Comments on Research Paper

“Marrying Monetary Policy with Macroprudential Regulation: Countercyclical Capital Buffer and Optimal Monetary Policy”

by Don Nakornthab

Dr. Iskandar Simorangkir

Bangko Sentral ng Pilipinas International Research Conference “Contemporary Challenges to Monetary Policy”
Manila - Philippines, 28-29 February 2012
1. Findings from The Research Paper
2. Addressing Macroprudential Policy with Monetary Policy. A very important topic but challenging one…
3. Possible Extension Research
4. Conclusion
Summary of The Research Paper

- It is a very topical and timely research paper which addresses macroprudential policy and its impact on monetary policy (interest rate policy).
- In this study, the macroprudential policy instrument is CAR (following Basel-III BCBS’s recommendation) with 3 classification (Minimum, Conservation Buffer and Countercyclical Buffer) as follows:

<table>
<thead>
<tr>
<th></th>
<th>Common Equity Tier 1</th>
<th>Tier 1 Capital</th>
<th>Total Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>4.5</td>
<td>6.0</td>
<td>8.0</td>
</tr>
<tr>
<td>Conservation buffer</td>
<td>2.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum plus conservation buffer</td>
<td>7.0</td>
<td>8.5</td>
<td>10.5</td>
</tr>
<tr>
<td>Countercyclical buffer range*</td>
<td>0 – 2.5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Note: The countercyclical buffer range is 0 to 2.5%.
• Refering to Cecchetti and Li (2005) plus forward looking variables, this small closed model incorporates bank lending channel (standard interest rate channel is exist) in an “adhoc” way with CAR Rule as follows:

\[ N_t \geq \left( c + \frac{1}{\gamma_1} \left( \frac{Y_t}{Y} \right)^{\gamma_2} \right) B_t, \]

• With this model setup, the paper analyzes and compares three scenarios: (1) Unconstrained_Capital_Requirement (2) Fixed-Capital_Requirement (where \( c = \text{Minimum} + \text{Conservation Buffer} \) and \( \Gamma_2 = 0 \)) (3) Countercyclical_Capital_Requirement (where \( \Gamma_2 > 0 \)).

• This paper concludes that "while countercyclical capital requirement helps moderate the impact of demand shock on output, it reduces the ability of the central bank to control inflation through the weakened monetary transmission mechanism". In short, countercyclical capital requirement is good for output gap stabilization, but bad for inflation stabilization.
Addressing Macroprudential Policy with Monetary Policy (1)

- Addressing macroprudential policy together with monetary policy is very important but very challenging task. This research paper has successfully attempted to contribute to this area.
- However, it is concluded in the paper that macroprudential is good for output stabilization but bad for inflation stabilization. This finding seems counter-intuitive for policy maker especially central bank which mainly is adopting inflation targeting.
- Furthermore, from policy recommendation perspective, the quantitative dynamics of the model is still less useful (IRF). Under Countercyclical_Capital_Requirement Scenario, surprisingly one cost shock needs a higher interest rate than other two Scenarios.

Figure 4. Impulse responses to a unitary cost shock
Addressing Macroeconomic Policy with Monetary Policy (2)

- Let’s step back a bit about the choice of macroprudential instrument. We note that this paper set capital requirement (CAR) as the macroprudential instrument due to the Basel-III recommendation.
- However, as we are all aware, banking in emerging countries right now has relatively high CAR. For example, in Indonesia, CAR for Bank is persistently around 16-17% which is high above minimum regulation 8%. So this facts denies the possibility of binding constraint as proposed by CAR Rule in this model. In other words, Banks could easily hinder not to follow the countercyclical capital requirement by setting a high CAR.
- One of alternative macroprudential instrument which is commonly discussed is that LTV (Loan to Value Ratio). In terms of application, as LTV is not only set by Bank but by both Bank and Borrower, it seems that LTV is always followed by those two agents. In other words, LTV will always exist in every single transaction. So, LTV would likely to always binding which very useful for practicality of regulation. For research with this instrument, Quint and Rabanal (2011) among others, is a good reference.
- However, this paper is nice and timely research which attempted to explore the interplay between macroprudential and monetary policies.
There are some area improvement on this topic research:

• More explicit microfoundation so dynamics and the mechanism of monetary and macroprudential in the model could be tracted easier. Gerali et al (2010) has started to incorporate explicit banks in their model.

• Open economy to capture the spillover from the international. This is inline with emerging country characteristic where the world shock commonly has significant impact to the country. Among others, we see Quint and Rabanal (2011) is a good reference on this issue.
Conclusion

- A good and timely research as macroprudential regulation should be enacted inline with other macro policies (monetary, fiscal etc).
- However, some finding are still counter-intuitive especially from policy recommendation perspective. Hence, it seems there is a model specification issue in this model setup (is the “lending channel” too addhock ? should be bank explicit modelled? ).
- Interesting extension research: more explicit microfoundation (agent bank as in Gerali et al (2010)), open economy (Quint and Rabanal(2011) among others).
References