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. No responsibility for them should be attributed to the Bank of Canada.
## The Role of Monetary Policy in Supporting Financial Stability: Smets Classifications

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