

Monetary Policy and Prudential Regulation: In Search of a New Normal

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The pre-crisis consensus

- Separation principle:
 - monetary policy sets interest rates to pursue a single mandate (monetary stability: strict inflation targeting) or a dual mandate (monetary and real stability: flexible inflation targeting);
 - prudential policy regulates financial institutions to mitigate financial distress essentially at the level of individual institutions (micro-prudential policy).

- “Financial stability ... a dangerous distraction” (Williams, 2015).
- Framework heavily criticized after the GFC:
 - low inflation (and low interest rates) do not imply financial stability, quite the opposite!
 - systemic dimension of prudential regulation underestimated/neglected.
- Need to take financial instability (high asset price volatility, high leverage) into account.

A tripartite mandate?

- Goals:
 - monetary stability (low inflation),
 - real stability (low unemployment),
 - financial stability (low asset price volatility, low leverage).
- Instrument:
 - interest rate (augmented Taylor rule).
- Super-flexible inflation targeting!

Disadvantages

- The consequences of interest rate changes on financial instability (dynamics of leverage and asset prices)
 - not well understood,
 - most likely limited,
 - characterized by long lags,
 - sometimes counterproductive (Svensson and the Swedish case).

Remark 1

- While a change in the policy rate will certainly affect financial stability, the sign and size of the effect is too uncertain and insufficient to justify the assignment of a financial stability objective to monetary policy.
- We would advocate instead an *operational separation* between monetary policy and prudential regulation.

Operational separation

- Monetary policy sets interest rates to achieve monetary and real stability.
- Prudential policy regulates financial institutions to mitigate
 - financial distress at the individual level (micro-prudential policy),
 - systemic risk (macro-prudential policy).

Externalities

- Separation is only operational. We are fully aware of the *reciprocal externalities* between monetary policy and prudential regulation:
 - low interest rates or QE at the ZLB may boost asset prices and leverage,
 - increasing capital requirements in a recession/deflation may hinder anti-deflation policies.

Coordination vs centralization

- Due to *spillovers*, the assignment of monetary and prudential policies to different agencies may be inefficient.
- Coordination may be a good idea.
- *Centralization* “under the same roof” is even better:
 - authorities in charge on monetary and prudential policies could exploit the *economies of scale* in collecting information useful for both policies.

Remark 2

- It is efficient to *centralize* both monetary and prudential policy at the *central bank level* in order to maximize the synergies of closer integration between the two.
- There are disadvantages, however. Centralization may increase the risk of *fiscal* or *financial* dominance over monetary policy.

Are we already there?

- The current architecture of prudential policy in the European Union is only partially in line with the remark above.
- The ECB, national central banks, other agencies are in charge of different aspects of prudential regulation with an evident lack of coordination.

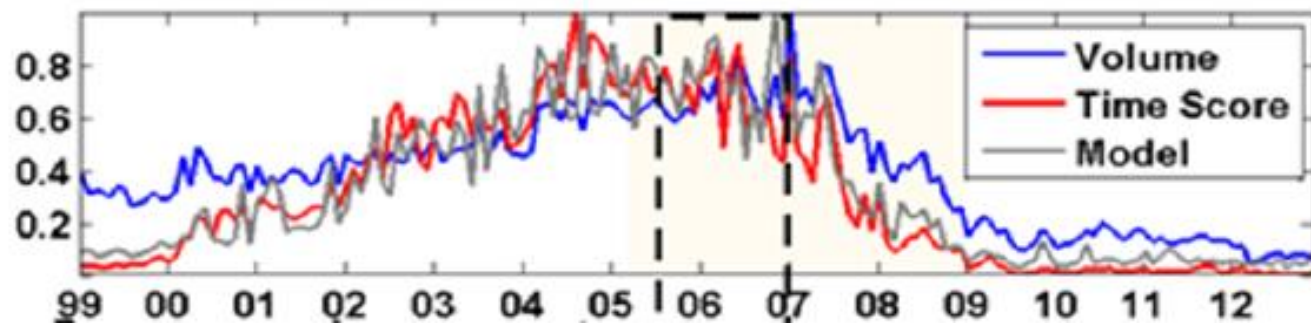
Early Warning Signals

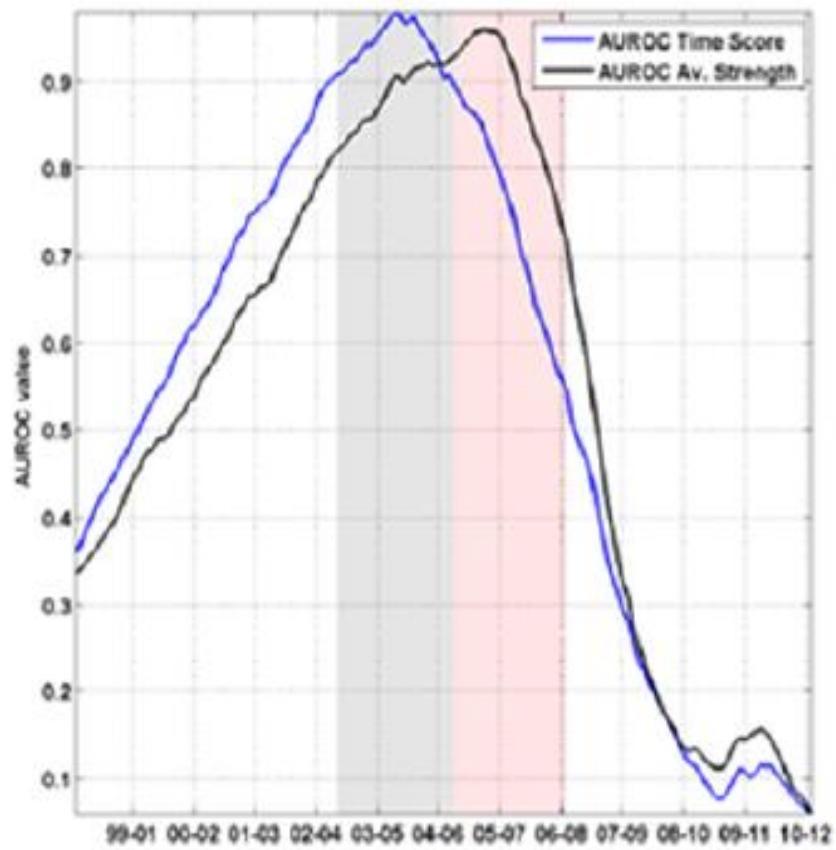
- Early Warning signals (EWS) are quantifiable indicators of
 - a financial crisis (financial EWS),
 - a recession (real EWS).
- Financial EWS could help to timely activate macro-prudential policies while real EWS may be used to activate macro-stabilization policies.

Financial EWS

- Network based EWS: connectivity.
- *Time score* (Spelta) simultaneously addresses the two dimensions of the build up of financial imbalances:
 - cross-sectional dimension due to financial institutions' interlinked exposures,
 - time dimension due to the financial cycle.

Normalized series

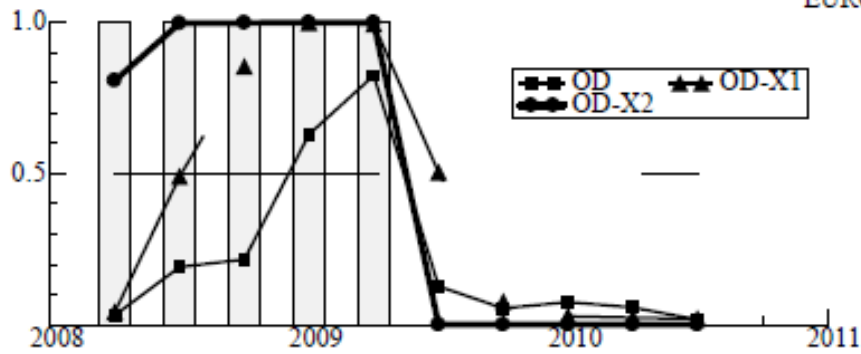




Real EWS

- *Macro-financial shocks* account for the fluctuations of *risk factors*:
 - size (SMB) and value (HML) factors (Fama and French, 1993), momentum (MOM), stock market liquidity (PSL), financial leverage (LEV), risk aversion (VOL).
- Therefore models augmented with risk factor innovations may be employed to detect EWS of an incoming recession.

Recession probabilities



Rates of growth

