

Discussion of “Effects of State-Dependent Forward Guidance, Large-Scale Asset Purchases and Fiscal Stimulus in a Low Interest Rate Environment”

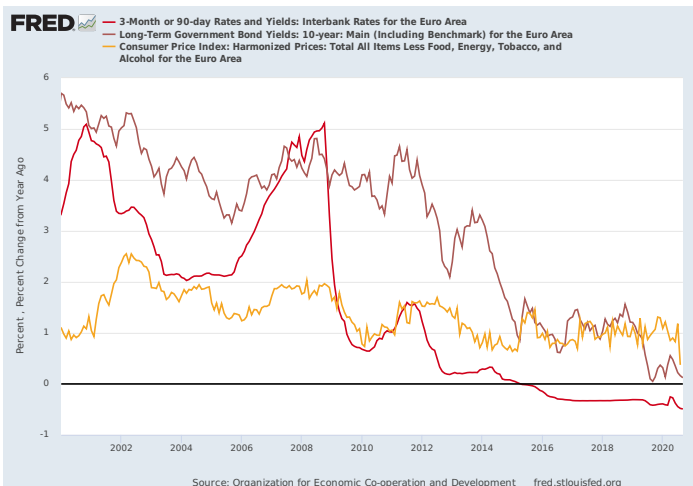
by Frank Smets & coauthors

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Hoover Oct 21, 2020

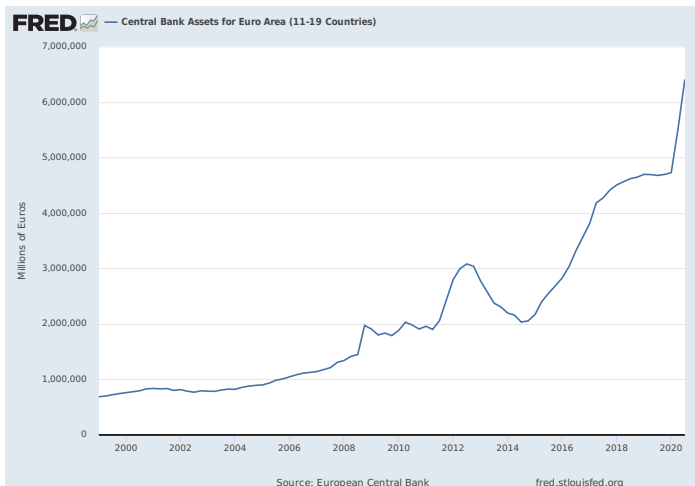
ECB Monetary policy

- Negative interest rates, less than 2% inflation

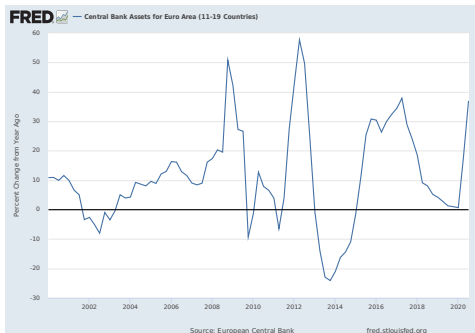


ECB Monetary policy

- Key second policy tool in low rate environment: asset purchases



How does size of the purchases get determined?



- ▶ Euro Crisis July 2012 "Whatever it takes", Mario Draghi
- ▶ March 12 2020 "We are not here to close spreads", Christine Lagarde
- ▶ March 18 2020 "There are no limits to our commitment to the euro."
"We are determined to use the full potential of our tools, within our mandate."

How will central banks determine their balance sheets?

- Important for policy makers to be explicit about their policy path
 - ▶ Sept 15 ECB Roundtable on the review of monetary policy strategy
 - ▶ 20, 30 year long term interest rate are close to zero,
low rate environment will be around for a long while
 - ▶ Asset purchases will be main tool (together with interest on reserves)
- Big applause to Frank for specifying equation (3) in his paper
 - ▶ Describes how asset purchases respond to macroeconomic conditions
Policy rule for asset purchases!

Why do asset purchases matter?

New Area-Wide Model NAWM II

- builds on New Keynesian model, where policy rate = rate on savings
 - ▶ fast transmission to many rates of return
 - slow transmission to rates on bank loans
- banks are special for lending and financially constrained
 - ▶ investment is bank-dependent
 - ▶ banks cannot issue equity, face leverage constraint
 - ▶ if their net worth is low, loan rates are high
- purchases are powerful in crisis and near ELB
 - purchases help recapitalize banks in bad times
 - especially near ELB where rates cannot be cut further

Complementary view for why asset purchases are important

Banks as payment providers (Piazzesi & al 2018, 2019)

- policy rate = rate on special bond held by banks (interbank loans)
 - ▶ slow transmission to all other rates
- banks not special for lending and can freely raise equity
- purchases are powerful when the central bank runs a floor system
 - ▶ purchases increase quality of assets that back inside money
 - ▶ more inside money creation, lowers other rates of return
- rule for asset purchases important for output & inflation
 - ▶ purchases are powerful even in highly securitized banking system
 - ▶ also away from ELB if floor system is maintained