ECON Seminar

Date: May 25, 2018 (Friday)
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Paper Title: Monetary Policy for a Bubbly World

Abstract: We propose a model of money, credit and bubbles, and use it to study the optimal response of monetary policy to asset bubbles. The main feature of the environment is that financial frictions limit the private sector ability’s to issue high-quality assets. In this environment, there is room for bubbles to pop up and burst, generating fluctuations in the capital stock and output. We characterize the role of monetary policy in this context, and show that it may be optimal for the monetary authority to enter liquidity traps in which money is used as a store of value. When bubbles grow and expand the supply of assets, the monetary authority responds by reducing real balances: when bubbles crash and reduce the supply of assets, the monetary authority responds by expanding real balances. We explore how the feasibility and optimality of this policy depends on the credibility of the monetary authority, on its fiscal backing, and on its ability to distribute seigniorage. We also use the model to interpret the expansion of central bank balance sheets in the aftermath of the financial crisis.