Policy panel: Central banks and central banking: what challenges and potential pitfalls ahead?

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Macroprudential policies
New challenges and new tools

- Financial stability objective given more weight after financial crisis

- Central bank should have important role in macroprudential decision making
  . Competence
  . Coordination

- What are the gains?
  . Theory: another instrument and additional goal
Will it work in practice?

- Booms – useful additional instrument
- High interest rate powerful instrument, but there are limitations
  - Low inflation?
  - Strong exchange rate?
- Counter-cyclical capital requirements and higher loan-to-value requirements will dampen the economy
  - Increase lending rates more than money market rate => mitigate pressure on exchange rate
Downturns and weak states of economy

1. Higher capital ratios make banks more resilient

2. Also in downturns, useful to coordinate monetary and macroprudential policy
   a. Mitigate possible adverse effects of low interest rate
   b. But – too tight requirements dampen economy

3. Will reduction in capital requirements stimulate the economy?
   a. Will markets require higher capital ratios?
Low employment and low capacity utilization likely scenario

- Risk of low demand in years to come
  - Low investment levels
  - High debt and deleveraging
  - Increased income inequality

- Low interest crucial, but zero lower bound has proven to be a real constraint
  - Macroprudential policy will not stimulate economy
A potential pitfall

- Fluctuations in inflation & wage growth even with low employment & low capacity utilization
- Potential pitfall – raise interest rate too early
- Standard result: policy tradeoff between variability in inflation and variability in output
- Based on questionable assumption that business fluctuations sum to zero over time
  - But – severe or longlasting downturns unlikely to be compensated => reduce average output
- Unions & workers weaker bargaining position than before => wage growth less persistent