Discussion of
"Loose Monetary Policy and Financial Instability"
by Grimm, Jordà, Schularick, Taylor
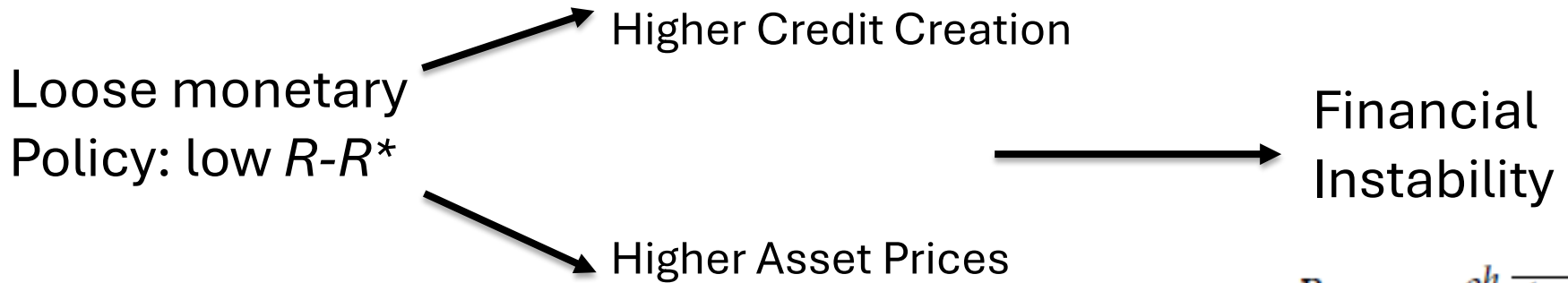
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Summary of the Paper

Loose monetary Policy: low *R-R** → Higher Credit Creation

Loose monetary Policy: low *R-R** → Higher Asset Prices

→ Financial Instability
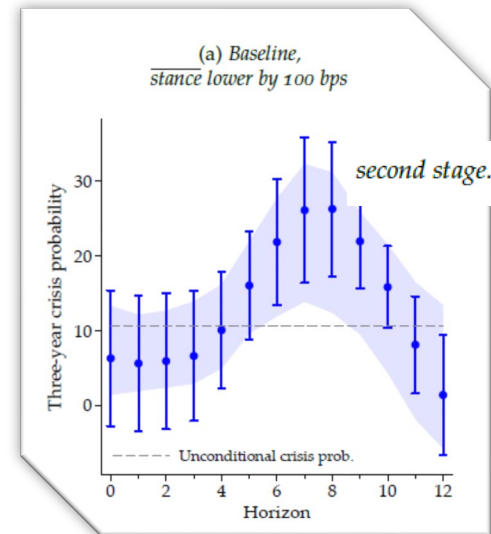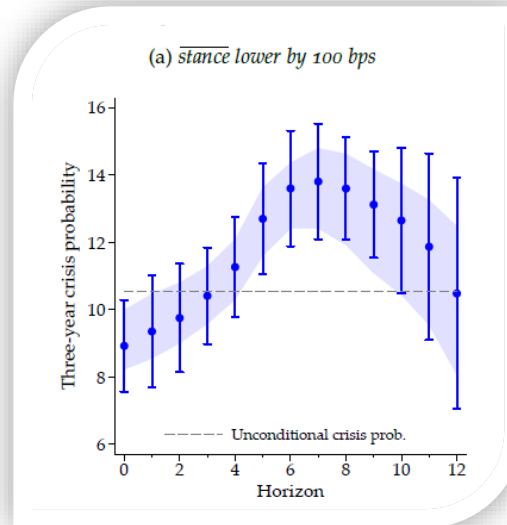
$$B_{i,t+h} = \beta^h \overline{stance}_{i,t}$$

$$R_{i,t} - \pi_{i,t} = \underbrace{r^*_{i,t}}_{r^*} + \underbrace{\tilde{R}_{i,t} - \tilde{\pi}_{i,t}}_{stance},$$

where the left side is denoted r.

$$\overline{stance}_{i,t} = \frac{1}{5} \sum_{k=0}^{4} \left(r_{i,t-k} - r^*_{i,t-k} \right)$$

(a) $\overline{stance}$ lower by 100 bps

Three-year crisis probability vs Horizon

- - - - Unconditional crisis prob.

(a) Baseline, $\overline{stance}$ lower by 100 bps

second stage.

Three-year crisis probability vs Horizon

- - - - Unconditional crisis prob.

1. Measures of R* are all over the place

Figure 5: Baseline model simulation and VAR estimate of Global R^*
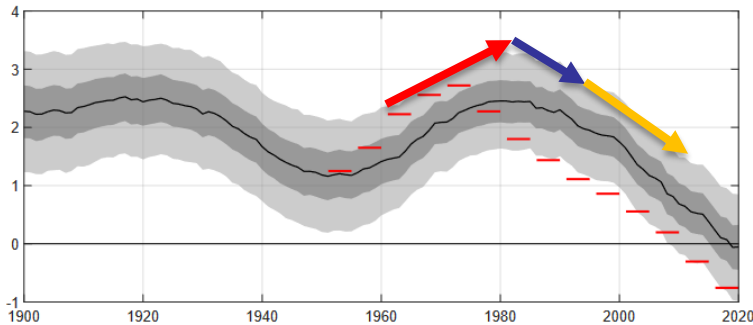
NOTE. The solid black line is the posterior median of the VAR estimate of Global R^* presented in Appendix D and the shaded areas show the 68 and 95 percent posterior intervals. The red lines show the baseline path for the real interest rate generated by the structural model, as shown in Figure 3. All interest rates are annualized percentage rates.

Finding R-Star
The Lubik-Matthes Estimate of the Natural Rate of Interest

--- Upper/Lower Bound   — Median
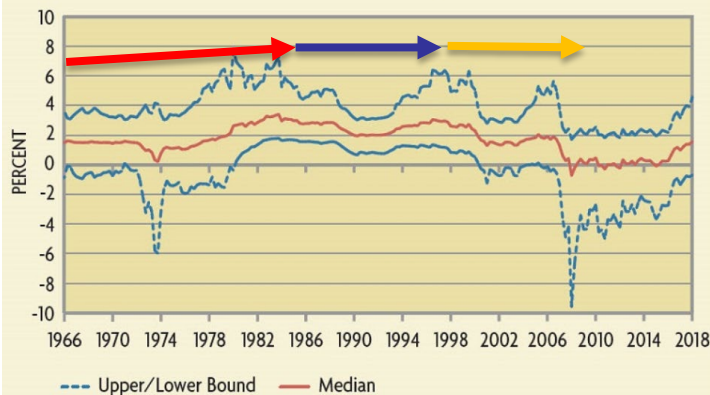
SOURCE: Thomas A. Lubik and Christian Matthes, "Calculating the Natural Rate of Interest: A Comparison of Two Alternative Approaches," Federal Reserve Bank of Richmond *Economic Brief* No. 15-10, October 2015.
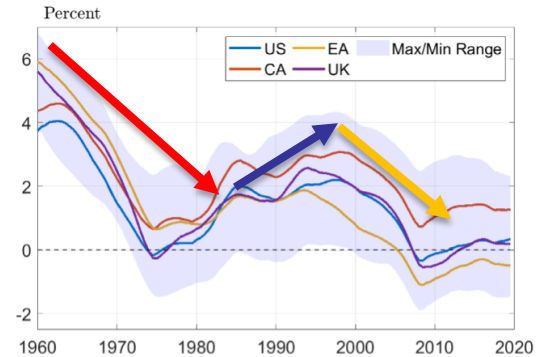
Fig. 5. Longer-run real neutral rates across advanced economies.
NOTE: Fig. 5 shows longer-run neutral interest rates estimated by the model of Section 3 using the median values of the posterior distribution of parameters. Economies are abbreviated as US for the United States, CA for Canada, EA for the euro area, and UK for the United Kingdom.

## HLW Estimates for the United States
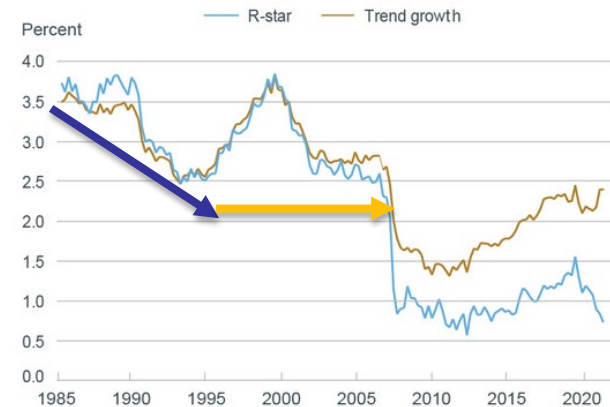
Sources: Holston, Laubach, and Williams (2017); Organisation for Economic Co-operation and Development (OECD).
Notes: Estimates are GDP-weighted averages across the United States, Canada, and the Euro Area. We use OECD estimates of GDP at purchasing power parity. For dates prior to 1995, Euro-Area weights are the summed weights of the eleven original Euro-Area countries

2. Debatable whether *R-R** measures stance

Measure of R* adopted here closer to some long-run concept measuring intercept of Taylor rule
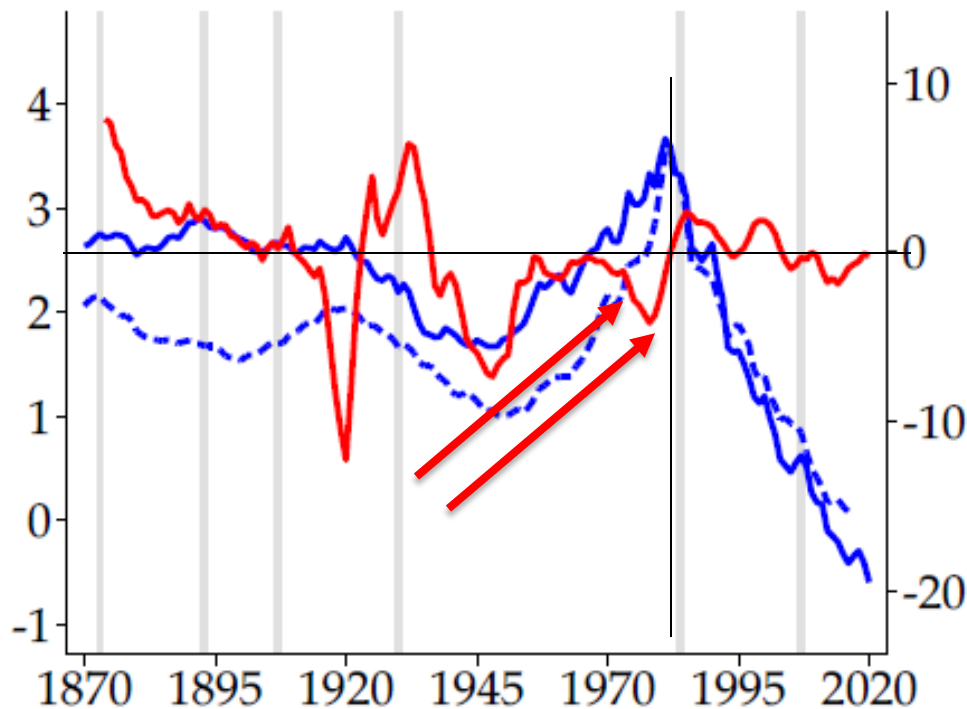
Policy is loose from 1930 through 1982, for 52 years in a row.

Policy is loose in the 1967-69 tightening cycle, even if FFR rose by 540 bps...

Policy is loose b/w 1972 and 1974, when FFR rises by 960 bps...

Policy is loose in April 1980, when Volcker raises the FFR to 17.6 percent.

3. R-R* **is more than just loose or tight policy**

- Policymaker follows Taylor rule
$$R - R^* = 2 + 1.5(\pi - 2) + 0.5y + \varepsilon$$

- The gap between R and R* is not the stance. It is just a composite of inflation movements, GDP movements, and monetary policy surprises.

- If CB aggressive against inflation , high $R - R^*$ measures inflationary surprises

- If CB aggressive against GDP, high $R - R^*$ measures activity surprises.

4. Add proof of concept, and more narrative

- Taken literally, the results of the paper suggest that higher interest rates can stimulate the economy → maybe higher R-R^* just means that activity is strong which reduces the probability of a crisis

- Not fully clear what the policy implications are. Should banks track a different R^*? Should R be permanently higher?

- Paper has a lot of robustness checks: it would be more useful to have a narrative of what the influential observations are. Can be done by country, can be done by period.

- For the US and other major countries, it would be nice to check that the characterization of the stance lines up with other historical studies. Current draft plots stance in appendix A.2, should be part of the main text for readers to see.

5. The trouble with dummies and cutoffs

Figure 2: *The connection between loose*

(a) $\overline{stance}$ *lower by 100 bps*

aylor (JST henceforth) Macro
a banking crisis chronology

: $crisis_{i,t}$ be a dummy that is equal to 1 if a financial crisis starts in country

$\max\{crisis_{i,t}, crisis_{i,t+1}, crisis_{i,t+2}\}$.

$$High\text{-}Debt\text{-}Growth_{i,t} = \mathbb{1}\{\Delta_3 (Debt/GDP)_{i,t} > 80^{th}\ percentile\},$$
$$High\text{-}Price\text{-}Growth_{i,t} = \mathbb{1}\{\Delta_3 (\log Price_{i,t}) > 66.7^{th}\ percentile\},$$
$$R\text{-}zone_{i,t} = High\text{-}Debt\text{-}Growth_{i,t} \times High\text{-}Price\text{-}Growth_{i,t}.$$

$$\overline{stance}_{i,t} = \frac{1}{5}\sum_{k=0}^{4}\left(r_{i,t-k} - r^*_{i,t-k}\right)$$

ry policy shocks such as the one that hit the
l, we instrument $\overline{stance}$ with 10 lags of $z_{i,t}$. Re
icy as the moving-average difference betwee