What Has The HANK Literature Taught Us About Monetary Policy?

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Heterogeneity in Macroeconomics: Implications for Policy
Federal Reserve Bank of New York
12 November 2021

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HANK Models

- More realistic model of household spending
  - MPCs: Relative importance of income versus interest rates
  - Poor and wealthy hand-to-mouth households
  - Heterogeneity: income sources, risk exposure, assets and debt portfolios

- Formally model and quantify:
  - Wider source of shocks: borrowing constraints, income risk, asset prices, transfers …
  - Wider channels of policy: wealth effects, redistribution, fiscal reaction …
  - Heterogeneous effects of shocks and policies

5 Lessons About Monetary Policy and Aggregate Stabilization

1. Aggregate stabilization through monetary policy is harder than we thought

2. Distributional effects of monetary policy may be more important than aggregate effects

3. Reminder that monetary and fiscal policy are closely intertwined

4. Welfare gains from aggregate stabilization stem from alleviating individual hardship

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5. Role of central banks and monetary policy

Lesson 1: Aggregate Stabilization is Hard

- Pre-HANK frameworks: strong direct role for monetary policy in aggregate stabilization:
  1. IS-LM:
     - Investment sensitive to interest rates
     - Consumption sensitive to money

     + large multiplier
  2. RANK:
     - Consumption sensitive to interest rates: intertemporal substitution

- Tenuous links: theoretically and empirically

- HANK:
  - Direct channels between monetary policy and aggregate activity drastically weakened
  - In their place, other channels arise: some new, some forgotten, some ignored

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Lesson 1: Aggregate Stabilization is Hard

1. Direct channels
    - Income effects: interest rate exposure
    - Valuation effects: inflation
    - Cashflow effects: ARM, fixed income
    - Housing market: prices, refinancing

2. Indirect channels
    - Asset prices and portfolio returns
    - Firm profits, dividends and investment
    - Level and cyclicality of labor income
    - Fiscal policy

- Each involves redistribution: moving resources between households with different MPCs
- Strongest channels: impact household disposable income and accessible wealth
- Particularly important: channels operating through housing market (ARM)

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  - Whenever aggregate effects are large: through less direct channels than in RANK
  - Transmission depends on many factors outside central bank control

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Example: Forward Guidance

- RANK: magic bullet descended from Euler equation and intertemporal substitution
- HANK:
  - Spending less sensitive to future interest rates
  - Construct economies with either large or small effects of forward guidance
  - Depends on details of indirect channels: firm profits, fiscal policy, …

Lesson 2: Redistributive Effects Cannot be Ignored

- Pre-HANK view:
  - Redistributive effects: second-order collateral damage from aggregate stabilization
  - Safely ignore: rely on fiscal policy to offset consequences
  - Political fabric of central bank independence: monetary policy only affects size of pie

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  - Redistributive effects: second-order collateral damage from aggregate stabilization
  - Safely ignore: rely on fiscal policy to offset consequences
  - Political fabric of central bank independence: monetary policy only affects size of pie
- Post-HANK view:
  - Stabilization through monetary policy necessarily has distributional consequences:
    - Indirect channels: more heterogeneous effects (MPCs, asset prices….)
    - Redistributive channels: *cov*(MPC, URE)
  - Redistribution often more consequential than aggregate effects

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Lesson 2: Redistributive Effects Cannot be Ignored

Example: Asset purchase programs

- Indirect transmission: uncertainty and disagreement over strength of aggregate effects
- Redistribution towards households with existing exposure

- HANK is one factor in a broader reckoning
  - Forced to let go of the fiction that we can separate stabilization from redistribution
  - Offer framework: central banking in an era where redistributive effects are not ignored

- Two broad reactions:
  1. Take advantage of new-found power to redistribute
  2. Temper attempts to fine-tune aggregate demand: unintended collateral damage

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Lesson 3: Reminder of Monetary and Fiscal Connection

- **Pre-RANK:** interconnectedness of monetary and fiscal policy well appreciated
  - Sargent, Wallace, Sims, …

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- **HANK:** cannot separate, even with passive fiscal policy
  - B>0: Interest rates affect government budget position vis-à-vis private sector
  - Tax or transfers must adjust at some horizon:
    - RA: details irrelevant
    - HA: details crucial
  - Strength of connection between monetary and fiscal policy:
    1. Size govt balance sheet
    2. Duration govt balance sheet

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Lesson 3: Reminder of Monetary and Fiscal Connection

- Duration of debt portfolio governs direct effect of interest rates:
  - Short maturity: details of fiscal response drive aggregate and distributional effects
  - Long maturity: interest rate exposure shifted to (subset of) households: wealth effects

- Channels and tools with large aggregate effects in HANK often resemble fiscal policy
  - Level and distribution of household income and liquid wealth
  - Quantitative easing: effectively subsidize purchase of certain assets
  - Direct purchase of government debt used to fund fiscal stimulus

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Lesson 4: Welfare Gains from Alleviating Individual Hardship

- Bourgeoning literature on optimal policy in HANK models: common theme
  - Gains from alleviating individual hardship swamp gains from aggregate stabilization
  - Optimal policies redistribute towards households whose consumption falls in recession

- Force is strong! What to do about it?
  - Introduce additional instruments to undo insurance and redistribution incentives?
  - Define welfare criteria that isolate stabilization from insurance and redistribution?

- Misses the point: HANK suggests aggregate stabilization is valuable only to extent that it:
  - Stabilizes individual consumption of most vulnerable households; or
  - Redistributes towards poor or exposed households

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- Surprising? In hindsight, not really, given:
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  - Relative welfare gains from eliminating business cycles vs completing markets

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- Normative lesson:

  (A) Should monetary policy lean into redistribution and alleviating hardship? or

  (B) Should we leave this to policy instruments better suited to this task?

- Positive lesson:
  - HANK models: provide theoretical cover for a lot of recent policy directions
  - Shifting mindset: from aggregate stabilization to alleviating individual hardship
  - Helped me make sense of recent central bank speeches and policy stances

Lesson 5: Central Banks Matter Beyond Fine-Tuning Demand

- **Lessons 1-4:** interpret as we should abandon monetary policy as a stabilization tool ?
  - Stabilization through monetary policy is hard:
    - Direct channels are weak
    - Strong channels are indirect, with many factors outside central bank control
    - Redistribution is unavoidable: sometimes in counter-productive ways
    - Fiscal implications are unavoidable
  - Even if we can succeed in stabilizing demand:
    - Likely small benefits relative to directly alleviating hardship
    - Better instruments exist for insurance and redistribution
    - Distributional implications threaten central bank independence

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Lesson 5: Central Banks Matter Beyond Fine-Tuning Demand

- Focus less on fine-tuning aggregate demand as primary goal of monetary policy
- **Re-focus attention:** achievable objectives of monetary policy:
  - Financial system: financial market liquidity, bank health, lender of last result
  - Payment system
  - Reasonable inflation: preventing hyperinflationary or deflationary outcomes
- Danger: overcommitting to a role to which they are unsuited, central banks risk jeopardizing the crucially important functions that they are uniquely posed to fulfill