Discussion of “The Interplay Between Financial Conditions and Monetary Policy Shocks,” by Bassetto, Benzoni and Serrao

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Overview

▶ Big and important question: how do monetary policy conditions and financial conditions interact?

▶ ”Sub-questions”:

▸ Does monetary policy respond systematically to credit conditions, in particular credit booms?
  - If so, is the response “adequate”? What role did the Fed’s stance play in the run-up to the 2007-2009 crisis?

▸ When monetary policy tightens exogenously, how do financial conditions respond?
  - Long literature on the credit channel of monetary policy

▸ Very nice paper that provides some simple and robust evidence, using recent innovations in measures of financial stress
  ▸ Gilchrist and Zakrajšek (2012), NFCI from the Chicago Fed
**Result 1: monetary policy responds to financial shocks (with a lag)**

\[
Y_t = \begin{pmatrix}
\log(\text{RGDP}_t) \\
\log(\text{BFI}_t) \\
\text{EBP}_t \\
\text{FFR}_t
\end{pmatrix}, \quad Y_t = A(L)Y_{t-1} + B\epsilon_t, \quad B \text{ lower triangular}.
\]
RESULT 2: FINANCIAL CONDITIONS WORSEN AFTER A MONETARY TIGHTENING

- Fed Funds innovations lead to a increase in EBP about 8 quarters out
- Lags output and investment response (slightly different with extended VAR)
Result 3: MP “leans against the wind” of credit booms

- Without the systematic MP response (red line), financial shocks would lead to more sustained expansions in output and investment.

- Toward the end of the 2004-2008 credit boom, the systematic response contributed to stabilizing output.
1. How “systematic” is the response of monetary policy to financial shocks? Does it contribute substantially to FFR movements?

2. Is it robust to identification schemes?

3. How should we interpret the result — are FC a part of the policy rule?

4. Other (non-VAR) evidence?
Comment 1: the FEV of variables wrt the FC shock

Extremely persistent contribution to FEV of FFR; point estimate is positive and large, but not significant.
“Systematic,” but only since the mid-1990s?
Comment 2: alternative identification scheme

- Cholesky identification: “agnostic” about the response of monetary policy
- More restrictive approach: document impulse responses to shocks that are associated with
  1. a fall in the financial conditions index on impact
  2. an increase in the Federal Funds rate at any point in the next 2 years
- Sign-restricted VAR in a Bayesian framework — Arias, Rubio-Ramirez and Waggoner (2014)
- More direct answer to the question: does monetary policy tighten after a credit boom?
- Leaves the response of output and investment (or anything else you would want to include in the VAR) unrestricted.
Comment 2: sign-identified policy response

Essentially **identical** impulse responses, except for the short-run response of monetary policy.

- Probably suggests could just have fit an AR model variable by variable, with innovations in EBP as an impulse variable.
Comment 3: interpretation

What to make of the (lagged) response of FFR to FC innovations?

\[
\hat{i}_t = r^n_t + \phi_\pi \pi_t + \phi_y \log \left( \frac{y_t}{y^n_t} \right) - \Phi(L) f_t
\]

- H1: it’s an artefact of the (lagged) response of output and inflation to FC innovations
  - \( \Phi(L) = 0 \) — simple Taylor rule
  - “Passive” leaning against the wind
  - At a very basic level, consistent with the timing of the responses

- H2: monetary policymakers respond to financial conditions independently from inflation & output
  - \( \Phi(L) \neq 0 \) — augmented Taylor rule
  - “Pro-actively” leaning against the wind
  - Lag structure?

Curdia and Woodford (JMCB, 2010) could provide a framework to test H1 and H2.

Important to understand deviations from optimality (i.e. construct an estimated rule); could shed light on the mid-2000’s experience.
Comment 4: other evidence

Broader question: historically (and setting aside 2007-2009), what role have financial conditions played in monetary policymakers’ rate-setting decisions?

Can we answer this question with another tool than VARs?

- Very large literature examining financial markets’ reaction to FOMC decisions / statements, starting (at least) with Cochrane and Piazzesi (2002) and Bernanke and Kuttner (2005)

- Typically uses high-frequency data; not clear whether it applies here (high-frequency measure of financial market stress?)

- Romer and Romer (2004) narrative approach potentially more promising

- Simple question: when there are large and persistent changes in financial conditions (as measured by e.g. the EBP), do FOMC minutes make more consistent mention of it?

- Parse FOMC minutes, as in Boukus and Rosenberg (2006)