Which r-star, public bonds or private investment? Measurement and policy implications

Discussion

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Disclaimer: The views expressed here are those of the presenter and are not necessarily the views of the Banque de France or the Eurosystem
OUTLINE

• Very rich paper.

• Three questions:
  1. Have central banks been mislead by using standard estimates of r*?
  2. Is there a puzzle in real returns to private capital?
  3. Do we have the wrong policy mix?
OUTLINE

• Very rich paper.

• Three questions:
  1. Have central banks been mislead by using standard estimates of r*? No, I don’t think so
  2. Is there a puzzle in real returns to private capital? Yes but where is it?
  3. Do we have the wrong policy mix? Maybe
NATURAL RATE OF INTEREST

• Have central banks been mislead by using standard estimates of $r^*$?

  • Practical answer:
    • Cross-check rather than front-line indicator
    • Only 1 chart out of 120 in the Monetary Policy Book
    • Policy in practice is much closer to the spirit of Orphanides and Williams
    • But $r^*$ is easier for narrative purposes
NATURAL RATE OF INTEREST

• Have central banks been mislead by using standard estimates of r*?
  • Technical answer:
    • Long-term sovereign bonds do not enter r* Laubach and Williams style estimates
      • Fed funds rate in the US
      • OIS for Euro Area
    • Identification of r* comes only from real GDP and inflation
    • r* is not a return on an instrument but a benchmark
      • Model counterfactual with no non-structural shocks
ESTIMATE OF R* (REAL) IN THE EURO AREA USING BAYESIAN MODEL AVERAGING (PERCENTAGE POINTS)

Fig 1. Estimate of r* (real) in the euro area using Bayesian model averaging (percentage points)

Note: BMA-r* is the filtered estimate of the natural rate of interest in nominal terms. Weights are computed based on the posterior likelihood; see Diebold and Lopez (1996) for a review of the methodology. In order to obtain the nominal level of a neutral short-term rate, a convention is to add the ECB’s 2 percentage points to the real r* estimate.

Source: Demfi calculations. Last observation: 2023.Q3
OUTPUT GAP FROM OUR BMA ESTIMATES

Sample period: 1972.Q2-2023.Q1
NATURAL RATE OF INTEREST

• Have central banks been mislead by using standard estimates of $r^*$?
  • Policy answer:
    • Estimates of $r^*$ seem to have performed remarkably well.
    • (Much better than I would have thought.)
REAL CONVERGENCE INTEREST RATE
Is there a puzzle in real returns to private capital?

YES

Fall in HLW for US between early 80s and last 5 years = 3.5% - 0.9% = 2.6%
Increase in gap = 1.2% - 0.6% = 0.6%
Cf Figure 15
Is there a puzzle in real returns to private capital?

**YES**

CPI Rent of Primary Residence in US City

Case-Shiller US National Home Price Index

Proxy for direction of change of rental return

Similar general upward trend as P/E ratio
Is there a puzzle in real returns to private capital?

YES

- Need model/analysis which reconciles trends in market returns and stability in National Accounting returns
- Q values? – ratio of market value to replacement cost
- Perpetual inventory method appropriate?
- How would National Accounting value Airbus?
**Policy mix?**

**MAYBE**

- Reducing financial frictions certainly first best
  - Completing capital markets union
  - Easier cross-border enforcement of contracts in EA
  - But what if the highest rates of return are elsewhere?
- But if this was easy to do it would have been done already

- QE in EA included corporate bonds (to try to lower m directly)

- If structural reforms are ruled out and monetary policy at the ZLB, then what?
  - Model calls for higher actual inflation relative to expected inflation
  - Inverse of the logic of forward guidance and Strategic Reviews (get expected inflation up to raise current inflation).
  - How to achieve this?
  - More fiscal policy still seems the most promising option (but difficult to readjust)