Comments on:
Financial Stability, Growth and Macroprudential Policy

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Motivation and Relevance to
"Growth & Inequality: Long-Term Effect of Short-Term Policies"

Macroprudential Policy, by limiting borrowing, has (at least) two opposing effects on growth:

- Negative effects in "good" time **(trend-reducing effect)**:

    1. through investment in capital and technology
    2. through consumption

- Positive effects in "bad" time **(volatility-reducing effect):**

    1. lower *probability* of a crisis
    2. lower *magnitude* of crises

With asymmetric business-cycles (driven by a one-sided credit constraint), over-all effect on long term growth is ambiguous.

The question: Which effect dominates growth and welfare?

Model-based quantitative answer

- Macroprudential policy reduces crises probability by 2/3, from 6.23% to 1.89%.

- At the cost of lowering average growth by 0.01pp only.

- Overall, Macroprudential policy generates welfare gains equivalent to 0.06% permanent increase in consumption.

Existing research directions
and available policy instruments

Financial frictions amplify business cycles.
Explored policy implications includes:

1. Employment of policy instruments for moping up *ex post*

2. Correction of externalities that induce over-borrowing *ex ante*:

   - Using Macroprudential regulation
   - Using Macroprudential *monetary* policy
   - Using Macroprudential *fiscal* policy (Pigouvian taxes and subsidies, the approach discussed by the present work)

Missing mechanisms of emerging economies

- Interest rate is exogenously constant (small open economy assumption). But:
  - Exogenous $\neq$ Constant. How the presence of (global) interest-rate shocks change results?
  - Is the proposed tax still proposed under (endogenous) debt-elastic (market-based) risk-premium?

- The exchange rate (ER) is an important driver of the collateral value (creditors' point of view). Most of the time, ER would be the most important contributor for fluctuations in the collateral value.
  1. Direct and indirect ER influences on the desired $\tau_t^{MP,b}$: $\partial \tau_t^{MP,b}/\partial \hat{q}_t < 0$, $\partial \tau_t^{MP,b}/\partial \hat{q}_{t+1} > 0$, $\partial \tau_t^{MP,b}/\partial r > 0$
  2. Exploring the effects of **endogenous** ER – important and interesting.

Missing shocks

TFP is the only shock in this paper. How general the qualitative and quantitative results are?

Other relevant and interesting shocks:

- This literature is driven by the existence of financial frictions, reflected by collateral constraints. What are the effects then of a shock to the allowed leverage $\left(-\frac{b_{t+1}}{q_t} < \phi \right)$?

- News shock - may generate **under**, rather than **over**borrowing (self fulfilling mechanism...).

Hidden channel of externality?

- The collateral value is driven by the growth decision:
  $q_t = \beta E_t \left[\frac{\lambda_{t+1}^{CE}}{\lambda_t^{CE}} \left(\alpha \theta_{t+1} \mathbf{z}_{t+1} + q_{t+1} \right) \right].$

- An externality in the growth decision? Missing discussion:
    - In normal times - growth contributes to (over?) borrowing. Not only directly (demand), but also indirectly (supply), through its contribution to the collateral value.
    - In crises, when the constraint binds, sacrifice consumption for growth (so as to relax the constraints)?

- Both Social Planners (Multi-instrument and Macroprudential) actually internalize, but the discussion is missing.

How pragmatic is a state-contingent tax-rate?

- Time varying tax rate that should be declared ex-ante (to affect present, forward-looking decisions and due to dynamic inconsistency), based on unavailable information.

- State-contingent tax-rate is politically challenging. **Fixed** tax rate is not the solution either – when the constraint binds, $\tau_t^b = 0$. Under what circumstances do we declare a situation of a credit crunch?

  - Political incentives to rush in.
  - Such declaration might be self fulfilling.
  - How, politically, do we increase τ_t^b immediately after a crisis?
  - How do we decide that the crisis end (heterogeneity, information structure)?

- Pragmatic alternative (at least politically) – interest-rate rule. In the model – technically equivalent solution method.

Quantitative and Qualitative Robustness

- The main message is quantitative – MP is cost effective(?)

- But the particular quantitative result is very model specific:
  - The utility function (specification and parameterization) is crucial for the volatility-trend tradeoff:
    1. through risk aversion
    2. through the trend and cycle components

  - The growth-enhancing expenditure (specification and parameterization) affects:
    1. the volatility-trend tradeoff
    2. $z_{t+1} \implies q_t \implies$ borrowing (supply & demand), constraint...

- Qualitatively, crises also have an evolutionary contribution:
  - Crises boost creative destruction, thus contributing to growth!
  - Precautionary behavior of both creditors and debtors ("too much stability", moral hazards...).

Concluding remarks

- Tractable model and well written paper!

- Policy, and response to crises, is based on understanding of the mechanisms involved.
  - But the paper focuses on a policy recommendation, based on a model-specific quantitative result.
  - I would consider, instead, emphasizing a model-based communication of the mechanisms in place.

Thank you!