The „Reversal Rate“: The Effective Lower Bound on Monetary Policy

by M. Brunnermeier and Y. Koby

discussant: Loriana Pelizzon

House of Finance

SAFE

Sustainable Architecture for Finance in Europe

A Cooperation of the Center for Financial Studies and Goethe University Frankfurt

Center for Financial Studies

Goethe Universität Frankfurt am Main

Research Questions:

What is the effective lower bound on Monetary Policy?

Does it exist a „zero lower bound“?

Is the „effective lower bound“ equal to the „zero lower bound“?

What are the perverse effects of Monetary Policy below the effective lower bound? What are the driving mechanisms?

HOUSE OF FINANCE SAFE

Key idea

The effective lower bound is given by the „reversal rate“: the rate at which accomodative monetary policy „reverse“ its effect.

An interest rate cut leads to two effects:

1. Substitution effect: banks reserve with loans and therefore credit growth
2. Wealth effect:
   - capital gain on bonds
   - reduction of banks‘ margings (in presence of banks‘ market power because of switching costs)

Key idea

In the case of a negative wealth effect:

- when the reduction of margins > capital gain:

$\Rightarrow$ capital requirements are binding and banks‘ credit reduces

$\Rightarrow$ A reduction of interest rates by CB generates the perverse effect of a reduction of banks‘ credit!

HOUSE OF FINANCE SAFE

Key idea

Timing and sequencing of Monetary Policy measures:

1. Induce banks to hold fxed interest rate bonds (through favourable refinancing operations)
2. Cut the policy rate to generate capital gains for a stealth recapitalization of the banking sector
3. Conduct QE so that banks could realize capital gains and switch their portfolios to short term bonds and reserves

At this stage another reduction of the interest rates is less effective or even contractionary

4. Increase interest rate so banks could increase again margins (The central bank in this case could „reload the gun“)

House of Finance SAFE

Comments

Monetary policy largely relais to expectations: how your results change if we consider expectations in your model? Does the reverse rate move up?

If the effect is largely driven by frictions and capital requirements the policy implications are:

a) Eliminate frictions and restore bank competition?
b) Reduce in this period capital requirements?

Comments

Is there another way (potentially complementary) to solve the problem?

- Induce the CB to lend money directly to governements that recapitalize banks?

- Find a substitute for banks that provides credit:
  - CB lend directly to SME
  - Shadow banking sector
  - P2P lending

Comments

- Timing: For how long the game could go on? For how long it is reasonable to keep the interest rate low through the Third phase: QE?
  - Given the current situation: Do you think that is already the time to increase interest rates?

- The problem we are facing of credit shrinking is:
  - a supply effect
  - a demand effect?

In both the cases it seems it is already the time to increase interest rates (is it true?)

HOUSE OF FINANCE SAFE

Comments

- If we are including in your model the perverse effects that low interest rates have on:
  - Insurances
  - Pension funds
  - Equity market „bubbles“
  - ....
- the three phases of Monetary Policy are justified (are really welfare improving)?
- Can fiscal policy solve the issue better?

HOUSE OF FINANCE SAFE

Very interesting ideas

I am looking forward to reading the complete paper!