Comments on "Credit frictions and optimal monetary policy", by Cúrdia and Woodford

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An important paper

- New Keynesian models: first generation.

  Nominal rigidities, monopolistic competition

- New Keynesian models; second generation.

  Introducing further, central, imperfections.

  – Labor markets. Unemployment

  – Credit markets

  – Financial markets

  – Goods markets. tough. to come

- CW paper will be the basic reference for credit market imperfections.

Why is the paper so important?

Typical Woodford technology:

- Introduce an additional imperfection in NK model. Here a wedge between borrowing and lending rates

- Work out the implications. Delicate choice of assumptions. Dynamic GE, with heterogeneity. But, from then on, no short cuts.

- Tough (exhausting, tedious?) slogging. Show all the unpleasant terms.

- Then, a simple structure emerges. Heterogeneity and wedge: Effects of wedge on (consumption) demand, and on (labor) supply.

- Strong positive and normative conclusions.

Prior beliefs: Two worries.

- Deterioration/Failure of financial intermediation may have very large adverse effects on demand and output.

- Monetary policy may just not work.

CW results:

- Effects on demand and output limited. Distribution effects, likely small aggregate effects.

- Monetary policy works.

- Optimal monetary policy still simple. (If exogenous wedge, same optimal target criterion. $\pi + (\lambda_y/\kappa)(x - x(-1)) = 0$)

Robust conclusions, or results of specific, perhaps unappealing, assumptions?

(Many other results, but no time:)

- Effects of intermediation on the effects of other shocks.

- Effects of shocks to borrowers' or savers' spending.

- Characteristics of optimal monetary policy.

- Taylor rules as approximations, bad or good.

- Reacting to credit aggregates.

The central CW assumptions:

- Intermediation between households. Savers and borrowers

- Difference: Effective discount rates: Savers discount less.

Implications: Effect of an increase in wedge on (consumption) demand.

- At same average rate, lower lending rate: savers save less; higher borrowing rate: borrowers borrow less.

- Distribution effect for sure. Borrowers borrow less/consume less. Savers lend less/consume more.

- Aggregate effect? As savers have relatively low consumption, account for less of total demand. So decrease in lending rate more than offset by increase in borrowing rate.

  (Quantitative role and lack of appeal of σ_b/σ_s different from 1.)

Increase in wedge on (labor) supply

- Savers want to consume more, work less. Borrowers want to consume less, work more.

- Distribution effect for sure.

- Aggregate effect. As savers work relatively more, they account for more of labor supply. Decrease in lending rate leads them to consume more, work less. Thus net decrease in labor supply.

Implications

- Wedge increases: Adverse shift in aggregate demand. Adverse shift in aggregate supply. (Not unlike standard supply shocks)

- Large distribution, but small aggregate, effects of wedge increases.

- Monetary policy still works: Affects the two rates.

Robustness?

- Suppose: Intermediation required for production.

  Production takes time, and firms need to borrow in order to buy inputs. Less intermediation, less production.

- Suppose: Intermediation between saving and investment.

  Investment requires financial intermediation. Less intermediation, less output next period.

- Non linearities and effectiveness of monetary policy?

  Suppose breakdown of intermediation. Firms cannot borrow. production/investment stops.

  Monetary policy affects the lending rate. No effect on production.

- Link with direct liquidity provision. Irrelevant in CW. But relevant in previous case.

Conclusions

- A gigantic methodological step.

- Much clarification of the potential implications.

- Do not buy the conclusions/policy implications quite yet.