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COMMENTS ON “A SAFE-ASSET PERSPECTIVE FOR AN INTEGRATED POLICY FRAMEWORK” by Markus Brunnermeier, Sebastian Merkel and Yuliy Sannikov

Frank R. Smets
European Central Bank and KU Leuven
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In this paper, Brunnermeier et al build on their work on their I-theory of money to develop an alternative integrated policy framework (IPF) to study optimal monetary policy, macroprudential policies, foreign exchange interventions and capital controls in an interconnected global financial system. This framework contrasts with the IPF developed by the IMF which is largely based on price setting frictions in the New Keynesian mode. In the Brunnermeier et al framework the key frictions are financial frictions. Those financial frictions create a demand for safe assets which in some cases can have a bubble component. The bubble component will depend on the convenience yield of the asset. In a world with financial frictions the bubble component will tend to increase the efficiency of the economy, but at the same time make it more susceptible to exogenous variations in interest rates or risk sentiment. This may then give rise to a financial cycle which can create endogenous risk. The role of policies in this framework is to eliminate as much as possible the endogenous risk, by intervening where the frictions are largest. The paper describes an international framework whereby the domestic safe asset competes with an international safe asset denominated in dollars. When the dollar interest rate falls, EME firms may leverage up by issuing dollar debt and this may sustain a domestic safe asset bubble as interest rates are low while growth is high. This boom may turn into a bust when US dollar interest rates go up, the domestic currency depreciates, financing costs go up and a negative feedback loop between banks, their customers and possibly the government sets in. In this framework, Brunnermeier et al analyse the impact and optimality of monetary policy, macroprudential policy, foreign exchange interventions and capital control management.

I have a few comments/questions.

First, it would be interesting to apply the proposed framework to the current covid-19 crisis. Following the spreading of the virus throughout the world, the risk-off sentiment increased dramatically leading to a dash for cash, i.e. an enormous increase in the demand for safe assets. This was accompanied by very large capital outflows from the EMDEs, tightening financial conditions in the EMDEs with higher spreads than in the GFC, and finally large depreciations of their currencies (although generally less so than in the GFC). These capital outflows come on top of the direct impact of the coronavirus in the EMEs and the impact of the large fall in oil and commodity prices due to the fall in world demand. Does the proposed IPF fit to the current Covid-19 crisis in the EMDEs. What are the policy implications?

Second, the IMF's IPF combines New Keynesian price setting frictions in both domestic and export markets with the prevalence of financial frictions including foreign exchange mismatches in domestic



and foreign financial markets. It would be useful to describe more precisely how the Brunnermeier et al IPF differs from this framework. Is it mostly the analysis of the demand for a safe asset and the possibility that the supply of the safe asset contains a bubble component? And to what extent do these differences lead to different policy implications? For example, an important policy instrument to deal with the fragility in EMEs due to their large dollar debts is to put in place a system of dollar swap lines (as the Fed has done). To what extent is the relevance of this policy different in both frameworks. In particular how does the notion of the safe assets as having a bubble component matter for the assessment of these policies?

Third, one salient feature of the policy response to the covid-19 crisis is that governments have implemented unprecedented easing of fiscal policy to protect firms from revenue shortfalls and workers from the reduction in wage income due to unemployment. In the IMF's IPF expansionary fiscal policy is likely to be quite effective in stimulating the economy in particular as interest rates are close to the effective lower bound. What are the implications of a high increase in the prospective supply of government bonds in the Brunnermeier et al framework? How does it affect the likelihood of the domestic bubble bursting? And how does it interact with monetary, macroprudential and exchange rate policies?

Fourth, Brunnermeier et al describe how their IPF may explain why the original trilemma is more a dilemma as argued by Rey (2018). This relies on the fact that a sudden increase in risk-off sentiment and a rise in the demand for US dollar safe assets, may lead to inflationary pressures in EMEs rather deflationary pressures that are more usual in developed countries. Is this consistent with the empirical evidence regarding the effect of international risk shocks or US monetary policy shocks on inflation in EMDEs versus advanced countries. For example, Dedola, Rivolta and Stracca (2017) "If the Fed sneezes, who catches a cold?", JIE (2017) find that following a US monetary policy tightening inflation declines especially in advanced economies, but also in EMDEs. An alternative model is one where because of the dollar denominated debt there is a reversal rate on the short term interest rates (as in "The Open-Economy ELB: Contractionary Monetary Easing and the Trilemma," by Cavallino and Sandri (2020), CEPR Discussion Paper 14683). In this paper, monetary policy is constrained in easing following a US interest rate tightening because it leads to a domestic exchange rate depreciation which will tend to tighten the balance sheet constraint in the face of foreign exchange mismatches. This would tend to lead to deflationary pressures in the EMDEs. What is the evidence of such different responses?

Finally, the paper analyses the relative merit of ex-ante policies that try to lean against the boom in times of risk-on sentiment (such as a pre-emptive tightening of macroprudential policies or a tax on capital inflows) versus ex-post policies that try to short-circuit the negative feedback loops in the bust period (e.g. dollar swaps or foreign exchange intervention). In doing so, it seems to argue more in favour of cleaning (i.e. ex-post policies) than leaning (ex-ante policies). One issue it does not address is the moral hazard implications of the ex-post policies. If agents realise that the central bank or the other



government authorities will intervene by satisfying the demand for safe assets and thereby short-circuiting the financial bust and negative feedback loops, is there a risk that this increases the size of the domestic safe asset bubble even more and thereby also increases the amplitude of the financial cycle. Is there an optimally sized bubble from an efficiency point of view which will have an impact on the optimal mix between ex-ante and ex-post policies?