The Macroeconomic Effects of Macroprudential Policy: Evidence from a Narrative Approach

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Discussion

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Macroeconomic Effects of Central Bank Policy

❑ Monetary Policy Shocks

- Short-Term Interest Rate (IR)

❑ Macroprudential Shocks

- Legal Reserve Requirements (RR)

❑ Three Major Contributions to the Literature

- Construct Improved Measure of Effective Reserve Requirements

- Narrative Methods to Construct RR Shocks

- Identification of Exogenous RR and IR Shocks

❑ Examine Macroeconomic Effects of RR and IR Shocks

Traditional Identification Strategies

❑ Structural Vector Autoregressions (SVAR)

❑ Local Projections

❑ Variables

- Real GDP Growth Rate

- Inflation

- Change in Effective Legal Reserve Requirement (ΔECRR)

- Change in Central Bank Interest Rate (ΔIR)

❑ Results with Both Methods

- Negative Effect of Higher IR on Economic Activity (Expected)

- No Negative Effect of Higher RR on Economic Activity (Puzzling)

❑ Issues with Both Methods

Narrative Method for Reserve Requirement Shock

❑ Reserve Requirement Shock

❑ Based on Romer and Romer (2010)

- IMF reports and Central Bank Documents

- Changes in Reserve Requirements

  - Endogenous – Motivated by Current or Projected Fluctuations in Output

  - Exogenous – Triggered by Other Reasons

- Use Exogenous Changes for Estimation

New Measure of Central Bank Interest Rate Shock

❑ Interest Rate Shock

❑ Based on Romer and Romer (2004)

- Regress ΔIR on:

  - Lagged Interest Rates

  - Lagged and Forecasted Inflation

  - Lagged and Forecasted GDP Growth

- Residuals are the Interest Rate Shock

Identification with Exogenous Shocks

❑ Local Projection Method

❑ Same as with Traditional Identification Except

  ● Exogenous Macroprudential and Monetary Shocks

❑ Macroprudential Shocks

  ● Negative Effect of Higher RR on Economic Activity

❑ Monetary Shocks

  ● Negative Effect of Higher IR on Economic Activity

❑ More Convincing than Traditional Methods

❑ No Results with Structural VARs

  ● Why?

Identification of RR Shock with Narrative Methods

❑ Most Important Result of the Paper

    ● Identification Method Matters for the RR Shock

    ● Identification Method Does Not Matter for the IR Shock

❑ The Narrative RR Shock Cannot be the True Unobserved Shock

    ● Classification into Exogenous and Endogenous Cannot be Correct

    ● Model is Misspecified

    ● Problem with all Applications of the Narrative Method

Identification with External Instruments

❑ RR Shock is a Good Candidate for an Instrument

- Plausibly Correlated with the Unobserved Shock

- Plausibly Uncorrelated with the Other Shocks

❑ Use Narrative RR Shock as an Instrument for the True Shock

❑ Structural VAR

- Method of External Instruments

- Ramey (Handbook of Macroeconomics, 2016)

❑ Local Projections – Instrumental Variables

- Stock and Watson (Economic Journal, 2018)

❑ Possible Issues with Weak Instruments

- Olea, Stock, and Watson (Journal of Econometrics, Forthcoming)

Conclusions

❑ Very Interesting Paper

❑ Several Important Contributions

  ● Improved Reserve Requirements Series

  ● Narrative Method for Identifying RR Shocks

  ● Solves "Puzzle" with Traditional Identification

❑ Can be Improved by Better Identification of the Shocks