Comments on "Maintaining price and financial stability by monetary and macroprudential policy – evidence from Asia and the Pacific"

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1. First of all, I would like to express my gratitude to Bank Indonesia and BIS for inviting me to this great conference and I am honoured to have an opportunity to discuss an excellent paper by Soyoung and Aaron.

2. I would like to comment on the paper from the viewpoints of its motivation, analysis and its implications, in that order.

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1. The motivation of this paper is straightforward. The global financial crisis has made us strongly aware of the importance of financial stability and therefore macroprudential policy. Thus, first of all, it is essential to know that macroprudential policy is effective in delivering financial stability in the first place. Second, we need to know if macroprudential policy has implications for price stability as well, because, if this is the case, monetary policy would be affected one way or the other. This issue immediately raises the question on the opposite causality: whether or not a feedback from monetary policy to financial stability may also exist. Putting them together, what we want to know is whether we have to recognise what may be called cross-spillover effects between macroprudential policy and monetary policy. And, if we do, a very critical question that immediately follows is how strong those cross-spillovers are. In other words, are macroprudential and monetary policies perfect substitutes or are they still sufficiently independent of each other that they can be regarded as two different sets of policies? As long as they are sufficiently independent, cross-spillovers may not be so problematic, at least in theory. I will come back to this very important point in a minute. In the meantime, I want to point out that the third motivation of this paper is to discuss all of the above in the Asia-Pacific context.

2. I think these motivations are all well founded. Before, turning to further discussion, let me make sure that we have broadly common understandings on the reasons behind the importance of financial stability.

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1. First, we had a number of lessons, including the period leading up to the 2008 Global Financial Crisis, which made us believe that a financial bubble tends to grow when price stability is maintained. Second, if not a financial bubble, disproportionate risk-taking in the financial sector compared with real economic activity has been widely observed in many countries in recent years under current extremely accommodative global monetary conditions. Third, in particular from the emerging market economies' perspective, the effects of monetary policy spillover from

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advanced economies may be successfully countered if measures other than interest rates are available in order to control domestic financial conditions.

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1. Now let me turn to the issues regarding interaction or cross-spillover between financial stability instruments and price stability instruments. One important point is that they do not have to be completely independent to each other. Some cross-spillovers are fine. But they should not be perfect substitutes for each other, or even near-perfect in a practical sense, in order to keep the possibility alive that financial and price stability would be achieved at the same time. This is the prerequisite for the Tinbergen principle to work: you have two sufficiently independent instruments, and then you can achieve two objectives. If those two instruments are not sufficiently independent, however, some other policies, maybe fiscal and/or structural policies, would be called upon for the sake of financial or price stability.

2. Another very important issue in practical policy settings is, even if the Tinbergen principle works in theory, how to make it work in the real world through effective coordination between price stability policy and financial stability policy no matter whether it is within a central bank or between relevant authorities. But this institutional policy framework issue is out of the scope of this paper.

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1. Now let me make some comments on the analysis. Generally speaking, I think that the method of the analysis and the data used for the analysis are quite sensible. Unfortunately, the number of countries examined here is limited to only four: Australia, Indonesia, Korea and Thailand. But this is not the authors' fault. This is simply due to data limitation. After all, macroprudence is relatively new area and there are always inherent challenges regarding data. Actually, it is encouraging that data collection efforts are ongoing and useful databases are increasingly available including the one on the policy actions on housing markets, which is used in this paper's analysis.

2. One possible way to circumvent the problem of data limitation is to broaden the geographical scope toward outside Asia, particularly some European countries. That way, we may also be able to get more useful insights with regard to similarities and differences between Asia-Pacific and Europe. If not by refinement of this paper itself, such an approach is worth exploring in some future similar works.

3. With regard to the analytical method including structural VARs, I think this is a fairly sensible approach when one wants to assess cross-spillovers of two different policies on their two different policy objectives. I also applaud the reasonably wide range of robustness testing that was done, which gives credibility to the empirical results.

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1. Now let me turn to the implications. The broad results of the analysis seem to be fairly reasonable and encouraging. First, macroprudential measures have the intended effect on financial stability, at least qualitatively. So, they are effective. Second, there are some cross-spillovers between macroprudential and monetary policy but they are far from perfect substitutes. These results are quite encouraging because this theoretically implies that, with an optimal combination of macroprudential and monetary policies, we will be able to achieve financial stability and price stability at the same time. In other words, Tinbergen's principle is going to

work if we are doing it right. Suggesting this possibility based on empirical evidence is a very important contribution of this paper.

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1. At the same time, however, some important questions remain unanswered once we start asking ourselves about how to apply these findings to actual policy decision makings.

2. First, it is worth exploring why, in the real world, there has been a bias towards low inflation and high credit growth in Asia-Pacific, despite the theoretical possibility of an optimal policy combination. In this regard, counterfactual analysis, based on the estimated VAR of this paper, to identify the optimal combination of macroprudential and monetary policies would be interesting. It is easy to expect that macroprudential policy should have been tighter and monetary policy should have been easier in a qualitative sense. But it would be interesting to know how far actual policies have been deviating from the optimal policy combination. This would be followed by the question why actual policy has deviated persistently from the optimal one. Is this because policy authorities simply didn't know the optimal policy parameters? Or is this because the optimal solution lies outside the range of feasible combination of two policies? Or is this because of lack of coordination, or other institutional failure?

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1. The second issue I would like to raise is: is it appropriate to continue assigning the price stability mandate exclusively to the monetary policymaker? Given the finding that macroprudential policy and monetary policy have cross-spillover effects on their respective mandates, the logically appropriate mandate structure is that both macroprudential and monetary policy authorities should be jointly responsible for both financial and price stability. In this regard, everybody has recently been talking about the importance of the monetary policy authority taking into account financial stability. But discussion is scarce over whether the macroprudential authority should consider price stability. This asymmetry may be called into question. As a matter of fact, according to this paper, macroprudential policy contributes to CPI even more than monetary policy. The relative importance of macroprudential and monetary policy in their capacity to affect the inflation rate should be further explored, given its profound implications for the very notion that monetary policy is the best and the most powerful measure to control inflation and deflation. For example, this relative importance issue should be tested against wider historical or geographical samples and with more careful treatment of commodity prices, for example, and other global factors. The bottom line here, however, is that as long as macroprudential policy has some implication for price stability, responsibility and accountability for price stability may have to be borne by macroprudential and monetary policymakers jointly.

2. A quick counterargument may be that joint responsibility for price stability could complicate policy communications: simplicity is the king particularly in the context of anchoring inflation expectations. However, if cross-spillover effects are indeed significant, there is no such a thing as a simple and straightforward way to understand the policy transmission in the first place. This may be an inconvenient truth, but we cannot ignore this. Simple communication may not be useful anyway, if the real world is actually much more complex.

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1. The third issue is about the assessment of trade-offs between financial stability and price stability. How much financial stability should we sacrifice for how much gain in

price stability, and vice versa? In other words, we need to know the loss function with regard to deviations from the two policy mandates. Without this, we would not be able to define an optimal combination of macroprudential and monetary policies in the first place. For example, a recent BIS paper (C Borio, M Erdem, A Filardo and B Hofmann, "The costs of deflations: a historical perspective", *BIS Quarterly Review*, March 2015) says that mild deflation, even for a relatively sustained period, is not very costly to the economy. If this is true, monetary authorities would be able to allow inflation to deviate downward rather substantially and even somewhat persistently if it is needed to ensure long-run financial stability. On the other hand, low inflation can be regarded as dangerous in the context of the zero lower bound of interest rates. If you emphasise this point, it would be better to avoid a lower-than-target inflation as far as financial stability risks are not imminent. This line of discussion ultimately comes down to the need to revisit the definition of price stability and financial stability.

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1. Finally, I would like to raise one more issue, which is important in the context of US monetary policy normalisation.

2. In an environment where US monetary policy is being tightened, many emerging economies may have to tighten their own monetary policy to prevent excessive exchange rate depreciation and capital outflows, particularly where large external debt have been accumulated. This means that monetary policy is biased towards financial stability, possibly at the expense of an economic slowdown and thus downward pressure on inflation. In such circumstances, therefore, whether or not easier macroprudential measures can be used to offset disinflationary pressures would be critically important.

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1. The bottom line is that this paper has made a great contribution to the identification of cross-spillover effects between financial stability policy and price stability policy based on Asian experience.

2. This great contribution makes us all the more aware that there remain many issues which need to be explored further by future research.