

Session 5: The Future of Inflation Targeting



**Should Policymakers
Respond Directly to
Financial Stability in their
Interest-Rate Rule?**

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The Background

- In his BIS paper (Tetangco, 2010), Gov. Tetangco raised issue of whether to broaden policy rule to include financial stability as target variable.

- As far back as Feb 1997, prior to the Asian crisis of that summer, in a SEACEN (1997) paper, I wrote that in monetary management, separation of twin goals of price and financial system stability neither tenable nor desirable.

The Background

- Not only twin goals of price and financial stability separated operationally, but interdependence not fully appreciated and examined.

- Monetary policy transmission mechanism ignored impact of financial instability on economy, and vice-versa.

The Background

- On top of unsustainable fixed exchange rate regime, extremely weak regulatory and supervisory structure over financial sector played critical role in Thai currency & economic crisis that began in July 1997.

- Strong, effective (and nimble use of) prudential instruments absent in Thailand at that time.
- Thus, even if an IT policy framework existed at that time, Thailand could not have prevented financial instability during 1997-1998 and its severe macroeconomic impact.

The Background

- Fast forward to 2007-2008.
- Collapse of U.S. housing mortgage market, manifested by Lehman's liquidation and bailouts of AIG and large U.S. banks, coincided with lapses in uncoordinated financial oversight.
- Limited purpose of paper is to answer narrower question posed by Governor Tetangco: should IT policy rule include some measure of financial stability as target variable?

The Background

- U.S., hit by financial crisis, had regulatory/supervisory responsibilities diffused among 5 agencies—BGFRS, CoC, FDIC, CFTC, and SEC.
- Lapses in financial oversight and incomplete regulation.

- Canada weathered financial crisis because of strong and effective cadre of regulators and supervisors backed up by stringent rules and regulations—only one govt agency, OSFI, regulates, examines, oversees banks & insurance institutions.

The Background

- While price stability has not guaranteed financial stability (U.S.), monetary policy and prudential policy have together contributed to both price and financial stability (Canada).

- No historical data to assess issue because no policy rule, past and present, has included financial stability as target variable.
- Literature addresses issue with *theoretical* simulations of calibrated DSGE models.

The Debate

- Mixed theoretical results.
- DSGE models with fully rational price expectations imply welfare gains with *augmented* policy rule. (Kannan et al, 2009, and references cited therein)

- Gains (losses) measured by lower (higher) volatilities for inflation and output.

The Debate

- Hybrid DSGE model with partly (70% of households) rational and partly (30%) adaptive price expectations imply welfare losses with *augmented* policy rule (Gelain et al, 2012, and references cited therein).

- Same hybrid DSGE model using a *traditional*, flexible policy rule, combined with prudential rules, identifies stringent loan to income ratios most effective in macroeconomic stabilization.

The Debate

- Same hybrid DSGE model with standard, flex IT rule, combined with prudential rule, implies policy rate inertia, manifested in measured, incremental changes in policy rate.

- Gelain model captures house price boom and rapid credit growth prior to 2007-2008 crisis, driven by unsophisticated new homebuyers that used simple, backward-looking rules about future house prices.

The Debate

- Woodford (2012) argues, with a new Keynesian model with credit frictions, for tighter monetary policy and “leaning against the wind” to reduce likelihood of financial crises.

- Svensson (2012) expands Woodford model by adding prudential instruments, allowing monetary policy and financial stability policy to be conducted separately.

The Debate

- Svensson's cyclical capital requirements allow authorities to control leverage directly, relative to Woodford's use of policy rate to influence output gap that in turn affects leverage.

Svensson says price stability and financial stability, although interdependent, must be separate objectives.

Each objective has its own instruments.

The Debate

- According to Dep. Gov. Svensson, policy rate is too blunt an instrument to prevent asset price bubbles.

- For price stability, instruments are policy rate and communication tools (e.g., inflation report).

The Debate



• For financial stability, prudential instruments are cyclical capital requirements, LTV ratios, minimum liquidity ratios, net stable funding ratio in Basel III.

• Other prudential tools include: dynamic loan loss provisioning (Spain); limits on net open foreign exchange positions; and loan to income ratios (most effective in Gelain model in macro stabilization).

The Debate

. Svensson contends that collapse of U.S. house mortgage market was caused not by monetary policy but by lapses in uncoordinated financial regulation and supervision, and incomplete regulation on, and understanding of, derivatives.

. Concludes that traditional, flex IT with inflation and resource utilization as targets in reaction function remains best practice before, during, and after the global crisis.

The Debate

- However, Svensson calls for more research, under way in central banks and academia, on role of financial factors in transmission mechanism.

- To my mind, there are other valid arguments favoring prudential policy as first best for financial stability.

My Thoughts

- Critical issue is the *quality* of systems of regulation and supervision of financial system.
- Is such system strong, effective, and well-coordinated enough to minimize likelihood of crises?
- When crises do occur, is such system nimble to use and effective enough to solve crises with minimal adverse effects on inflation and growth?

My Thoughts

• Can it be designed to minimize negative effects of moral hazard, recognizing presence of imperfect (asymmetric) information in lending markets?

• IMF study (Dell'Ariccia et al, 2012), using data on 170 countries from 1960-2010, finds weak empirical evidence that monetary tightening has contained rapid credit booms and fallout on economy.

My Thoughts

- Study finds that monetary tightening increased risks associated with credit expansion.

- E.g., higher domestic loan rate induced cheaper foreign funding, with currency and maturity mismatches.

My Thoughts

- Triggered teaser contracts and interest-only loans.

- More risk-taking encouraged by explicit/implicit govt guarantees protecting banking system, or expectations of public bailout when things go bad (Dell'Ariccia, 2012).

- Interaction of imperfect information, moral hazard, and loose financial oversight limits effectiveness of raising interest rates to counter rapid credit growth. (Villanueva 2008, Ch1, Strategies for Financial Reforms)

My Thoughts

- Properly regulated and supervised banks with adequate capital and provisions for loan losses essential for interest rates to influence the desired movements in bank credit.

- Such banks, when faced with excess demand for loans, may not raise lending rates but ration credit to minimize adverse selection and incentive effects identified by Stiglitz and Weiss (1981) and Mankiw (1986).

My Thoughts

- In an open economy, another reason why banks may not raise lending rates is the availability of abundant foreign funding carrying lower interest rates (Sonali Jain-Chandra and D. Filiz Unsal, 2012).

Theoretical justification for conjecture that higher policy rate would have significant financial stability effect is uncertain.

There is also weak *empirical* evidence for such conjecture.

Conclusion



Thus, until research on this issue provides a definitive answer, it appears that the present standard, flex IT with inflation and resource utilization as targets remains best practice.

However, there is urgent need to better understand effects of financial stability variables on inflation and resource utilization.

So that monetary policy can respond appropriately and in timely manner to any changes in financial stability that affect inflation and output.

Conclusion

- As in case of excessive movements in the exchange rate (ER), IT central banks dampen ER fluctuations to stabilize output and inflation via foreign exchange intervention. ER is not a separate target in the policy rule.

- Similarly, IT central banks counter potential financial instability to minimize adverse effects on inflation and resource utilization via nimble use of tough and effective prudential policy. Financial stability is not a separate target in the policy rule.

Conclusion

.Tough and effective prudential policy best first line of defense against signs of financial instability. Carl Walsh, in *The Future of Inflation Targeting* (2011) states, “...the first best policy involves an adequate system of financial market regulation.”

- However, because prudential policy is open to circumvention and arbitrage, regulators and supervisors have to be vigilant, creative, and nimble in applying prudential policy, and to coordinate it across national borders.

Conclusion



Whether responsibility for prudential policy resides with central bank or another government agency is sovereign choice of national authorities.

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