:
  - Long-run cost of capital can be moderated, but requires significant subsidies.
  - Short run domestic amplification of shocks and cross-border spillovers substantially mitigated.
- Overall level and distribution of welfare gains depend on cooperation between MaP authorities:
  - Cooperation: Ramsey policy maximizing global welfare.
  - No cooperation: Nash equilibrium, where each country maximizes its own welfare.
  - Policies under cooperation yield higher gains but these are markedly skewed toward the peripheral economy.

Comments

- MaP policy, as modelled, has a very "fiscal flavor" to it.
    - Reliance on distortionary taxation to make policy intervention costly makes results sensitive to government budget balance specification.

Table 6: Gains from cooperation in percentage of permanent consumption (quarterly values) †

MaP funding	Global Welfare	EME Welfare	AE Welfare
Baseline country size ($n = 0.15$)			
With public debt	1.12	7.87	0.187
Without public debt	0.99	12.8	-0.68

Comments

- Reduced-form approach to MaP policy obscures the implications for specific instruments and omits potentially important channels of transmission.

  > "[F]rom a cost perspective, a tax on lending [revenue] can be viewed as an acceptable **short-cut** if the underlying motivation is capital requirements."

- Model features an explicit representation of banks' balance sheets.

  $\rightarrow$ Informative to look at implications for the capital-to-assets ratio.

  $\rightarrow$ Amenable to an explicit representation of various MaP instruments.

Comments

- Asymmetric distribution of welfare gains “points to potential political-economy obstacles to the achievement of cooperative outcomes.”
  - Main benefits from cooperation accrue from mitigating spillovers.
  - Cooperation leads to altruistic policies from the center country.
- Relevance of “intermediate regimes”?
  - Lambertini and Rovelli (2003), Galati and Moessner (2013) and Binder et al. (2017) propose looking at a leader-follower regime modelled as the Stackelberg game equilibrium.
  - Potentially an option to avoid the non-cooperative regime in a context of asymmetric gains.

Comments

- Possible extensions:
  - Nominal rigidities: do these results carry over to the New Keynesian framework?
  - What is the role of center-country monetary policy shocks?
  - What is the effect of currency mismatches and how can MaP policies address them?

Conclusion

- Very clear and intuitive paper.
- Thorough and insightful analysis.
- Strongly encourage everyone to read it!