Discussion

Allen, Kim and Walther Inflation targeting and financial stability

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The quest for nominal stability:
Lessons from three decades with inflation targeting
Stockholm, 23-24 May 2018

The views expressed are my own and not necessarily those of the ECB

More than 10 years ago…

Figure 10. Three views

	MODIFIED JACKSON HOLE CONSENSUS	LEANING AGAINST THE WIND VINDICATED	FINANCIAL STABILITY IS PRICE STABILITY
Monetary policy	Framework largely unchanged Limited effects on credit and risk taking Blunt instrument to deal with imbalances	Financial stability as secondary objective: lengthening of horizon Affects risk-taking "Gets in all of the cracks"	Twin objectives on equal footing Unblocks balance sheet impairments; avoids financial imbalances in upturns
Macro prudential	Granular and effective	Cannot fully address financial cycle; arbitrage	Indistinguishable from monetary policy
Interaction	Limited interaction and easy separation of objectives, instruments, …	Financial fragility affects monetary transmission are price stability	Financial stability and price stability are intimately interlinked
Issues	Coordination? Lender of last resort?	Coordination? Overburden money policy?	Time inconsistency problems?
Models	Svensson; Collard, Dellas, Diba and Loisel (2012)	Borio; Woodford (2012)	Brunnermeier and Sannikov (2012)

Source: Smets (2013), "Financial stability and monetary policy: How closely interlinked?", **Riksbank** Economic Review 2013:3.

Franklin in the right column?

- Likes the Norges Bank set-up better than the Riksbank's.
- Argues macroprudential policies are not very effective: leakage – real estate more attractive than alternative (stock market).
- Shows that monetary policy (liquidity policy) can stabilise the financial system and produce first-best (Allen, Carletti and Gale, 2014).

FS considerations in ECB strategy

- Primary objective of monetary policy is price stability, whereas macro and micro-prudential policies are the first line of defense against financial stability risks
- Financial stability is a pre-condition for price stability and vice versa
  - Clear conceptual case for the ECB to take financial stability into account, while avoiding misperception that the ECB is responsible for financial stability
  - Under stressed conditions: monetary policy measures aimed at maintaining price stability and ensuring a smooth transmission typically help to restore financial stability
- FS considerations are accounted for via the medium-term orientation, but monetary policy reaction to financial stability concerns depends on prevailing circumstances:
  - No systematic "leaning-against the wind" or "cleaning"
  - Optimal horizon is context-specific and depends on origin, magnitude and persistence of deviation of inflation from the target

FS considerations in practice

- From ECB 2021 Monetary Policy Strategy background note: "…, an in-depth assessment of the interaction between monetary policy and financial stability will be conducted as part of the monetary and financial analysis at regular intervals and considered at the monetary policy meetings of the Governing Council, drawing on the Financial Stability Review and other relevant material."
- This is reflected in a short paragraph in the relevant Monetary Policy Statement.
  - E.g. December 2023 MPS:
  - "In line with our monetary policy strategy, the Governing Council thoroughly assessed the links between monetary policy and financial stability. Euro area banks have demonstrated their resilience. They have high capital ratios and have become significantly more profitable over the past year. But the financial stability outlook remains fragile in the current environment of tightening financing conditions, weak growth and geopolitical tensions. In particular, the situation could worsen if banks' funding costs were to increase by more than expected and if more borrowers were to struggle to repay their loans. At the same time, the overall impact of such a scenario on the economy should be contained if financial markets react in an orderly fashion. Macroprudential policy remains the first line of defence against the build-up of financial vulnerabilities, and the measures in place contribute to preserving the financial system's resilience.

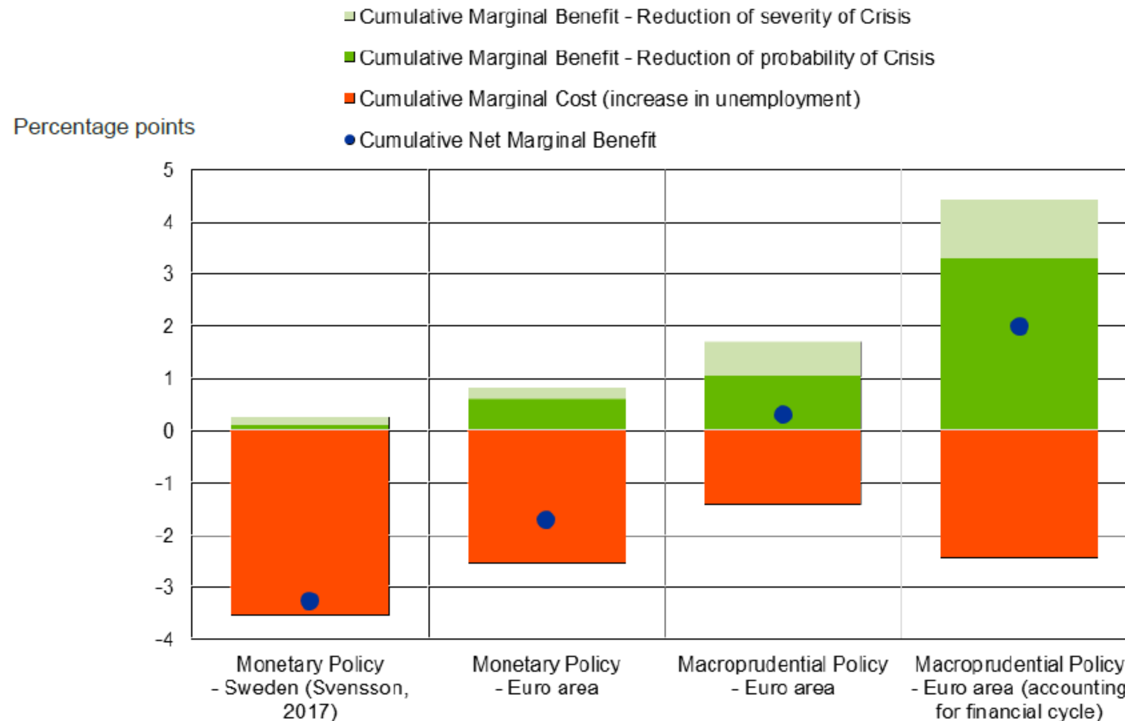
Effectiveness of macroprudential policies?

- Is the Chinese experience the most relevant to assess the effectiveness of macroprudential policies?
- Laeven, Maddaloni and Mendicino (2023):
  - "A growing number of papers provides empirical evidence on the effectiveness of macroprudential policies in moderating credit and asset price cycles (Bruno et al. 2017; Cerruti et al, 2017; Ampudia et al. 2021) and reducing negative GDP tail risks (Chavleishvili et al. 2021a)."
- Threats: Inaction bias (discussion on positive neutral countercyclical capital buffer) – Leakage (need to enhance macroprudential policy over non-bank finance)
- The recent experience suggests that high capital and liquidity buffers (Basel III) and strong supervision are the more important elements to ensure financial stability.

Effective policy assignment
(Constancio, 2018)

Net marginal costs of "leaning against the wind": Monetary policy vs. macroprudential policy

(Cumulative impact after 40 quarters; in percentage points of the loss function)



Sources: Svensson (2017), Darracq Pariès, Kok and Rodriquez Palenzuela (2011) and ECB calculations.

Note: The monetary policy measure is a 1 pp. increase of the policy rate over 4 quarters. The macroprudential measure considered here is a 1 pp. increase of the capital buffer requirement. The "financial cycle" variable is a composite measure of four indicators including total credit growth, house price growth, interest service burden and debt-to-income ratio.

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What monetary policy?

- *Liquidity policy*: role of central banks as liquidity providers and lenders of last resort is well known:
  - Most central banks have an ample reserves regime with an elastic supply of reserves (FRFA); non-bank financial sector?
- This role is compatible with using conventional *interest rate policy* to target inflation… possibly in a flexible way to account for financial stability considerations.
- In between, many *unconventional* measures (PEPP – LTROs – TPI - …) that are justified on the basis of "*ensuring or repairing a smooth transmission*"; typically more targeted and temporary.

Stance versus transmission

- One of the interesting questions for future strategy reviews is whether one should more clearly distinguish actions geared at affecting the monetary policy stance from those that are geared at avoiding disruptions to the transmission mechanism. A resurrection of the separation principle?
- The recent tightening episode is revealing:
- Monetary policy tightening has been strong.
- At the same time, central banks have been quite forceful in their responses to incipient financial instability events:
  - Fed in response to SVB etc
  - BoE in response to the DLI event
  - ECB in response to possible sovereign risk (TPI)
- Arguably this has contributed to a smoother, possibly less strong, but maybe also more sustainable transmission of the interest rate tightening.