BANK FOR INTERNATIONAL SETTLEMENTS

Current state of policy models in the Americas: How financial considerations are currently taken into account?

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How we got here?

- The Consultative Council for the Americas (CCA) proposed to consider a research project: "*to provide an analytical framework for analysing policy choices beyond the use of interest rates in an inflation targeting framework*".
- The eight central banks participating in this conference joined this project in January 2013.

The initial state (1)

- Financial stability considerations have been always a concern. Different approaches to tackle this issue:
  1) "Canonical" (all-in-one) models: no one (yet) there.
  2) Modifications of existing models, some examples:
     - BoC: term premia + risk spreads in TOTEM II; financial stability considerations (eg financial accelerator, debt-deflation and bank-capital mechanisms) in multicountry model (BoC-GEM-FIN).
     - FED: financial accelerator + risk premia and spreads in multi-country model (SIGMA).
     - BANXICO: financial block in its main model for policy analysis.
     - BCRA: DSGE with banks and financial dollarisation (ARGEM)

The initial state (2)

3) Minor modifications to models to answer specific questions. Some examples:
   - BCCh: exogenous interest rate spreads to analyse particular stress scenarios.
   - BCRP: main model modified to capture balance sheet effects (negative effects on output gap of a large depreciation).
   - BCB: effects of changes in reserve requirements.
   - Colombia: effects of excessive optimism about future fundamentals.
4) Satellite models: eg macro stress-testing models.

What do we need?

- Model the feedback between financial and real sectors (financial frictions, financial intermediaries)
- Generate endogenous financial booms and busts (financial frictions, departures from rational behaviour and from representative agent models, persistent deviations from market clearing).
- Introduce alternative policy instruments.

What do we have?

- 8 very interesting papers, useful for policy analysis, tailor-made for each particular economy.
- Also, they are contributions to the economic literature.
- Current focus is in the feedback between real and financial sectors and the use of some alternative instruments (eg capital requirements, LTV, reserve requirements).
- Some of them estimated for their respective economies.

Some takeaways

- The aim of this project is to build tractable models that allow for the analysis of macroprudential policies.
- The modelling strategy poses some challenges and trade-offs: shortcuts/ad hoc functions bring tractability at the expense of losing normative analysis (eg, how macroprudential policies fix market failures?).
- How to capture (in a feasible way) the nonlinearities embedded in the transmission channels between the financial sector and the real economy?