

Overview and discussion

Final comments prepared for the 2nd BIS CCA Conference on
“Monetary policy, financial stability and the business cycle”
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* These comments reflect the views of the author and not necessarily those of the BIS or of central banks participating in the meeting.



Second BIS Consultative Council for the Americas Conference

“Monetary policy, financial stability and the business cycle”

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Building on the success of the first BIS Consultative Council of the Americas research [conference](#) held in Buenos Aires in 2010, the BIS CCA held a second research conference in Ottawa, Canada, in May 2011. Organised by a scientific committee composed primarily of the Directors of Research of the six BIS CCA member central banks, the conference included nine papers on the general topic of “Monetary policy, financial stability and the business cycle”.

Towards a macro-financial stability framework

The nine conference papers each clarify some aspect of the policy objective of macroeconomic and financial stability. Three components of policy contribute to the objectives of price stability, maximum sustainable growth, and a stable financial system: (i) monetary policy; (ii) fiscal policy; and (iii) regulatory policy. Importantly, though, we should always keep in mind that monetary policy and price stability provide the foundation for the other objectives. So, while price stability may not be enough,² without it we have nothing. Fiscal policy also has essential role to play in a stability-oriented macro-financial framework. Automatic stabilisers are central, but the government is an insurance company that must be ready for both physical and economic catastrophe. For this, it needs a reserve fund; buffers that do not require budgets to balance over the cycle but to go beyond what looks like sustainability in normal times and stay on average in surplus. Finally, regulatory policy plays a key role. Until recently, financial regulators and supervisors focused on the health of individual institutions, ignoring the externalities single actors impose on the system as a whole. The new focus on macroprudential regulation, taking a system-wide view designed to explicitly address the systemic risk arising from externalities of individual actions, provides the third and financial component of a system that can deliver stability.

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In assessing policy implementation in the future, let me highlight a few points. First, the transmission mechanisms for policy and the feedback between the real and financial sectors depend on the structure of the financial system, which is constantly evolving. The obvious implication is that the transmission mechanism itself is constantly changing. Second, there are potential conflicts between macroprudential and monetary policies. There may be times when policies to combat systemic risk involve moving in ways that destabilise real activity and the aggregate price level. Third, globalisation makes things even more complicated than they already are. The free flow of capital and goods and services across national boundaries has clear economic benefits for everyone involved. But not all cross-border flows are created equal. There are good ones and bad ones; and they can be too large. And fourth, we need urgently to develop measures that can help us to assess systemic vulnerabilities. This means measures quantifying the sources of systemic risk including those arising from interconnectedness, feedback and procyclicality.

Policy components

Turning to some of the details of the conference, let me start with the elements of policy. Which ones played a role in the remarkable degree of resilience displayed by emerging markets economies (EMEs) during the last global financial crisis? One is the ability to implement countercyclical policy. Brahim Coulibaly's (Board of Governors of the Federal Reserve System) paper "**Has monetary policy in emerging market economies graduated? Lessons from the global financial crisis**" covers all the policy components. Coulibaly suggests that such countercyclical policy was made possible by stronger macroeconomic fundamentals and reduced vulnerabilities, including greater openness to trade and finance, financial deepening and financial reforms. The adoption of credible monetary policy frameworks such as inflation targeting has also played an important role. The discussant noted that in some settings, countercyclical monetary policy might not be seen as desirable. For example, in the presence of currency mismatches and balance sheet effects from depreciation, authorities might resort to tighter (procyclical) policies during a crisis.

Three additional papers examine system-wide issues that are of clear concern to regulators. "**Market freeze and recovery: trading dynamics under optimal intervention by a market-maker-of-last-resort**", by Jonathan Chiu (Bank of Canada) and Thorsten Koepl, presents a framework for understanding how market-making helped restore proper market

² W White, "[Is price stability enough?](#)", *BIS Working Papers*, no 205, April 2006.



functioning during the crisis. In the model presented in this paper, the market freezes when the average quality of assets falls unexpectedly and permanently as a result of an unforeseen shock. The authors show how a “market-maker of last resort” can revive the market by buying bad assets and assuming any losses. However, it was noted in the discussion that a “market-maker of last resort” may face some issues, including time-consistency and moral hazard.

“Too-connected-to-fail institutions and payment system’s stability: assessing challenges for financial authorities”, by Carlos León, Clara Machado, Freddy Cepeda and Miguel Sarmiento (Bank of the Republic of Colombia), explores the implications of a taking a system-wide perspective. The paper proposes a way to derive a measure of “too connected to fail” institutions from their transaction volumes.

The final paper in this group is the assessment of bank capital cyclicity in **“Bank capital buffers, lending growth and economic cycle: empirical evidence for Brazil”**, by Benjamin Miranda Tabak (Central Bank of Brazil), Ana Clara Noronha and Daniel Cajueiro. These authors look for evidence of procyclicality in Brazil’s financial system and conclude that in an economic downturn banks (particularly public banks) increase capital buffers. This lowers lending and amplifies contraction. The result implies that policy instruments to dampen financial system procyclicality – such as the countercyclical capital buffer that is a part of the macroprudential overlay in Basel III – can play an important role in stabilisation policy.

Complications and interactions

Several papers address some of the complications and interactions that arise when considering the design and implementation of a macro-financial stability framework. Three papers illustrate the implications of financial system structure for policy transmission mechanisms.

Turning first to bank-based systems, in **“The bank lending channel in Peru: evidence and transmission mechanism”**, Cesar Carrera (Central Reserve Bank of Peru) finds evidence of a bank lending channel in Peru. There is, he estimates, an inverse relationship between credit growth and the stance of monetary policy. While this amplifies the impact of monetary policy actions, the effect is small as the pass-through from the policy rate to market rates, and the impact of the latter on credit (the credit channel), are smaller than in economies with more advanced financial markets.

In **“The risk-taking channel and monetary transmission mechanism in Colombia”**, Martha López, Fernando Tenjo and Hector Zárate of the Bank of the Republic look for



evidence of a risk-taking channel in monetary policy. That is, lowering interest rates increases the riskiness of bank lending activity, controlling for the macroeconomic environment, as well as a wide variety of borrower- and bank-specific characteristics. The authors find evidence that, when policy rates fall, default rates rise on new loan originations, but fall on those loans already outstanding.³ The discussant suggested that the authors consider exploiting further the cross-sectional dimension of the data.

The risk-taking channel may also operate in a market-based financial system. Simona Cociuba (Federal Reserve Bank of Dallas), Malik Shukayev and Alexander Ueberfeldt (Bank of Canada) have this in mind in their paper “**Financial intermediation, risk taking and monetary policy**”. The authors discuss two opposing mechanisms that may come into play when interest rates are lowered: a *portfolio channel*, in which intermediaries searching for yield increase the share of risky projects in their portfolios, and a *collateral channel*, in which the collateral constraints tighten and feasible risk-taking declines. Their benchmark model suggests that the collateral channel dominates the portfolio channel, so low interest rates lead to *less* risk-taking. However, the portfolio channel becomes dominant – and lower interest rates are associated with more risk-taking – when their model is extended to include mispricing of risky assets by rating agencies, as the collateral constraints faced by financial intermediaries are then relaxed.

While the benefits of globalisation and financial integration (lower costs of financing, greater financial depth) are generally accepted, the extent to which they may make EMEs more vulnerable raises continuing concern. Three papers assess the extent of financial integration and its implications. In “**FX comovements: disentangling the role of global market factors, carry-trades and idiosyncratic components**”, José Gonzalo Rangel (Bank of Mexico) finds that the co-movement of FX excess returns across countries increased over the past decade, strengthening further both before and after the financial crisis.⁴

Rodrigo Caputo, Juan Pablo Medina and Claudio Soto (Central Bank of Chile), in their paper “**Understanding the impact of the global financial shock on the Chilean Economy**”, conclude that financial shocks and the contraction in global demand played a major role in explaining the 2009 downturn in Chile’s economic activity. A counterfactual exercise

³ They also find that these effects are higher for small banks and highly leveraged banks. There are also asymmetries in the transmission mechanism: lower policy interest rates have a larger impact on economic than do higher policy rates.

⁴ More precisely, the author analyses short- and long-run dynamic components of FX excess return correlations and examines their relationship with economic fundamentals for 29 currencies during the period 1999–2010.



suggests that such a large external shock requires a more aggressive policy response to output fluctuations.

Finally, the previously mentioned paper by Coulibaly, “**Has monetary policy in emerging market economies graduated? Lessons from the global financial crisis**”, finds that countercyclical monetary policy enhances resilience during crises. This is made possible by stronger macroeconomic fundamentals and reduced vulnerabilities, including greater openness to trade and finance, financial deepening and financial reforms.

The way forward

As a natural way forward, let me close with a series of questions raised by the work presented at the conference:

1. The transmission mechanism
 - What are the consequences of maintaining low interest rates for a long time?
 - What will be the impact on the monetary policy transmission mechanism of changes in the regulatory environment?
2. Emergency lending and emergency market-making
 - To whom should central banks be lending?
 - Should central banks act as market makers? If so, how and when?
3. Potential conflicts among goals
 - What is the best way to organise the governance of macroeconomic and prudential policymaking to reconcile conflicting goals?
 - How can inflation targeting and financial stability policy work together?
4. Measurement
 - How can we measure the different aspects of systemic risk?