BANK FOR INTERNATIONAL SETTLEMENTS

# Comment on “Integrating monetary policy and financial stability: A new framework”

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# What the paper does

- Apply the current best practice to develop financial stability risk indicators
- Describe a new ‘Model Platform’, a framework to incorporate financial stability into monetary policy analysis
- Offer an insight into how the Monetary Policy Committee (MPC) assesses financial stability when deliberating interest rate policy

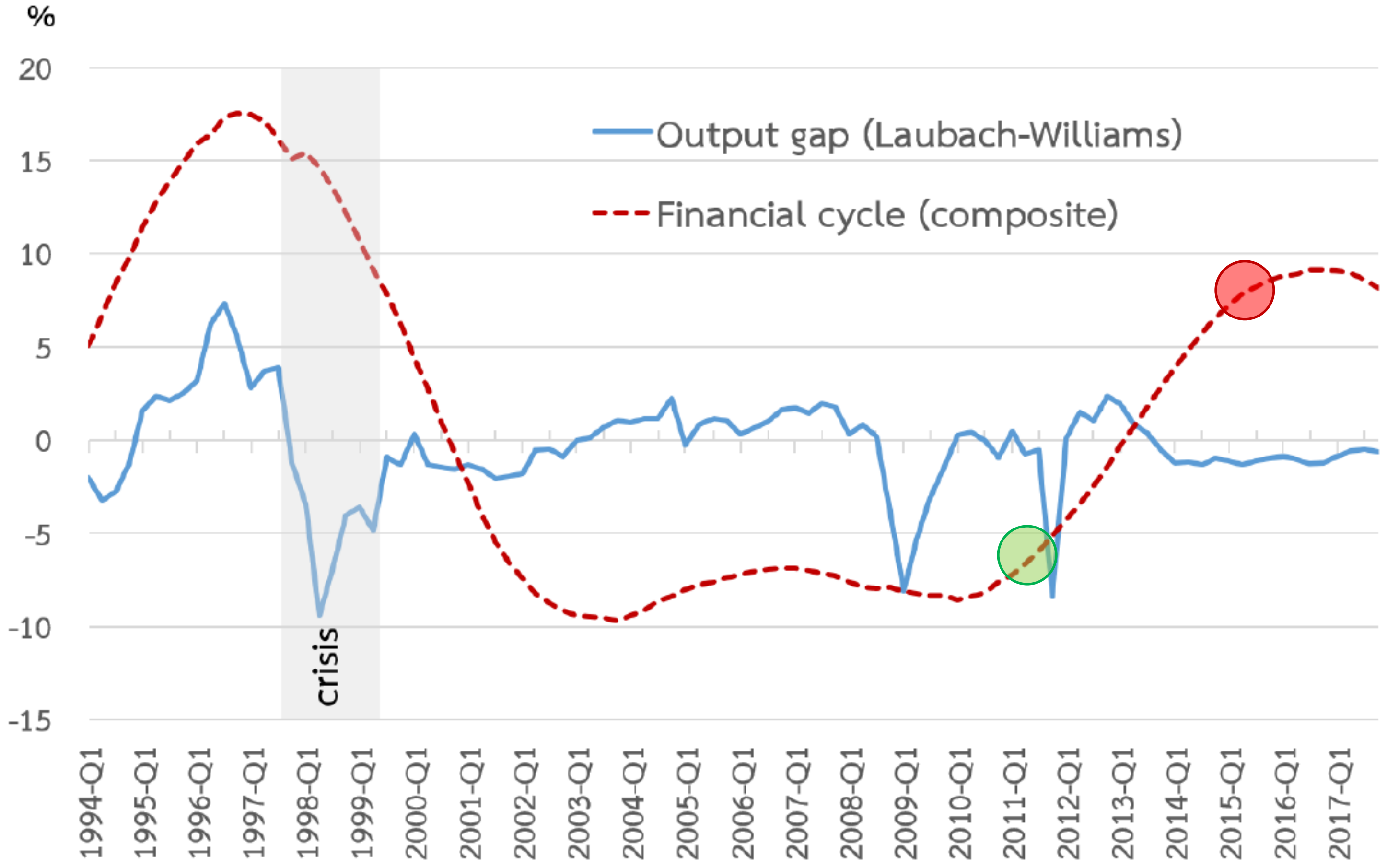
# Paper's contributions

- The BOT's first comprehensive attempt at 'how to do it'
  - A benchmark study
  - A key milestone for the BOT, an experienced practitioner of the idea
- A major step-up from BOT's previous conceptual studies
  - A practical policy analysis used in MPC's decision-making process
- A balanced and commendable treatment of a top policy issue
  - Valuable contribution to the frontier of debate and central banking community

# Modular framework

1. Financial stability is *incorporated*, not quite fully *integrated*
   - Analytical framework follows Svensson's (2017) modular approach
     - Monitor & react when red light flashes; otherwise target inflation as usual
     - Red light flashes when a crisis risk reaches some threshold
     - Burden of proof is on leaning-against-the-wind (LAW) policy
   - Problems
     - Once red light flashes, it is often too late to act
     - Framing problem in crisis terms is too narrow, and sets the bar too high
     - Svensson (2017) shows one should <u>never</u> lean in his model!

# MPC may wish to buy insurance early



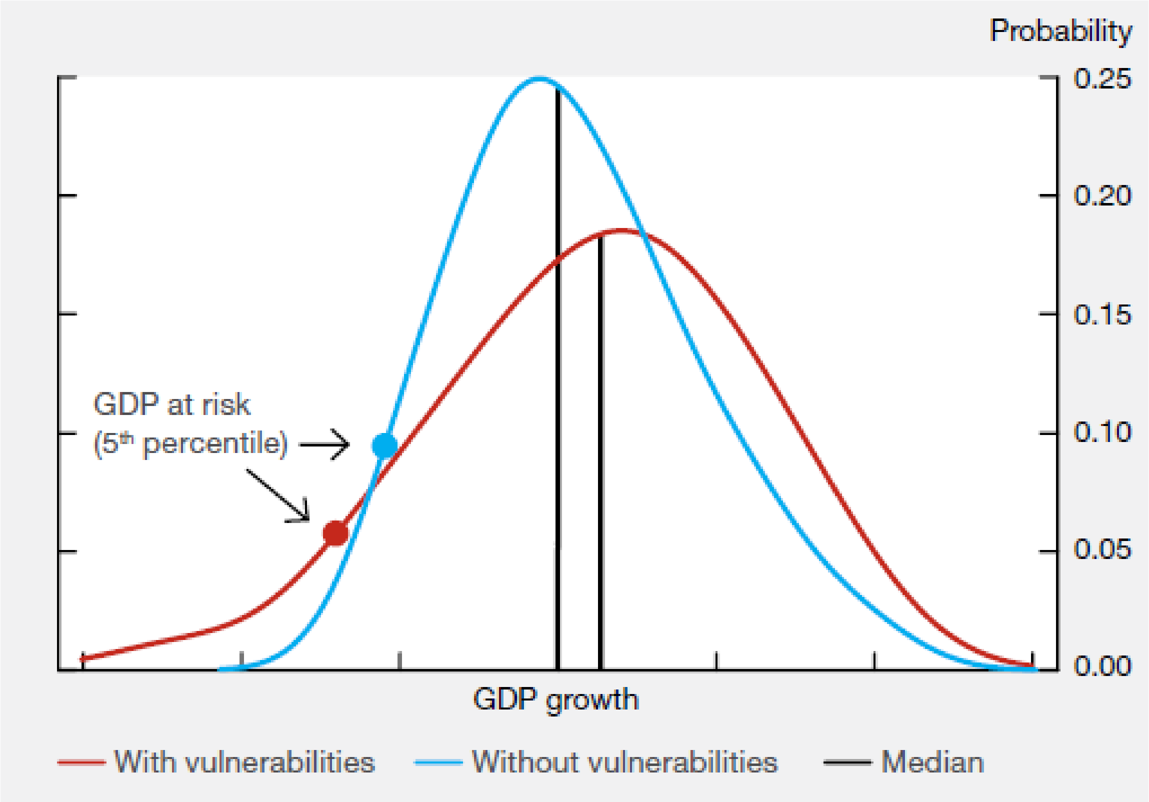

MPC Statement, March 2011

"คณะกรรมการฯ ประเมินว่าการปรับอัตราดอกเบี้ยนโยบายสู่ระดับปกติอย่างค่อยเป็นค่อยไปยังมีความเหมาะสมที่จะดูแลการคาดการณ์เงินเฟ้อไม่ให้เร่งขึ้น และลดโอกาสที่จะเกิดความไม่สมดุลในระบบการเงินได้"

# Integrated framework

2. An integrated framework has financial stability built into the economic projection
   - Higher financial imbalances weigh on future growth, even without crisis
     - Debt overhang for borrowers (e.g. high household debt now)
     - Deleveraging by lenders
     - Loss of wealth lowers confidence
   - The tradeoff is between short-term growth and their long-term sustainability
   - This intertemporal trade-off should be factored in <u>at all times</u>, and policy should adjust as the trade-off evolves
   - Analogies of leaning
     - Regular exercise and healthy diet even when all lights are green – the point is to stay fit and healthy
     - Limit your speed when driving (avoid last-ditch brakes/airbags)

# Possible tools in an integrated framework



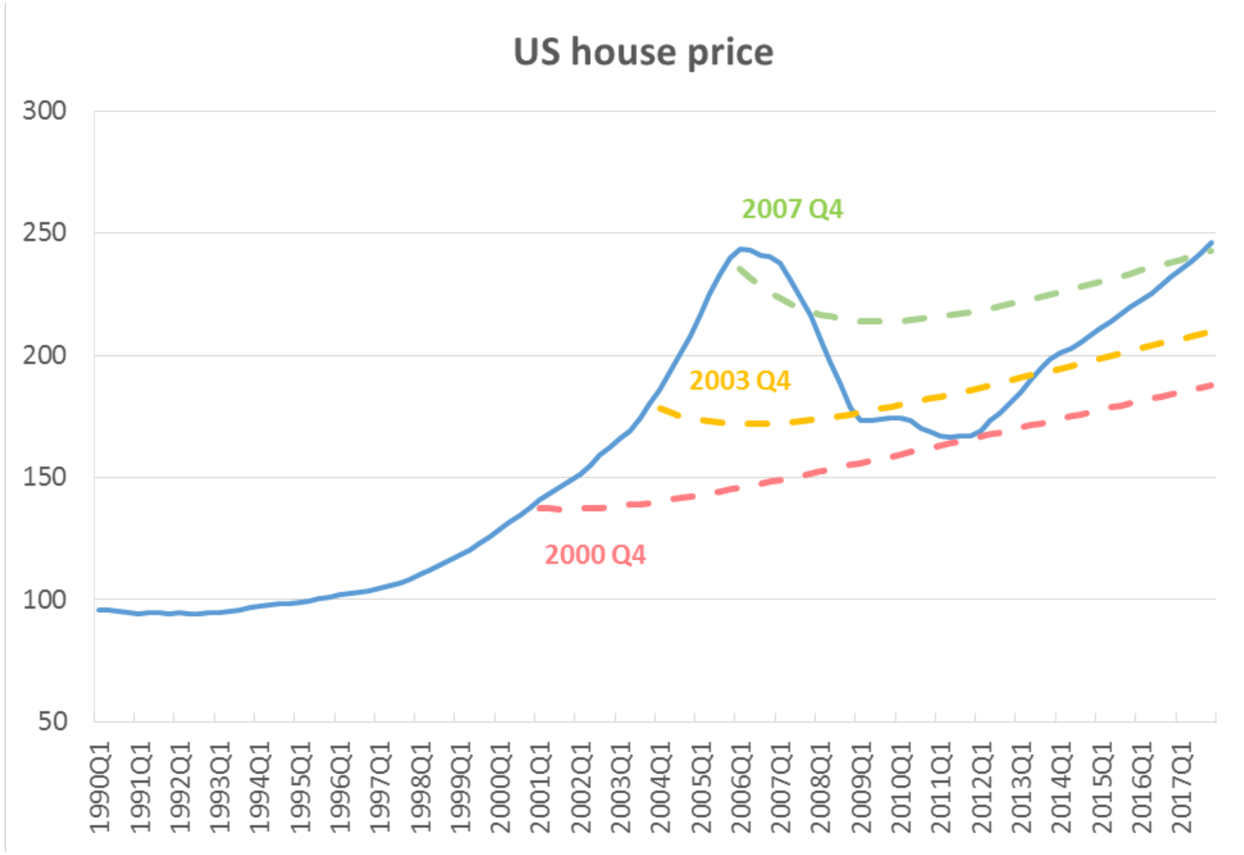

Bank of Canada Financial System Review, June 2018

- MPC weighs various outcomes
- Choose policy rate to deliver the desired outcome
- This is systematic leaning policy!

# Living without the holy grail

3. Having a does-it-all model would be ideal, but also hardest
   - The challenge is to model financial boom-bust cycles
     - More than adding banks and financial frictions into the macro model
     - Need to model financial *instability*, not financial equilibrium
   - Standard models (incl. VAR and DSGE) are based on equilibrium notion
     - Biased against leaning – booms caused by shocks and the equilibrium always pulls you back
     - Why lean when there is no wind?
     - In reality, shocks often reflect a lack of imagination
   - Don’t hold your breath

# Why did no one see it coming?



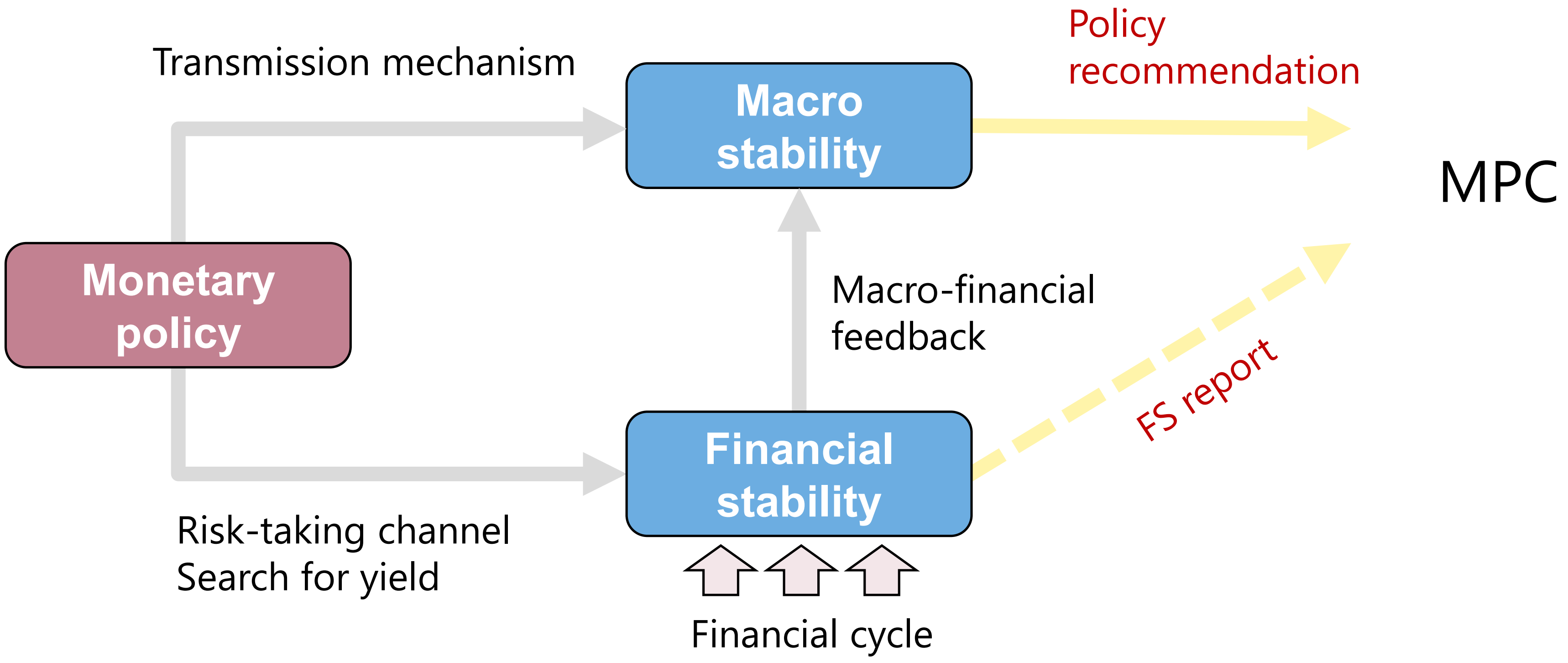

- Models can only sharpen human insights, not substitute for them
- Judgements and imaginations will remain important tools for policymakers
- Need to understand better the nature of financial upswing, and implications for downswing

# Blending research and judgements

The "core module" could be separated into two parts

a) A robust tool to map financial risks into economic projection

b) A collection of self-contained macro-financial models, to be used in parallel



# Usual critiques on leaning

4. FAQs on systematic leaning policy
   - Won't inflation run below target?
     - No. There can be a relief phase during deleveraging
     - Financial busts are far more deflationary
   - Doesn't the cost generally exceed the benefit?
     - No, under 3 conditions:
       1. the financial system is prone to endogenous boom-bust
       2. Tightening now can help mitigate the boom
       3. Easing later cannot fully absorb the bust
   - Why not leave FS to macroprudential (Tinbergen's separation)?
     - If macpru is feasible, effective, and less costly, then use it first!
     - But will it be used first?

Thank you