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

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Norges Bank 6 June 2014

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

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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

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Downturns and weak states of economy

- Higher capital ratios make banks more resilient

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

- Will reduction in capital requirements stimulate the economy?
  - Will markets require higher capital ratios?

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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

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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