Monetary Policy and Financial Stability

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The views expressed here are those of the authors and do not necessarily represent those of the IMF or the IMF Board

Talk Plan

Review debate on monetary policy and financial stability

- Cost benefit analysis
- Role of financial variables in estimating potential output
- Governance challenges when MP has multiple targets

Pre-crisis Consensus: No leaning against the wind

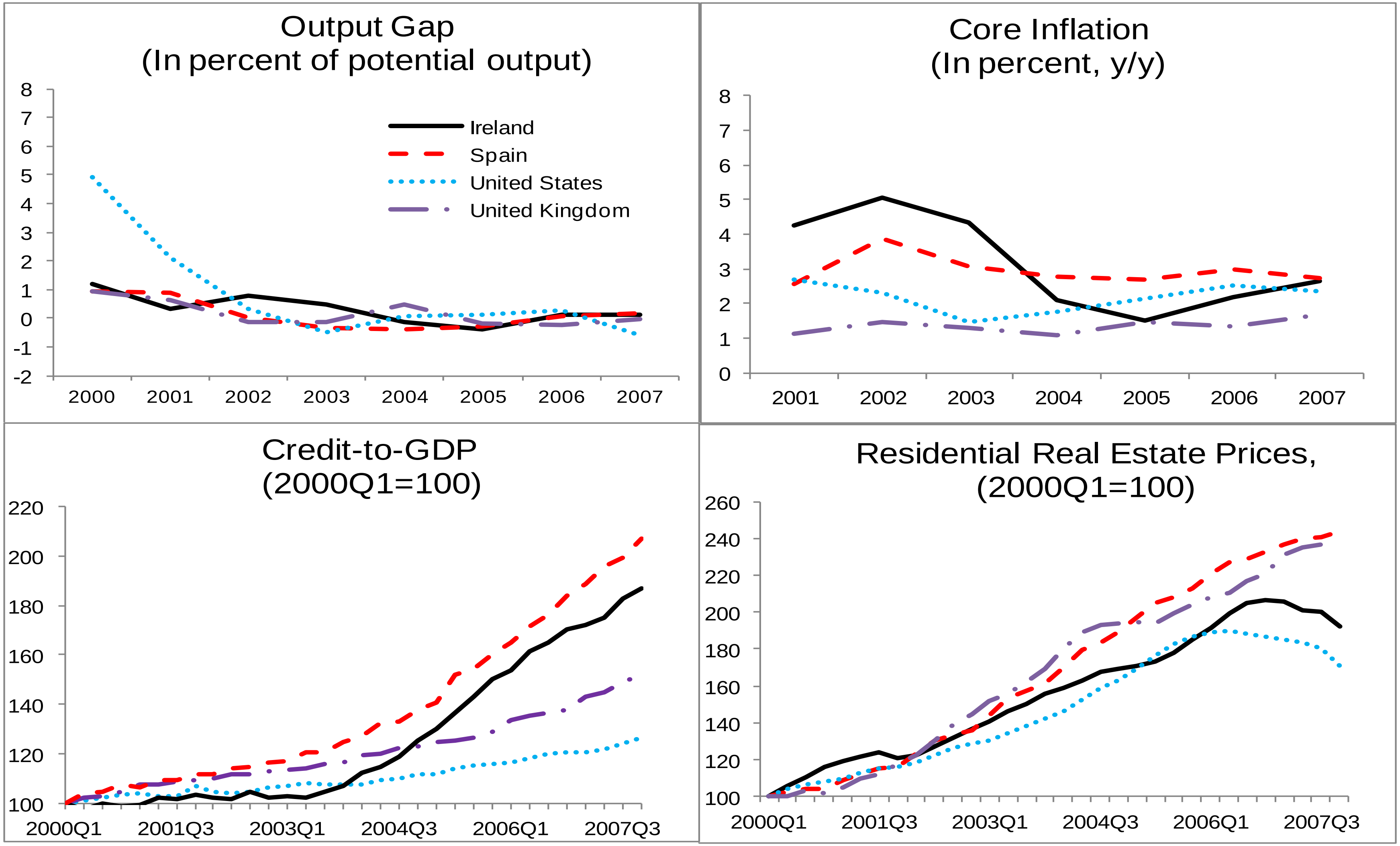
"I find it difficult to conceive the degree of central bank certainty to justify the scale of preemptive tightening that would likely be necessary to neutralize a bubble." Alan Greenspan, 2002.

"First, the Fed cannot reliably identify bubbles in asset prices. Second, even if it could identify bubbles, monetary policy is far too blunt a tool for effective use against them." Ben Bernanke, 2002.

"…monetary policy should not respond to asset prices per se, but rather to changes in the outlook for inflation and aggregate demand resulting from asset price movements…attempting to "prick" an asset price bubble, should be avoided." Rick Mishkin, 2008

Pre-crisis: Macro ok, but risks were growing

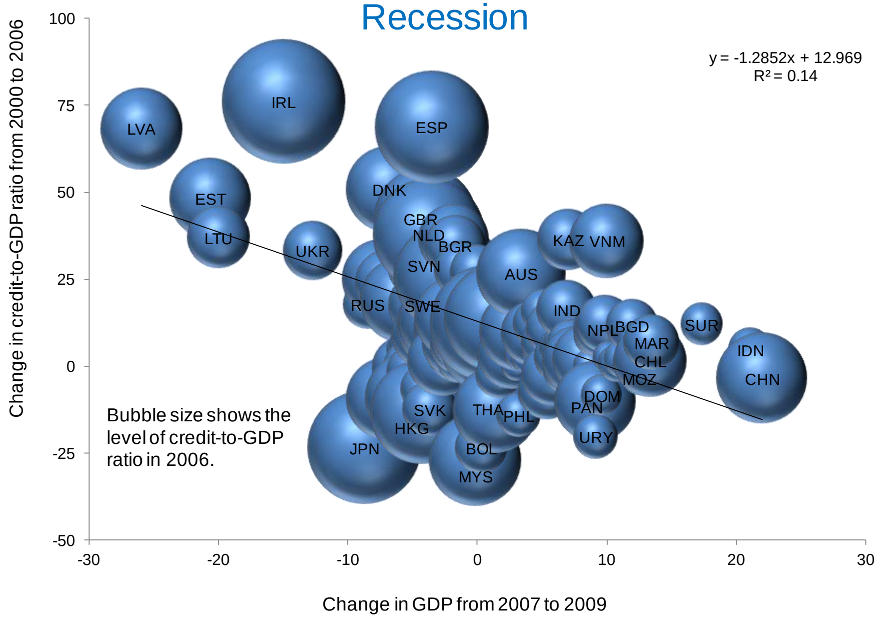
Figure 1. Output Gap, Core Inflation, and Financial Indicators Before the Crisis



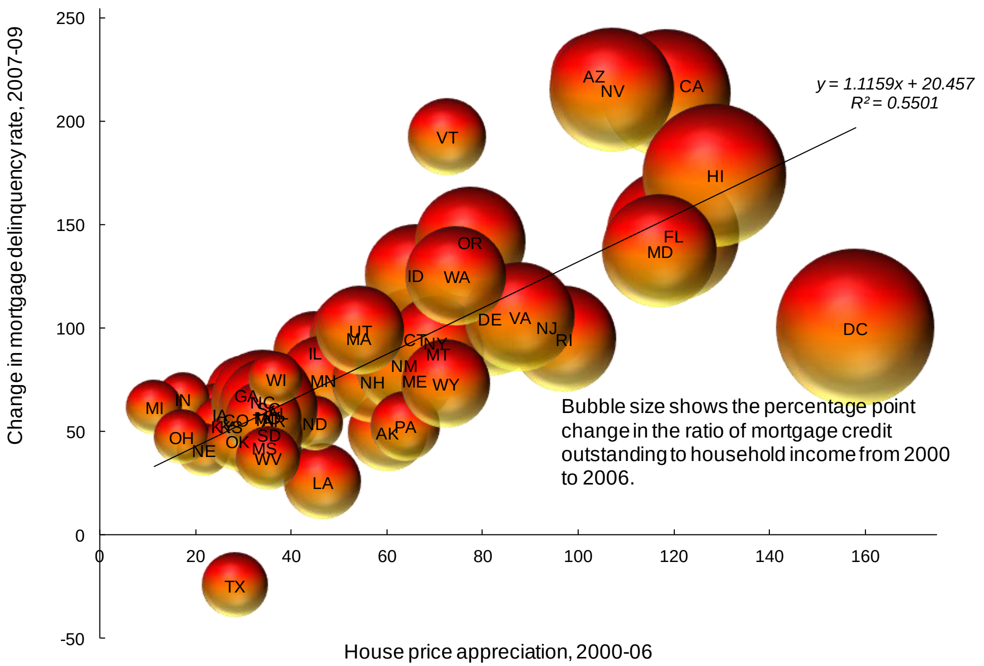
Source: World Economic Outlook (September 2007 vintage for the output gap) and Haver Analytics.

Crisis: severity in line with magnitude of credit booms

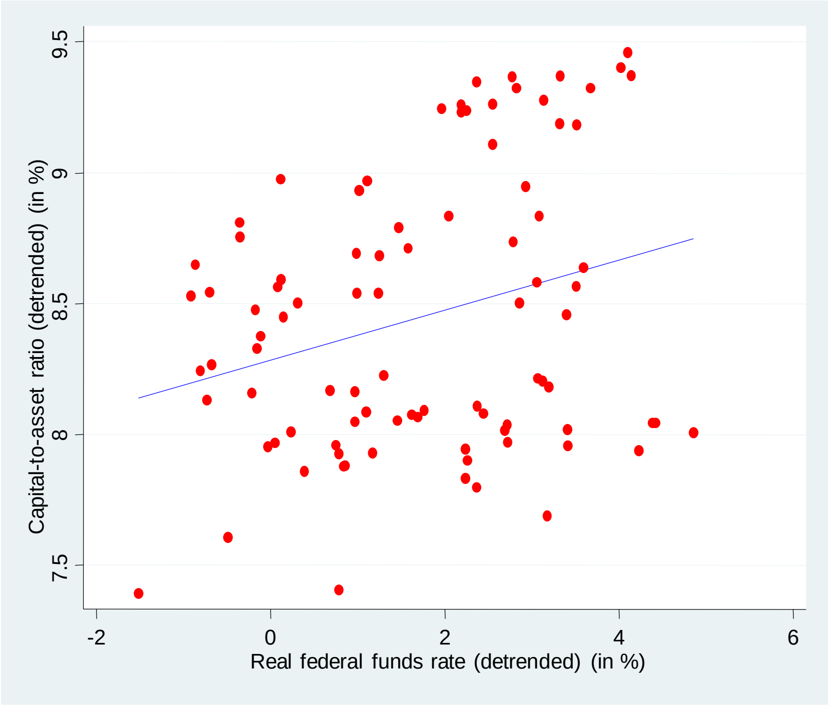
Credit Growth and Depth of Great Recession

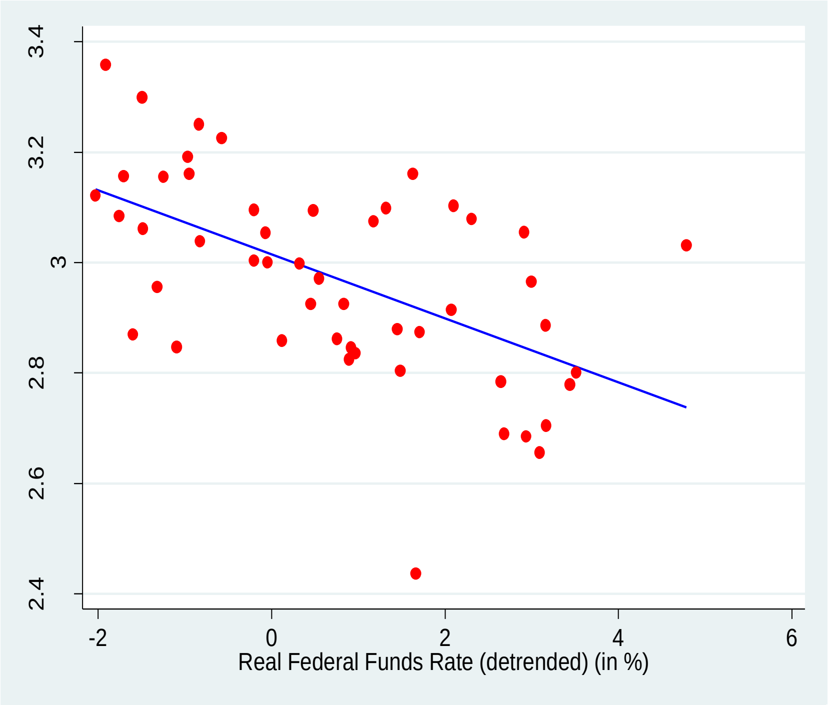


Subprime Boom and Defaults



Monetary policy and risk taking





Dell'Ariccia, Laeven, Suarez, 2016, (JF, forthcoming)

Today's views are more diverse

"*Monetary policy is poorly suited for dealing with financial stability concerns, even as a last resort.*" John Williams, 2015

"For existing empirical estimates and reasonable assumptions, the marginal cost of leaning against the wind is much higher than the marginal benefits. Thus, leaning against the wind is not justified. Lars Svensson, 2015

"*Monetary policy faces significant limitations as a tool to promote financial stability… [But] it may be appropriate to adjust monetary policy to 'get in the cracks' that persist in the macroprudential framework.*" Janet Yellen, 2014

"*It would make sense not to rule out the possible use of the interest rate for this purpose, particularly when other tools appear to be lacking.*" Stan Fischer, 2015

"*In other words, we have been leaning against the wind.*" Oystein Olsen, 2015

"*Financial stability is too large a task for prudential… frameworks alone. Monetary policy strategies also need to… lean against the build-up of financial imbalances even if near-term inflation remains low and stable."* Jaime Caruana, 2011

To lean or not to lean? A three step approach

1 **Transmission**

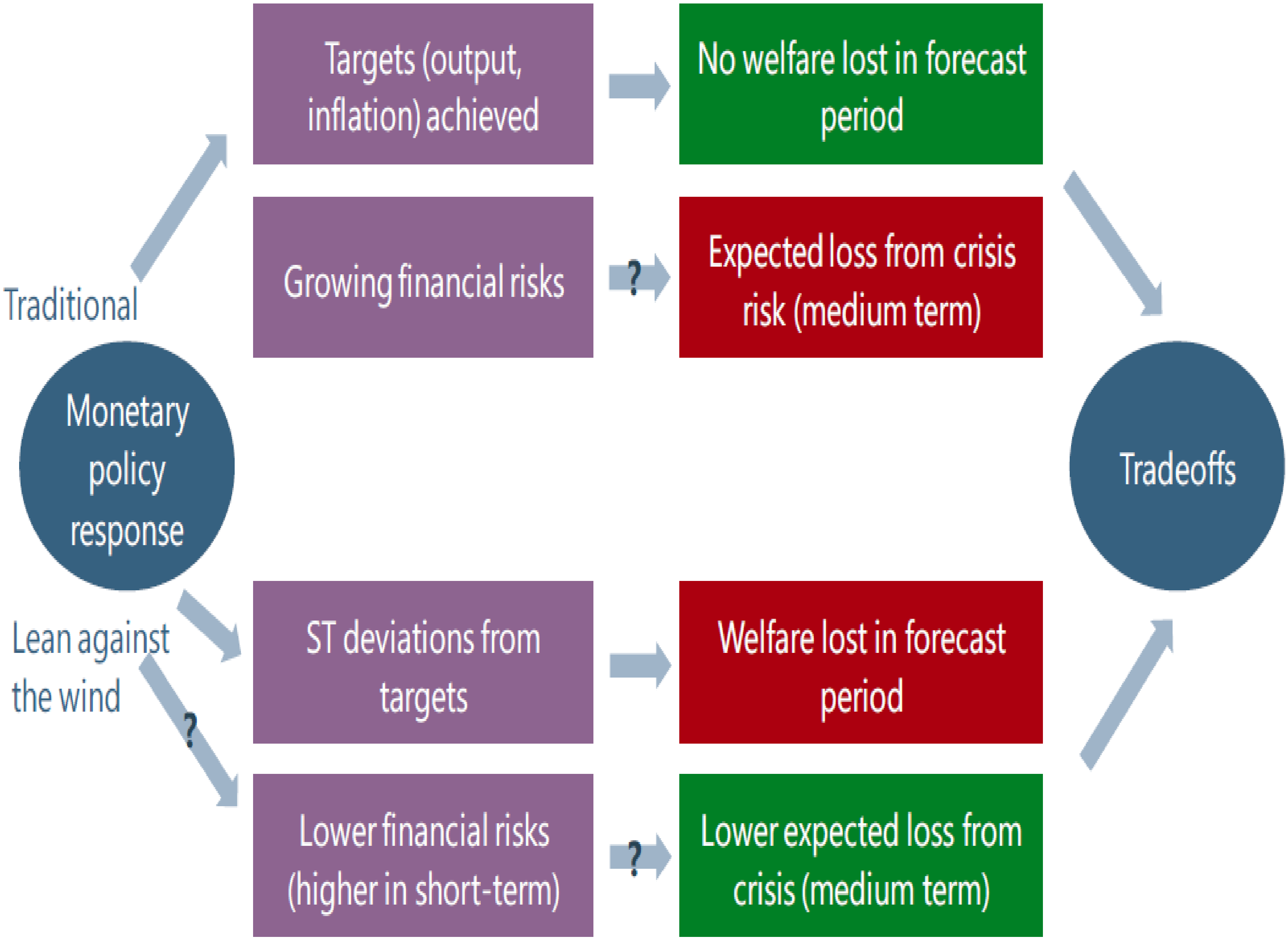
- How does monetary policy affect financial variables?
- What are the effects on financial stability?

2 **Tradeoffs**

- Is policy tightening for inflation purposes sufficient?
- How often do we see a conflict between price and financial stability objectives?

3 **Welfare analysis**

- Costs and benefits of leaning against the wind


Targets (output, inflation) achieved
No welfare lost in forecast period
Growing financial risks
?
Expected loss from crisis risk (medium term)
Traditional
Monetary policy response
Tradeoffs
Lean against the wind
?
ST deviations from targets
Welfare lost in forecast period
Lower financial risks (higher in short-term)
?
Lower expected loss from crisis (medium term)

Costs/benefits analysis: Should monetary policy lean against the wind?

In general, no.

- Reasonable parameters suggest costs exceed benefits
- Other tools (macro- and micro-prudential)

Yet, benefits grow relative to costs when:

- *Conjuncture*: rapid credit growth, low unemployment, high probability of long-lasting and severe crisis,
- *Structure*: large, interconnected economy (spillovers)

Prudential policies should be the first policy considered

- More targeted, probably less costly,
- Both micro- and macro-prudential can play a role

A Different Role for Financial Variables?

Before the GFC:

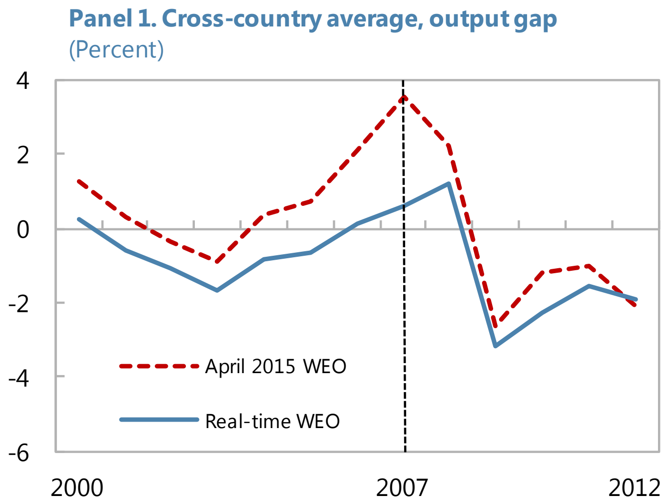
- Real-time estimates of output gaps did not signal substantial overheating
- CPI inflation was below target in most advanced economies

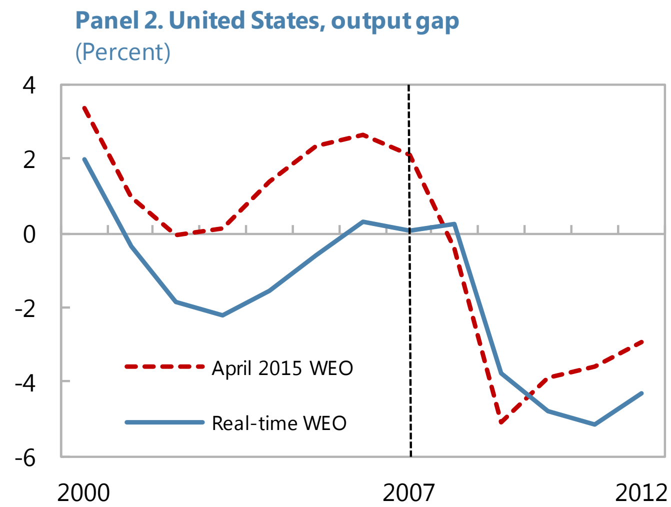
After the GFC:

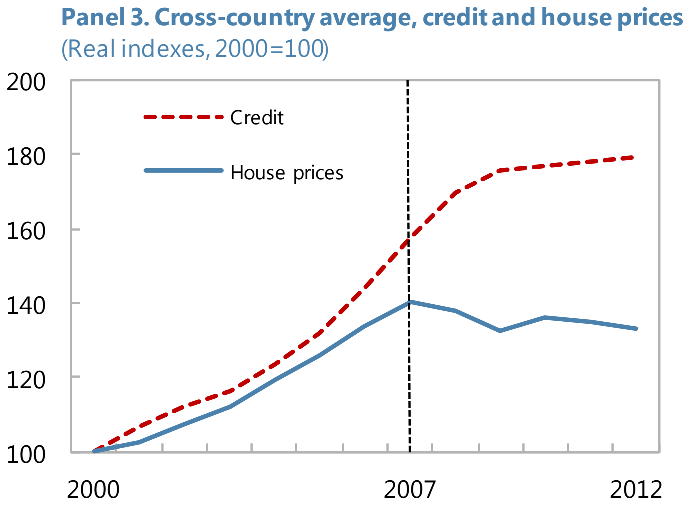
- Large upward revisions to output gaps
- Greater awareness of the role of housing and credit booms

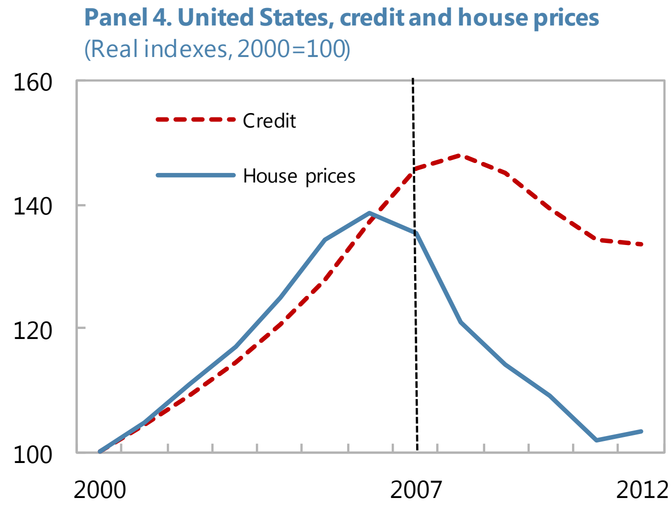
Use real-time financial data to reduce errors in potential output estimates

Potential output a bit of a moving target

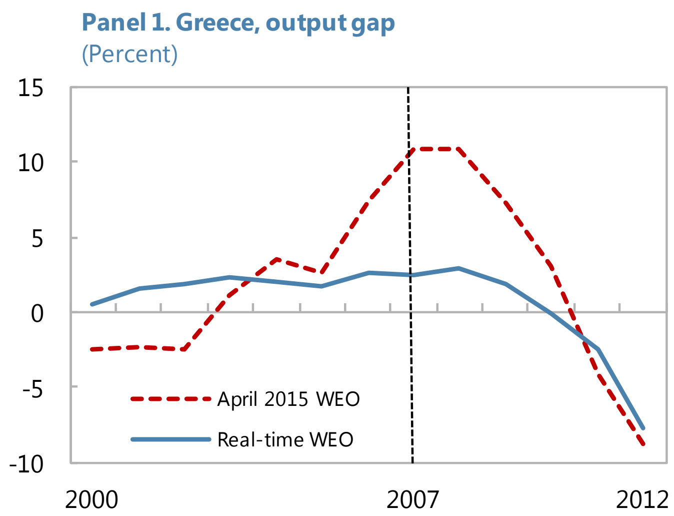


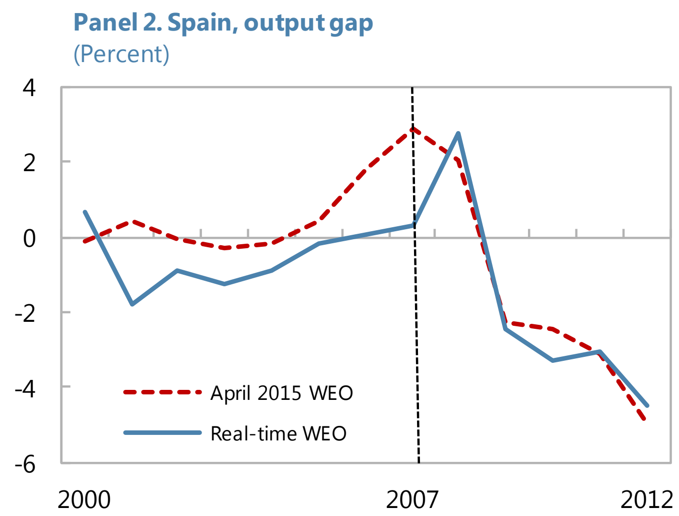


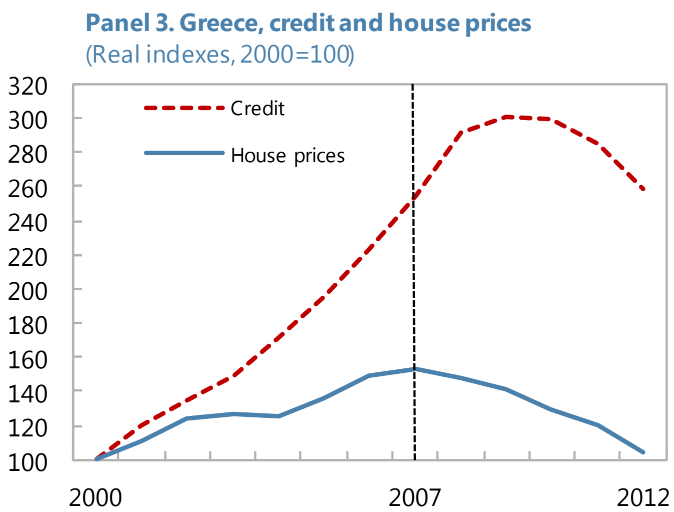


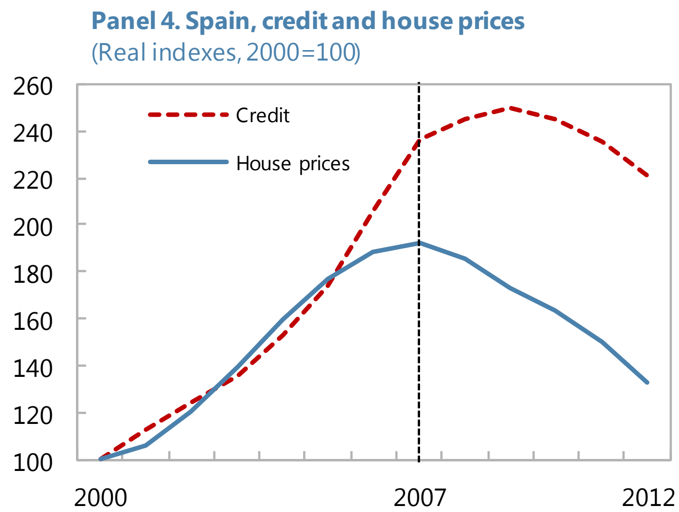


Potential output a bit of a moving target

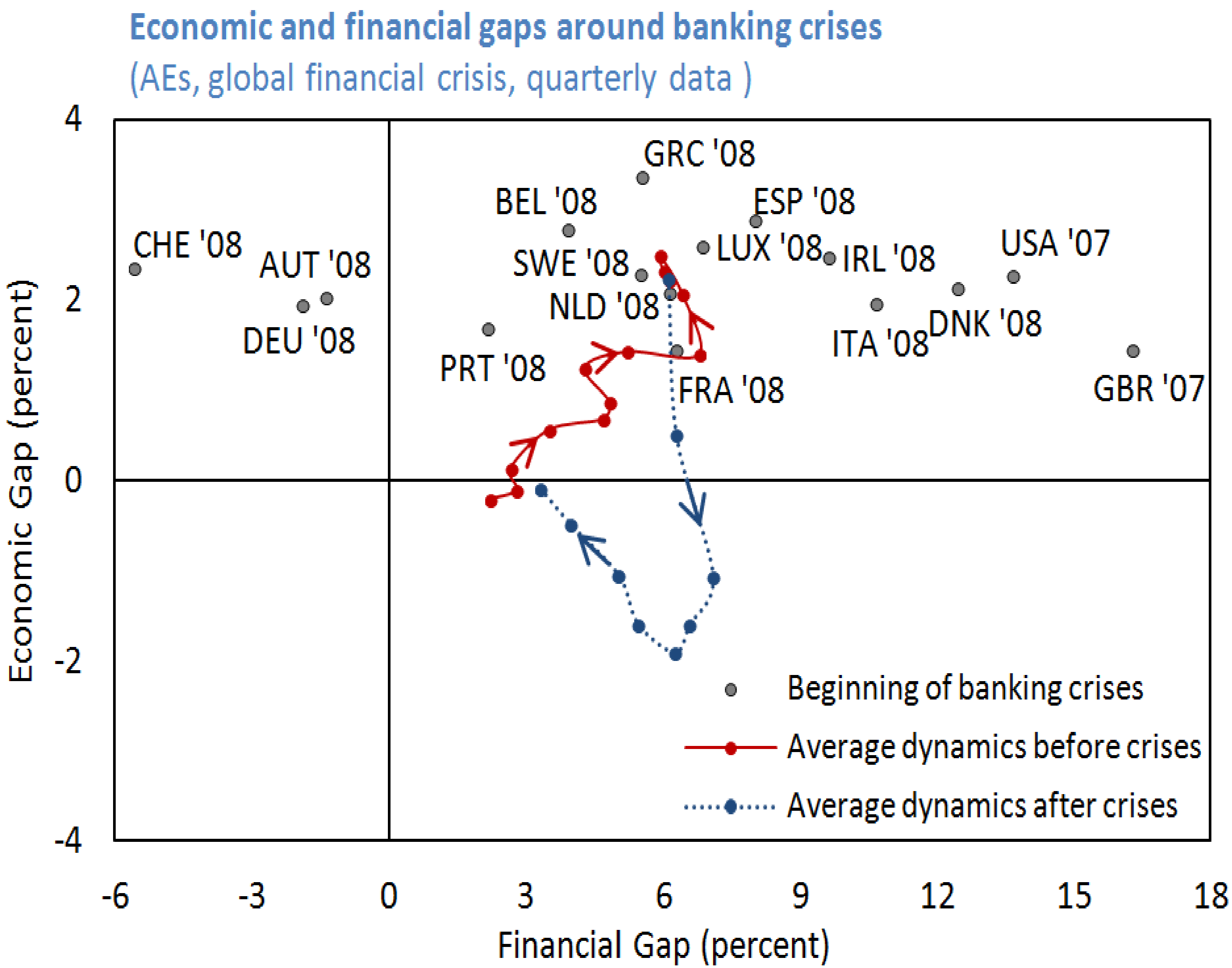




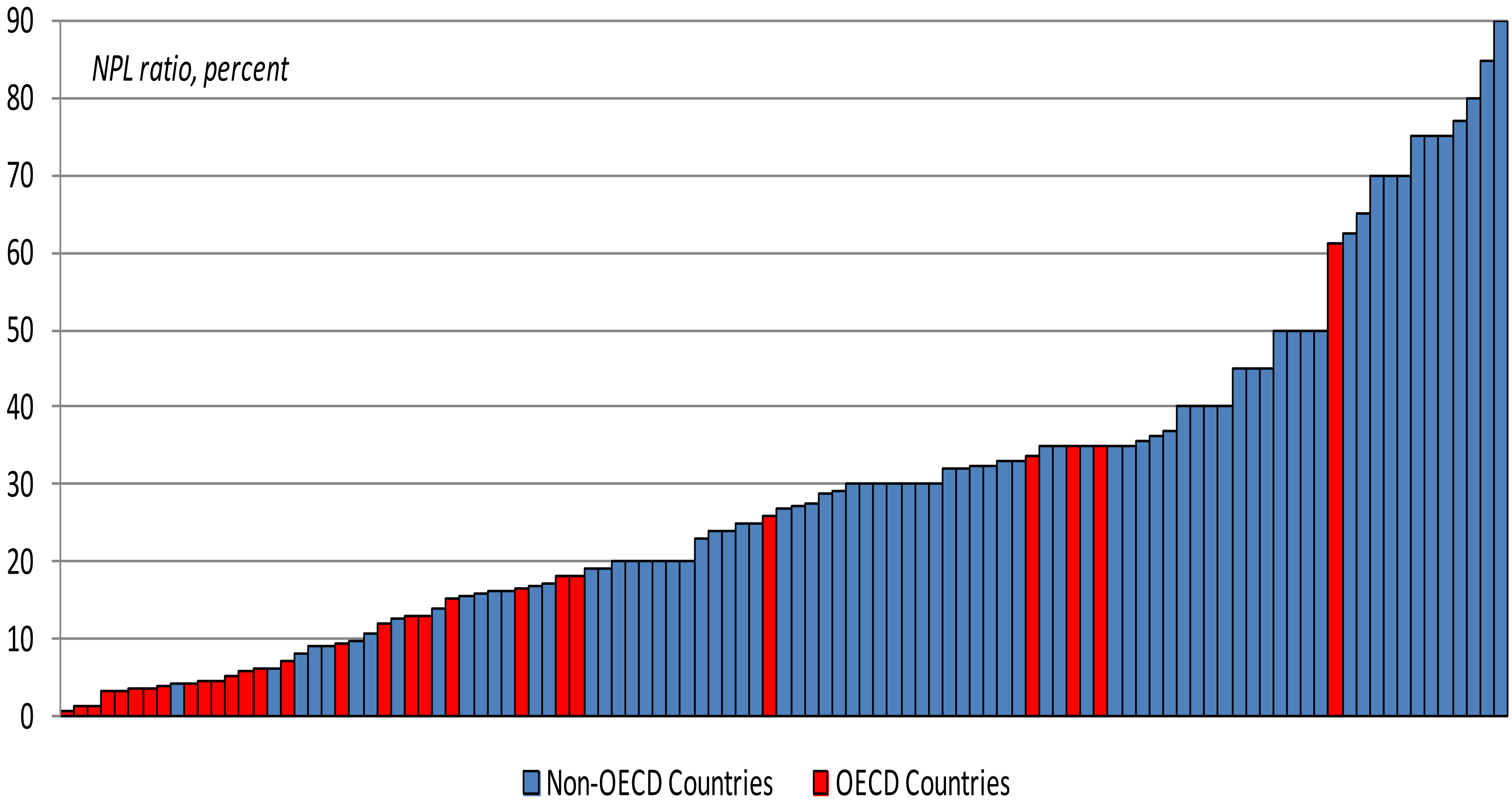




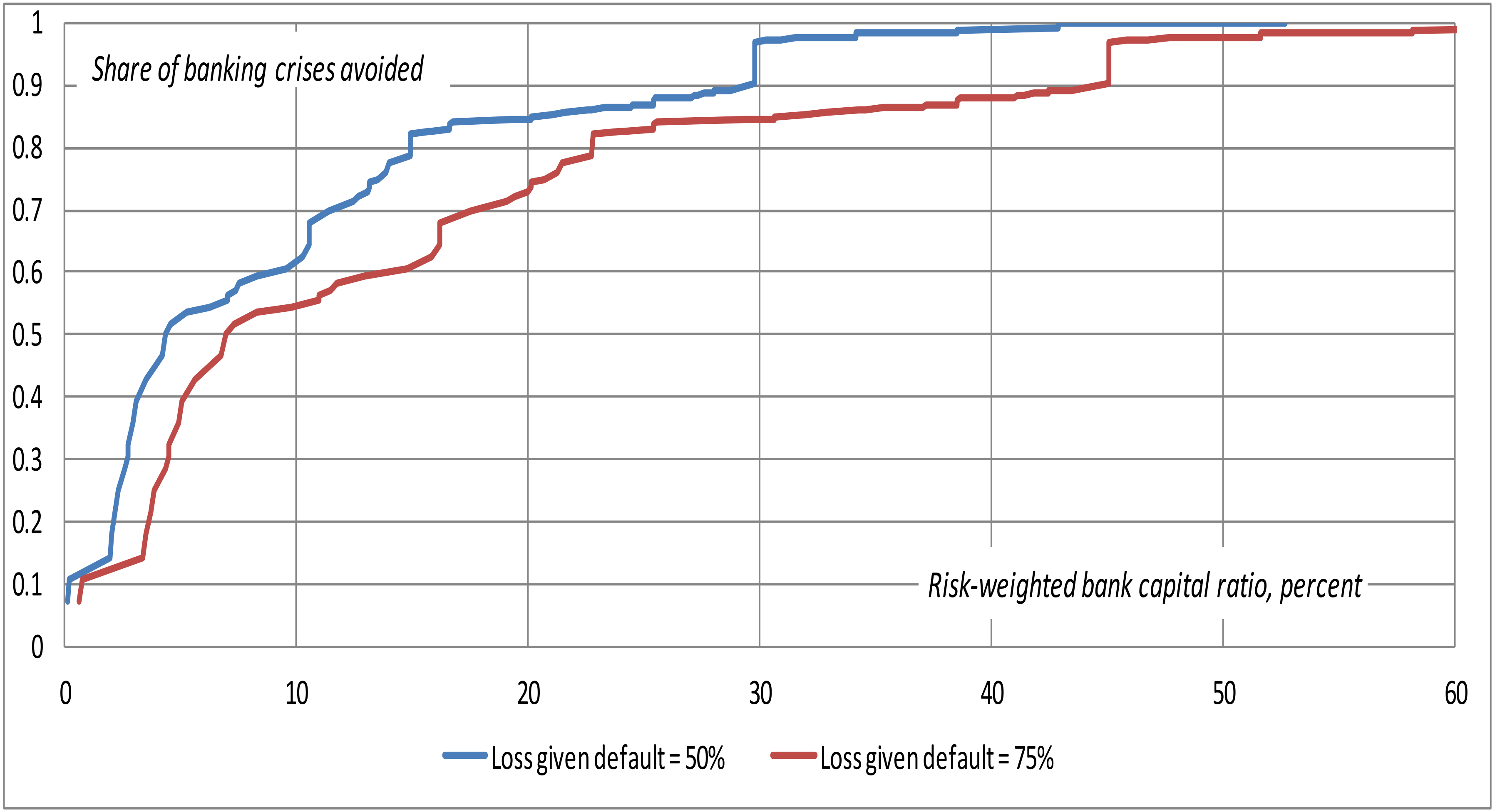
Economic and financial overheating



Bank NPLs in crises



Role of bank capital/loss absorption



Governance issues with financial stability mandate

Outsourcing price stability to independent CBs was "easy":

- A clear and measurable objective: low and stable inflation (some attention to short-term output)
- Clearly understood (often mono-dimensional) tools: the policy rate
- Accountability led to properly designed incentives for central bankers

Outsourcing financial stability is much more complicated

Governance issues with financial stability mandate

Paradox of success

- Unlike monetary pol.: No easily measurable target (is there a too stable financial sector?)
- Unlike prudential supervision: No yardstick
- Nobody sees the crisis that did not happen

Politically charged (with or without MaP)

- Hit most vulnerable
- Against increased credit access

Need for rule-based approach. But…

- Measurability makes delegation challenging
- Far from calibration of DSGE standards

Risks to Central Bank Independence?

Theoretical foundation for CB independence on price stability:

- Inflation is an inferior tool to deal with fiscal constraints
- Time-inconsistency problem
- This clearly still desirable

Analogous arguments for financial stability?

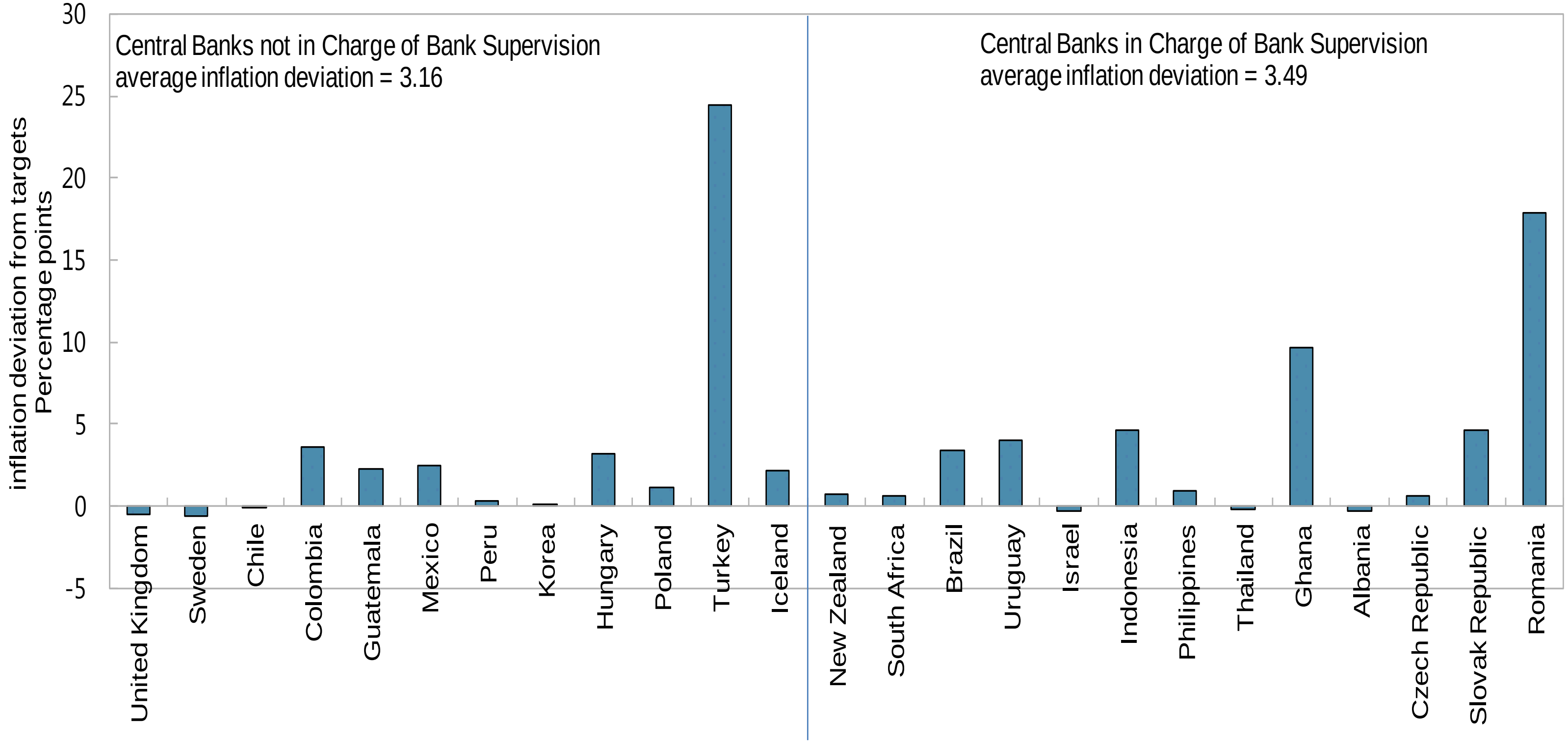
- Governments may be tempted to use regulation to distort incentives for banks to finance the treasury
- Politicians may be reluctant to tighten if this is politically costly

Legitimate concerns

- Democratic deficit if a central bank is endowed with powers ranging from setting interest rates to credit allocation and financial regulation
- Especially in the context of mandates with measurability issues

Evidence so far suggests no significant difference in inflation performance with multiple mandates

Figure 7. Inflation Performance and Bank Supervision among Inflation Targeters



Note: Average inflation deviation from the target since the central bank introduced inflation targeting until 2006Q4. Difference in means is not statistically significant.

Source: Central Banks' websites, Haver Analytics, and staff calculations.

Yet, important concerns remain

So far, a financial stability mandate has meant to be in charge of relatively “a-cyclical” bank regulation and supervision

Political pressures can intensify:

- Tools with more targeted effects (with clearer winners and losers)
- Cyclical use of prudential tools

Communication/credibility challenges

- One tool/two targets
- Conflicting mandates

Key challenge:

- Protecting MP independence (on price stability) if government/public chooses to exercise greater oversight on new central bank responsibilities