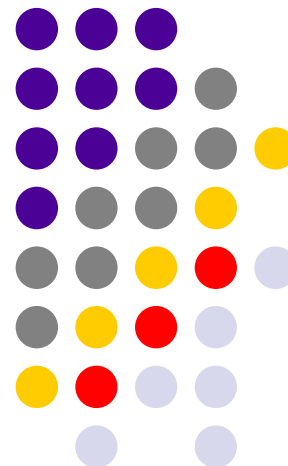


Monetary Policy and Financial Instability: An Integrated Micro-Macro Approach *by* *De Graeve, Kick, and Koetter*



Pierre L. Siklos
WLU & VERC



LAURIER

An Ambitious Empirical Exercise



- Recognizes the importance of micro and macro links in the ‘nexus’ between monetary policy and financial stability
- Recognizes the need for an evaluation of the connections between monetary policy shocks and financial stability (although it really is financial ‘fragility’)

The Problem



- “There is no obvious framework for summarizing developments in financial stability in a single quantitative manner.” (ECB Financial Stability Review, Dec 2005, p.131)
 - This paper ignores this view

It Gets Worse



- There isn't even a decent theory linking financial stability and monetary policy but...
 - CB seem to have done such a good job why not?
 - Are Central banks getting ahead of themselves?



Should a CB ‘Stick to its Knitting?’

		Price Stability	Financial Stability
a)	Measurement and Definition	Yes, subject to technical queries	Hardly, except by its absence
b)	Instrument for control	Yes, subject to lags	Limited, and difficult to adjust
c)	Accountable	Yes	Hardly
d)	Forecasting Structure	Central tendency of distribution	Tails of distribution
e)	Forecasting Procedure	Standard Forecasts	Simulations or Stress Tests
f)	Administrative Procedure	Simple	Difficult

From Goodhart 2006



Questions to be raised

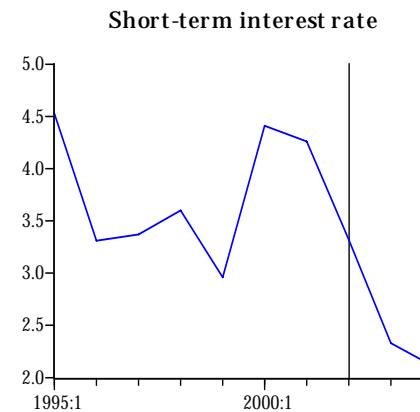
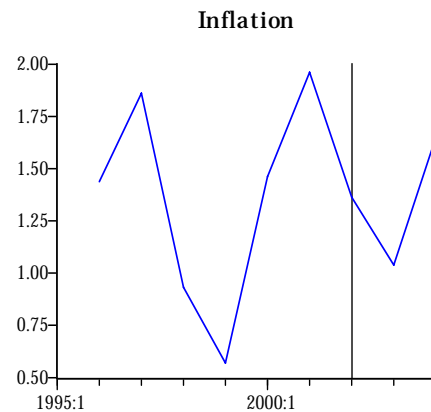
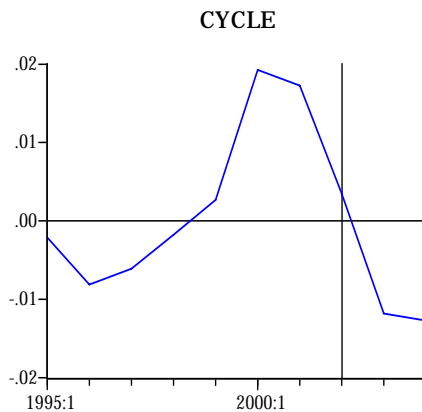


- Is Price stability not good enough?
- If we can't tell when a bubble will burst how can we tell when a system becomes 'too fragile'?

What's So Special About Germany



- Rich micro level data
- What about the macro?



What Do the Authors Do?



- 1. Micro model \Leftrightarrow PD
- 2. Macro model \Leftrightarrow MP shocks
- Combine 1 & 2 to empirically demonstrate that there is a ‘trade-off’ between financial stability and monetary policy

How do the Authors Do It?



- 1. A logit type model
- 2. A VAR consisting of Y, P, and R
- 3. A panel type VAR which permits interaction between the M and F segments of the economy

Anything Wrong with this?



- Its really an annual model
 - “I should clarify what kinds of financial volatility are of concern to a central bank. Generally speaking, prompt adjustment in the prices of assets to new information is to be expected” Longworth (2006)
- Sign restrictions are used to identify MP shocks (R^* Y^* P^*) but surely size matters
- Bank specific variables are exogenous (a limitation acknowledged by the authors)
- Other:
 - No role for expectations
 - What about asset prices more generally? (housing)
 - Is 1995-2004 a single policy regime?
 - Why is monetary policy shouldering the entire burden?

Anything Wrong with this?

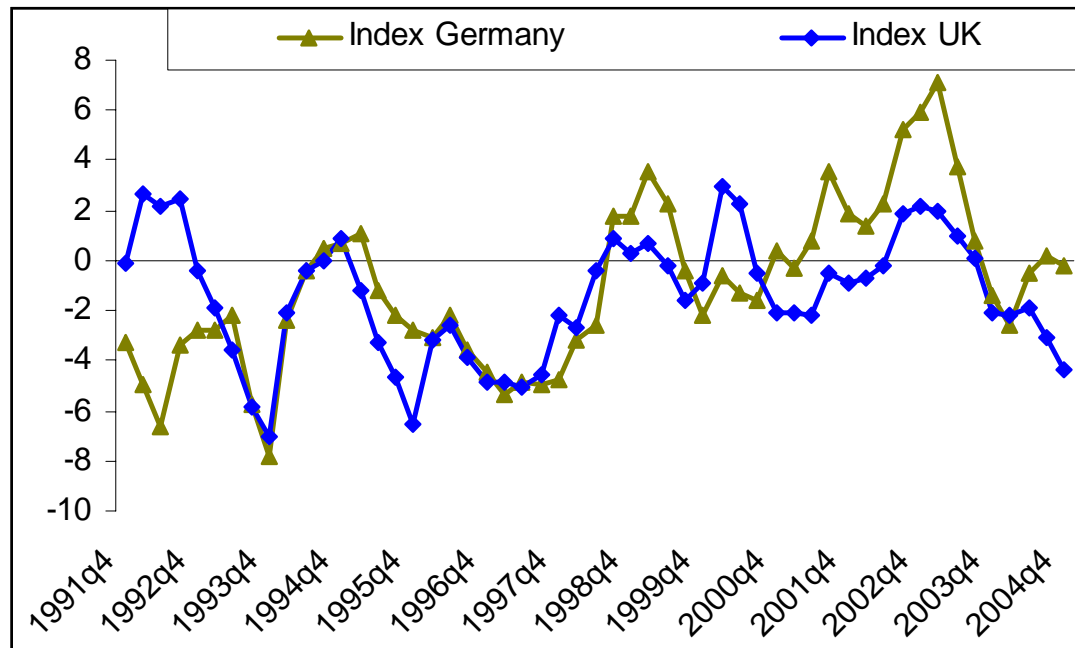


- What about Volatility?
 - “As a central bank, we tend not to worry about financial volatility for its own sake, but about the potential financial instability and economic cost of excessive financial volatility.” Longworth (2006, <http://www.bankofcanada.ca/en/speeches/2006/sp06-18.html#1>)



Policy Implications?

- Why should financial stability be a single factor? (Goodhart 2006)



HIGH is bad
Low is GOOD

Policy Implications?



- Does Basel II not have an impact on how PD will be measured in the future?
- Even if a trade-off of the kind suggested in the paper exists, this type of VAR exercise is not up to the task unless it can be used as a forecasting tool
- The empirical analysis does not address the sample selectivity type bias not can it address the moral hazard issues raised by a CB with a 'dual' mandate