International Coordination of Monetary and Macro-Prudential policies

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1Views expressed here are not necessarily the views of the BIS.
Introduction

When is international policy coordination desirable?

- Literature starting from Obstfeld and Rogoff (1992) finds little gains to international coordination on monetary policy (MP).

- But what about macro-prudential policy (MaP)?
  
  - Does a similar kind of result hold?
  
  - How do gains to international cooperation, if any, depend on economies’ fundamentals?
  
  - Do these gains depend on how MP is conducted (cooperative vs. non-cooperative)?
Introduction

Main results

- For given MaP policies, there are gains to MP cooperation at the global level, but they are asymmetric.
  - Region loosing to MP cooperation has no interest in coordination.

- Under non-cooperative MP, all regions experience positive gains to cooperating on MaP policies.
  - Cooperative MaP policies easier to implement than cooperative MP.

- Gains from cooperative MaP policies disappear under cooperative MP.
  - Cooperating on MP would help, but given the difficulty, cooperating on MaP remains the best option.
Introduction

The intuitions for the results in one slide.

- **Gains to MP cooperation are asymmetric:**
  - Under Nash MP, domestic interest rate maximizes domestic welfare.
  - With a global market, world equilibrium interest rate (FC) is the max
  - FC are hence optimal for one region, but too tight for the other.
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  - FC are hence optimal for one region, but too tight for the other.

- **Under Nash MP, all regions are better-off under cooperative MaP:**
  - FC under Nash MP are too tight for the global economy.
  - Coop. MaP aims at easing "too tight FC". How? by allowing for more cross-border capital flows $\Rightarrow$ higher welfare in both regions.
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  - Coop. MaP aims at easing "too tight FC". How? by allowing for more cross-border capital flows \( \Rightarrow \) higher welfare in both regions.

- **Gains to MaP cooperation go away under coop. MP:**
  - With cooperative MP, FC are suboptimal for each individual region, but ability to steer FC through domestic MaP is more limited.
  - Both Nash and coop. optimal MaP focus on capital flows and risk sharing.
Introduction

Some papers in the literature.

- **Policy coordination:**
  - extensive literature on MP coordination (cross-border, cross-policy). Engel (2016) provides a nice survey.
  - Much less on MaP coordination. Engel (2015) and Jeanne (2014)
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- **MP and MaP in open economy:**
  - Effectiveness: Rey (dilemma vs. trilemma), Mendoza (2016) and Aizenmann et al. (2018).
  - Leakages: Aiyar (2012) for the UK, Barroso et al. (2016) for Brazil
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- **Liquidity management/provision**
  - Under-insurance and pecuniary externalities (Gromb and Vayanos 2002, Lorenzoni 2008 or Stein 2012), particularly in open economy context (Caballero and Krishnamurthy 2003 or Jeanne and Korinek 2010, Brunnermeier and Sannikov (2014)).
The model
Framework and technologies.

- A 3-period economy à la Holmstrom-Tirole (1998) with 2 regions. In each region, risk neutral banks maximize final profits.

At date 0, banks with a unit endowment, can invest $I$ in a risky asset. Risky assets yield $\rho I$ or 0 at date 1; yields negatively correlated across regions.

At date 1, uncertainty unravels: Banks can save for a return $\theta I$. Banks whose risky assets do not pay can reinvest for a return $\rho K$.
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- At date 0, banks with a unit endowment, can invest $l$ in a risky asset.
  - Risky assets yield $\rho l$ or 0 at date 1; yields negatively correlated across regions.

- At date 1, uncertainty unravels:
  - Banks can save for a return $\theta \rho$.
  - Banks whose risky assets do not pay-off can reinvest for a return $\rho$.
The model

- Markets
  - **Ex ante risk sharing**: At date 0, banks can issue claims on their risky assets.
  - **Ex post market for liquidity**: At date 1, once uncertainty is resolved, banks can exchange liquidity.

- Policies
  - **Monetary policy**: Setting the return to savings between date 1 and date 2 (*deposit facility*).
  - **Macro-prudential policy**: Choosing how many claims banks can at most issue at date 0 (*leverage ratio or CFM*).
The model

Timing

Policy making stage

1. Macro-prudential authorities set limit of claim issuance.
2. Monetary policy authorities set the return on deposit facility.

Decentralized Equilibrium

1. Banks choose risk sharing portfolio (assets and liabilities).
2. Market equilibrium determines the amount of, and return on risk sharing claims.

1. Uncertainty unravels.
2. Risk sharing contracts are executed.
3. A market for ex post liquidity opens.

1. Reinvestment pays-off.
2. Contracts for ex post liquidity are executed.
3. Agents enjoy their profits.
The decentralized equilibrium

- The portfolio problem for region $i$ banks:

$$\max_{L_i, L_{-i}} \frac{1}{2} \pi_{i,1} r_{-i,2} + \frac{1}{2} \pi_{i,2}$$
The decentralized equilibrium

The portfolio problem for region \( i \) banks:

\[
\max_{L_i; L_{-i}} \frac{1}{2} \pi_{i,1} r_{-i,2} + \frac{1}{2} \pi_{i,2}
\]

\[
\pi_{i,1} = \rho (1 + L_i - L_{-i}) - r_{i,1} L_i \text{ and } L_i \leq \phi_i l_i
\]

s.t.

Equilibrium amount and return on ex ante capital flows:

\[
L_j = \phi_j (1 + L_i - L_{-i})
\]
The decentralized equilibrium

- The portfolio problem for region $i$ banks:

$$\max_{L_i; L_{-i}} \frac{1}{2} \pi_{i,1} r_{-i,2} + \frac{1}{2} \pi_{i,2}$$

$$\pi_{i,1} = \rho (1 + L_i - L_{-i}) - r_{i,1} L_i \text{ and } L_i \leq \phi_i l_i$$

$$\pi_{i,2} = \rho (\beta r_{-i,1} L_{-i} + D_i) - r_{i,2} D_i$$

s.t.
The decentralized equilibrium

- The portfolio problem for region $i$ banks:

$$\max_{L_i;L_{-i}} \frac{1}{2} \pi_{i,1} r_{-i,2} + \frac{1}{2} \pi_{i,2}$$

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$$\pi_{i,2} = \rho (\beta r_{-i,1} L_{-i} + D_i) - r_{i,2} D_i \text{ and }$$

$$D_i \leq \begin{cases} 
\rho j_i - \beta r_{-i,1} L_{-i} \text{ (size limit)} \\
\phi (\beta r_{-i,1} L_{-i} + D_i) \text{ (financial limit)} 
\end{cases}$$
The decentralized equilibrium

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\[
\max_{L_i; L_{-i}} \frac{1}{2} \pi_{i,1} r_{-i,2} + \frac{1}{2} \pi_{i,2}
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\[
\begin{align*}
\pi_{i,1} &= \rho (1 + L_i - L_{-i}) - r_{i,1} L_i \quad \text{and} \quad L_i \leq \phi_i L_i \\
\pi_{i,2} &= \rho (\beta r_{-i,1} L_{-i} + D_i) - r_{i,2} D_i \quad \text{and} \\
D_i &\leq \begin{cases} 
\rho \bar{j}_i - \beta r_{-i,1} L_{-i} & \text{(size limit)} \\
\phi (\beta r_{-i,1} L_{-i} + D_i) & \text{(financial limit)}
\end{cases}
\end{align*}
\]

- Equilibrium amount and return on ex ante capital flows:

\[
L_j = \phi_j \frac{1 - \varphi_j}{1 - \phi_j \varphi_j} \quad \text{and} \quad \beta r_{j,1} = r_{j,2} \quad \text{for} \quad j = \{i; -i\}
\]

- Capital inflows and outflows are \textit{negatively} correlated. Return to buying insurance \textit{equal} to return on ex post liquidity.
The decentralized equilibrium

Notations: \( R_{j,t} = r_{j,t} / \rho \) and \( 1 - \nu_i = (1 - q) \bar{j}_i \). When region \( i \) banks need to reinvest, market for ex post funding equilibrium:

\[
1 + L_{-i} - L_i \underbrace{= \beta R_{-i,1} L_{-i} + (1 - \nu_i)}_{\text{Funding Demand}}
\]

(\( \beta \) is the coefficient of the market for funding demand)
The decentralized equilibrium

- Notations: $R_{j,t} = r_{j,t}/\rho$ and $1 - \nu_i = (1 - q)\bar{j}_i$. When region $i$ banks need to reinvest, market for ex post funding equilibrium:

$$\underbrace{1 + L_{-i} - L_i}_{\text{Funding Supply}} = \underbrace{\beta R_{-i,1}L_{-i} + (1 - \nu_i)}_{\text{Funding Demand}}$$

- Supply and demand for funding are inelastic $\Rightarrow$ corner solutions
The decentralized equilibrium

- Inelastic funding supply and demand with $\beta < 1 \implies$ unique equilibrium with excess funding supply:

$$(R_{i,2}; R_{-i,2}) = \theta = \max (\theta_i; \theta_{-i})$$

and

$$\begin{cases} 
L_i \leq v_i + (1 - \theta) L_{-i} \\
L_{-i} \leq v_{-i} + (1 - \theta) L_i 
\end{cases}$$
The decentralized equilibrium

- Inelastic funding supply and demand with $\beta < 1 \Rightarrow$ unique equilibrium with excess funding supply:

$$ (R_{i,2}; R_{-i,2}) = \theta = \max (\theta_i; \theta_{-i}) \quad \text{and} \quad \left\{ \begin{array}{l} L_i \leq v_i + (1 - \theta) L_{-i} \\ L_{-i} \leq v_{-i} + (1 - \theta) L_i \end{array} \right. $$

- Higher degree of risk sharing (higher $(L_i; L_{-i})$) can be sustained with easier funding conditions (lower $\theta$)
  - With lower $\theta$, funding demand -say from banks of region $i$- goes down. Excess funding supply compatible with region $-i$ banks holding more claims $L_i$ from region $i$ banks.
  - Variant of the risk taking channel of monetary policy: lower interest rates allow larger cross-border risk-sharing instead of more risk taking.
Optimal monetary policy

The non-cooperative equilibrium

- MP makers in region $i$ choose the domestic interest rate $\theta_i$:
  - to maximize domestic banks’ expected profits
  - subject to banks arbitraging between deposit facilities
Optimal monetary policy
The non-cooperative equilibrium

- MP makers in region $i$ choose the domestic interest rate $\theta_i$:
  - to maximize *domestic* banks’ expected profits
  - subject to banks arbitraging between deposit facilities

- The problem for MP maker in region $i$:

$$\max_{\theta_i} \pi_i = \left[ 1 + \left( 1 - \frac{1}{\beta} R_{i,2} \right) L_i \right] R_{-i,2} + (1 - R_{i,2}) \left( 1 - \nu_i \right)$$

s.t. $R_{i,2} = R_{-i,2} = \max (\theta_i; \theta_{-i})$

Optimal interest rates under Nash MP satisfy $\theta_i = \theta_n = \beta 2 \max \left( 1 + \nu_i L_i \right) R_{-i,2} + (1 - R_{i,2}) \left( 1 - \nu_i \right)$

CBs set lower interest rates when domestic banks are more leveraged, i.e. hold more risk sharing liabilities.

Eq. interest rate $\theta_n$ is optimal for one region, too high for the other.
Optimal monetary policy

The non-cooperative equilibrium

- MP makers in region $i$ choose the domestic interest rate $\theta_i$:
  - to maximize domestic banks’ expected profits
  - subject to banks arbitraging between deposit facilities

- The problem for MP maker in region $i$:
  $\max_{\theta_i} \pi_i = \left[ 1 + \left( 1 - \frac{1}{\beta} R_{i,2} \right) L_i \right] R_{-i,2} + (1 - R_{i,2}) (1 - \nu_i)$
  s.t. $R_{i,2} = R_{-i,2} = \max (\theta_i; \theta_{-i})$

- Optimal interest rates under Nash MP satisfy
  $\theta_i = \theta_{-i} = \theta_n \equiv \frac{\beta}{2} \max \left[ 1 + \frac{\nu_i}{L_i} \right]$
  - CBs set lower interest rates when domestic banks are more leveraged, i.e. hold more risk sharing liabilities.
  - Eq. interest rate $\theta_n$ is optimal for one region, too high for the other.
Optimal macro-prudential policy

The non-cooperative equilibrium

- MaP policy makers choose $\varphi$ to maximize banks’ profits, subject to
  - bank individual decisions to issue claims for risk sharing
  - which region is setting the global interest rate $\theta_n$
  - the constraints on the decentralized equilibrium
Optimal macro-prudential policy

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- MaP policy makers choose $\varphi$ to maximize banks' profits, subject to
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  - which region is setting the global interest rate $\theta_n$
  - the constraints on the decentralized equilibrium

- Optimal MaP policy in the "interest rate setting" region:

$$\max_{\varphi_i} \pi_i = \left[ \nu_i + \left( 1 - \frac{1}{\beta} \theta_n \right) L_i \right] \theta_n$$

s.t.

$$L_i = \frac{\varphi_i (1 - \varphi_i)}{1 - \varphi_i \varphi_i} \text{ and } \theta_n = \frac{\beta}{2} \left[ 1 + \frac{\nu_i}{L_i} \right] \text{ and } L_i \leq \frac{\nu_i}{\nu_{-i}} L_{-i}$$

$$L_i \leq \nu_i + (1 - \theta_n) L_{-i} \text{ and } L_{-i} \leq \nu_{-i} + (1 - \theta_n) L_i$$
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s.t.

$$L_i = \frac{\varphi_i(1-\varphi^{-i})}{1-\varphi^{-i}\varphi_i} \text{ and } \theta_n = \frac{\beta}{2} \left[ 1 + \frac{\nu_i}{L_i} \right] \text{ and } L_i \leq \frac{\nu_i}{\nu^{-i}} L^{-i}$$

$$L_i \leq \nu_i + (1 - \theta_n) L^{-i} \text{ and } L^{-i} \leq \nu^{-i} + (1 - \theta_n) L_i$$

- Capital inflows $L_i$ unambiguously raise profits $\pi_i$:

$$L_i = \min \left\{ \nu_i + (1 - \theta_n) L^{-i}; \frac{\nu_i}{\nu^{-i}} L^{-i} \right\}$$
Optimal MaP policy in the "non-interest rate setting" region:

\[
\begin{align*}
\max_{\varphi_i} \pi_i &= \left[ \nu_i + \left( 1 - \frac{1}{\beta} \theta_n \right) L_{-i} \right] \theta_n \\
L_{-i} &= \frac{\varphi_i (1-\varphi_i)}{1-\varphi_i \varphi_i} \quad \text{and} \quad L_i = \varphi_i \frac{1-\varphi_i}{1-\varphi_i \varphi_i} \\
\theta_n &= \frac{\beta}{2} \left[ 1 + \frac{\nu_i}{L_i} \right] \quad \text{and} \quad L_{-i} \geq \frac{\nu_i}{\nu_i} L_i \\
L_i \leq \nu_i + (1 - \theta_n) L_{-i} \quad \text{and} \quad L_{-i} \leq \nu_i + (1 - \theta_n) L_i
\end{align*}
\]
Optimal macro-prudential policy

The non-cooperative equilibrium

- Optimal MaP policy in the "non-interest rate setting" region:

\[
\max_{\varphi_i} \pi_i = \left[ v_i + \left(1 - \frac{1}{\beta} \theta_n\right) L_{-i} \right] \theta_n
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\[
L_{-i} = \frac{\varphi_i (1-\varphi_i)}{1-\varphi_i \varphi_i} \quad \text{and} \quad L_i = \varphi_i \frac{1-\varphi_i}{1-\varphi_i \varphi_i}
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\[
\theta_n = \frac{\beta}{2} \left[ 1 + \frac{v_i}{L_i} \right] \quad \text{and} \quad L_{-i} \geq \frac{v_i}{v_i} L_i
\]

\[
L_i \leq v_i + (1 - \theta_n) L_{-i} \quad \text{and} \quad L_{-i} \leq v_i + (1 - \theta_n) L_i
\]

- Trade-off btw risk sharing and funding conditions; with higher $\varphi_i$
  - larger capital inflows $L_{-i} \Rightarrow \textbf{larger} \text{ expected profits } \pi_{-i}$
  - lower capital outflows $L_i \Rightarrow \text{tighter FC} \Rightarrow \textbf{lower} \text{ expected profits } \pi_{-i}$

\[
L_{-i} = \min \left\{ L_n (L_i) ; v_i + (1 - \theta_n) L_i \right\}
\]
Optimal macro-prudential policy

The cooperative equilibrium

\[
\max_{\varphi_i; \varphi_{-i}} \pi_i + \pi_{-i} = \left[ \nu_i + \nu_{-i} + \left(1 - \frac{1}{\beta} \theta_n\right) (L_i + L_{-i}) \right] \theta_n
\]

\[
\begin{align*}
L_i &= \frac{\varphi_i(1-\varphi_{-i})}{1-\varphi_i \varphi_{-i}} \quad \text{and} \quad L_{-i} = \frac{\varphi_{-i}(1-\varphi_i)}{1-\varphi_i \varphi_{-i}} \\
\theta_n &= \frac{\beta}{2} \left[ 1 + \frac{\nu_i}{L_i} \right] \quad \text{and} \quad L_{-i} \geq \frac{\nu_{-i}}{\nu_i} L_i \\
L_i &\leq \nu_i + (1 - \theta_n) L_{-i} \quad \text{and} \quad L_{-i} \leq \nu_{-i} + (1 - \theta_n) L_i
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Optimal macro-prudential policy

The cooperative equilibrium

\[
\max_{\phi_i; \phi_{-i}} \pi_i + \pi_{-i} = \left[ \nu_i + \nu_{-i} + \left( 1 - \frac{1}{\beta} \theta_n \right) (L_i + L_{-i}) \right] \theta_n
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\[
\begin{cases}
L_i = \frac{\phi_i(1 - \phi_{-i})}{1 - \phi_i \phi_{-i}} \text{ and } L_{-i} = \frac{\phi_{-i}(1 - \phi_i)}{1 - \phi_i \phi_{-i}} \\
\theta_n = \frac{\beta}{2} \left[ 1 + \frac{\nu_i}{L_i} \right] \text{ and } L_{-i} \geq \frac{\nu_{-i}}{\nu_i} L_i \\
L_i \leq \nu_i + (1 - \theta_n) L_{-i} \text{ and } L_{-i} \leq \nu_{-i} + (1 - \theta_n) L_i
\end{cases}
\]

- No trade-off for MaP in "interest rate setting" region: higher $\phi_i$
  - larger global capital flows $(L_i + L_{-i}) \Rightarrow \text{larger} \ \text{global profits}$
  - lower interest rate $\theta_n \Rightarrow \text{larger} \ \text{global profits}$

\[
L_i = \min \left\{ \nu_i + (1 - \theta_n) L_{-i}; \frac{\nu_i}{\nu_{-i}} L_{-i} \right\}
\]
Optimal macro-prudential policy

The cooperative equilibrium

- Trade-off for MaP in "non-interest rate setting" region: higher $\phi_i$
  - larger global capital flows $(L_i + L_{-i})$ ⇒ larger global profits
  - higher interest rate $\theta_n$ ⇒ lower global profits

$$L_{-i} = \min \{ L_c(L_i); \nu_{-i} + (1 - \theta_n)L_i \}$$
Optimal macro-prudential policy

The cooperative equilibrium

- Trade-off for MaP in "non-interest rate setting" region: higher $\phi_{-i}$
  - larger global capital flows $(L_i + L_{-i}) \Rightarrow$ larger global profits
  - higher interest rate $\theta_n \Rightarrow$ lower global profits

\[
L_{-i} = \min \{ L_c (L_i); v_{-i} + (1 - \theta_n) L_i \}
\]

- FOC in the Nash and cooperative games:
Optimal macro-prudential policy

The cooperative equilibrium

- Trade-off for MaP in "non-interest rate setting" region: higher $\varphi_{-i}$
  - larger global capital flows $(L_i + L_{-i}) \Rightarrow \text{larger global profits}$
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\[ L_{-i} = \min \{ L_c(L_i); \nu_{-i} + (1 - \theta_n) L_i \} \]

- FOC in the Nash and cooperative games:

\[ \left( 1 - \frac{\theta_n}{\beta} \right) \theta_n \]

MG of larger $\varphi_{-i}$
Optimal macro-prudential policy

The cooperative equilibrium

- Trade-off for MaP in "non-interest rate setting" region: higher $\varphi_{-i}$
  - larger global capital flows $(L_i + L_{-i}) \Rightarrow \textbf{larger} global profits
  - higher interest rate $\theta_n \Rightarrow \textbf{lower} global profits

$$L_{-i} = \min \{ L_c (L_i) ; \nu_{-i} + (1 - \theta_n) L_i \}$$

- FOC in the Nash and cooperative games:

$$\left(1 - \frac{\theta_n}{\beta} \right) \theta_n = \frac{\nu_{-i} + \left(1 - \frac{2}{\beta} \theta_n \right) L_{-i}}{\text{MC of larger } \varphi_{-i}} \frac{\partial \theta_n}{\partial L_i} \varphi_i$$

$$\frac{\nu_{-i}}{\text{MG of larger } \varphi_{-i}}$$
Optimal macro-prudential policy

The cooperative equilibrium

- Trade-off for MaP in "non-interest rate setting" region: higher $\phi_i$
  - larger global capital flows $(L_i + L_{-i}) \Rightarrow \text{larger global profits}$
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$$L_{-i} = \min \left\{L_c(L_i); v_{-i} + (1 - \theta_n)L_i \right\}$$

- FOC in the Nash and cooperative games:

$$\left(1 - \frac{\theta_n}{\beta} \right) \theta_n = \left[ v_{-i} + \left(1 - \frac{2}{\beta} \theta_n \right)L_{-i} \right] \frac{\partial \theta_n}{\partial L_i} \phi_i$$ \hspace{2cm} \text{MG of larger } \phi_{-i}$$

$$\left(1 - \frac{\theta_n}{\beta} \right) \theta_n (1 - \phi_i)$$ \hspace{2cm} \text{MC of larger } \phi_{-i}$$

$$\left(1 - \frac{\theta_n}{\beta} \right) \theta_n (1 - \phi_i)$$ \hspace{2cm} \text{MG of larger } \phi_{-i}$$
Optimal macro-prudential policy

The cooperative equilibrium

- Trade-off for MaP in "non-interest rate setting" region: higher $\phi_i$
  - larger global capital flows $(L_i + L_{-i}) \Rightarrow$ larger global profits
  - higher interest rate $\theta_n \Rightarrow$ lower global profits

$$L_{-i} = \min \{ L_c (L_i) ; \nu_{-i} + (1 - \theta_n) L_i \}$$

- FOC in the Nash and cooperative games:

$$\left( 1 - \frac{\theta_n}{\beta} \right) \theta_n = \left[ \nu_{-i} + \left( 1 - \frac{2}{\beta} \theta_n \right) L_{-i} \right] \frac{\partial \theta_n}{\partial L_i} \phi_i$$

$$\left( 1 - \frac{\theta_n}{\beta} \right) \theta_n (1 - \phi_i) = \left[ \nu_{-i} + \left( 1 - \frac{2}{\beta} \theta_n \right) L_{-i} \right] \frac{\partial \theta_n}{\partial L_i} \phi_i$$
Optimal macro-prudential policy

The cooperative equilibrium

- Trade-off for MaP in "non-interest rate setting" region: higher $\phi_i$
  - larger global capital flows $(L_i + L_{-i}) \Rightarrow \text{larger} \ global \ profits$
  - higher interest rate $\theta_n \Rightarrow \text{lower} \ global \ profits$

$$L_{-i} = \min \{L_c (L_i) ; \nu_{-i} + (1 - \theta_n) L_i\}$$

- FOC in the Nash and cooperative games:

$$\left(1 - \frac{\theta_n}{\beta}\right) \theta_n = \left[\nu_{-i} + \left(1 - \frac{2}{\beta} \theta_n\right) L_{-i}\right] \frac{\partial \theta_n}{\partial L_i} \phi_i$$

$$\left(1 - \frac{\theta_n}{\beta}\right) \theta_n (1 - \phi_i) = \left[\nu_{-i} + \left(1 - \frac{2}{\beta} \theta_n\right) L_{-i}\right] \frac{\partial \theta_n}{\partial L_i} \phi_i$$

- Higher $\phi_{-i}$ raises global capital flows $L_{-i} + L_i$ but less than it raises capital inflows $L_{-i} \Rightarrow L_c (L_i) \leq L_n (L_i)$.
Optimal macro-prudential policy
Comparing Nash and cooperation

\[ L_i = v_i + (1 - \theta_n) L_{-i} \]

\[ L_{-i} = L_n(L_i) \]
Optimal MaP policy under Nash MP
Comparing Nash and cooperation

\[ L_{-i} = L_c(L_i) \]

\[ L_{-i} = L_n(L_i) \]
Optimal macro-prudential policy
Comparing Nash and cooperation
Optimal macro-prudential policy
Comparing Nash and cooperation

1. Region $i$ restricts capital inflows $L_{-i}$ under cooperation

Optimal macro-prudential policy
Comparing Nash and cooperation

1. Region $i$ restricts capital inflows $L_{-i}$ under cooperation

2. Spill-over into region $i$:
   - Capital inflows $L_i$ into region $i$ are larger and MP sets lower interest rate $\theta_n$
Optimal macro-prudential policy
Comparing Nash and cooperation

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   - With larger capital inflows \(L_i\), MP optimally sets lower interest rate \(\theta_n\)

4. Spill-back into region \(-i\):
   - Inefficiency for region \(-i\) from too tight funding conditions is reduced
   - Region \(-i\) decides to allow for larger capital inflows \(L_{-i}\)
Optimal macro-prudential policy
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3. Feedback loop:
   1. With easier funding conditions $\theta_n$, MaP can allow for larger capital inflows $L_i$ (*diversification channel of MP*).
   2. With larger capital inflows $L_i$, MP optimally sets lower interest rate $\theta_n$.

4. Spill-back into region $-i$:
   1. Inefficiency for region $-i$ from too tight funding conditions is reduced.
   2. Region $-i$ decides to allow for larger capital inflows $L_{-i}$.

Both regions are better-off cooperating on MaP.
Conclusions

- We have developed a model of monetary and macro-prudential policy cross-border coordination where
  - *monetary policy* determines the cost of ex post borrowing
  - *macro-prudential policy* determines the degree of cross-border (ex ante) risk sharing.
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- Analysis suggests so far that coordinating MaP can help to reduce MP Nash-induced inefficiency.
State-contingent interest rates

- Idea: banks running fixed-scale reinvestment can shirk and claim to run variable-scale reinvestment. They then reap a marginal return $\rho_s$ only with some probability $p_s$.

- Incentive constraint which precludes shirking writes as:

$$
(\beta r_{-i,1} L_{-i} + D_j) \rho - D_j r_{i,2} \geq [(\beta r_{-i,1} L_{-i} + D) \rho_s - D r_{i,2}] p_s
$$

with $\beta r_{-i,1} L_{-i} + D_j = j_i \rho$ and $D = \frac{\phi}{1-\phi} \beta r_{-i,1} L_{-i}$

$$
R_{i,2} = \theta_{-i} \leq \frac{1 - \alpha_i \theta_i L_{-i}}{1 - \beta_i \theta_i L_{-i}}
$$

- Trade-off for MaP unchanged:
  - Larger ex ante capital inflows $L_{-i}$ vs. lower return on ex post lending $\theta_{-i}$ and higher cost of ex post borrowing $\theta_i$. 

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