INTERACTION BETWEEN MONETARY AND MACROPRUDENTIAL POLICIES

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Presentation at the "*Macroprudential policy: Taking stock of the state of the art, and ways forward* "

5th Annual Conference of the Bilateral Assistance and Capacity Building for Central Banks (BCC) program

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Motivation

Post-crisis consensus has stressed the importance of an integrated approach in terms of economic management

- **Monetary and financial stability are mutually dependent**
- **Financial friction adds a previously ignored dimension to economic analysis**

The challenges are only more complex for developing small open economies, like Albania

We need to develop better analytical tools and coordination procedures, in order to extract joint synergies

Overview

1. **Interaction of monetary and macro prudential policies**
2. **How it differs in the SEE region**
3. **A coordinating framework for Albania: a special case**
4. **Concluding remarks**

Overview

1. **Interaction of monetary and macro prudential policies**
   - **Pre-crisis consensus**
   - **Post-crisis (emerging) consensus**
2. **How it differs in the SEE region**
3. **A coordinating framework for Albania: a special case**
4. **Concluding remarks**

1. Pre-crisis consensus

- Under simplified assumptions, monetary stability was perceived as a sufficient condition for overall economic stability
  - Prevailing frictions in the economy were perceived to be limited to the real sector
  - Under the rational expectations premise, economic management policies increasingly become rule-based
    - Accounting for the time-inconsistency problem, economic stabilization duties were delegated to 'technocratic', independent and accountable banks
- Financial markets were assumed to be self-regulating and efficient
  - Regulations and supervision did mostly have a micro-prudential perspective
  - Second-guessing asset-prices was deemed to be futile and leaning against the wind undesirable
  - Under a correct system of incentives, financial stability would originate as a result of sound individual institutions & sound individual market segments
- Monetary and macro-prudential policies were thought of as non-overlapping domains
  - Financial crisis: mopping up the effects rather than leaning against the wind

2. Post-crisis consensus

Lessons learned:

- The latest financial crises shows (IMF 2013, IMF 2015, Smet 2014):
    - Price stability alone is not enough to ensure financial stability
    - Financial crisis are costly: macro and microprudential policies have to be strenthened
    - Prudential tools alone can not ensure financial stability
    - Other policy tools might be used to decrease the likelihood of a crisis

3. Post-crisis consensus

Discussion points:

- MP has to lean against financial booms (Borio 2016):
  - MP need to lean early, otherwise costs grow as risk increase over time
  - The larger the imbalance, the greater the benefit, because the bust is large
- Using MP to achieve financial stability may be counterproductive (Svensson (2016); Bernanke (2015))
  - Central bank credibility
  - Effectiveness of monetary policy
  - Communication strateg
- IMF (2013) and Smets (2013) take a more nuanced view
  - MP can be deployed to enhance financial stability, albeit imperfectly and only as a last resort

Overview

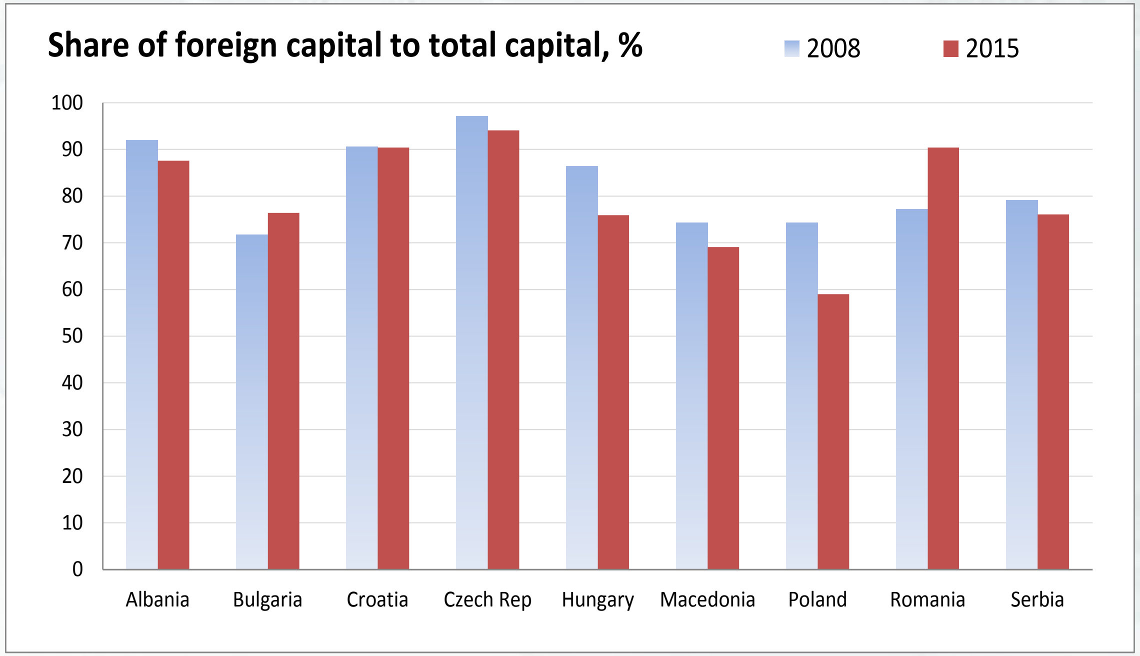
1. Interaction of monetary and macro prudential policies
2. How it differs in the SEE region
   - Predominance of foreign-owned banks
   - High level of euroization
3. A coordinating framework for Albania: a special case
4. Concluding remarks

Additional considerations for the SEE region

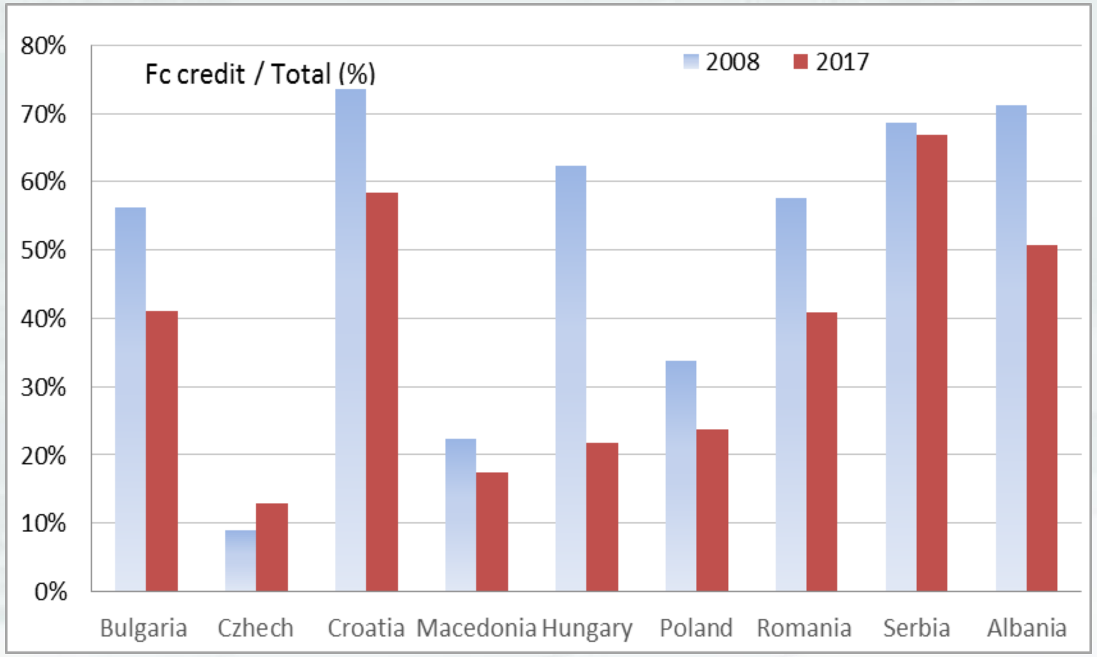
The SEE comprises a collection of developing small open economies, on their path to EU integration / accession

Two idiosyncratic features of our financial system pose additional challenges:

- Capital flows and a predominance of foreign (mostly EU) banks
- A high level of asset & liabilities euroization



Source: BSCEE annual report 2016



Source: Central banks website- monetary statistics

1. Capital flows and foreign bank's dominance

Capital flows and a foreign dominated banking system tend to:

- Reduce the effectiveness of monetary policy and macroprudential tools
- Amplify externally induced financial shocks
- Increase the need for coordination

1. Capital flows and foreign bank's dominance

Reducing the effectiveness of monetary & macroprudential policies

<table>
<tr><th></th><th colspan="2">Pre-Crisis</th><th colspan="2">Post-Crisis</th></tr>
<tr><td>Challenges</td><td colspan="2">Symptoms:
Overheating economy
Poor-sectorial distribution of credit

Causes:
Aggressive credit growth
Pro-cyclical fiscal policies</td><td colspan="2">Symptoms:
Negative output gaps and high NPLs
Probable hysteresis effects from weak growth

Causes:
Weak credit growth on account partial deleveraging / de-risking
Limited fiscal space for countercyclical policies</td></tr>
<tr><td>The BoA response</td><td>Monetary policy:
• Progressive tightening of monetary policy</td><td>Macroprudential tools:
• Higher risk weights / provisioning of FX loans
• Limits on lending growth to un-hedged borrowers
• Higher LTV requirements</td><td>Monetary policy:
• Extremely expansionary monetary policy stance</td><td>Macroprudential tools:
• Lower risk weights / provisioning for a 'desired' credit growth
• Encourage loan restructuring
• Improve NPL resolution framework
• Discourage deleverage</td></tr>
<tr><td>Results</td><td colspan="2">Impaired effectiveness, due to high competition-driven risk-taking behavior induced by EU banks</td><td colspan="2">Impaired effectiveness, due to high risk-aversion among EU banks</td></tr>
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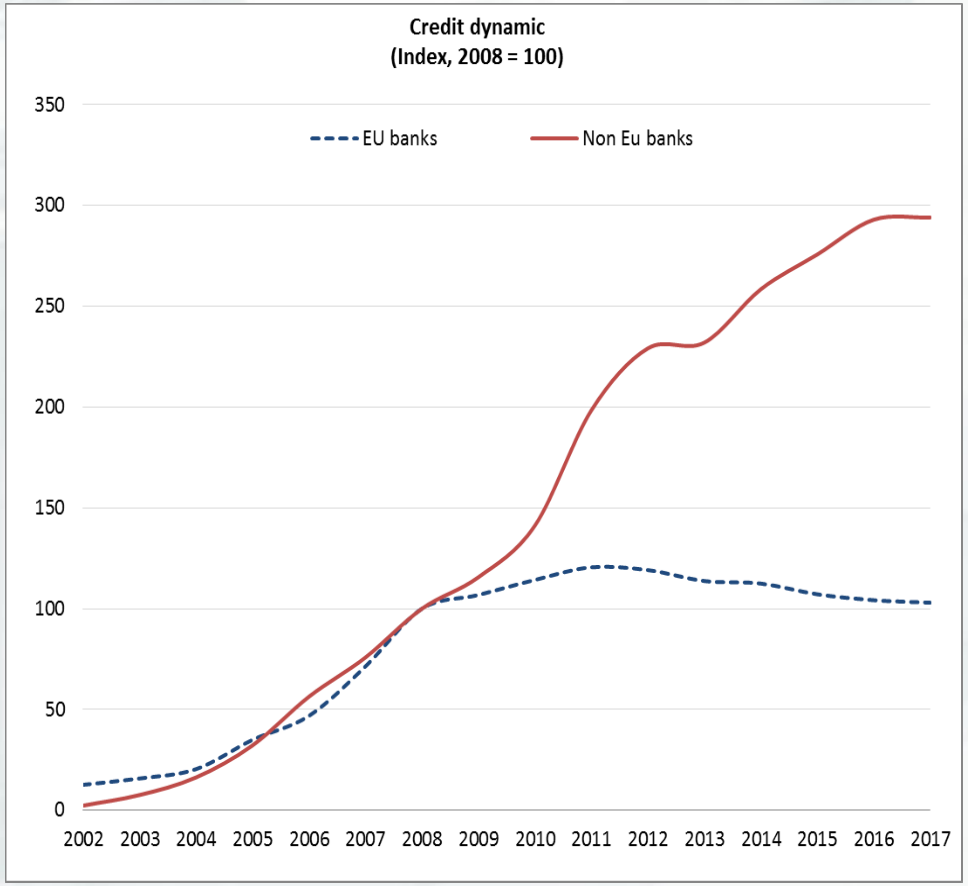
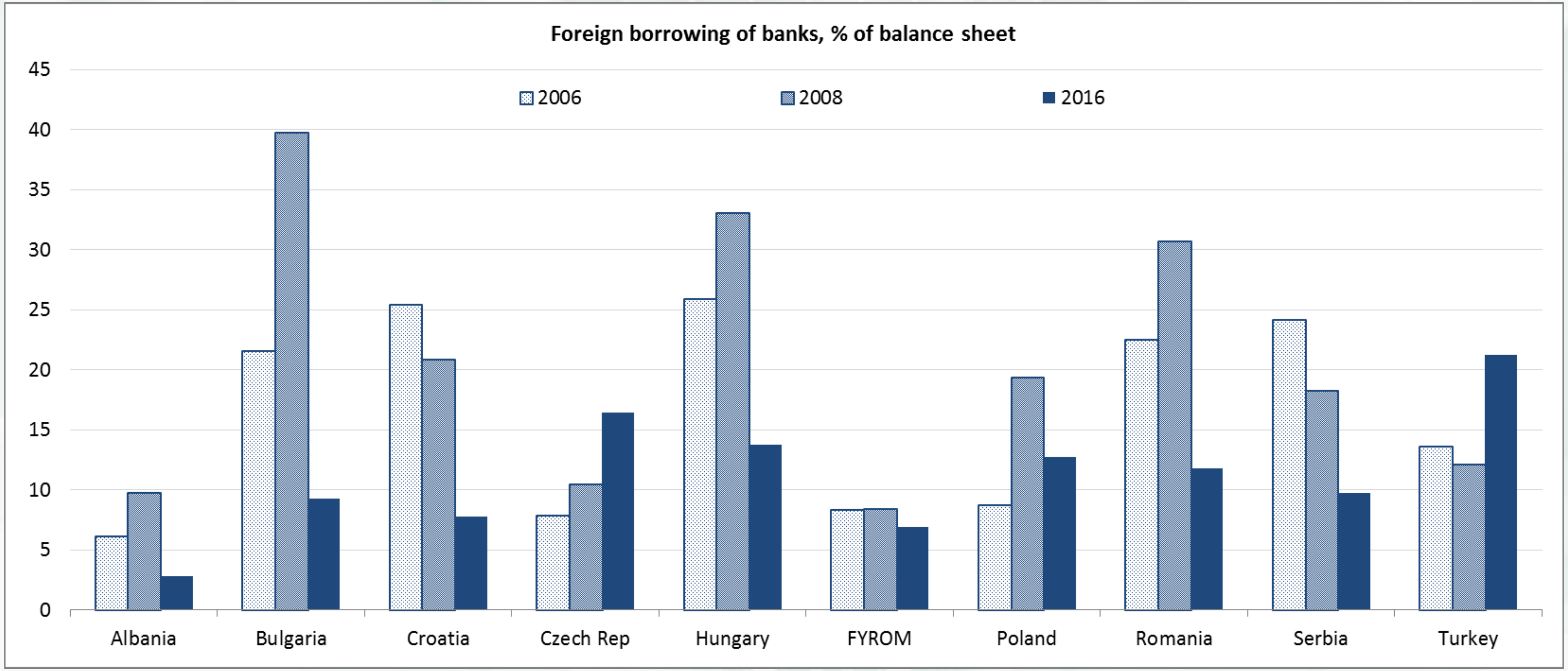


Source: Bank of Albania

1. Capital flows and foreign bank's dominance

Amplifying externally induced financial shocks



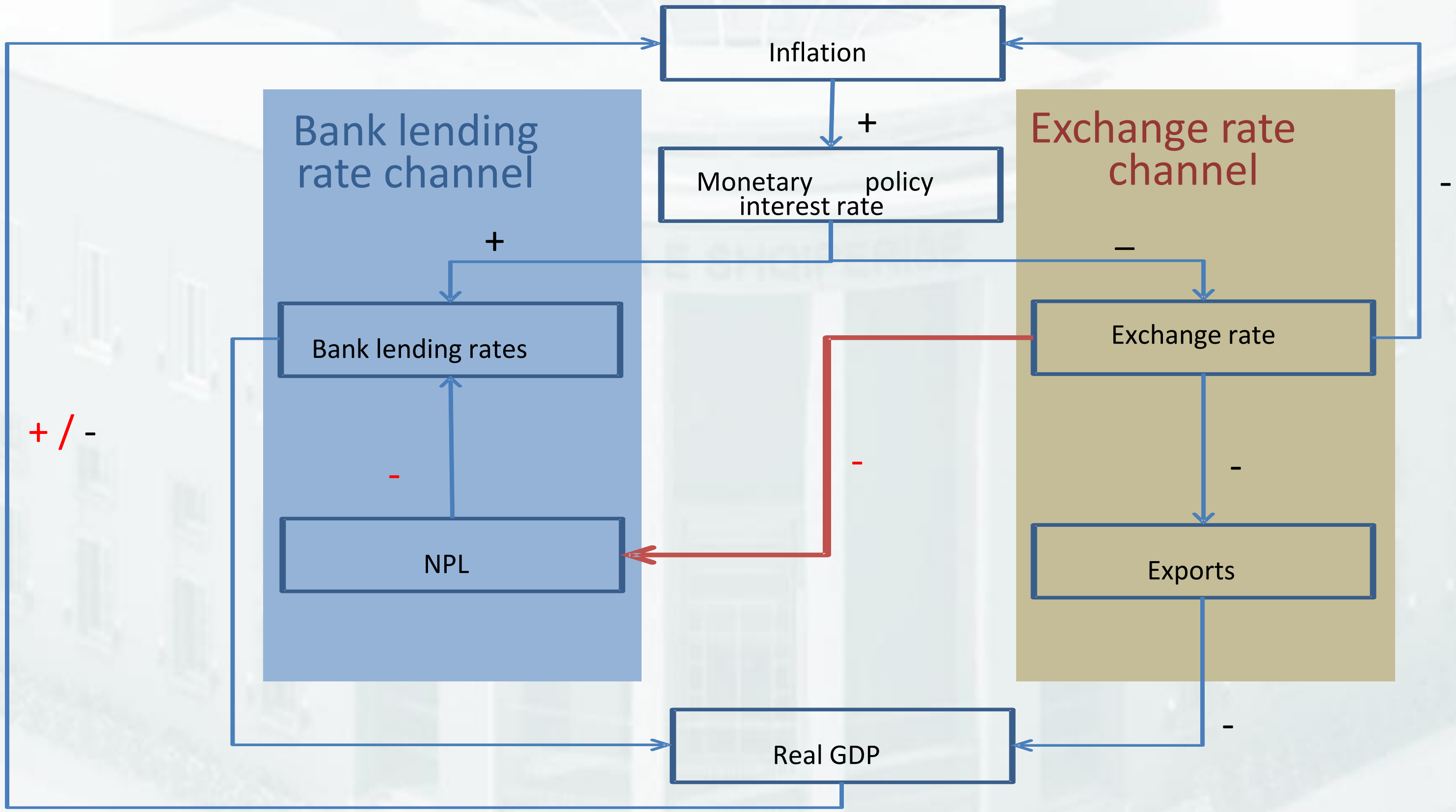
Source: Central banks website- monetary statistics

2. Euroization

- A euroized financial system tends to correlate with foreign-bank dominated banking system
- A euroized financial system tends to:
  - Impair the transmission mechanism of monetary policy
  - Raise additional financial stability concerns via the un-hedged borrowers channel

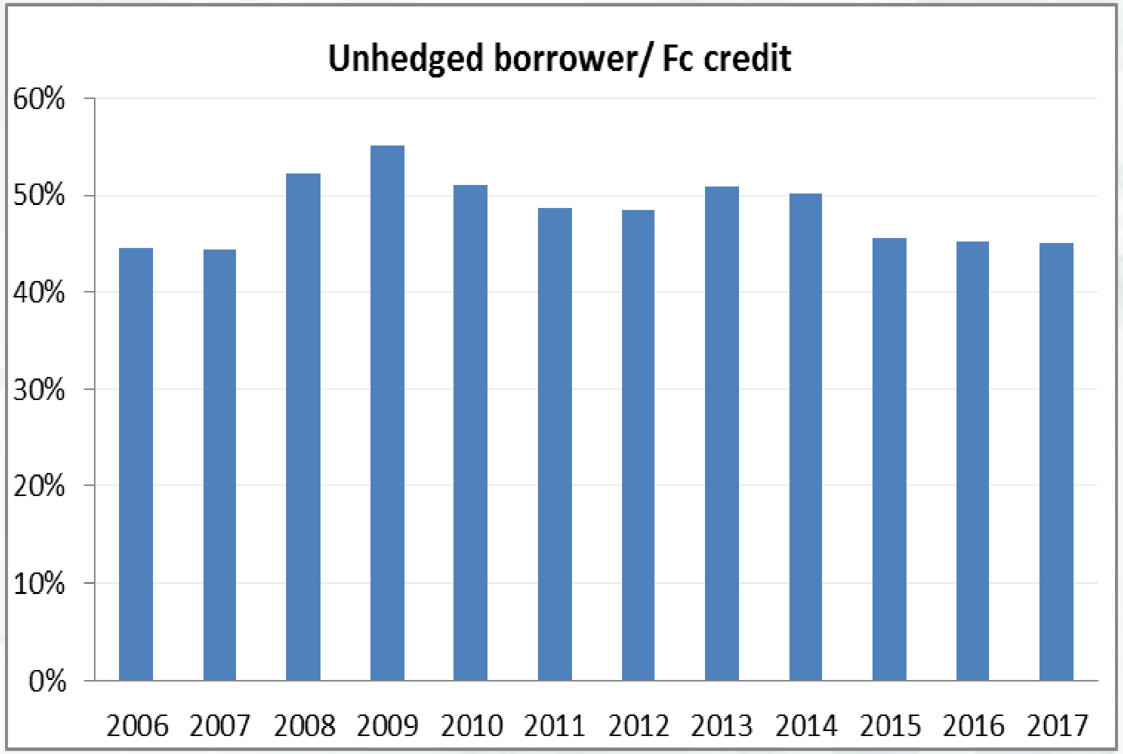
2. Euroization

Impairment of the MP transmission mechanism

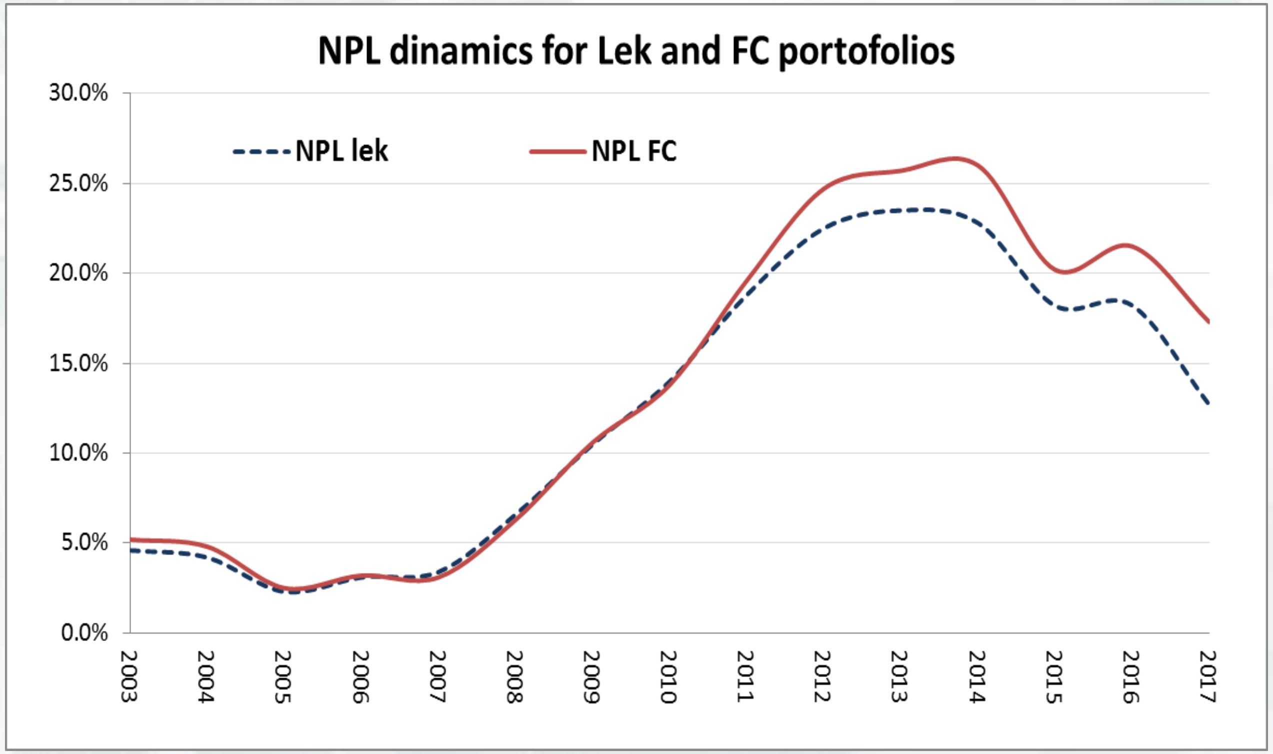


2. Euroization

Un-hedged borrowers and NPLs



Source: Bank of Albania



Source: Bank of Albania

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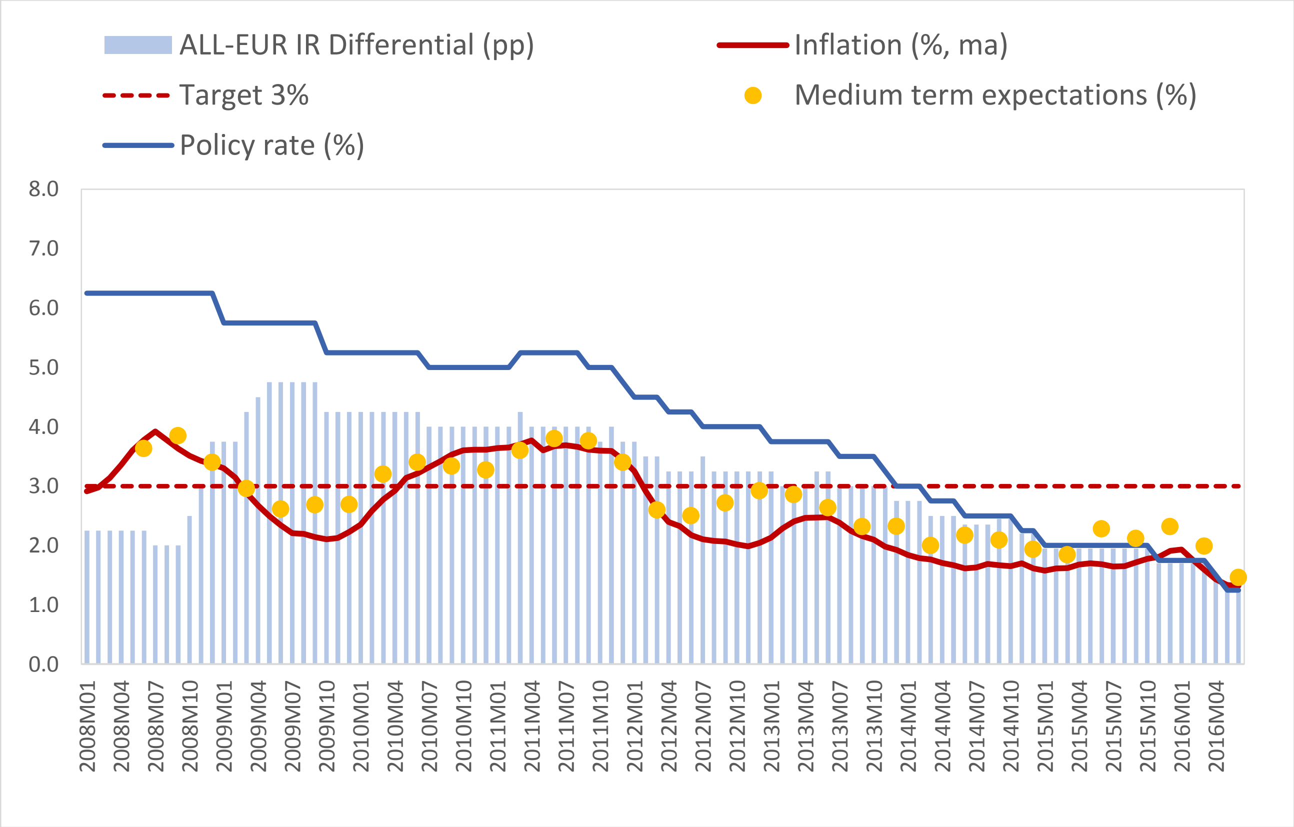
1. The context

Conducting monetary policy close to the lower bound

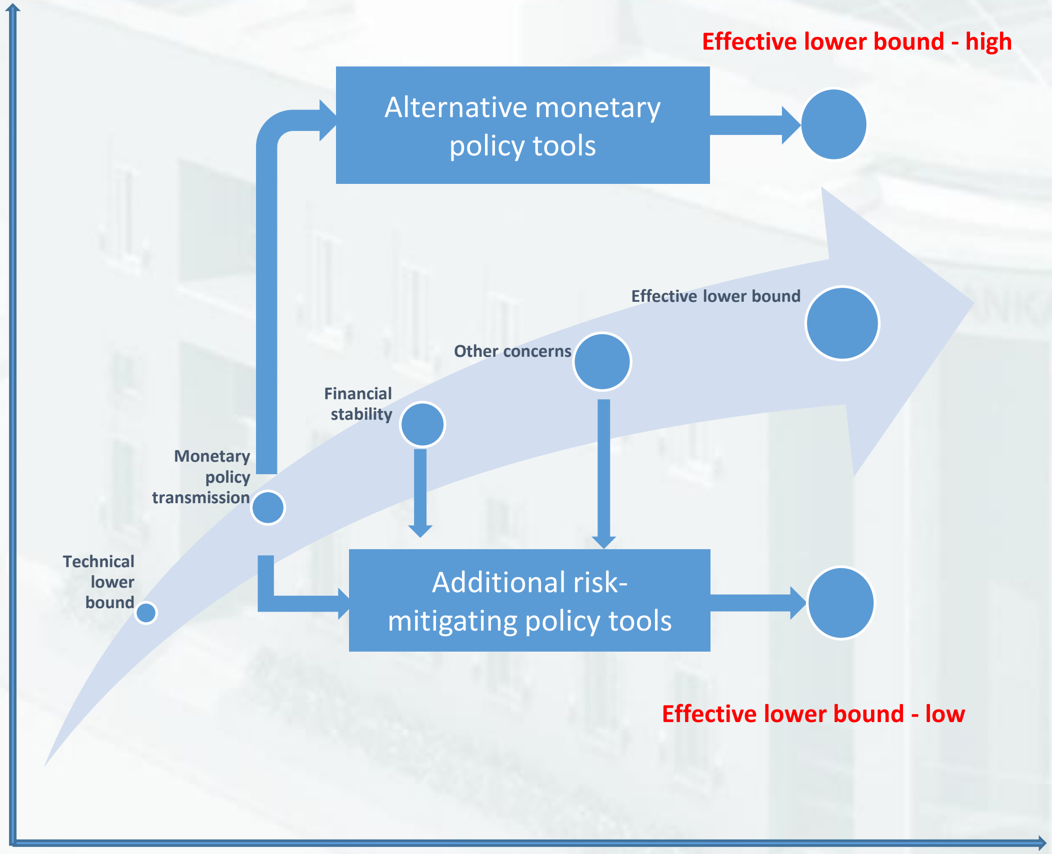


Source: Bank of Albania

- **How to deliver additional monetary stimulus?**
  - **Lower further the policy rate, or**
  - **Employ unconventional tools**
- **How low could we go with our policy rate?**
- **What cost-benefit analysis framework could be employed to assess trade-offs?**

2. The conceptual framework

The effective lower bound*



* See forthcoming IMF Working Paper 'The Effective Lower Policy Rate Bound in Albania', by Guido della Valle, Romain Veyrune, Erald Themeli, Ezequiel Cabezon, and Shaoyu Guo

The effective lower bound, as a function of:

- **Monetary transmission effectiveness**
  - **Perverse risk-taking incentives**
- **Financial stability concerns:**
  - **Impact on real & financial sector balance sheets**
  - **Impact on the liabilities side of the banking system**

3. The operationalizing of the framework

The ‘barometer’ as a dashboard to summarize the distance from the ELB

- **The monetary policy barometer as non-parametric tool to account for the impact of monetary policy on the:**
  - **Composition and maturity of banking system liabilities**
  - **Impact on exchange rate (and, potentially, on the balance sheets)**
  - **The impact on RoA & RoE of the banking system**
  - **The impact on the volatility (and implied risk premia) of financial markets**

Source: Bank of Albania

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Concluding remarks

- Academic and policy-makers consensus is converging towards a more holistic approach towards monetary & financial stability
- For Albania and other developing SOEs, the point has been more obvious in the past, though not less challenging
- The BoA is striving to improve the coordination of two policies, through:
  - Strengthening its expertise in each of the two areas
  - Increased communication among the two functions
  - Introduced coordinating mechanisms among the two, though the process covers – as of yet – only specific cases

Thank you!

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References

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Appendix: IMF's view of pre & post crisis consensus on monetary and prudential policies

Source: International Monetary Fund 2013: "The interaction of monetary and macroprudential policies", pp 6.