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Monetary Policy and Financial Stability: Bringing Policy Models to Practice

Presentation to the closing conference of the BIS CCA Research Network on "Incorporating financial stability considerations into central bank policy models"

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The views expressed in this presentation are my own.
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The Role of Monetary Policy in Supporting Financial Stability: Smets Classifications

Modified Jackson Hole Consensus	Leaning Against the Wind Vindicated	Financial Stability is Price Stability
• MP framework largely unchanged • MP thought to have limited effects on credit and risk taking • Blunt instrument to deal with imbalances	• FS as secondary objective of MP; occasional lengthening of horizon • MP affects credit and risk taking • MP “gets in all of the cracks”	• Twin objectives on equal footing • Unblocks BS impairments; avoids financial imbalances in upturns

The Bank of Canada's Framework

- Price stability is paramount
  - Return inflation to target over time (6-8 quarters, on average)
- But flexible IT framework provides scope to address buildup of financial vulnerabilities
  - Monetary policy is last line of defence
  - Exceptional circumstances
- **Need to more fully specify circumstances under which it would be appropriate to use MP for FS purposes**

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Elements of an Ideal Targeting Framework

- Target Criterion
  - Target Variable
  - Target Level
  - Target Horizon
- Transmission
  - Estimates of impact of policy action on target variable
- Trade-offs
  - Estimates of costs and benefits of policy action

Transmission

- Current policy models are helpful

- Example: Impact of monetary policy action on household debt to disposable income ratio
  - Models provide non-trivial guidance on:
    - Sign
    - Timing
    - Magnitude

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Trade-offs

- Current policy models provide incomplete information

- Ideally models would provide estimates of:
  - Benefits of policy action:
    - Reduced probability of future crisis ✗
    - Reduced severity of future crisis ✓
    - Analysis of benefits should account for macropru policies
  - Costs of policy action:
    - Underutilized resources ✓
    - Credibility of price stability objective ✗

Target Criterion

- Current policy models largely silent

- Target Variable
  - Likely to be state-contingent
  - Models likely to evolve with circumstances
- Target Level
  - Models should provide estimate of natural level of target variable that would prevail in absence of distortions/frictions
- Target Horizon
  - Likely to be state-contingent, but straightforward to derive
  - Will depend on estimates of trade-offs

Conclusions

- Policy models have the potential to help clarify the role of MP in maintaining FS
- Models already provide useful guidance regarding the transmission of MP actions to real and financial variables
- Priority should be given to improving modeling of trade-offs and natural levels of financial variables

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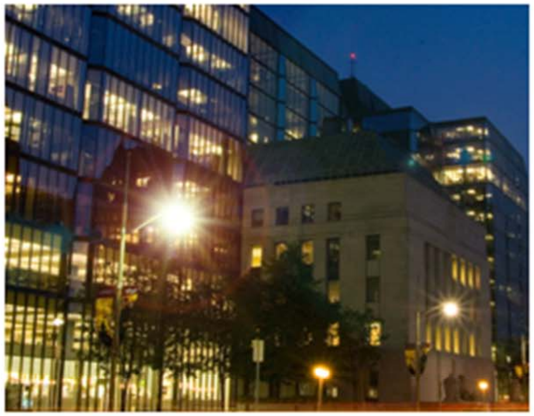
Thank you



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