Coordinating Monetary and Financial Regulatory Policies

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Summary

- Model with price rigidities and occasionally binding leverage constraint on intermediaries

- Pecuniary externality: Banks do not take into account effects of constraint on asset prices/marginal investors

- Macroprudential policy can redistribute and smooth intermediaries' relative capacity to borrow across states of the world

What I Liked

- Rigorous approach based on relatively standard model

- Puts together two frictions critical to policy / objectives

- Can compare different institutional solutions within same world

- Lends itself to calibration

What could be improved

- The paper is hard to read for a "non-macro person"

- Describe in greater detail main frictions/market failures and rationale for policy intervention

- Provide better intuition for main results

- Examples of how policies work: for instance how capital requirements vary over "cycle"

- Discuss alternative policy mandates

What I Think Is Missing

- Credibility associated with simple mandates critical issue

- If not, why not giving independent agencies the "proper" objective function

- Gains from coordination have to be compared with costs from loss of credibility

- Additional tradeoff: transparency/accountability vs coordination

- Risks to central bank independence

Political Economy of Central Bank Independence

- Simple observable targets and instruments

- Ex post accountability

- Can we replicate this model for macroprudential policy?

- A new intermediate target?

Monetary Policy Affects Output (we know) & Risk Taking

- Effect on output/inflation relatively well understood

- Effects on macro-financial stability:

  - Theoretically, it can go either way (risk-shifting versus leverage and portfolio reallocation)

  - Empirically, seems to be: low interest rates → more risk taking

  - Emerging consensus that prolonged periods of easy money may lead to trouble (short term more complex)

Effects of Macro-prudential Policy?

- Effects on macro-financial stability. Proposed measures:

    - Reduce risk taking (cyclical CARs)

    - Strengthen financial sector (dynamic provisioning)

    - Reduce balance sheet vulnerabilities (LTV & DTI limits)

- Effects on output/inflation:

    - Likely to reduce credit flows

    - Contain demand

    - Lower output growth

Separate Agencies with Different Mandates

- ▶ CB tasked with price/output stability:

    - ▶ Not necessarily indifferent to risk/financial stability

    - ▶ But greater weight on inflation/output gap

- ▶ FA tasked with macro-financial stability:

    - ▶ May care about output/inflation as they affects balance sheets

    - ▶ But focus on risk taking, financial sector strength, balance sheet vulnerability

Outcome Under Separate Agencies

- Separation improves credibility
  - Especially if CB's mandate very clear
  - Similar to fiscal/monetary policy divorce
- At potential cost of second-best policy mix
- Example, in a recession:
  - CB cuts rate aggressively to stimulate demand
  - FA reacts by tightening macro-prudential regulation to reduce risk-taking → CB eases even more → FA ….
  - Result: a policy mix with too low interest rates and too tight macro-prudential measures

Centralized Solution

- ▶ Two objectives, two instruments
  - ▶ Single agency internalizes effects of policy action on both targets
  - ▶ Can be designed to set optimal policy mix

- ▶ But dual targets question commitment to either one
  - ▶ Reluctant to tighten macro-prudential if demand weak?
  - ▶ Forbearance on banks to support output?
  - ▶ Will it fight inflation if it means to hurt banks in the short run?
  - ▶ Will it ease aggressively as needed, if it means more risk taking?

- ▶ Credibility issues are costly
  - ▶ Increase sacrifice ratio (higher r to achieve same inflation rate)
  - ▶ Not dissimilar from Barro-Gordon