

# **Monetary Policy in the Grip of a Pincer Movement**

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**Discussion by Giovanni Dell’Ariccia (*IMF* and *CEPR*)**

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The views expressed in this paper are those of the authors and do not necessarily represent those of the IMF, its Executive Board, or Management.

# Summary

- Interesting paper. Nice summary of previous work by the authors
  - Makes the case to take financial conditions into account beyond their short term impact on output/inflation when setting monetary policy
1. Increasingly volatile financial cycle distinct from the business cycle
  2. It can have a long/medium term impact on real interest rates, output, and inflation
  3. “Excessive” focus on inflation targeting may have exacerbated the problem
  4. Decreased sensitivity of inflation to the cycle and interest rates makes it a poorer indicator of overheating

# Policy conclusions

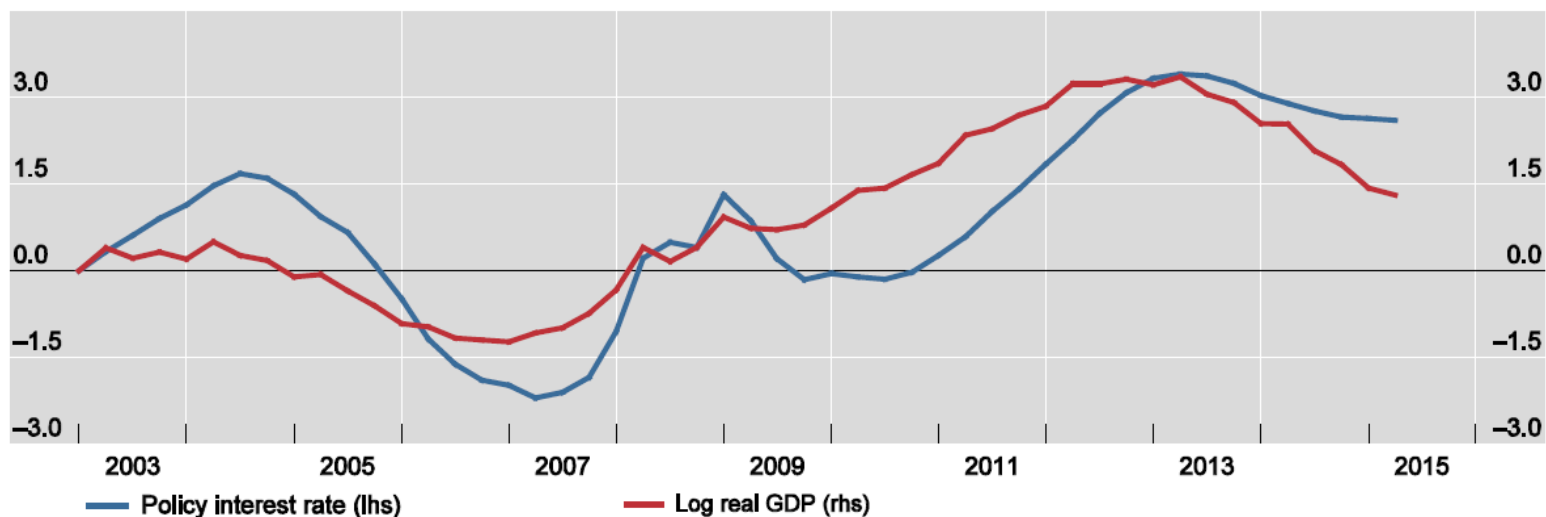
- A policy rule (a Taylor rule 2.0) that incorporated financial conditions would lead to reduced output volatility

Difference between counterfactual and actual outcomes

Graph 10

Percentage points

Per cent

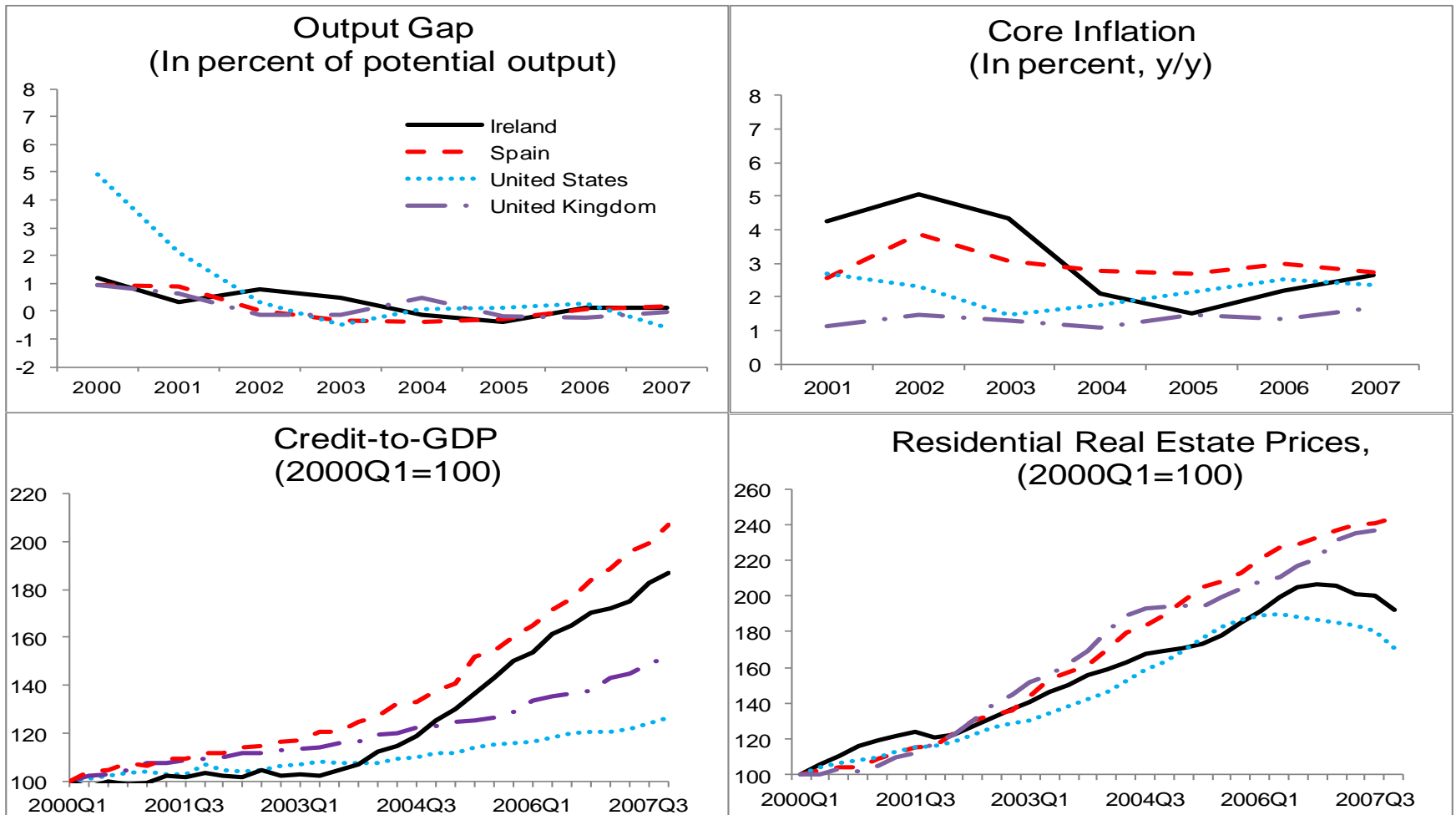


# Comments

- From a theory standpoint: Frictions other than price rigidities may justify role for financial variables in policy rule
  - Iacoviello, Woodford-Curdia etc.
- From a policy standpoint a few conditions need to be satisfied for this to make sense:
  1. Large real benefits from smoothing out the financial cycle
  2. The policy rate has to be an effective tool to do so:
    - Leads/lags
    - Predictable and systematic relationship
  3. Costs from deviating from traditional inflation/output objective need to be limited
  4. Other tools available?

# Discrepancy between macro and financial conditions

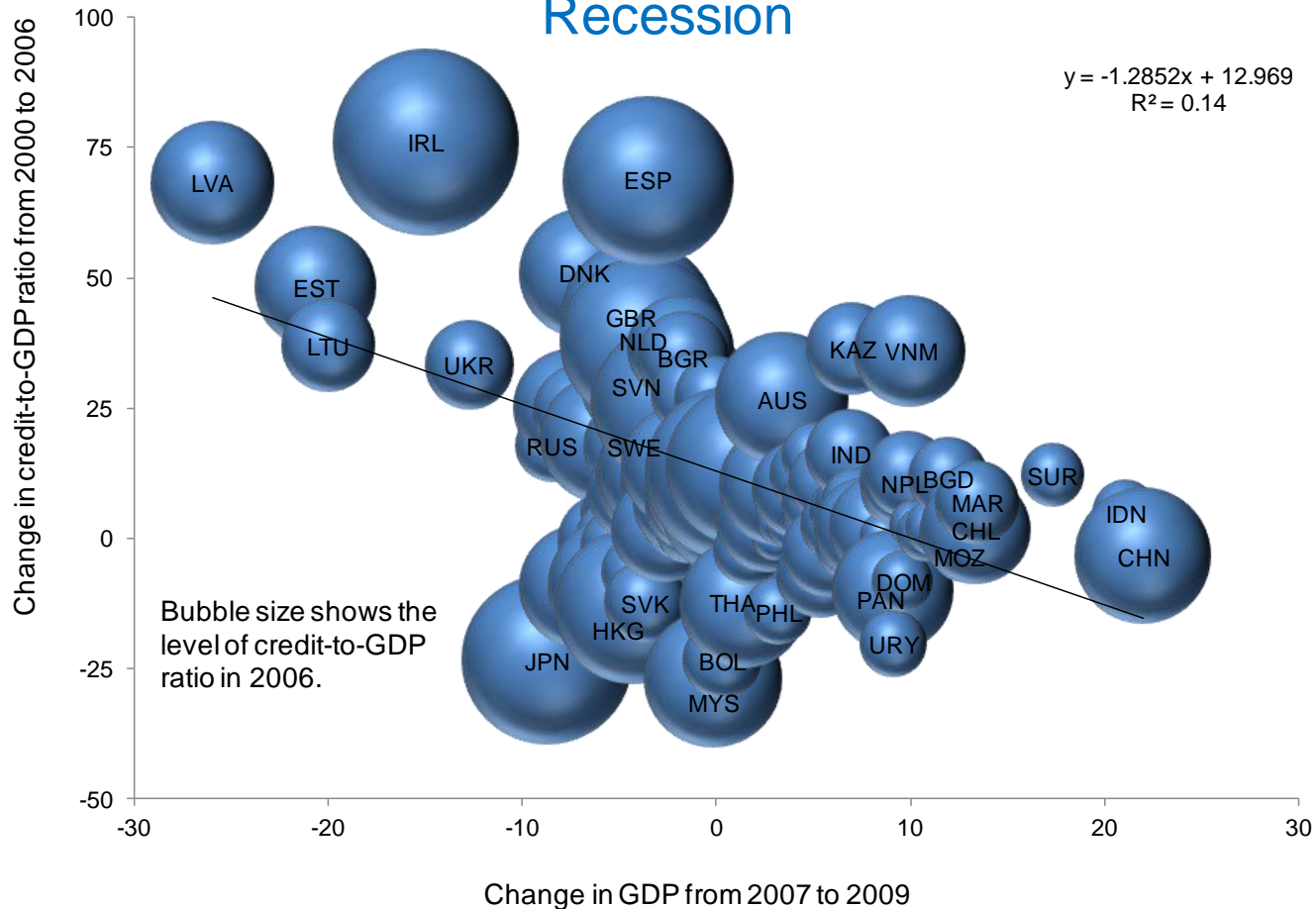
**Figure 1. Output Gap, Core Inflation, and Financial Indicators Before the Crisis**



Source: World Economic Outlook (September 2007 vintage for the output gap) and Haver Analytics.

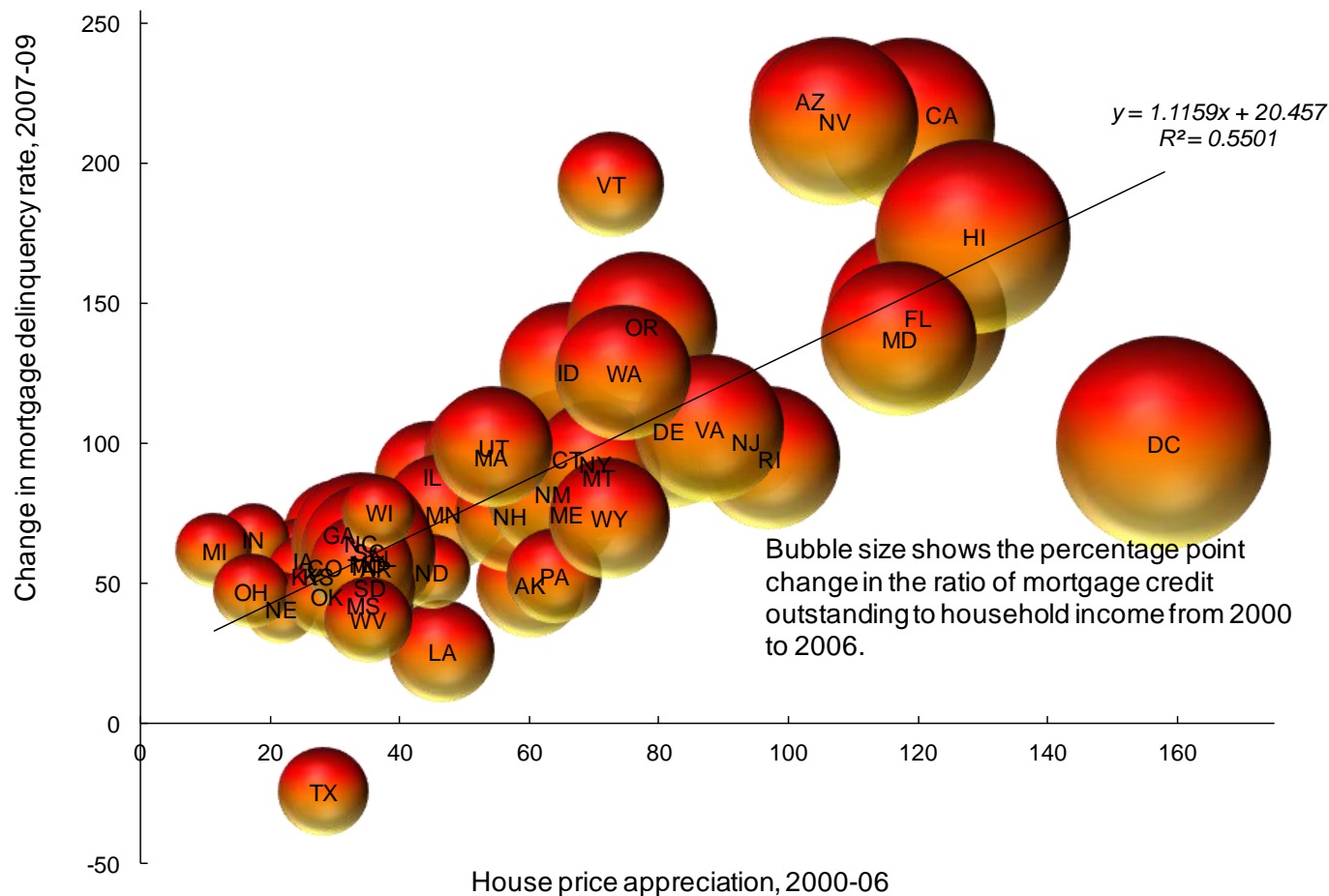
# Crisis: severity in line with magnitude of credit booms

## Credit Growth and Depth of Great Recession

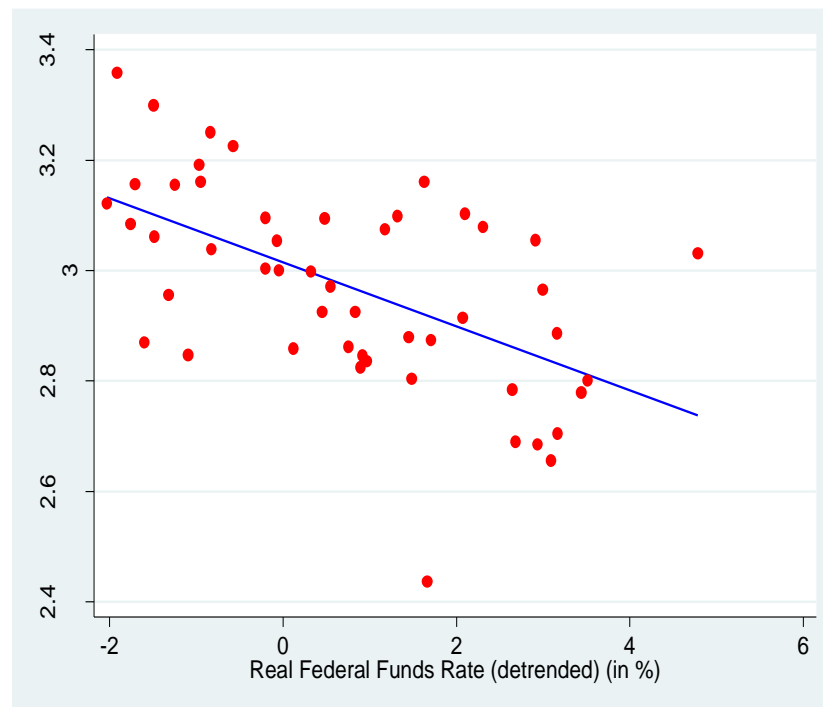
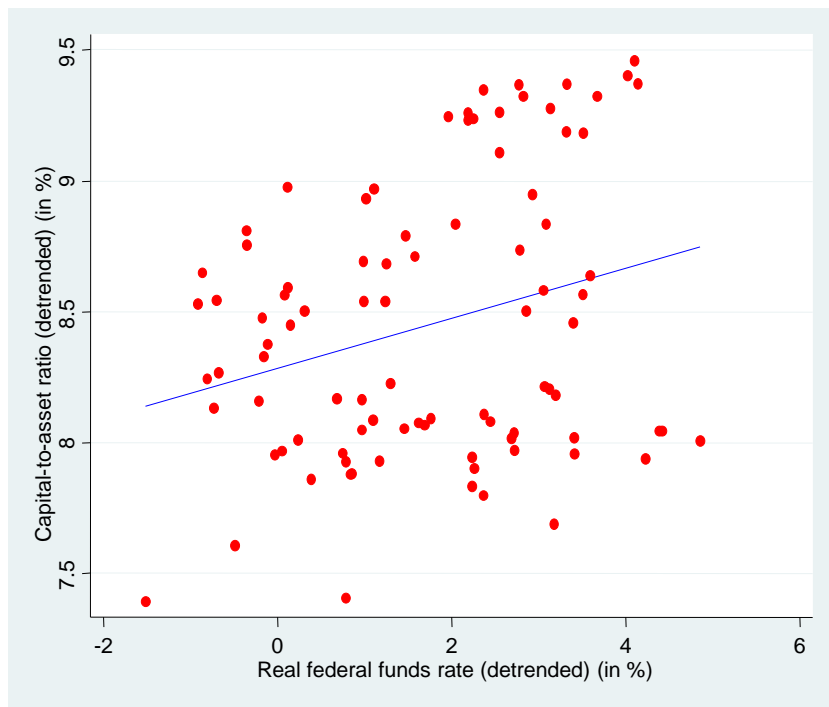


# Crisis: severity in line with magnitude of credit booms

## Subprime Boom and Defaults

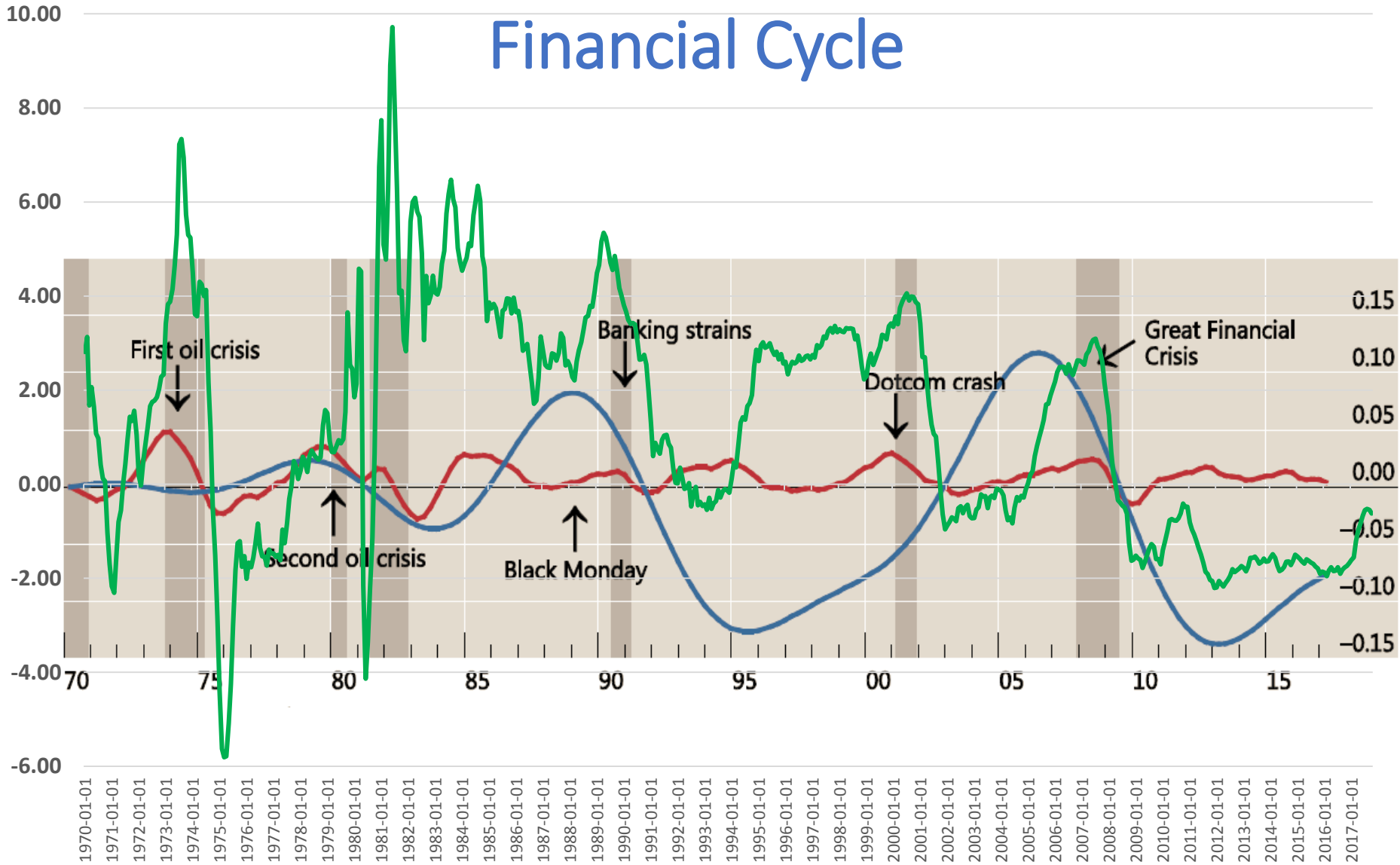


# Risk Taking: evidence from the US



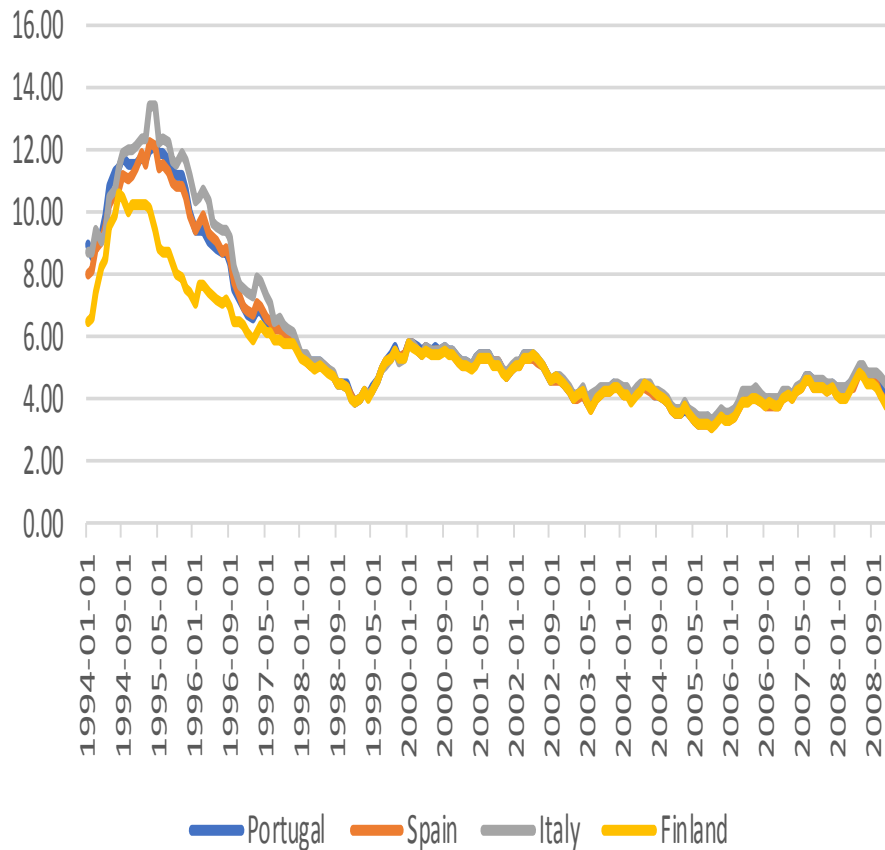


# Real Federal Fund Rate and the Financial Cycle

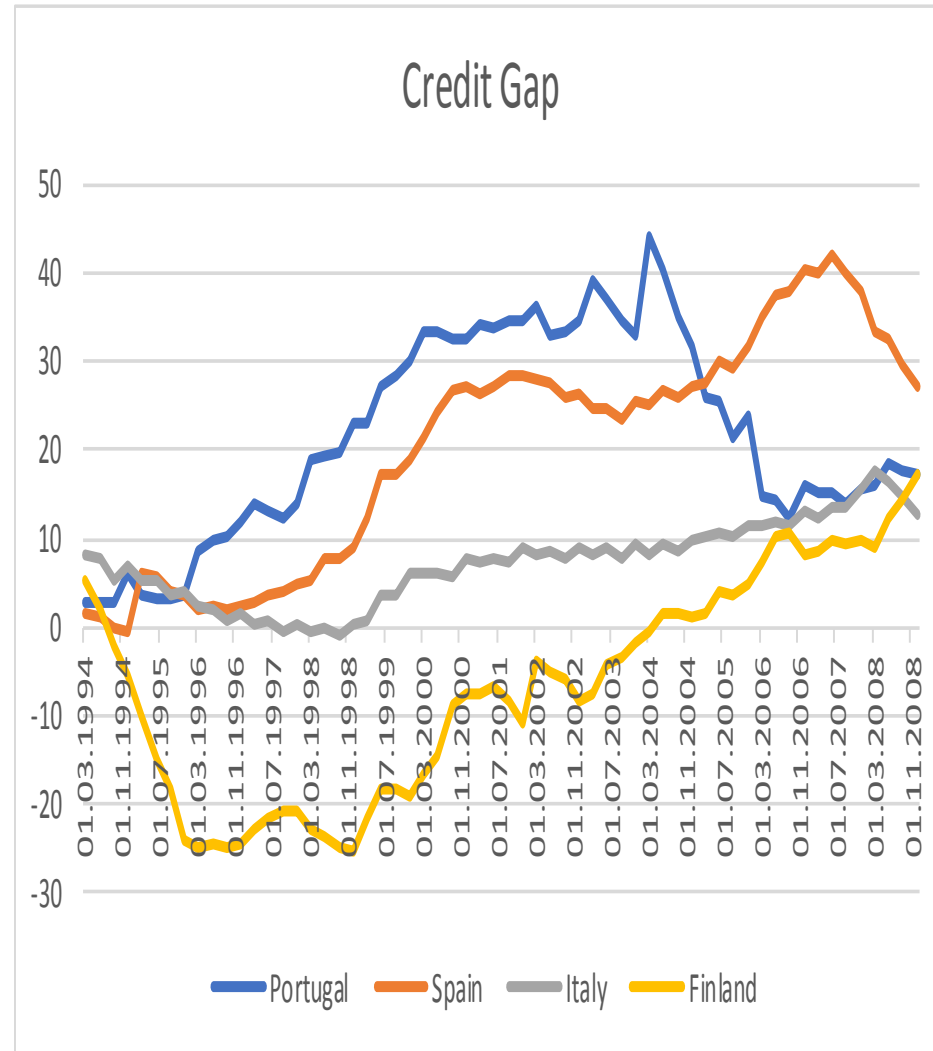


# Interest Rates and Credit Gaps

## 10-year Sovx Bond Rate



## Credit Gap



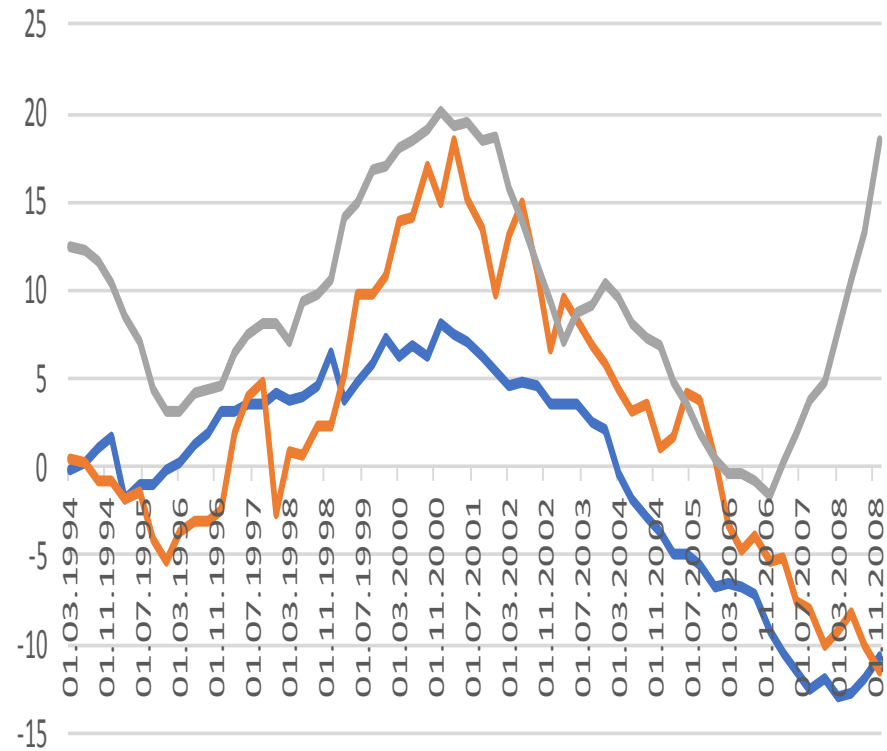
# Interest Rates and Credit Gaps

## 10-year Sovx Bond Rate

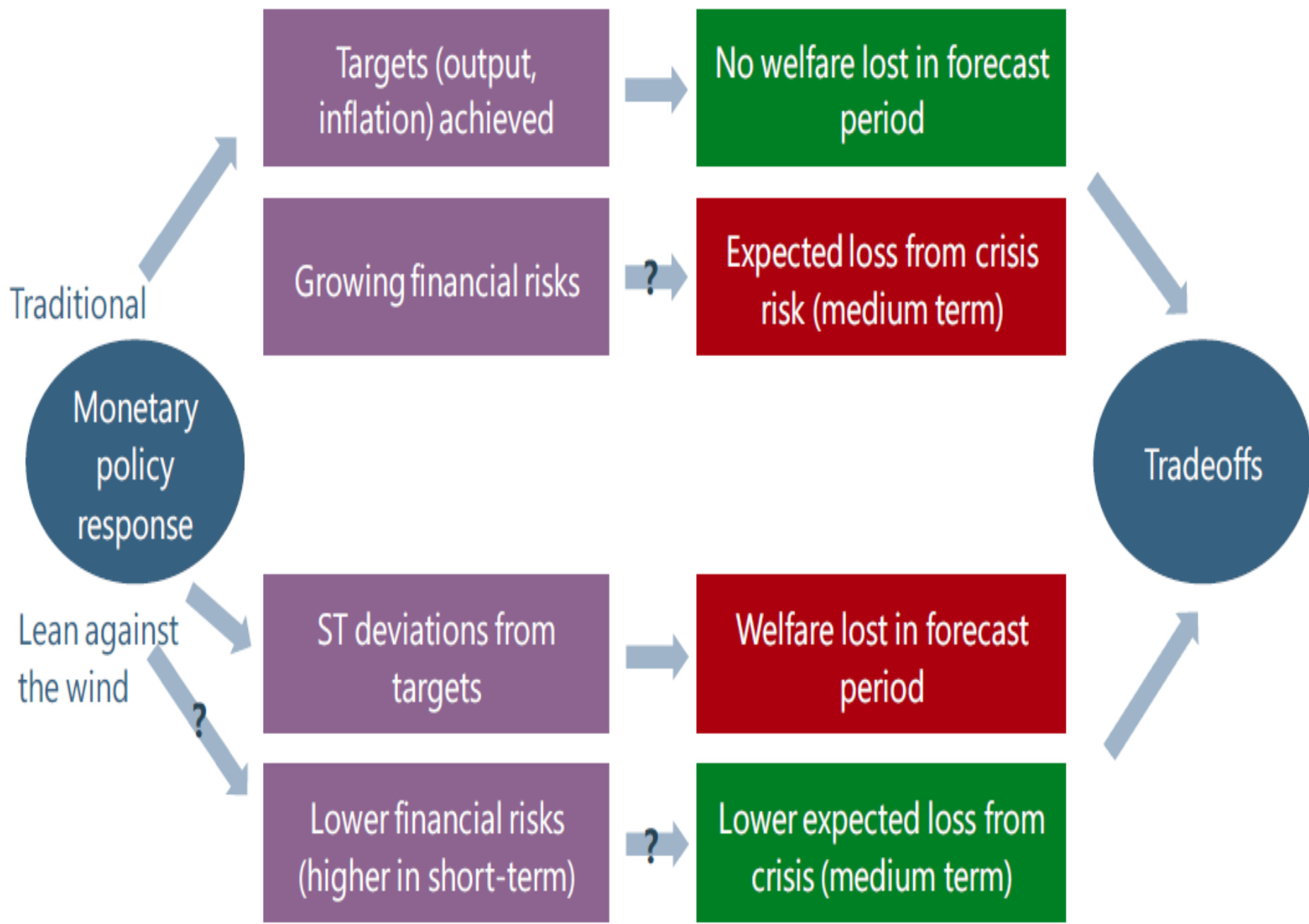


Germany Netherlands Belgium

## Credit Gap



Germany Netherlands Belgium



# Costs/benefits analysis: Should monetary policy lean against the wind?

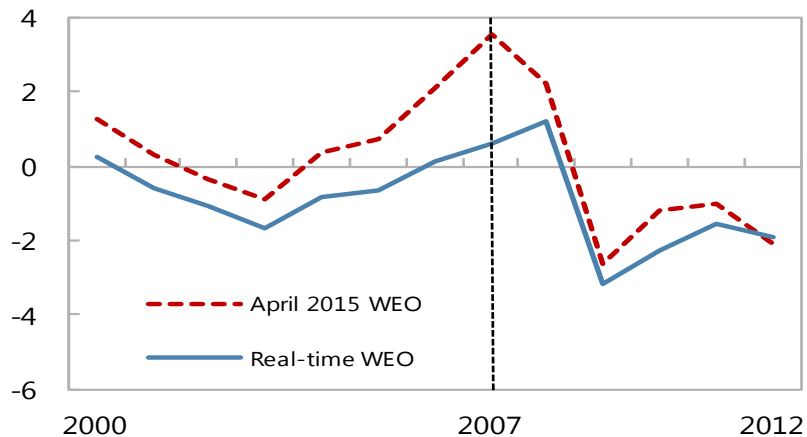
- IMF paper's view: In general, no.
  - Reasonable parameters suggest costs exceed benefits
  - Other tools (macro- and micro-prudential)
- Yet, benefits grow relative to costs when:
  - Conjuncture: rapid credit growth, low unemployment, high probability of long-lasting and severe crisis,
  - Structure: large, interconnected economy (spillovers)
- Prudential policies should be the first policy considered
  - More targeted, probably less costly,
  - Both micro- and macro-prudential can play a role

# A Different Role for Financial Variables?

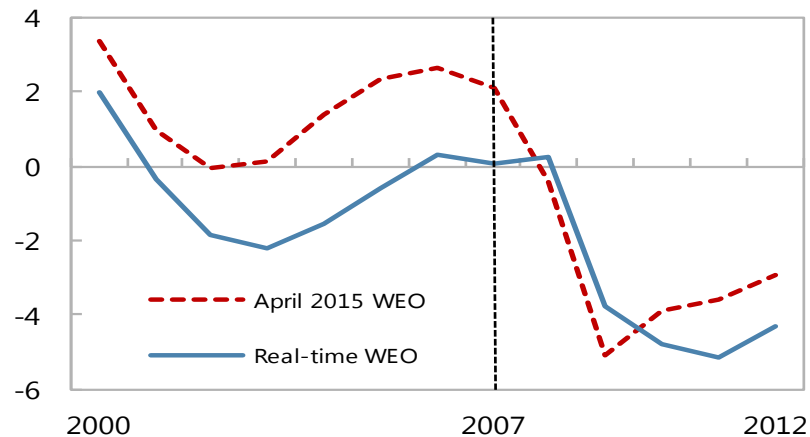
- Before the GFC:
  - Real-time estimates of output gaps did not signal major overheating
  - CPI inflation was below target in most advanced economies
- After the GFC:
  - Large upward revisions to output gaps
  - Greater awareness of the role of housing and credit booms

# Potential output a bit of a moving target

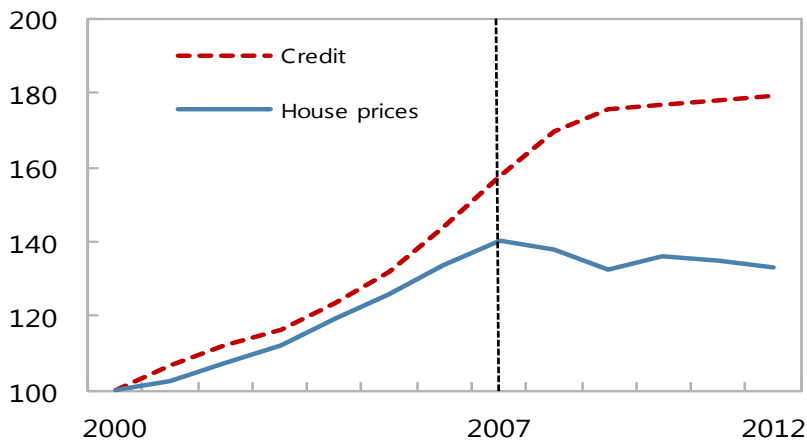
**Panel 1. Cross-country average, output gap**  
(Percent)



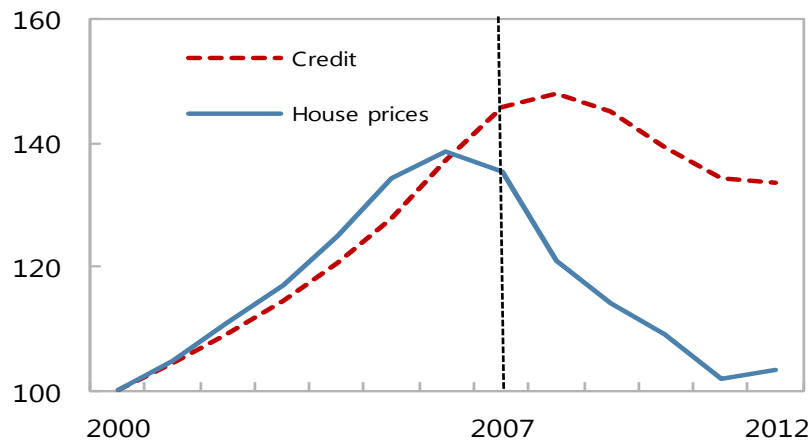
**Panel 2. United States, output gap**  
(Percent)



**Panel 3. Cross-country average, credit and house prices**  
(Real indexes, 2000=100)

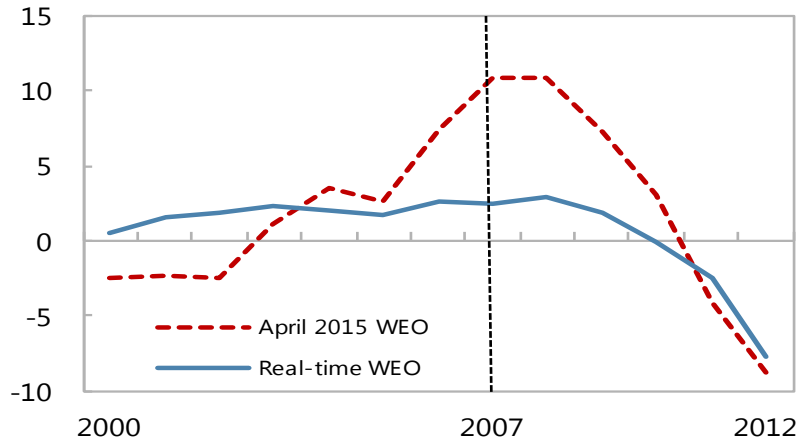


**Panel 4. United States, credit and house prices**  
(Real indexes, 2000=100)

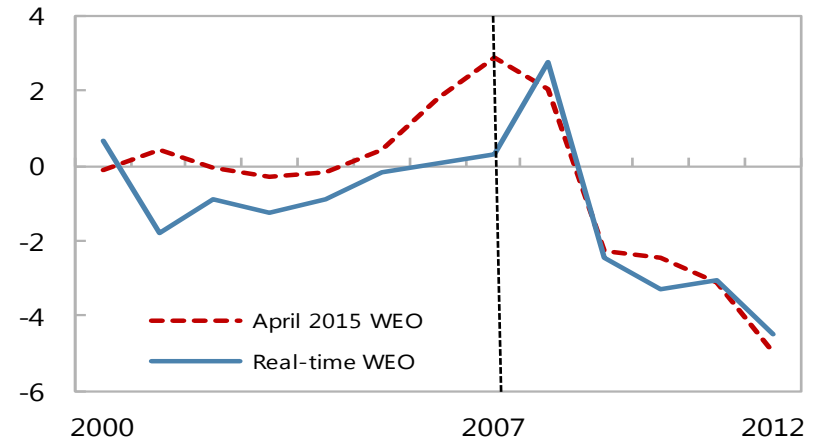


# Potential output a bit of a moving target

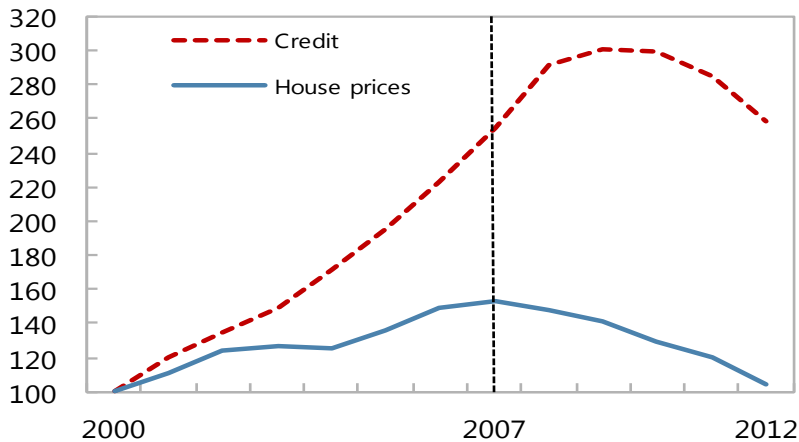
**Panel 1. Greece, output gap**  
(Percent)



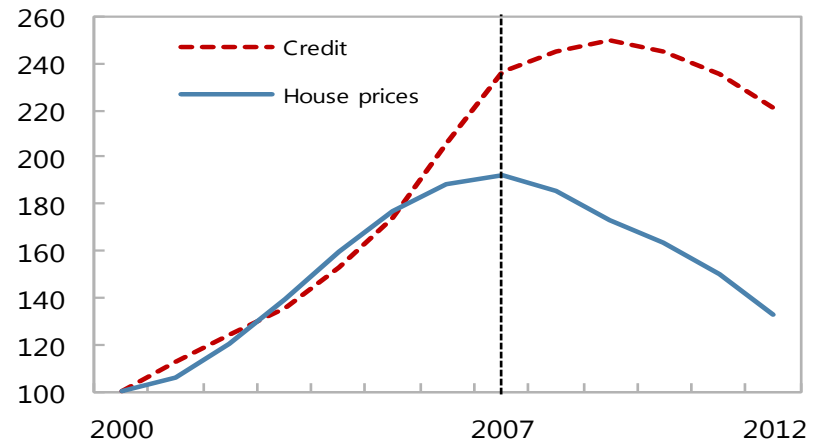
**Panel 2. Spain, output gap**  
(Percent)



**Panel 3. Greece, credit and house prices**  
(Real indexes, 2000=100)



**Panel 4. Spain, credit and house prices**  
(Real indexes, 2000=100)



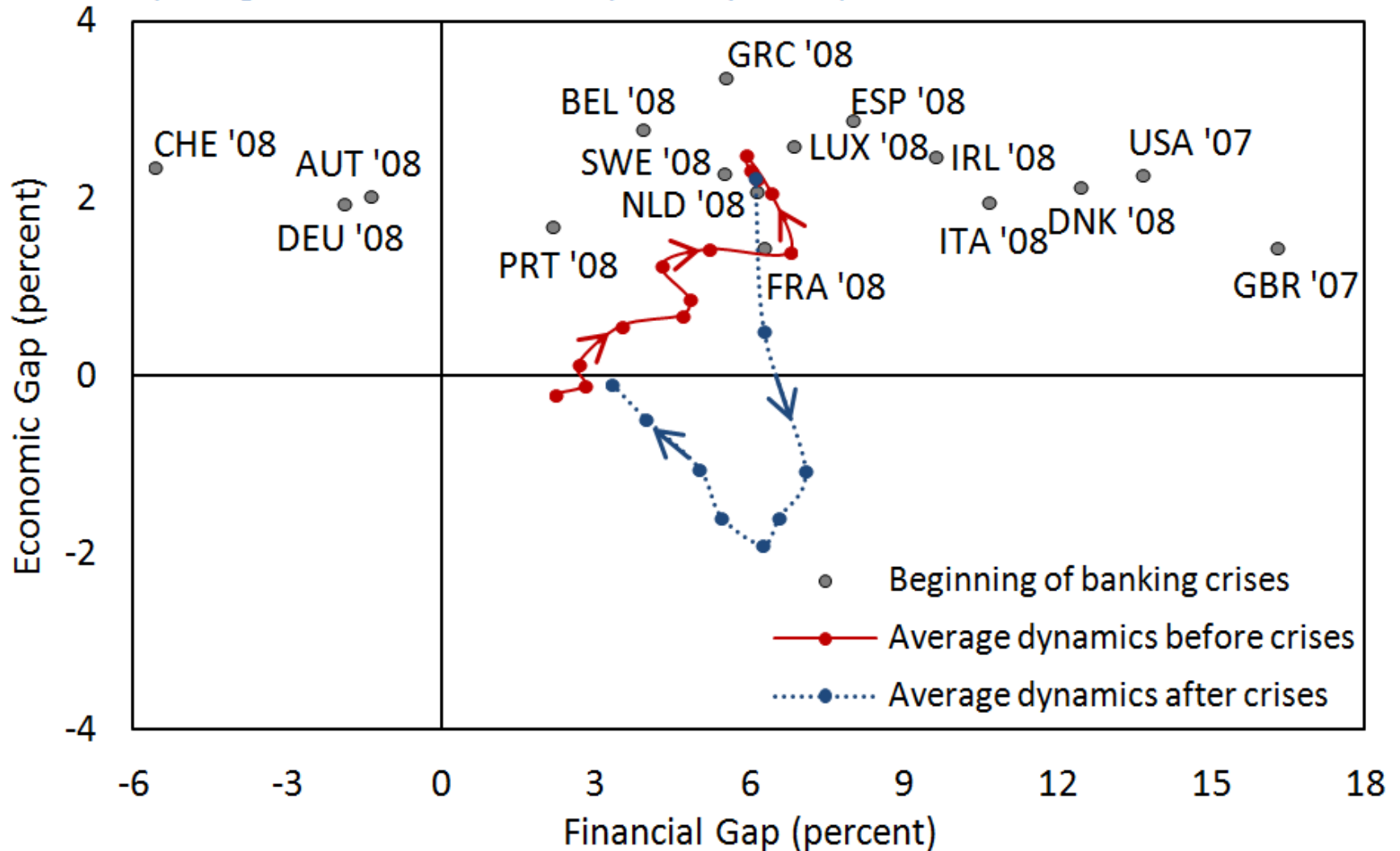


# A Different Role for Financial Variables?

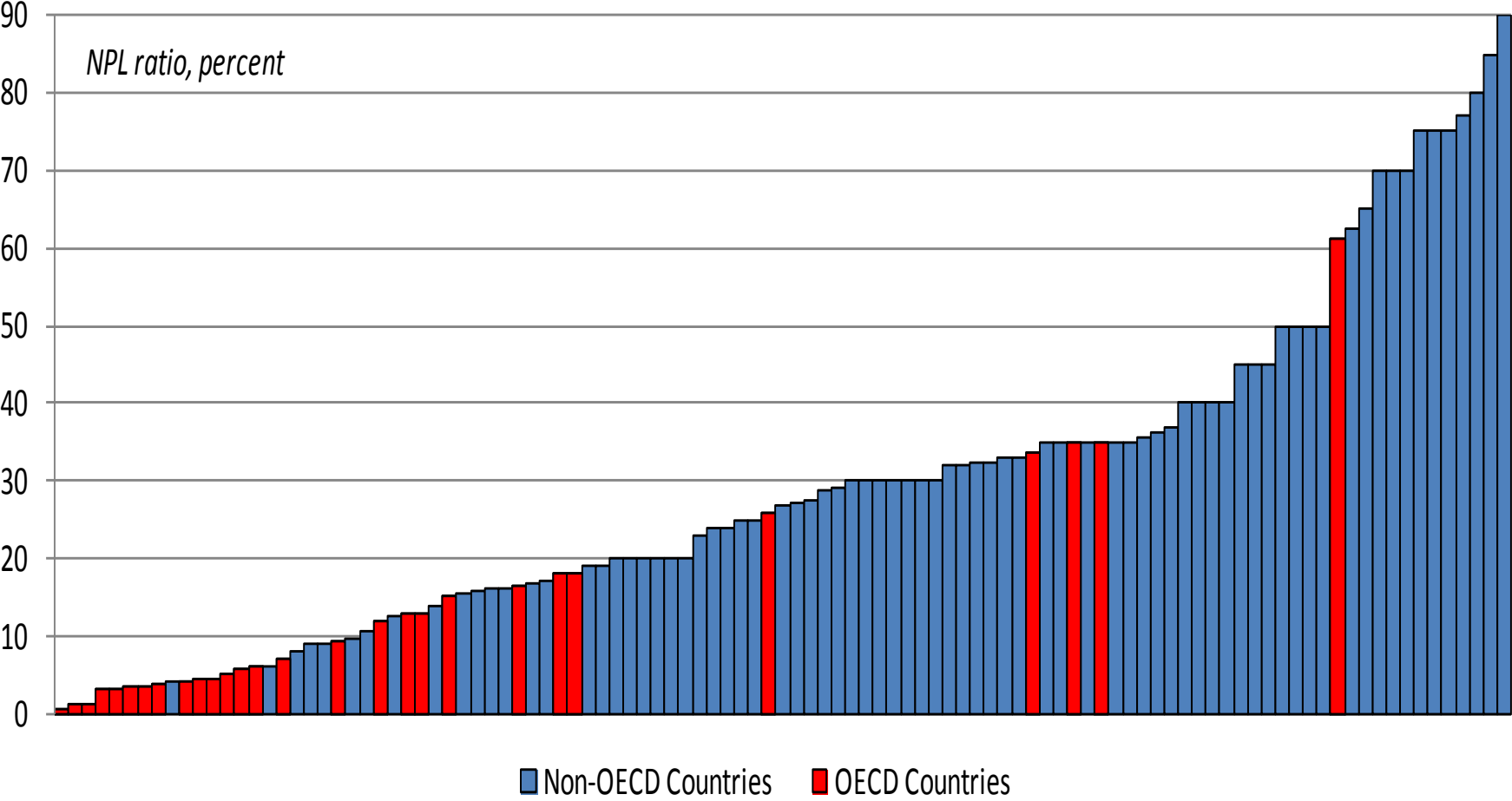
- Use real-time financial data to reduce errors in potential output estimates
- On average you can predict about 1/3 of adjustment
- Conflict between mandates looks smaller ex-post than ex-ante

# Economic and financial overheating

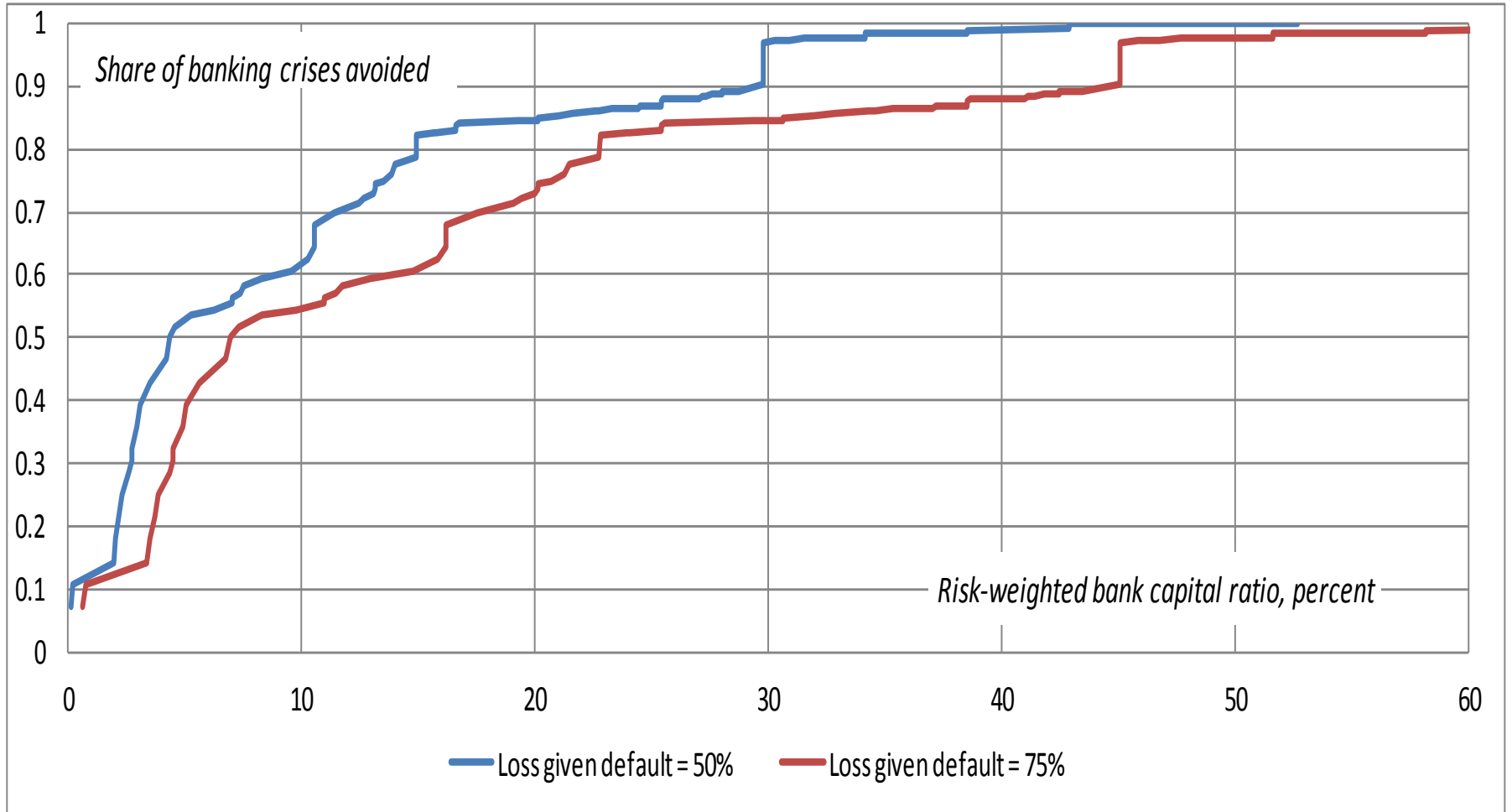
**Economic and financial gaps around banking crises**  
(AEs, global financial crisis, quarterly data )



# Bank NPLs in crises



# Role of bank capital/loss absorption



# Bank Losses in Percent of GDP

