Discussion on “Liquidity, Business Cycles, and Monetary Policy” by Nobu Kiyotaki and John Moore

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[1] The views expressed here do not necessarily reflect the views of the Federal Reserve Bank of San Francisco or the Federal Reserve System.

Summary

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- Two-way interactions between asset prices and aggregate quantities: different from standard RBC models and standard finance models
- By exchanging money for equity, the unconventional monetary policy can alleviate liquidity shocks and expand investment; but conventional monetary policy is neutral.

Comments

- Empirical implications: two-way interactions between asset prices and aggregate quantities can be a potentially powerful transmission mechanism for business cycle shocks
- Policy implications: it matters what kind of assets to exchange (treasury bills or equity) in open market operations.

It's a great paper that will influence the thinking of academics and policymakers in years to come.

Discussions

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- To answer this question, two sets of issues need to be addressed:
    1. An empirical issue: Are the liquidity constraints quantitatively important in shaping business cycles?
    2. A policy issue: To what extent does monetary policy (esp. unconventional policy) affect the real economy?

Quantitative importance of liquidity constraints

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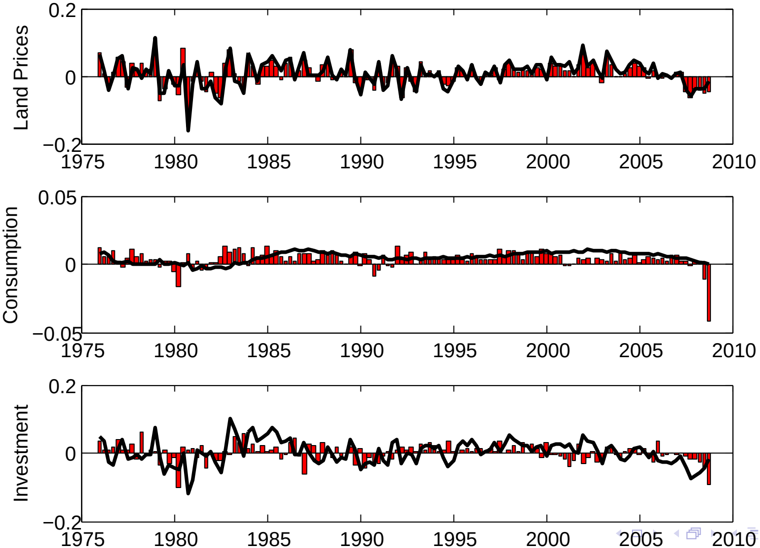
- Recent work by Liu, Wang, and Zha (LWZ, 2009) shows that interactions between asset prices and aggregate quantities are quantitatively important.
- The key is to have some shocks that move the asset prices. While TFP shock does not move asset prices much, some other shocks do (see Figure).

Contributions of housing demand shock in the LWZ model



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- Is the unconventional policy important for business cycles? It can be. Financial interdependence (e.g., credit chains) can further strengthen the real effects of monetary policy.
- Caution: The expectation effects of regime switching can be important (Liu, Waggoner, and Zha (2009)).
- Current situations: Do Fed policies help alleviate impaired liquidity (without raising inflation expectations)?

Looking ahead...

- Important subject of research: to assess the empirical performance of the liquidity business cycle (LBC) model.

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- Should consider replacing the RBC core with the more promising LBC core in a new generation of DSGE models for policy analysis.