

The New Financial Regulation in Basel III and Monetary Policy: A Macroprudential Approach

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Summary

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Conclusions

- DSGE model to study Basel III: extremely clear summary.
- Welfare-Based criterion to study what can go wrong under the different policies (very valuable!)
- Comparison across different regimes (Basel I, II and III)
- Welfare analysis and discussion of how to make everyone potentially better off (Kaldor-Hicks scheme)

Main Messages

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- Monetary Policy need respond more to inflation because the transmission changes when capital requirements become tighter.
- Increasing the CRR has negligible effects on output and inflation volatilities once MP is optimized. But reduces financial volatility (by about 5 percent from BII to BIII).
- If the countercyclical capital buffer is implemented on top of static requirement in an *optimal way* financial volatility more than halves. Inflation volatility halves as well while output volatility rises a bit.

Comment I: Implementability

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Schmitt-Grohé and Uribe (Optimal simple and implementable monetary and fiscal rules, JME 2007) (p.1709) criteria for a rule to be operational:

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- I. locally unique equilibrium.
- II. non-negative interest rates.

Comment I: Implementability

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Schmitt-Grohé and Uribe (Optimal simple and implementable monetary and fiscal rules, JME 2007) (p.1709) criteria for a rule to be operational:

- I. locally unique equilibrium.
- II. non-negative interest rates.
- III. coefficient on inflation between 0 and 3.
 - Relaxing the constraint can deliver optimal responses to inflation like 332!
 - At the same time the welfare difference is tiny (flat welfare function for high values of (ϕ_π))

Comment I (ct'd)

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- ① To assess to which extent the ZLB is a concerns and how this changes across different regimes: how does the unconditional variance of the policy rate compares with its steady state value?

Comment I (ct'd)

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- ① To assess to which extent the ZLB is a concern and how this changes across different regimes: how does the unconditional variance of the policy rate compares with its steady state value?
- ② What is the welfare difference between the various optimal values?
Counterfactuals in which the inflation coefficient is kept fixed while the CRR changes to isolate the effects of the two separately.

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- ① To assess to which extent the ZLB is a concern and how this changes across different regimes: how does the unconditional variance of the policy rate compares with its steady state value?
- ② What is the welfare difference between the various optimal values?
Counterfactuals in which the inflation coefficient is kept fixed while the CRR changes to isolate the effects of the two separately.
- ③ Do you also face a lower bound on the cyclical component of the buffer?

Comment II: Comparison to Ramsey

Kiley and Sim (2015) study Ramsey policies in a similar setting:

	Loss (%)
Baseline (no macroprudential policy)	-0.40
Optimized simple rules	
Instrument: r_t and τ_t^m	-0.19
Instrument: r_t	-0.28
Ramsey Policy with	
Instrument: r_t and τ_t^m	0
Instrument: r_t	-0.22
Instrument: τ_t^m	-0.04

Table : Table 4 (p. 29) in Kiley, Michael T. and Jae Sim (2015). "Optimal Monetary and Macroprudential Policies: Gains and Pitfalls in a Model of Financial Intermediation," Finance and Economics Discussion Series 2015-078. Washington: Board of Governors of the Federal Reserve System, <http://dx.doi.org/10.17016/FEDS.2015.078>.

Ramsey MP \simeq Optimal MP Rule

Ramsey MacroPru \succ MacroPru Rule

Comment II (ct'd)

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- Simple MacroPru rules have a hard time distinguishing good from bad credit (Kiley and Sim, 2015).
- Would be interesting to optimize the rule when some shocks are switched off to verify along which dimensions the optimized rule is better.
- Also, the relative size of the shocks is crucial in this exercise (especially since the model is not estimated).
- Why focus on MP shocks?

Other Comments

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- Do you have a sense if these results are sensitive to the specifics of the credit market? e.g. what if banks had a different role, i.e. they created money as opposed to transferring resources (Jakab and Kumhof, 2014)?
- What about the interactions between monetary and macro prudential policymakers (De Paoli and Paustian 2013)?

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- Very clearly written paper that offers an excellent summary of the regime changes leading up to Basel III
- Welfare-based evaluation of simple policy rules
- An optimized capital-buffer rule can reduce financial volatility significantly
- Would love to see more detail on the shocks (their calibration and how the rules perform in response to different shocks) and a more implementable version (e.g. smaller coefficients on inflation) so we could appreciate how they compare.