"Should the current monetary policy framework be adjusted to meet (new)post---crisis challenges?"

ECB and Its Watchers XVII

Anil K Kashyap

- The usual case against worrying about financial stability

- Alternative mechanism

- Will inflation data give us a warning?

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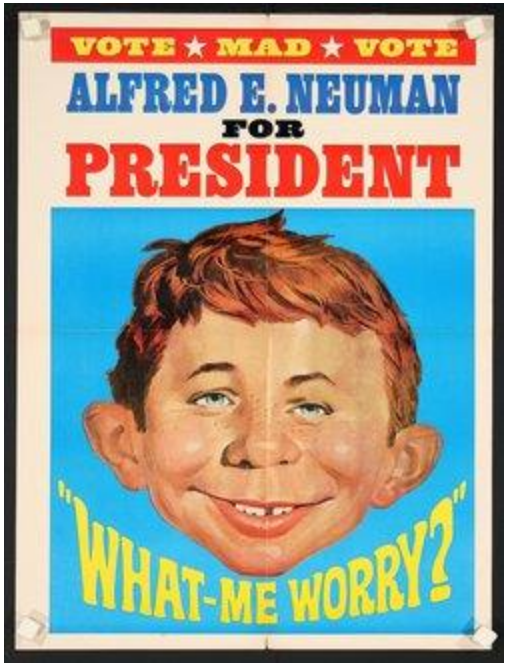


- Do financial conditions matter only to the extent that they matter for future output and inflation?
  - Standard view: yes, tail risk is already especially important
  - But, crises are hard to predict and monetary policy is a very blunt tool ➔ crazy to use monetary policy

- Furthermore, if a crisis probability is exogenous then taking out insurance against it is prudent ➔ Lean with the wind!
  - This is true even if macro prudential tools are weak

Other considerations

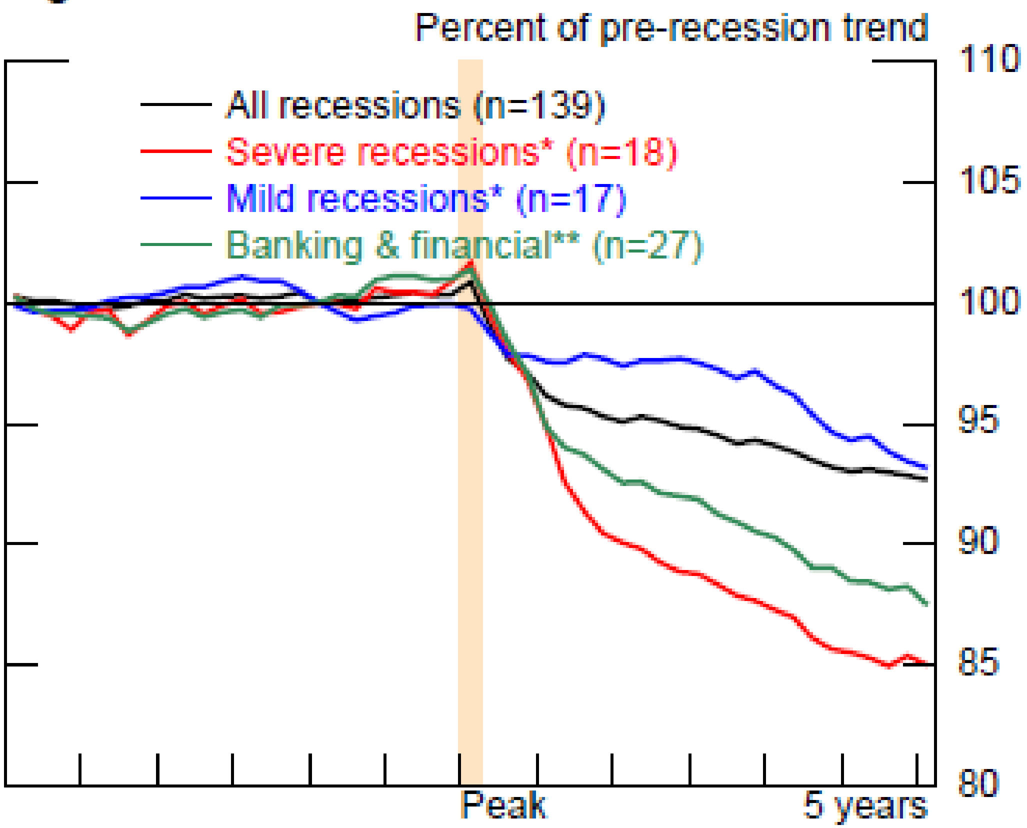
- Central banks are regulators and lenders of last resort, NOT just technocrats setting an interest rate in a vacuum.

- Peek, Rosengren, Tootell give two **special** reasons why instability matters per se
  - Bail out costs to the taxpayer
  - Public outrage over bailouts that threaten independence

- How best to model instability? Is it connected to monetary policy? Does it lead to unusual losses?

Financial instability and the path for y*

Fig 3. incl. GFC



GDP trend calculated as exponential function growing at the four-year average two years prior to the peak
* Severe recessions are in the top 25th percent of recessions as measured by both depth and duration. Similarly, mild recessions are in the bottom 25th percentile of each category.
** B&F recessions include 10 severe recessions.

Martin, Munyan, and Wilson (2015)
http://www.federalreserve.gov/econresdata/ifdp/2015/files/ifdp1145.pdf

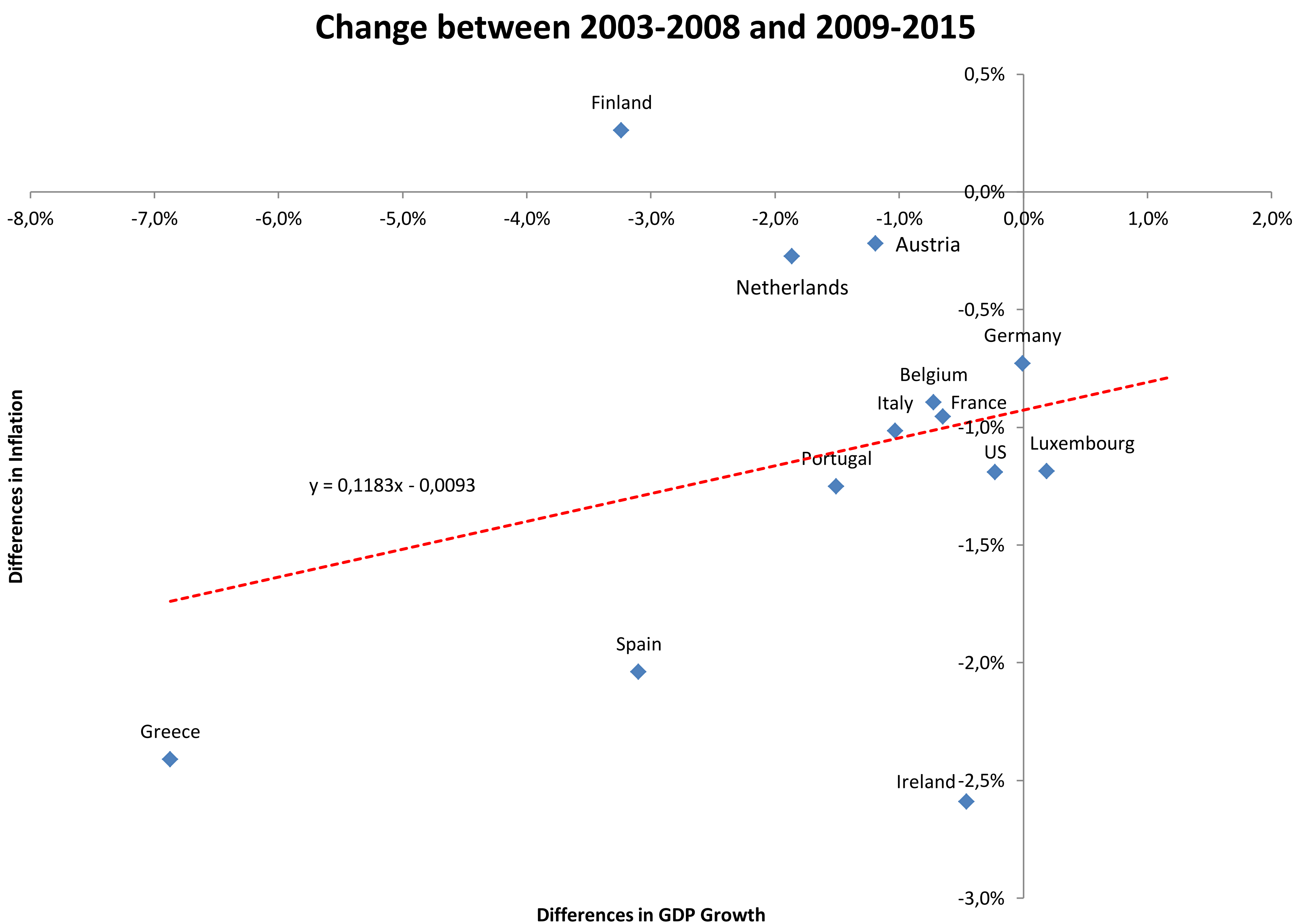
Gourio and Kashyap: Suppose that monetary policy influences risk taking and

- risk taking alters the probability of a crisis
- and crises have very <u>persistent</u> output losses

Implies very different trade off for leaning against the wind ➔

Lean now slows growth in the future but also can prevent a very costly crisis

Can we count on inflation to signal impending instability?



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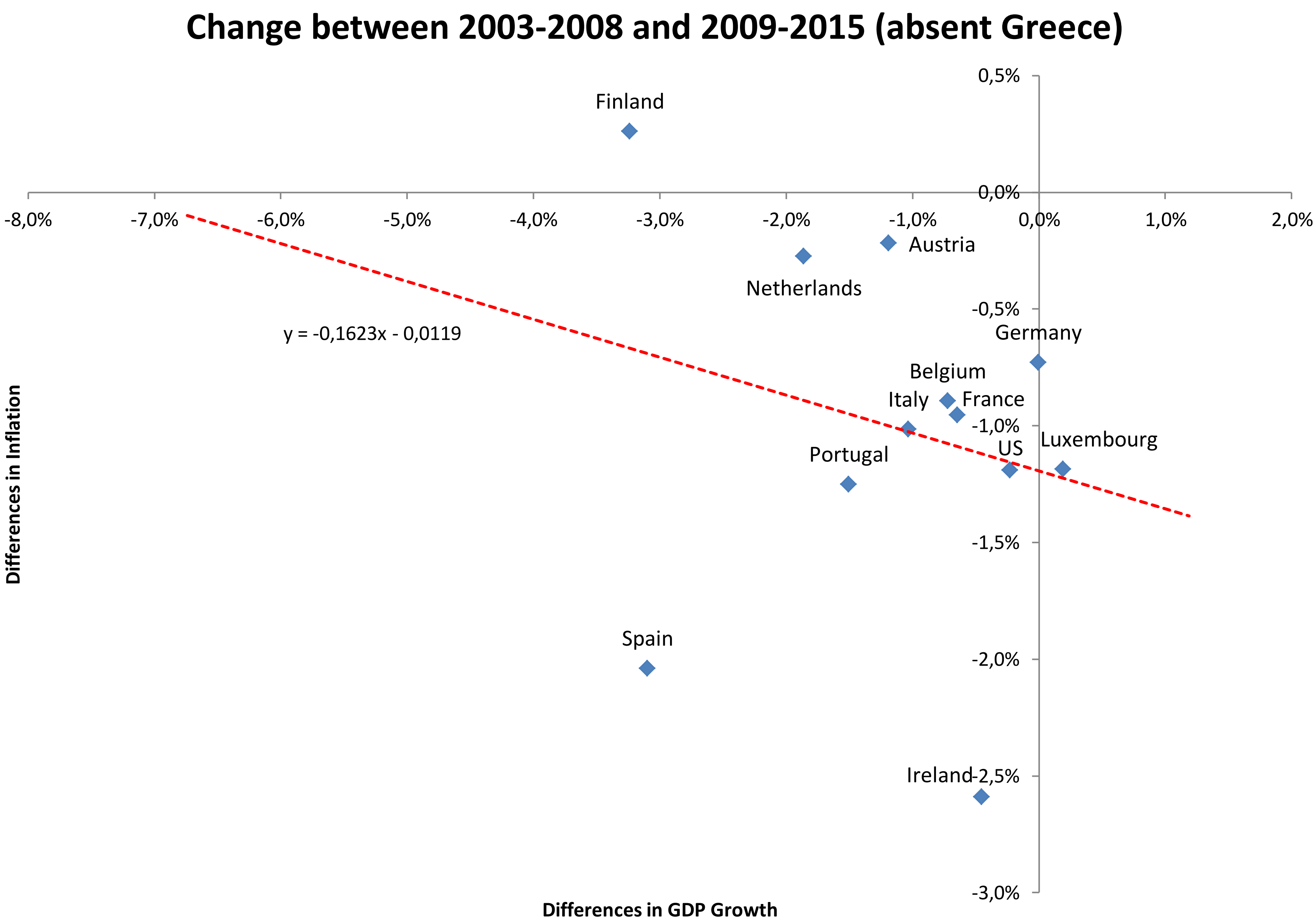

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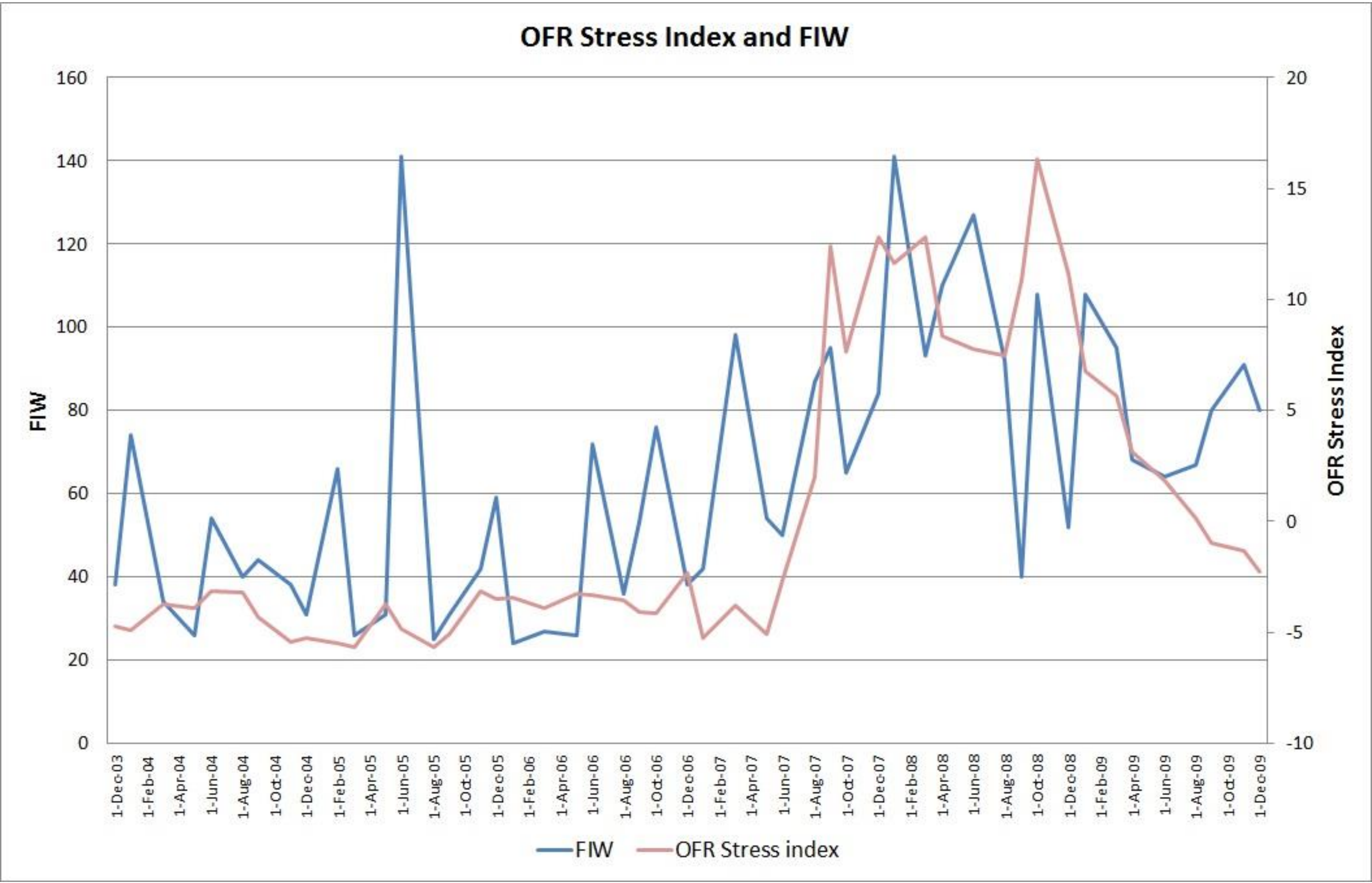
Measuring instability



Open questions

- How do we measure instability risk?
  - I doubt any single variable is going to be sufficient and we probability want to look at quantities and spreads
- Should central banks lobby to have their mandates adjusted?
  - I think they will absorb the blame for crises and it is plausible that their actions can contribute to them. So yes I would want more authority.
- Is the Bank of England model the right way to go?
  - I think it certainly beats the US and euro area model for tackling instability. But it has not been tested yet…