Comments on "Managing monetary and financial stability in a dynamic global environment: Bank Indonesia's policy perspectives"

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Summary

The paper comprises two distinct parts. The first provides an overview of the interaction between traditional monetary policy and various macroprudential policy measures. The second discusses the impact of such policies on the basis of results obtained from Bank Indonesia's macroeconomic model. The paper contains a clearly defined motivation, and the overview segues very well into several applications discussed in the second part of the paper. Indonesia's example is certainly interesting to many other emerging market economies (EMEs) with a relatively free movement of capital.

Comments

Overall, the paper arrives at a relatively optimistic conclusion. With the right mix of monetary policy (broadly speaking) and macroprudential policy measures, it is possible to achieve both low and stable inflation as well as a stable financial system (see Graph 2.3 for an overview of different policy mixes).

The authors are, of course, not alone in reaching such a conclusion. Much of the recent literature points to the same direction, even if it may be too soon to declare the issue settled. For example, Maddaloni and Peydró (2013) review the situation in the euro area after the Great Financial Crisis of 2008–2009 and find that interest rate and macroprudential policies can enhance each other's effects. More specifically, if central banks lean against the wind in their interest rate policy, more active use of macroprudential measures may allow them to keep interest rates lower than they otherwise would need to be. The IMF (2013) arrives at similar conclusions at a more general level.

However, most of the existing literature (with significant exceptions in the current volume, of course) deals with issues of macroprudential policy in advanced economies (AEs). Therefore, potential policy conclusions for EMEs with different institutional arrangements may be limited. I think that the authors could have put greater emphasis on this aspect in their excellent contribution. For example, it is not clear whether the current literature places sufficient emphasis on the effects of exchange rate movements and capital flows on financial stability. In this connection, the paper would benefit from discussing the relative importance of measures relating to domestic lending versus measures of a macroprudential nature relating to the

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foreign exchange operations of banks. Moreover, it would be interesting for a reader, who may not be so familiar with the situation in Indonesia, to know how often macroprudential measures were changed or implemented by Bank Indonesia, and how those measures were communicated. The latter point is all the more significant given the emphasis placed on communication in current discussions of monetary policy.

In the second part of the paper, the authors discuss the macroeconomic model used to assess effects of monetary policy and macroprudential measures on a vector of outcome variables. As such, the theoretical framework is relatively standard (even if the model is quite complex), and Graph 3.3 provides a good summary of the interrelations within the model. However, a number of issues remain somewhat unclear, and more detailed information would benefit the reader and make the authors' argument more convincing.

First, the definition of the credit gap is somewhat unclear. How is it actually measured? Second, the LTV ratio has a clear effect on mortgage and car lending, but how large is the share of those components on overall bank lending? Third, I would have reservations regarding the quantification of macroeconomic risks. The International Country Risk Guide (ICRG) is well-known, but by no means the only provider of such risk metrics. How often do their risk measures change, for example? If the authors used a different risk metric in their estimation work, would the results change?

Moreover, some aspects of the paper would warrant deeper discussion. First, when there is a shock to the world output gap or the world interest rate, there is almost no difference in the estimated outcomes of whether just monetary policy or monetary policy and macroprudential measures are used together. It would be useful to read why this is so, as this could give us an idea of the limits of macroprudential policy. Second, it is not exactly clear what the current account shock is. Is it the same thing as an exogenous shock to the real exchange rate? Interestingly, in this case a carefully balanced use of monetary policy and macroprudential measures seems to work very well. Third, in the case of a capital account shock an appropriate policy mix works well. However, since the current and capital accounts are basically just two sides of the same coin, it would be beneficial to try to disentangle these two effects.

In a related comment, are there other market-based measures that would help deal with such external shocks? For example, if borrowing in foreign currency provides tax advantages, could policy action be undertaken directly to manage this source of distortion? Can the private sector insure itself better with various derivatives etc?

Concluding remarks

The current paper provides an excellent overview of the recent literature on the interaction between traditional monetary policy and macroprudential measures. It is especially valuable that such an exercise has been done for an EME. It is comforting that most of the conclusions carry over from the literature devoted to more advanced economies. At the same time, the current paper leaves a number of open questions relating to macroprudential policies in EMEs, especially when the banking sector is vulnerable to exchange rate movements.

References

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Maddaloni, A and J-L Peydró (2013): "Monetary policy, macroprudential policy, and banking stability: evidence from the euro area", *International Journal of Central Banking*, vol 12, no 3, pp 121–167.