

# “Should U.S. Monetary Policy Have a Ternary Mandate?”

FRB Boston, October 2, 2015

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- Recap and open questions
- Alternative mechanism
- Broader Taylor rule debate

# Main issues

- Do financial conditions matter only to the extent that they matter for future output and inflation?
  - Standard view is that of course through that channel with perhaps an emphasis on tail risk
- Alternative view instability matters per se
  - Bail out costs, political economy?
- Adopting a third mandate
  - Making it operational (including measuring instability risks)
  - Implications for conduct of policy

# Their model

$$\underset{r, R^C}{Min} \Gamma(Y_t - Y^*)^2 + \Phi(\pi_t - \pi^*)^2 + K(FI_t - FI^*)^2$$

$$Y_t = \alpha_0 + \alpha_1 r_t + \alpha_2 (FI_t - FI^*) + \alpha_3 R_t + \eta_t$$

$$\pi_t = \beta_0 + \beta_1 (Y_t - Y^*) + \varepsilon_t$$

where  $\beta_0 = \pi^*$  when expectations are well-anchored

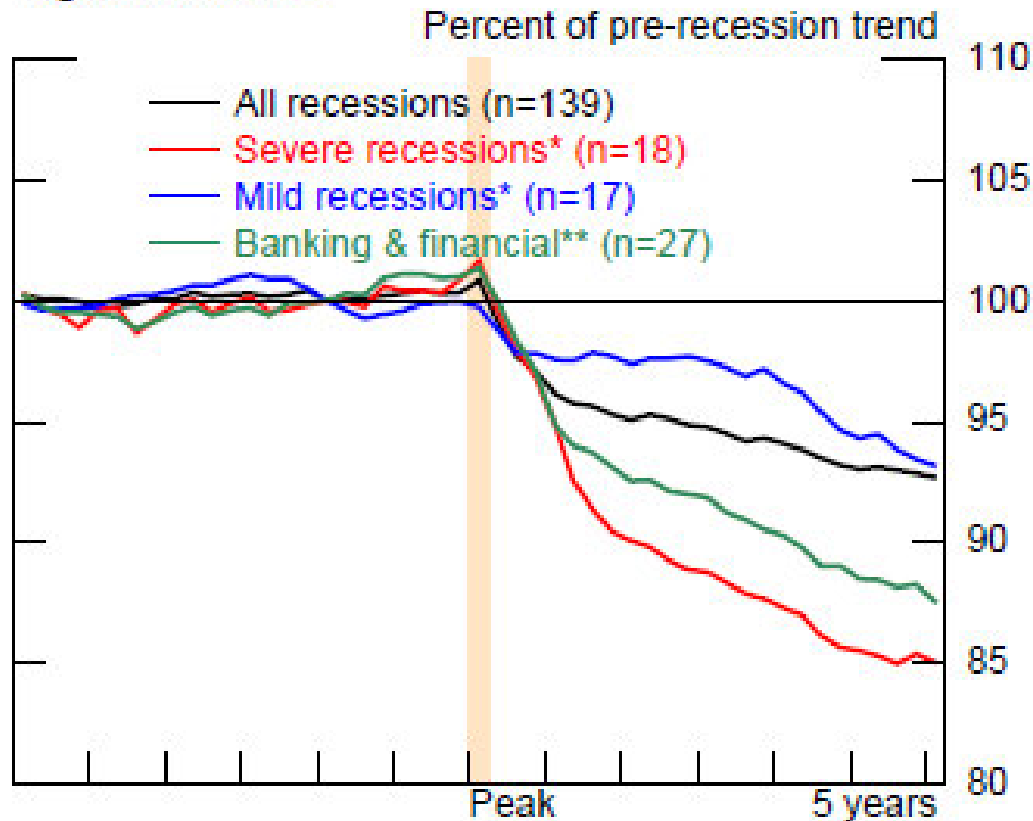
$$FI_t = \delta_0 + \delta_1 R_t + \delta_2 (P_t^A - P_F^A) + \lambda_t \quad \text{where } P_F^A \equiv \text{fundamental value}$$

$$R_t = \bar{R} + R^C + \xi_t$$

$$P_t^A = \rho_0 + \rho_1 (r_t - r^*) + \mu_t \quad \text{where } \rho_0 = P_F^A$$

# Financial instability and the path for $y^*$

**Fig 3. incl. GFC**



GDP trend calculated as exponential function growing at the four-year average two years prior to the peak

\* Severe recessions are in the top 25th percent of recessions as measured by both depth and duration. Similarly, mild recessions are in the bottom 25th percentile of each category.

\*\* B&F recessions include 10 severe recessions.

Martin, Munyan, and Wilson (2015)

<http://www.federalreserve.gov/econresdata/ifdp/2015/files/ifdp1145.pdf>

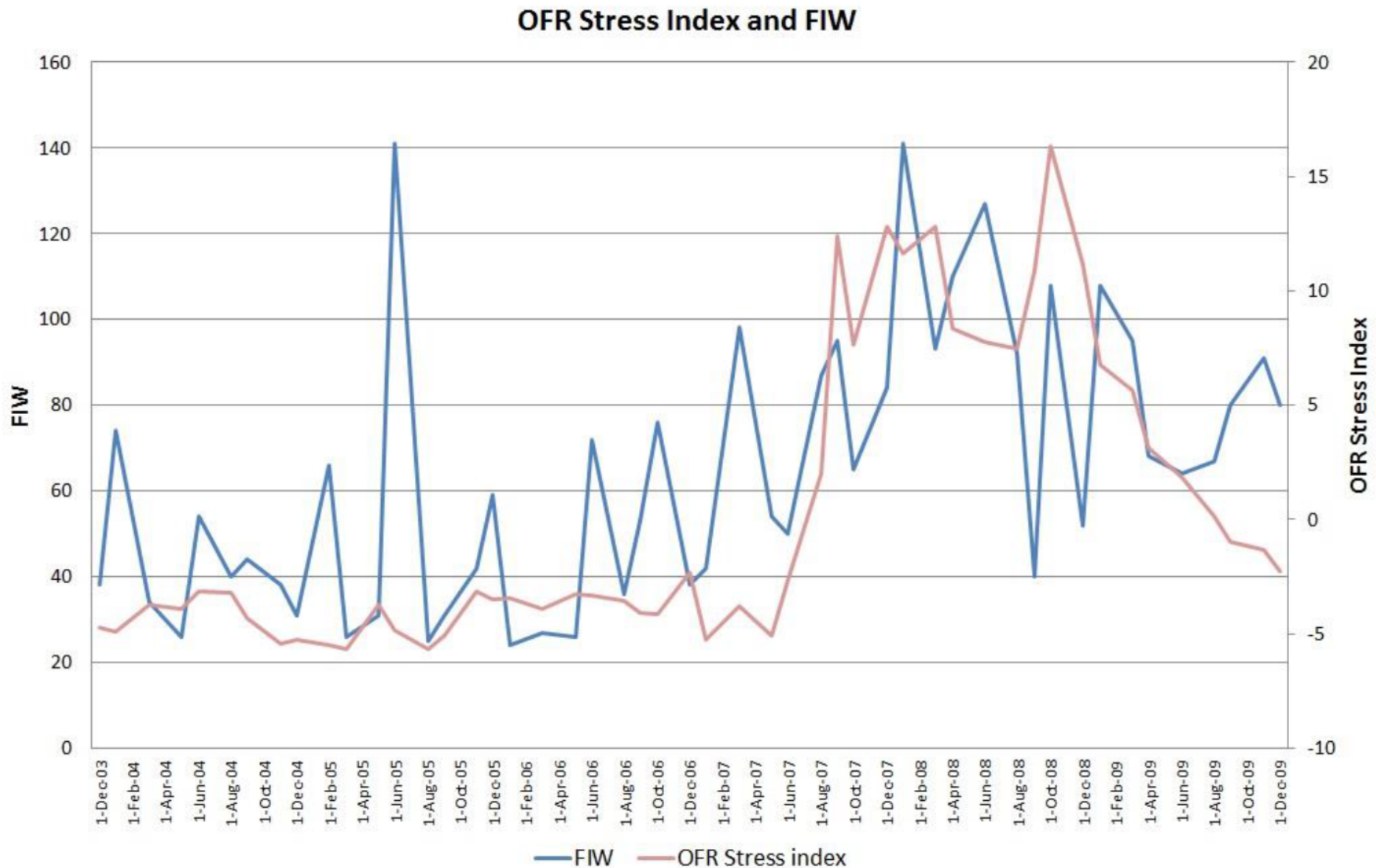
# Mechanisms by which financial instability reduces the path for $y^*$

- Zombie financing whereby failing to clean up insolvent banks kills productivity (Japan?).
- Bad government credit policies lead to misallocated capital (China?).
- Debt overhang after a credit boom (subprime?) so fast growth followed by slow growth may not average out.
- Is reaching for yield with zero rates likely to lead to any special versions of these issues?

# Policy implications if financial instability changes the path for $y^*$

- Not all credit booms should be coded as sowing the seeds of instability
- Effects depend partly on whether  $y$  and  $y^*$  are equally (and simultaneously) affected by the financial instability
- Effects depend on how forecasts for  $y^*$  and future gaps evolve

# Measuring instability



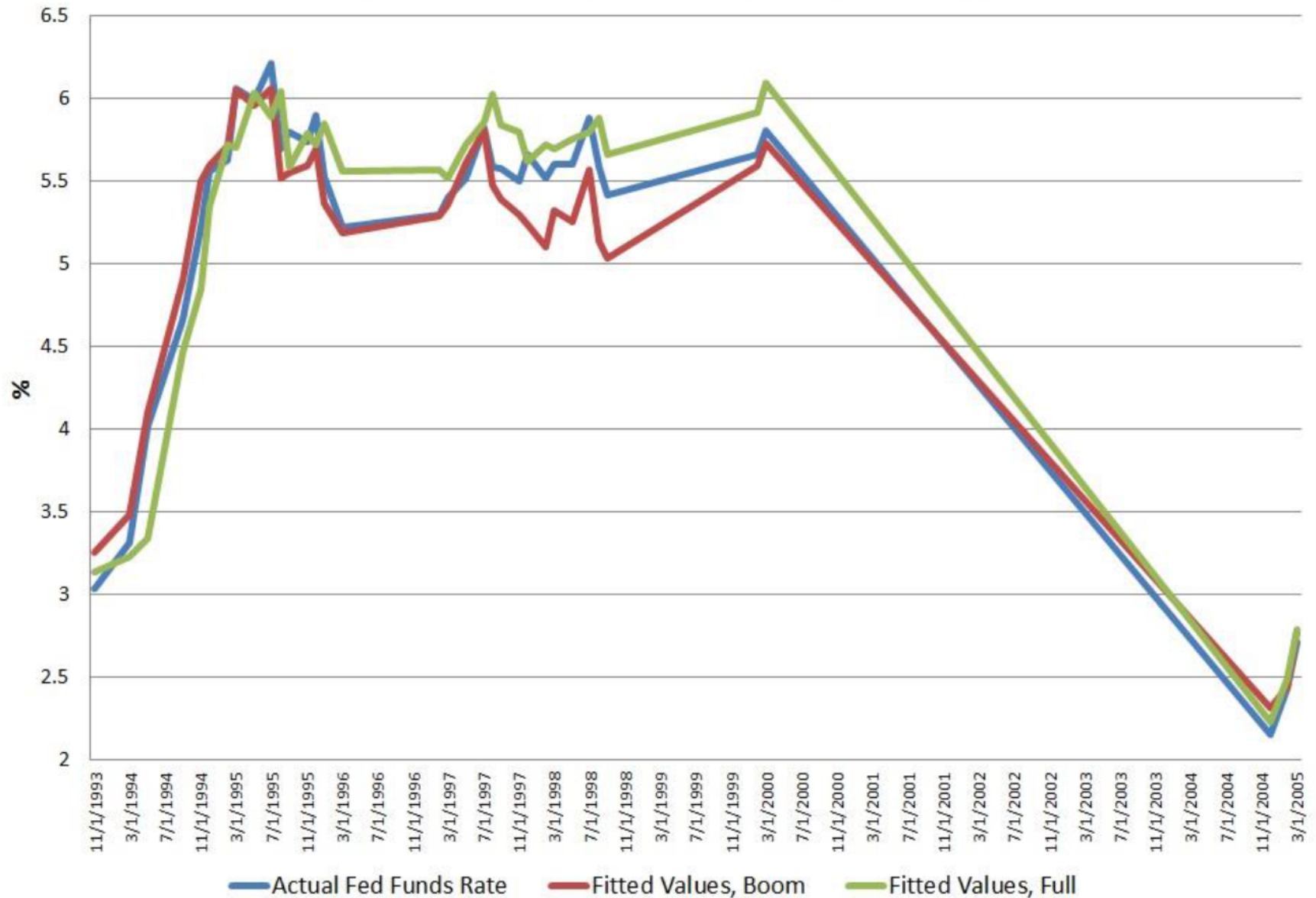
# Acting on concerns about Financial stability?

- March 2014 minutes
- In their discussion of recent financial developments, participants saw financial conditions as generally consistent with the Committee's policy intentions. However, several participants mentioned trends that, if continued, could become a concern from the perspective of financial stability. **A couple of participants pointed to the decline in credit spreads to relatively low levels by historical standards;** one of these participants noted the risk of either a sharp rise in spreads, which could have negative repercussions for aggregate demand, or a continuation of the decline in spreads, which could undermine financial stability over time. One participant voiced concern about high levels of margin debt and of equity market valuations as well as a notable shift into commodity investments. Another participant stressed the growth in consumer credit to less creditworthy households.
- April 2014 minutes
- In their discussion of financial stability, participants generally did not see imbalances that posed significant near-term risks to the financial system and the broader economy, but they nevertheless reviewed some financial developments that pointed to potential future risks. **A couple of participants noted that conditions in the leveraged loan market had become stretched, although equity cushions on new deals remained above levels seen prior to the financial crisis. Two others saw declining credit spreads, particularly on speculative-grade corporate bonds, as consistent with an increase in investors' appetite for risk. In addition, several participants noted that the low level of expected volatility implied by some financial market prices might also signal an increase in risk appetite. Some stated that it would be helpful to continue to explore the appropriate regulatory, supervisory, and monetary policy responses to potential risks to financial stability.**

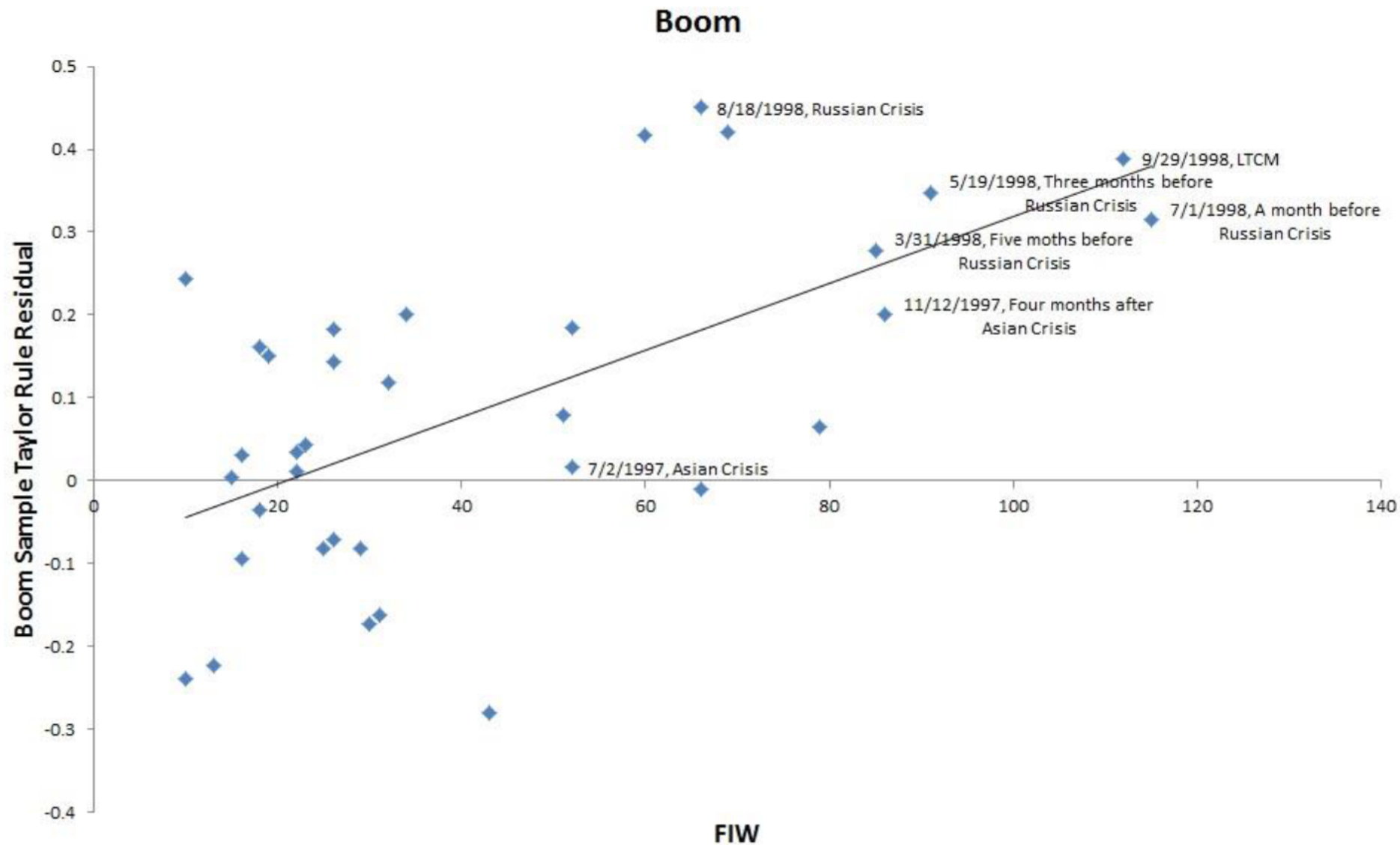


# Time Varying Taylor Rule Weights

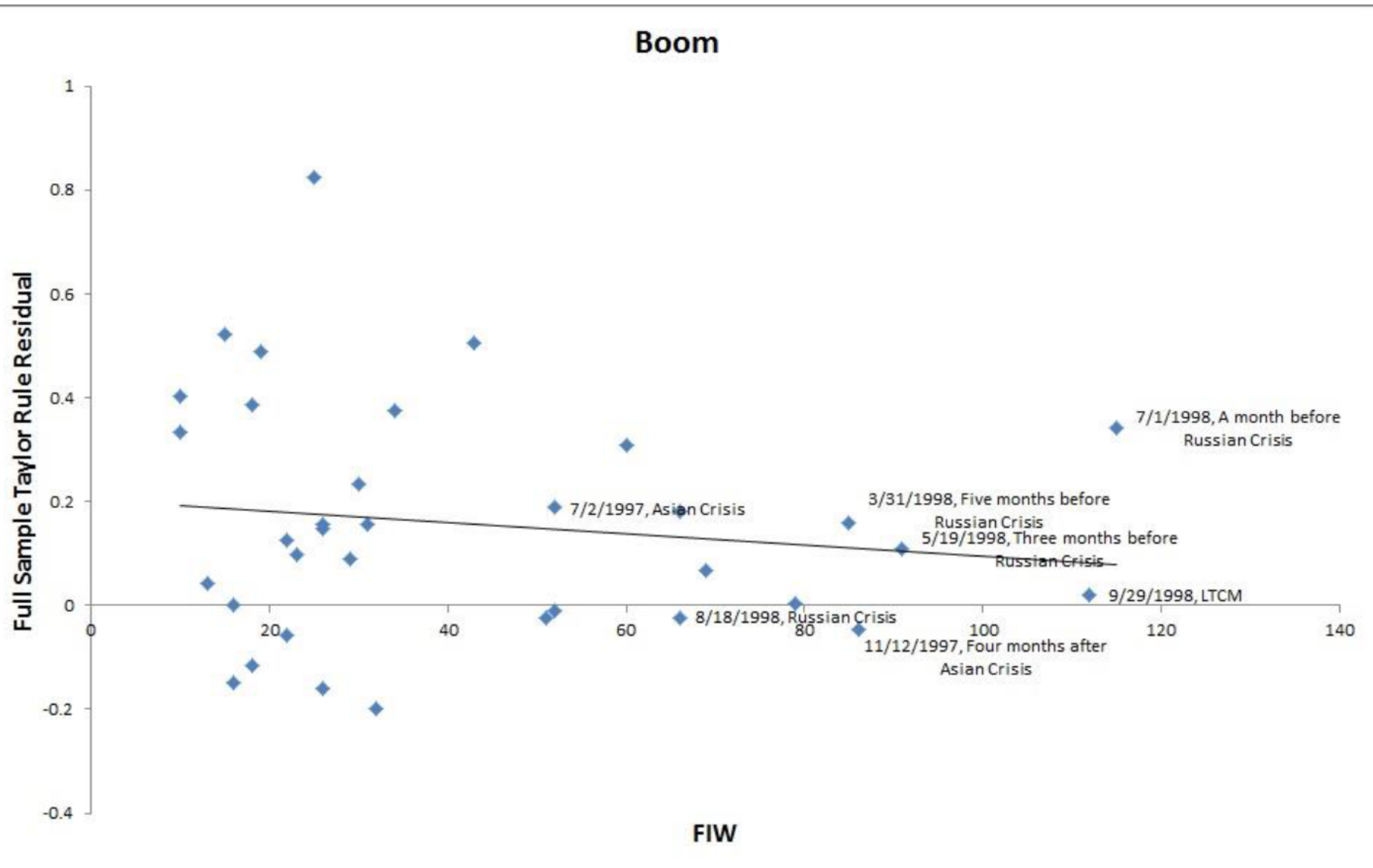
Actual Fed Funds Rate and Alternative Fitted Values, Boom



# Is the FOMC responding differently in booms?



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# Larger issues around Taylor style rules

- The real time data issues are a first-order problem that probably on their own should end this debate about whether a reference rule will be valuable.
- We should admit that the Great Moderation generated complacency and lead to over-confidence about the workings of the economy. Absent that unusual period we would not be discussing reference rules.
- We still do not yet understand how to measure financial instability risks nor how to model their effects
- Adopting a reference rule now is a REALLY bad idea