SVERIGES RIKSBANK

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Liquidity, Business Cycles and Monetary Policy

May 2009

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Motivation

- How do aggregate production and asset prices fluctuate with shocks to productivity and liquidity?
- What can monetary policy do?
- Build a workhorse model of money **and** liquidity: RBC+ Limited Commitment

Why Money?

- No intrinsic value
- Limited Commitment
- Money is more liquid than equity
- Money "lubricates" the transfers of resources from savers to investors in presence of liquidity constraints

The Mechanism in a Nutshell

- Each period only a randomly chosen fraction of entrepreneurs can invest.
- How do they finance their investments?
  - Raise the investment cost externally by selling at most a fraction θ of their own equity (**Borrowing Constraint**)
  - Raise funds for the down-payment:
    - Sell at most a fraction ϕ of other agents' equity (**Resaleability Constraint**)
    - Sell/use money
- Borrowing + Resaleability Constraint = Liquidity Constraint
- For low values of θ and average ϕ money is essential because it's more liquid than equity

Main results

- Money has a low rate of return $\Rightarrow$ Low risk-free rate puzzle
- RoR_{Money} < RoR_{Equity} < Rate of time preference $\Rightarrow$ Stock market participation puzzle
- Feedback from asset markets to output:
  - Liquidity Shock $\Rightarrow$ Amount of equity that can be used for down-payment $\downarrow$ $\Rightarrow$ Equity price $\downarrow$ $\Rightarrow$ Required down-payment per unit of new investment$\uparrow$ $\Rightarrow$ Investment $\downarrow$
- Government can (partly) stabilize the economy with open market operations

Comments

- Very insightful paper
- Extremely elegant, easy aggregation follows from linearity of individual policy rules, closed form solutions for the steady state
- Stock market participation puzzle: workers cannot borrow....
- Effects of news shock on stock prices with limited enforcement (Walentin (2008))

Comments, cont'd

- Fiscal consequences of open market operations ≈ effects on aggregate demand of future taxes
- Expectations of future open market operations
- Microeconomic distortions: policy interference with informativeness of asset prices
- Compare these distortions with the welfare consequences of not intervening, study distributional issues; a fully fledged welfare analysis would be useful!

Comments, final

- Monetary policy and liquidity – an area which will be studied intensively in years to come
- One aspect – the zero lower bound to policy rates may infact be > 0, due to liquidity concerns