

Discussion of “Prudential Policy with Distorted Beliefs ” by Eduardo Davila and Angus Walther 2021 AEA Meetings

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The views expressed herein are those of the authors and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.

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Very interesting results

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Paper also looks at case with bailouts and monetary policy

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★ Two practical questions:

- Paper's characterization is for *any* beliefs, but which ones should social planner use?
- How to empirically assess agents' beliefs?

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Alternative approach to fin. regulation is based on externalities

- Induce agents to choose what is right for them individually vs. what is wrong for them individually but socially desirable

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- Bianchi-Boz-Mendoza 2012 prudential tax with pecuniary externalities and non-RE beliefs

$$\tau = \underbrace{\frac{E_t^P[u'(t+1)]}{E_t[u'(t+1)]}}_{\text{internality}} - 1 + \underbrace{\frac{E_t^I[\kappa' \mu' Q' u''_{t+1}] - E_t^P[\kappa' \mu' Q' u''_{t+1}]}{E_t[u'_{t+1}]}}_{\text{interaction}} + \underbrace{\frac{E_t^I[-\kappa' \mu' Q' u''_{t+1}]}{E_t[u'_{t+1}]}}_{\text{externality}}$$

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- Interaction term is larger if investors are more optimistic
 - Investors belief of μ' is lower

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Study of Monetary Policy

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★ Does monetary policy still have prudential role in more explicit monetary model?

- *Monetary policy would affect the marginal benefits from investment*

Interesting and important paper

- Very clean analytical and intuitive results
- Potentially a building block in exciting research agenda

Avenues for fruitful future work

- Interaction between externalities and internalities
- More explicit monetary considerations