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# **Comment by Chris Sims on Noah Willams's “Monetary Policy under Financial Uncertainty”**

November 20, 2011

## To get started on important questions, simplify

- The paper does not attempt to model crises as arising endogenously.
- There is an exogenously evolving, 1st order AR, risk spread.
- In crisis mode, it enters the otherwise standard NK model in the Phillips curve and IS equations, with different distributed lags in the two equations.

## **Simplification here is in principle a good idea**

- There may be too much focus in macro research on how we got into this, relative to how we get out.
- Treating regulatory policies as separate, therefore leaving them out of the model, is justifiable as a first step.
- Treating central bank interest rate policy as having no influence on the probability of a crisis abstracts from an important and controversial issue, but this seems to me also justifiable as a first step.

## **Unfair comments start here.**

- Treating the central bank as unable to influence credit spreads seems to me much harder to justify.

## Liquidity policy

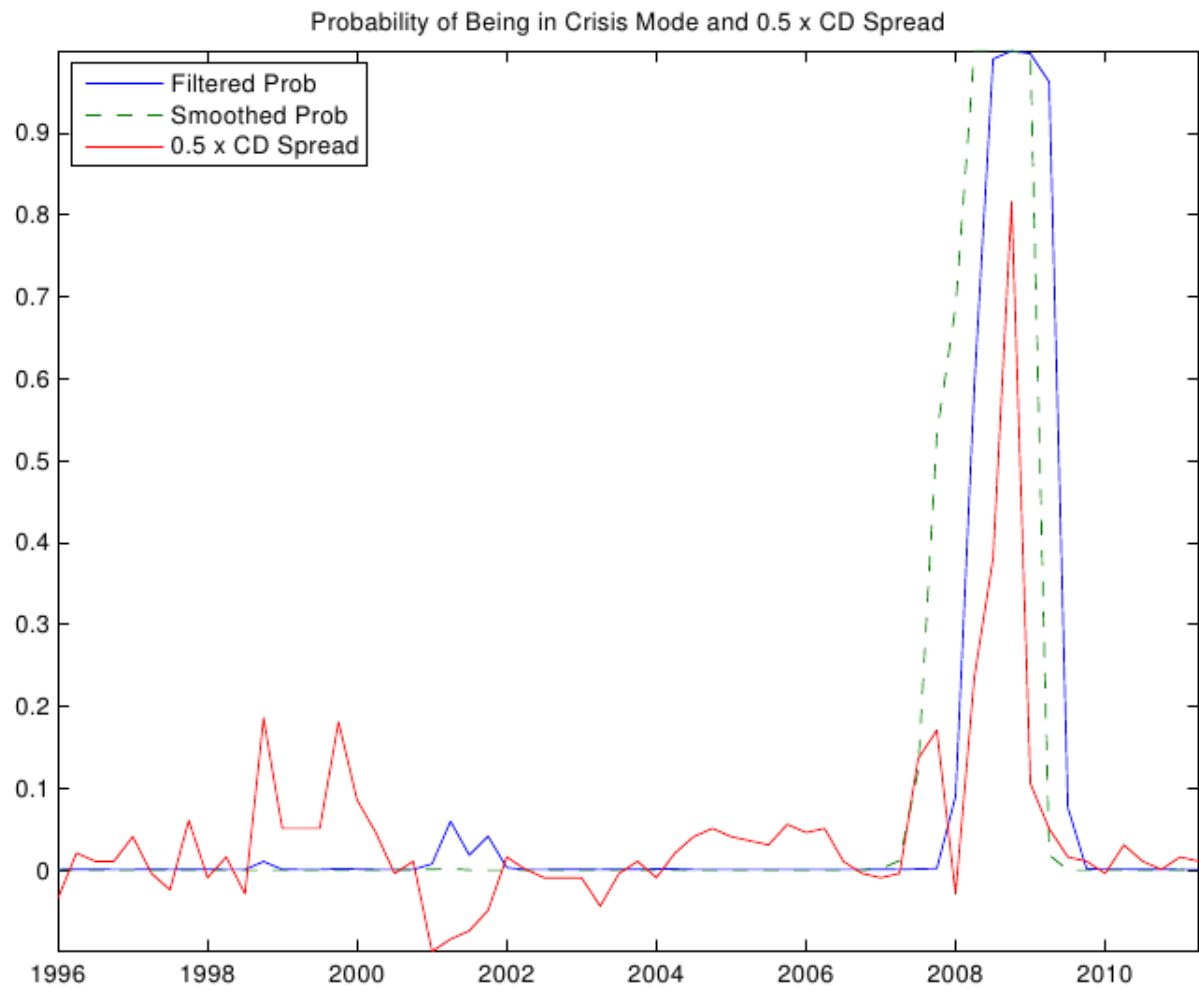
- Most central banks vastly and rapidly expanded their balance sheets during the crisis.
- They did this to revive frozen asset markets, and to some extent succeeded, reducing interest rate spreads.
- These policies have costs that affect subsequent monetary policy.
- Large balance sheets magnify the effects of monetary policy on government budgets, which could affect future monetary policy either through direct political intervention from outside the central bank, or by affecting central bank policy decisions at the margin because of worries about potential political intervention.

## Modeling balance sheet/liquidity policy

- This is not easy — so it's probably unfair to ask that it be done as part of a first step.
- It probably requires modeling fiscal-monetary interactions, and possibly political economy.
- But it seems so central to accurately characterizing the current policy environment that it certainly would be nice to make some attempt to include it.

## Fairer comments

- I don't understand Figure 3.3.
- It seems to show filtered probabilities of being in a crisis of exactly zero during late 2007, while the smoothed probabilities for the same period are near one.
- In other words, based on data up to this period, the model implies certainty that there is no crisis, but with hindsight the model identifies this period as a crisis period.
- So the model sees an extremely unlikely (even impossible) event as having occurred, which ought to imply the model has very low likelihood.





## **BOP worse than AOP?**

- That with both the private sector and the government doing BOP, this could be worse than with both doing AOP, is plausible.
- But policy always has the option, it would seem, of implementing AOP, yet the paper seems to assert that with the private sector displaying BOP, policy according to BOP could be worse than AOP.
- I may misunderstand the paper, or it may be that the way equilibrium is being formulated, the BOP policy-makers are not taking account of an avenue of feedback from their choices to private behavior.

## An interesting result

- In Figure 4.6, a penalty on the squared interest rate in the policy objective function does avoid hitting the zero bound. It keeps the decline in output low. It seems to do so by generating higher inflation through the crisis period than any other policy specification.
- Since the interest rate path seems little different from that for the estimated policy rule, I don't understand how this is arising. It does seem that higher inflation is being engineered as insurance against the consequences of the ZLB.