Bringing policy models to practice: Issues and challenges

Closing Conference of the BIS CCA Research Network on "Incorporating financial stability considerations into central bank policy models"

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The Financial Crisis: sequels

1 **The 2008-2009 financial crisis made clear the need to reassess the prevailing macroeconomic policy framework.**

- ✓ *Price stability no longer thought of as a sufficient condition for financial stability.*

- ✓ *Micro prudential supervision ill-equipped to cope with systemic-wide risks associated to the financial sector.*

Need for immediate policy action to mitigate sources of systemic risk

→

De facto introduction of macro prudential policy

The need to amplify the macroeconomic framework for policy analysis

2 **Despite some early antecedents, in general, the prevailing toolkit for macroeconomic policy analysis did not provide adequate setups to answer arising questions.**

✓ The rapidly growing literature that has surged in recent years has contributed to deepening our understanding of the implications of the interaction between the financial and the non-financial sector.

✓ One of the main goals of the models proposed should aim at providing guidelines to establish a new paradigm for macroeconomic policy analysis.

Key Questions

3. Key questions to organize the discussion (and possibly the research agenda) from a policymaker perspective:

Should monetary policy use the interest rate to lean against the wind?

or

Should monetary policy and macro prudential policy work as complements?

Key Questions

3 Key questions to organize the discussion (and possibly the research agenda) from a policymaker perspective:

Opposing arguments prevail:

“To the extent that market rates exert an influence on risk appetite, or on the incentives to engage in maturity transformation, changes in rates may reach into corners of the market that supervision and regulation cannot”. [1/]

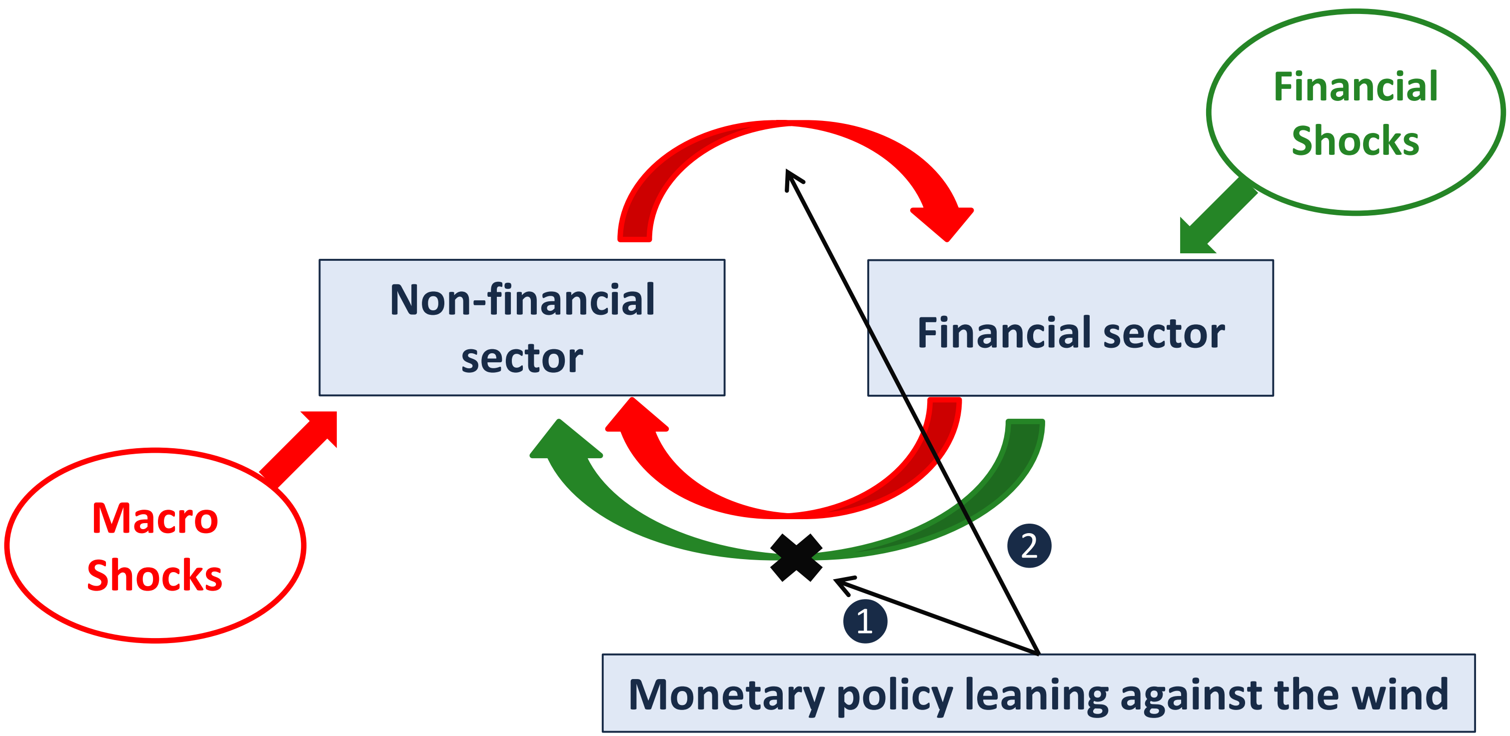
vs

Sound macro prudential policy should target specific market failures in financial systems as monetary policy may be a too blunt tool for addressing financial stability risks.

1/ Stein (2013). “Overheating in Credit Markets: Origins, Measurement, and Policy Responses.”

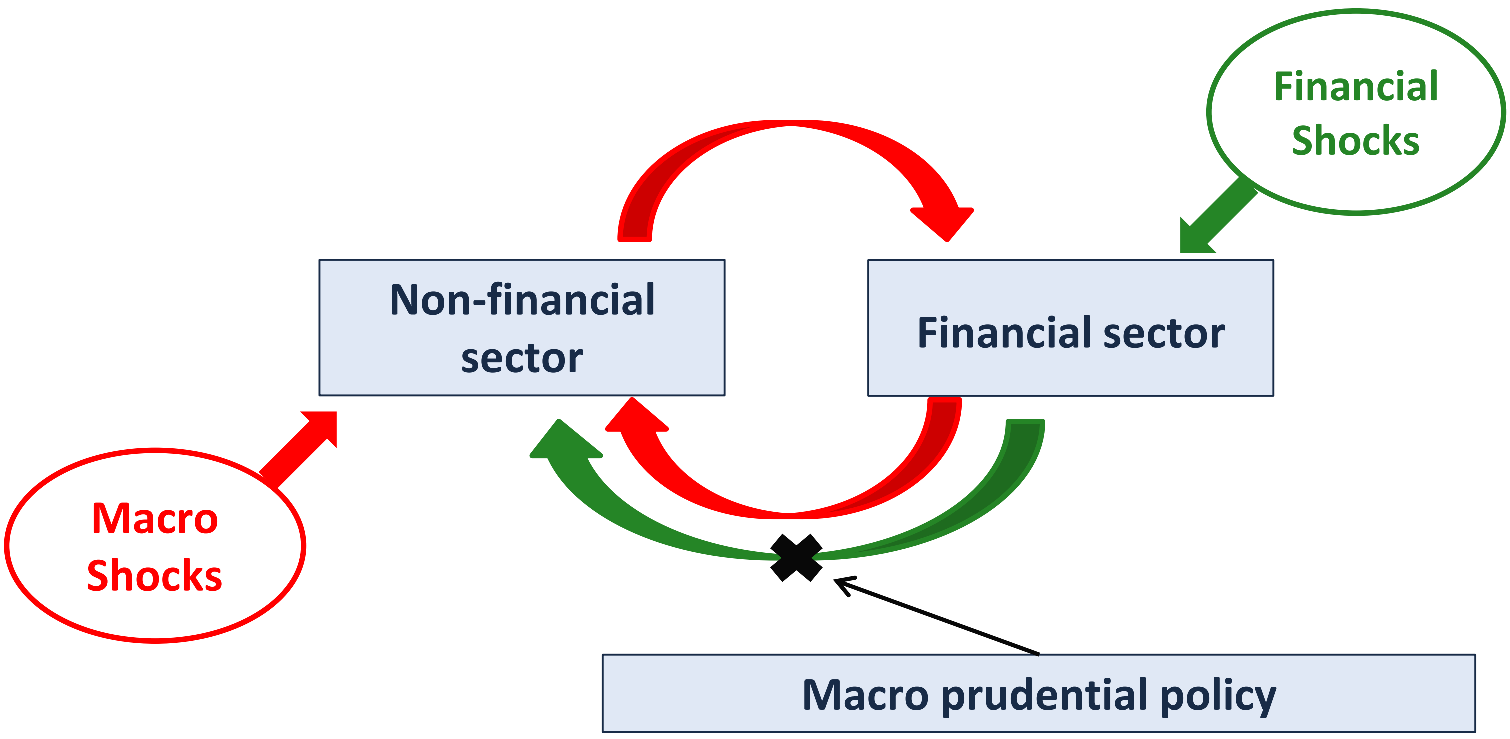
Monetary policy leaning against the wind/monetary policy and macro prudential policy as complements

- The idea of monetary policy and macroprudencial policy working as complements seems to be more compelling:
  - ✓ It reduces the costs of using monetary policy to pursue two objectives (in line with Tinbergen's one objective – one instrument principle).



Monetary policy leaning against the wind/monetary policy and macro prudential policy as complements

- The idea of monetary policy and macroprudencial policy working as complements seems to be the more compelling:
  - ✓ It would be possitive if macro prudential policies were able to contain the effects of financial shocks.



Profession working with monetary policy and macro prudential policy as complements

~~Should monetary policy use the interest rate to lean against the wind?~~

~~or~~

Should monetary policy and macro prudential policy work as complements? ✓

Further questions:

A. Monetary policy only (leaning against the wind) as a second best:
   - ✓ Is this robust?

B. Monetary policy and macro prudential policy as complements:
   - ✓ Under what conditions should they be adjusted in the same direction?
   - ✓ Under what conditions is there a trade-off between them?

The need to amplify the macroeconomic framework for policy analysis

4 To answer these questions, fundamental modeling decisions have to be made:

i. Modeling approach?

ii. Relevant frictions to model/channels at work?

iii. Measure of financial stability that governs macro prudential policy?

iv. Choice of policy instruments

Bringing policy models to practice

Bringing policy models to practice **entails going from a positive domain to a normative one to formulate policy prescriptions**.

In this context, modeling decisions do matter a lot since they potentially entail different policy implications.

i. Modeling approach

- *Will have implications for its use:*
  - ✓ *Macro/financial analysis and forecasting (incorporation of financial frictions that enrich transmission mechanisms and allow for financial shocks to be introduced).*
  - ✓ *Macroprudential analysis (enable to examine the impact of macro prudential instruments and regulations on the macroeconomy).*
  - ✓ *Satellite models (complement other models and provide intuition)*

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ii. Frictions to model/channels at work?

- *Understanding the way financial markets work in a particular economy will dictate relevant financial frictions and transmission channels:*
  - ✓ *Degree of financial penetration*
  - ✓ *Use of credit*
  - ✓ *Bank's business models*
  - ✓ *Source of funding, etc.*

Bringing policy models to practice

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iii. Measure of financial stability that governs macro prudential policy?

- *Credit growth*
- *Interest rate spreads*

Bringing policy models to practice

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iv. Choice of policy instruments

- Different types of macro prudential instruments:
  - ✓ Tools focusing on lenders' behavior, on borrowers' behavior, capital flow management tools.
- Some instruments are politically hard to use.
  - ✓ For instance, LTV vs capital requirements

Bringing policy models to practice

5 Some of the main challenges:

- No workhorse model in the horizon (at least in the short term):
  - ✓ *Financial systems are different across countries and may entail different implication to macro modeling and hence to policy prescriptions (some findings in this conference highlight this idea).*
- Need for simultaneous work on:
  - ✓ *Macro/financial dynamics around the steady state.*
  - ✓ *Small, stylized models to understand triggers that lead to "crisis mode" (non-linear) dynamics.*
- Likewise, simultaneous work needed on:
  - ✓ *Preventive macro prudential policy and tools.*
  - ✓ *Reactive macro prudential policy (likely to be more difficult to incorporate in models).*