



Comments on Zoleta: Large-Scale Asset Purchase and Sovereign Debt Market During the Pandemic

Peter J. Morgan

Senior Consulting Economist and Advisor to the Dean
Asian Development Bank Institute

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Introduction

Objectives and contribution:

- The paper examines how the large-scale asset purchases (LSAP) program during the pandemic could be an effective alternative monetary policy tool.
- Using a modified New Keynesian model, it investigates the effectiveness of LSAP policies in improving liquidity conditions in the Philippine financial market.
- Main findings:
 - LSAP can ease liquidity conditions in sovereign debt market
 - LSAP can complement conventional monetary policy
 - LSAP can be effective even if conventional monetary policy is not

Comment:

- The paper provides a nice discussion and analysis of these issues. The relevance of the results for policy is unclear.

1. Background

- Pandemic led to rise in volatility of Philippine sovereign bond yields
 - Given the limited fiscal space and the weakening of the national government's fiscal position, the BSP implemented LSAP to improve national government fiscal solvency and ease liquidity conditions of the sovereign debt market.
- Concerns:
 - LSAP could blur the delineation between the role of fiscal and monetary authorities during the counter-cyclical policy
 - Using LSAP to monetize debt may pose significant risks to fiscal dominance
 - How does LSAP affect the transmission of monetary policy in the real economy?

2. Model: Modified NK DSGE

- The standard assumption in the NK DSGE model is there is only one financial asset and asset price, i.e., is the short-term interest rate
- This paper introduces a simple financial friction, where short-term bonds and long-term bonds are not perfect substitutes
- Financial intermediaries face portfolio adjustment costs in rebalancing their holdings of assets, i.e., the “portfolio balance effect”
- No government spending and distortionary taxes in the model
- No banking sector
- No real investment, only in money or securities
- Perfect foresight

3. Financial intermediaries

- The financial intermediaries maximize profit by having a positive difference between the returns it earns from its asset portfolio holding and the deposit return paid to the customers.
- The relative importance of cost adjustment is driven by the parameter ν , the larger this parameter the more costly it is for the intermediaries to adjust their portfolio

$$\frac{\nu}{2} \left(\delta \frac{B_t}{B_{L,t}} - 1 \right)^2$$

- The parameter ν dictates the cost of adjusting the household portfolio between short and long-term government bonds. It is the elasticity long term sovereign yield to the short-term yield
Variation in ν drives the model results.

$$\tilde{R}_t = E_t \tilde{R}_{L,t+1} + \nu \left(\tilde{b}_t - \tilde{b}_{L,t} \right) \quad \nu \equiv \beta \frac{\delta \nu}{b_L}$$

4. Comments on the model

- Various ways to model financial frictions
 - Credit spread fluctuates with the volatility of the entrepreneurs' net worth (Christiano, Motto, and Rostagno 2013)
 - Net worth and liquidity mismatch between banks' assets and liabilities makes banks susceptible to bank runs in the emergence of a crisis (Gertler and Kiyotaki 2015)
 - This paper isolates the impact of the portfolio balance effect, but it is not clear that this is the most important channel

5. Comments on modelling results

- Three scenarios for cost of portfolio adjustment
 - I. $v = 0$: Standard NK DSGE
 - II. $v = 0.1$: UK estimate from Harrison (2012) (baseline)
 - III. $v = 0.2$: Philippine estimate (how derived?)
- Interest rate policy change under scenario III
 - A greater reduction in nominal interest rates compared to the Baseline and NK scenarios
 - Response of output and inflation is weaker, suggesting a loss in efficiency in the transmission of monetary policy
 - May be an issue for countries like the Philippines with financial market imperfections

Comments on modelling results (cont'd)

- LSAP increase under scenario III
 - Larger impacts on output and inflation, in fact inflation remains higher throughout forecast period
 - I-t rates converge back to steady state, but s-t rates remain high relative to steady state, so yield premium stays low
 - Some more explanation of this result would be useful
- Response to negative demand shock using interest rate policy under scenario III
 - The reduction in short-term nominal interest rates translated into less of a decline in long-term yields compared with other scenarios

6. Comments/suggestions

- A nice discussion of issues for developing countries with less-perfect financial markets; the overall modelling work very closely follows Harrison (2012)
- Not too surprising that LSAP operations can lower long-term bond yields by reducing their supply to the market
 - Can help offset the tendency of l-t rates to rise when open-market operations reduce the supply of short-term bonds
 - But less convinced about the impacts on GDP and inflation
 - After all, the Bank of Japan implemented a very large LSAP for a number of years without achieving its inflation target
- NK DSGE model is a ‘workhorse model’ for monetary policy analysis, but still has many limitations
- Modelling financial frictions through the portfolio balance effect gives a window for a role for LSAP in the NK model, but is not necessarily the main source of financial frictions in the economy

Comments/suggestions (2)

- Harrison (2012) suggests quite a bit of uncertainty about v , so need more discussion about why 0.2 was chosen, plus some sensitivity analysis
- Harrison (2012) deals primarily with the case where the policy rate is at its lower bound, but not this paper
- The definition of liquidity is rather simple, i.e., the ratio of s-t and l-t bonds held by the financial intermediary
 - Is this what we really mean by liquidity being an issue?
 - It abstracts from issues such as capital flows

Minor comments

- The discussion originally started with the problem of market volatility, but this is not addressed by the model
- Needs some editing, has a number of incomplete sentences and/or odd sentence breaks

Thank you!