Discussion

Leaning against persistent financial cycles with occasional crises

by T. Kockerols, E. M. Kravik and Y. Mimir

Caterina Mendicino
(European Central Bank)

ECB - 6th Macroprudential Policy Group (MPPG) research workshop

16 October 2023

This paper

WHAT?

- Study optimal leaning against the wind (LAW)-type policies

WHY?

- Explore policy options which have the potential to reduce increased financial vulnerabilities following loose monetary policy stance

HOW?

- New Keynesian model with endogenous probability of crisis
- Optimal response coefficient to a positive real house price gap in simple rule

Main Questions

- Should central banks take financial imbalances into account in monetary policy decisions?

  $\Rightarrow$ Under which conditions a leaning against the wind (LAW)-type monetary policy is advisable to address financial stability risks?

- How does it compare to optimal LAW-type macroprudential policy in the form of optimal long-run bank capital regulation?

Framework (1)

- Large scale New Keynesian (NK) DSGE model
  - Real and nominal rigidities as in Smets and Wouters (2007)
  - Small open economy estimated to Norway (NEMO)
- Housing sector as in Iacoviello (2005)
  - LTV constraints for HH and NFC
- Banking sector as in Gerali et al (2010)
  - Interest rates set in a monopolistically competitive fashion s.t. cost $\Rightarrow$ imperfect and sluggish interest rate pass-through from the policy rate to loan and deposit rates
  - target level of risk-weighted capital requirements: CR level CCyB

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Discussion (1): model features

- What are the key features of the model...
  - ...drive the results
  - ...which justify the need for macroprudential policy?

Framework (2)

- Hybrid expectations for house prices
  - Model-consistent expectations with respect to all prices and quantities except for households' house price expectations (Gelain et al., 2013) $\Rightarrow$ a fraction of HH has rational expectations while the rest expects house prices to follow a moving average process
- Long-term mortgage debt contracts as in Gelain et al. (2017)
- Normal vs Crisis times: Endogenous Markov-switching framework
  - Occasionally binding effective lower bound (ELB)
  - Asymmetric LAW policy: responds only to positive house price gap
  - CCYB release during crisis
  - Probability of crisis driven by HH credit developments

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Discussion (2): crisis

- What about crises associated to tightening rather than loosening cycles and high liquidity needs?
- Would the Endogenous Markov-switching framework allow to capture a crisis regime with high policy rates and high inflation?

Main Results

- Under empirically plausible financial cycles leaning against the wind (LAW)-type **monetary policy** not generally advisable to address financial stability risks

  $\Rightarrow$ increase inflation volatility and the frequency of ELB episodes and the severity of crises

- LAW by long-run **capital requirements** is better suited to address risks to financial stability

  $\Rightarrow$ reduce both the frequency of ELB episodes and the severity of crises
  $\Rightarrow$ limited effectiveness of CCyB

Discussion (3): results

- Since the crisis is triggered by HH credit developments, what about the LTV...
  - ...as a LAW-type of policy?
  - ...interaction with long-run capital requirements?