BANK FOR INTERNATIONAL SETTLEMENTS

Beyond narrow mandates: Thoughts on financial stability functions

Remarks as part of a Policy Panel
Annual Research Conference of the National Bank of Ukraine
19 May 2017

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Cautiously heading for the middle ground?

- Smets' 3 camps
  - Modified Jackson Hole (specialization of functions)
  - Leaning against the wind (regulation not fully effective, monetary policy should lean, perhaps not just as a backup)
  - Financial stability is price stability (radical re-conception)
- Smets in the middle ground?
  - Financial booms and busts have very big costs
  - Price stability + microprudential regulation not enough to assure financial stability
  - Both regulatory & price instruments affect both risk-taking & intertemporal choices, as research increasingly confirms
  - But major political economy risks argue for the institutional arrangements of the MJH camp

End up in the same place, though racked more

- Third camp has strong intellectual attraction
  - Will likely become the dominant thought process with the passage of time
- Middle camp beset by uncertainties
  - How do specific behaviours add up in a full system context?
  - Non-linearities abound, making almost every extreme outcome possible
- Political economy issues more troubling than Smets suggests
  - Legitimacy demands clearer objectives
  - Clearer objectives are inescapably multi-dimensional
  - Tradeoffs cannot (yet) be preconfigured or left to “experts”

The intellectual attraction of price=financial stability

- Smets: Brunnermeier & Sannikov (2012); the I-theory of money
  - Price and financial stability are intertwined because money and intermediation are.
  - Both policies are about reducing financial frictions that impede efficient exchange (in the full array of shocks)
- Reading monetary history:
  - Money, credit and financial service specialists intertwined, in post-commodity money eras
  - "Monetary system" evolves to better meet needs of trade (exchange betw. strangers, across distance & thru time)
  - Repeating breakdowns involving sudden losses in value
  - The public good is a reliable (stable & predictable) monetary system. Inflationary & insolvency crises create unreliability.

Key political economy considerations

- Integrating theory is very new, very incomplete.
- Price based instruments are limited.
  - Interest rates for intertemporal incentives (in NK) & wealth redistribution via bond price changes (in I-money)
  - Otherwise direct regulation
- Regulation has side effects
  - Dynamic efficiency
  - Selective incidence
  - Exposure to design flaws (high knowledge requirements)
  - Exposure to rent seeking
  - Arbitrary impacts on property rights of service providers
  - Public finances as residual insurer

Key political economy considerations (continued)

- Tradeoffs highly uncertain
  - Which financial stability has what welfare costs? By how much?
  - Future financial stability payoff for lower incomes, higher unemployment, greater macro volatility in the medium term?
  - Tradeoffs due to side effects of regulatory actions?
- Delegation of tradeoffs to independent agencies
  - Delegation works best when tasks clear (to specify, to monitor)
  - Specifying tasks: objectives, constraints, limitations
  - Helped by narrow range of tasks

Key political economy considerations (continued)

- Risks from delegations of both macroeconomic and financial stability to the central bank
  - Smets: reputation and time inconsistency
  - Archer: legitimacy of institution may be questioned
  - Weidmann: contagion of political influence
  - Bureaucratic incentives (shirking … cheating)
- Possible risk management devices
  - Banking Act (2009) objectives as template
  - Separate decision-making bodies (BOE model)
  - Separate institutions with information sharing requirements