Comments on R. Hockett, “The Finance Franchise”, by Menzie Chinn (mchinn@lafollette.wisc.edu)

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Nomenclature: The Franchisor-Franchisee metaphor is reminiscent of the principal-agent metaphor in the micro/game theory/IO literature.

The loanable funds (LF) versus the finance and money creation (FMC) model of banks: The FMC model of banks needs to pretty explicitly dispense with a neoclassical interpretation of bank behavior. But this does not mean that banks do not face constraints, and/or necessarily provide financing purely elastically. If the Fed targets the policy rate exogenously, then for that target rate, the banks could provide funds with infinite elasticity. Whether they would in reality depends on the extent to which the capital-asset ratio (leverage) is approaching a binding constraint (imposed by regulation), or a induces a higher perceived level of risk.

Finally, the credit creation process itself is monitored and would likely induce a change in the policy rate, at which time open market operations would be implemented, altering the portfolio of securities versus loans on the asset side of the balance sheet. This would lead to knock-on effect, increasing bond yields, and changing the relative attractiveness of loans versus securities holdings.

Policy recommendations (I): Targeting systemically important prices. In some ways this is an idea that is mainstream. Generally, there is some acceptance of the view that it is not sufficient to examine only output and inflation gaps in deciding on monetary policy. And similarly, the view that monetary/financial policy cannot be simply summarized by the policy rate (such as the Fed funds) is becoming more accepted.

The argument that one would intervene on more than one price is also accepted, given the recent experiences with quantitative and credit easing (which essentially are operating on the long term Treasury yield and the yield on Agency mortgage backed securities). The proposal at hand goes far beyond in two dimensions. First it imagines the targeting ongoing even under non-exigent circumstances, i.e., continuously. Second, the objectives are to generally facilitate the flows of funds to “the correct” activities, whereas QE/CE aimed at restoring the overall economy by hitting two financial prices.

A big difference between the proposed measure and QE/CE as implemented in the US is that in the case of QE/CE, the Fed purchased securities backed by the full faith and credit of the USG (Agency MBS’s had that characteristic given the financial GSE’s were placed under Federal government conservatorship).

Purchasing equities means that the central bank (and hence by extension the USG) takes on the risk. We don’t even know if the public is willing to accept the potential capital losses the Fed is going to

experience on long term US Treasurys and MBS's when interest rates rise, let alone on equities that can have their value to go zero.

Policy recommendations (II): The Public Investment Authority. The ability of the Authority to finance projects that would otherwise not be financed (using private investor funds) seems to rely upon the government having a lower discount rate (valuing future outcomes higher than private agents) and willing to shoulder the risk associated with selecting projects. This isn't an argument against the measure, but merely a recognition that the undertaking is not costless.