NATIONAL BANK OF ROMANIA

Trade-offs in modern central banking

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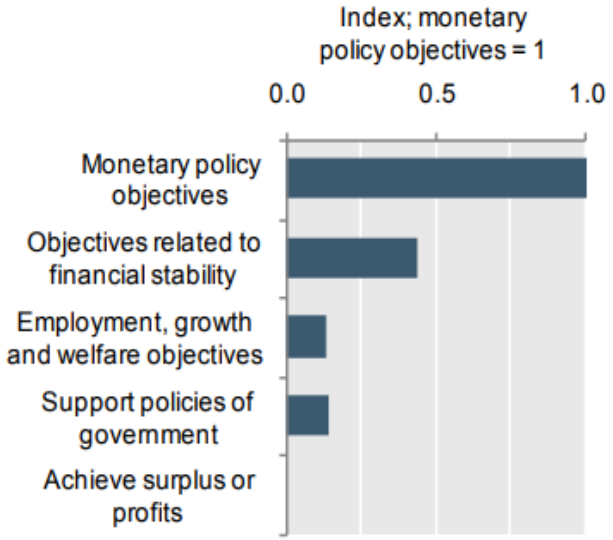
I. Central Banks' mandate
Implicit (*de facto*) vs. explicit (*de jure*) mandate

- The majority of central banks operate under an implicit mandate on financial stability.
- Of 146 central bank laws, less than 1/5 have an explicit objective for financial stability
- But: price stability is increasingly influenced by financial stability.

Weight of central bank objectives in central bank laws

Per cent of 47 central banks

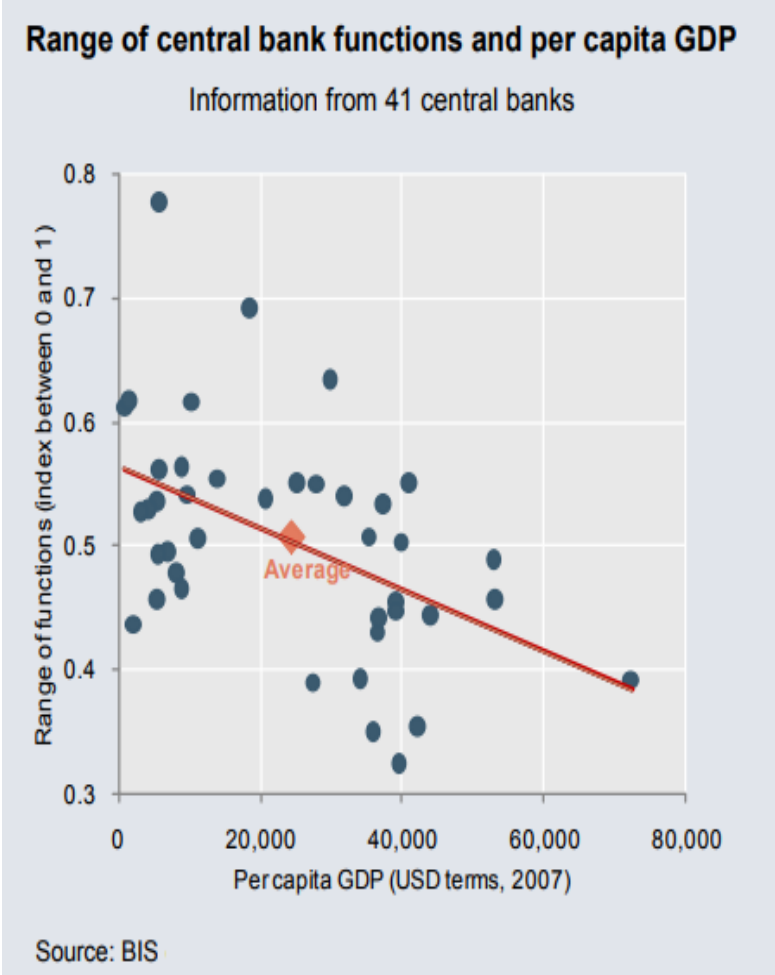


Source: BIS analysis of central bank laws

Central banks' role tends to be higher in less developed economies…

Central banks in emerging market economies tend to be allocated a wider range of functions than central banks in industrialized economies - *BIS*

- In ***less developed countries*** central bank is often a source of expertise that can be used in a wide range of applications.
- Central banks are often responsible for guiding the development of immature financial systems.
- In ***industrialized economies*** central banks tend to have narrowed their range of functions over time.

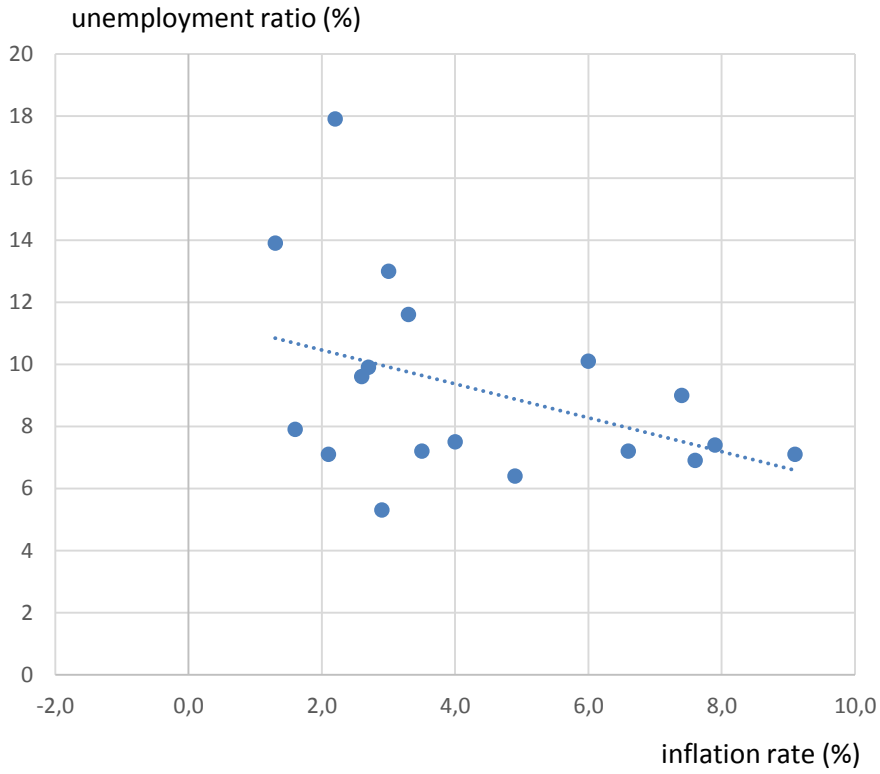


…but also in developed economies, in times of crisis

- Monetary policy is overburdened in times of crisis, trying to address the failures of the fiscal policy
- Monetary policy can only help structural reforms in the short run, while tensions are accumulating in the background
- Unconventional monetary policies have unintended consequences, including misallocation of resources and increase in asset prices
- The unthinkable: Long term money neutrality may not be guaranteed
- Too much financial innovation took us back to the early ages when Central Banks were set up to prevent money issuing with no real value; provide liquidity to the financial system; act as the bank of commercial banks; and hold government debt

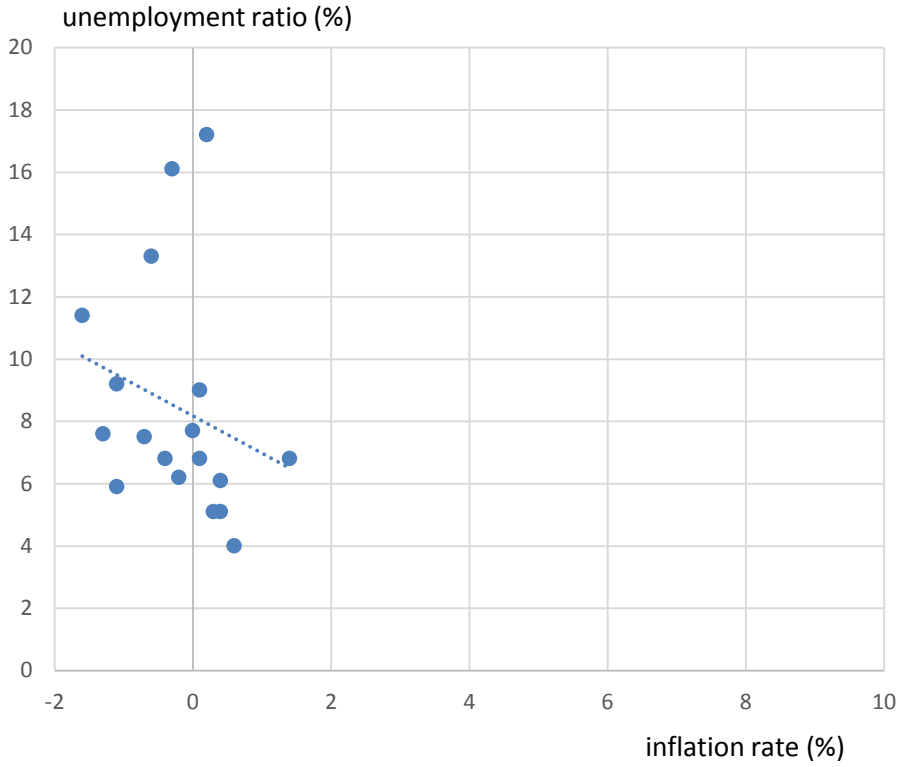
II. Traditional trade offs
Is the Philips curve actually flat in catching-up economies?

Inflation and unemployment in emerging European economies before crisis (2005 – 2007)



Note: BG, CZ, HR, HU, PL, RO
Source: Eurostat

Inflation and unemployment in emerging European economies in present (2014 – 2016)



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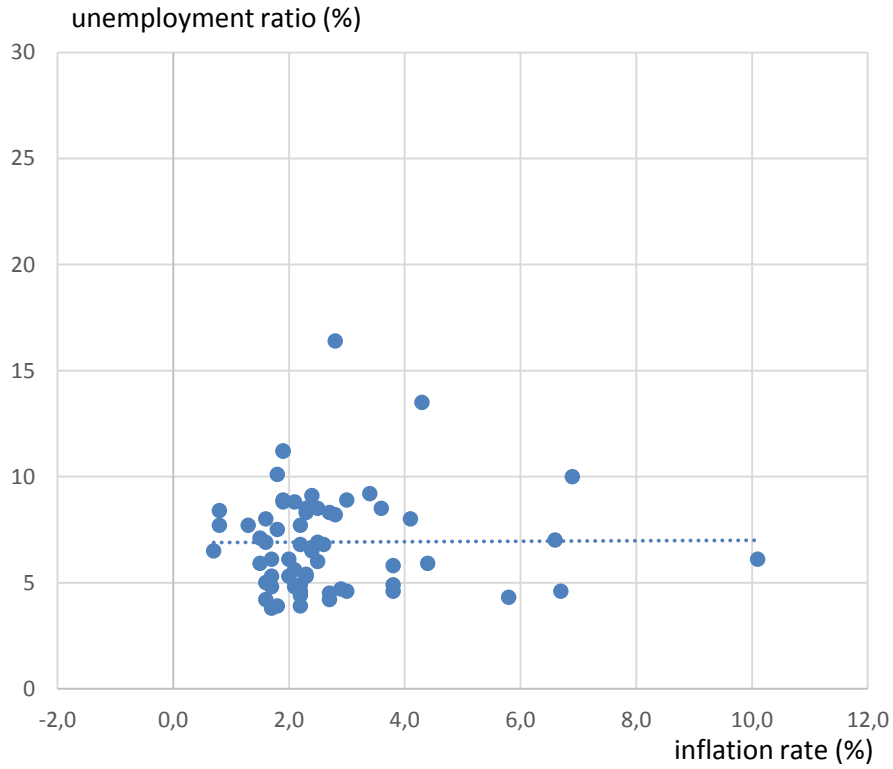
Source: Eurostat

While in the developed EU, the Philips curve may have been reenacted by deflation

Inflation and unemployment in developed European economies before crisis (2005 – 2007)



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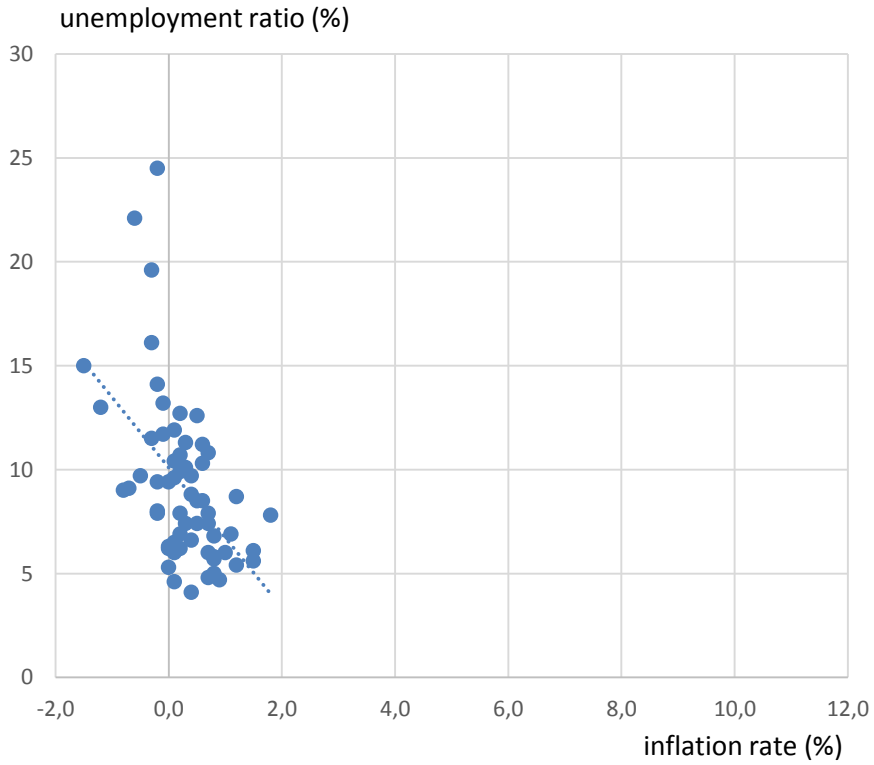
Inflation and unemployment in developed European economies in present (2014 – 2016)



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Independence, not isolation

- Central banks' independence does not mean isolation from the overall economic landscape and from the policy mix
- Is there a decoupling between inflation and growth?
- Orthodox economic theory has been challenged by the crisis. Can a dogma hold true only from time to time?
- Does exit from QE mean that central banks should abandon their new found roles?
- New global factors influencing inflation: migration, global value chains.

III. New understanding of trade offs in Central Banks
Rules vs. discretion

- Capitalism is based on capital AND rule-of-law.
- Discretion, as opposed to rules, creates uncertainty.
- Rules = constrained discretion?
- Rules are NOT made to be broken.
- Deregulation was at the heart of global financial crisis.
- Discretion is case-by-case deregulation.
- Not applying commonly agreed rules weakens the credibility of any regulator or supervisor.
- But what happens when conditions change? Ex-ante flexibility (rules should allow for some flexibility) is better than ex-post discretion

Trade-off between national and supra-national

- Micro-prudential supervision and crisis management (resolution) provides additional instruments for propping up financial stability, but…
- …creates a significant operational burden and could generate a reputational issue for the whole central bank in case of failure
- Micro-prudential supervision at group level and resolution at national level stimulates wrong incentives
- Mismatch between going-concern policies and interests and gone concern resolvability strategies
- Resolution framework is supposed to address also the home-host issues; however, the resolvability of cross-border groups could challenge the financial stability and financial policies.
- When home-host burden-sharing mechanism doesn't work, the host country should provide the backstop, which could be in conflict with monetary and financial policy.

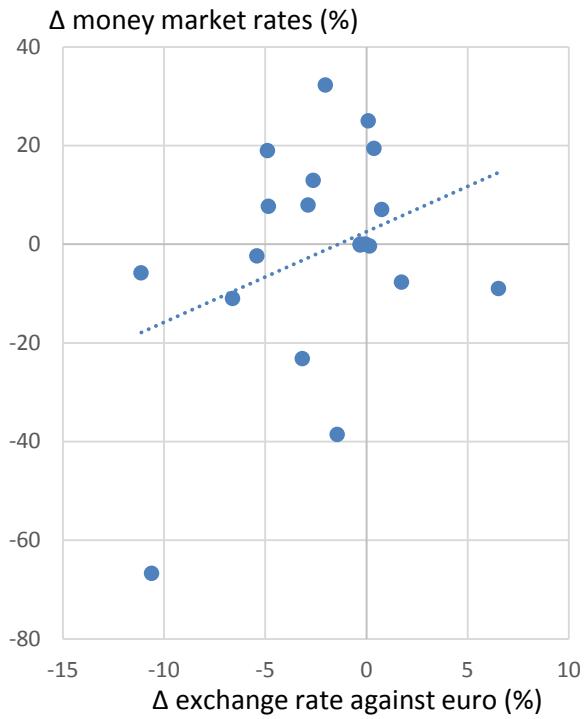
Trade-off between monetary policy and exchange rate policy

- Monetary policy (demand management) vs. exchange rate policy (external competitiveness)
  - Changes in interest rates could lead to excessive movements of exchange rates
  - Higher interest rates as a result of inflation pressures may stimulate “fiat money” inflows which may further trigger spikes in exchange rate volatility
  - Pressure to keep interest rates higher due to risk of currency depreciation may interfere with the price stability objective
  - Monetary policy decisions cannot be taken in isolation. Their impact on capital flows in an open economy should be assessed.

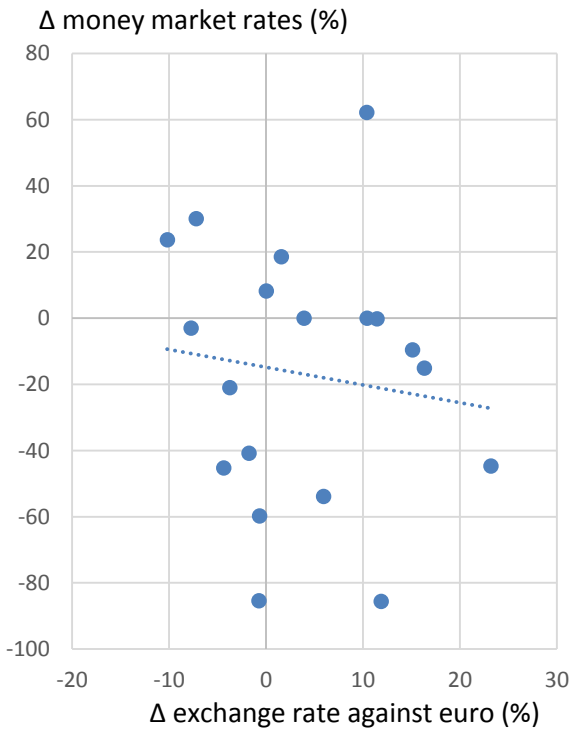
Evidence of trade-off between monetary and exchange rate policies across business cycle

Variation of money market interest rates and of exchange rates in EU

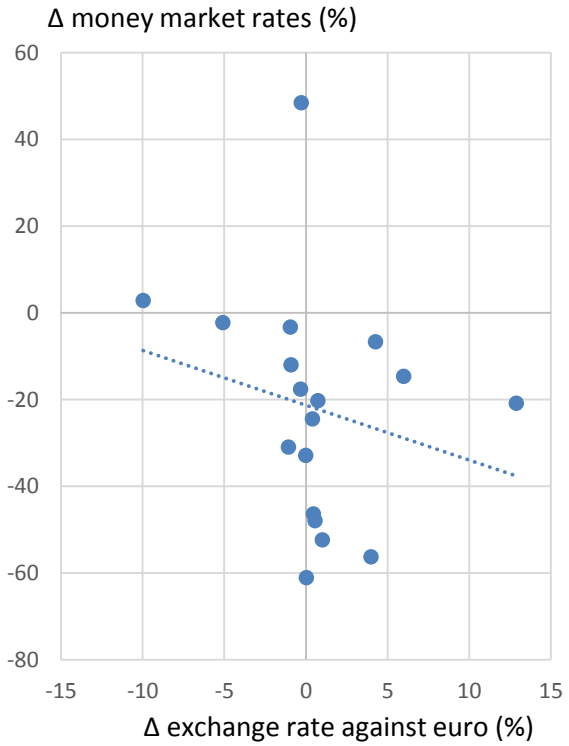
Pre-crisis (2005 – 2007)



Crisis (2008 – 2010)



Recovery (2013 – 2016)



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Source: Eurostat

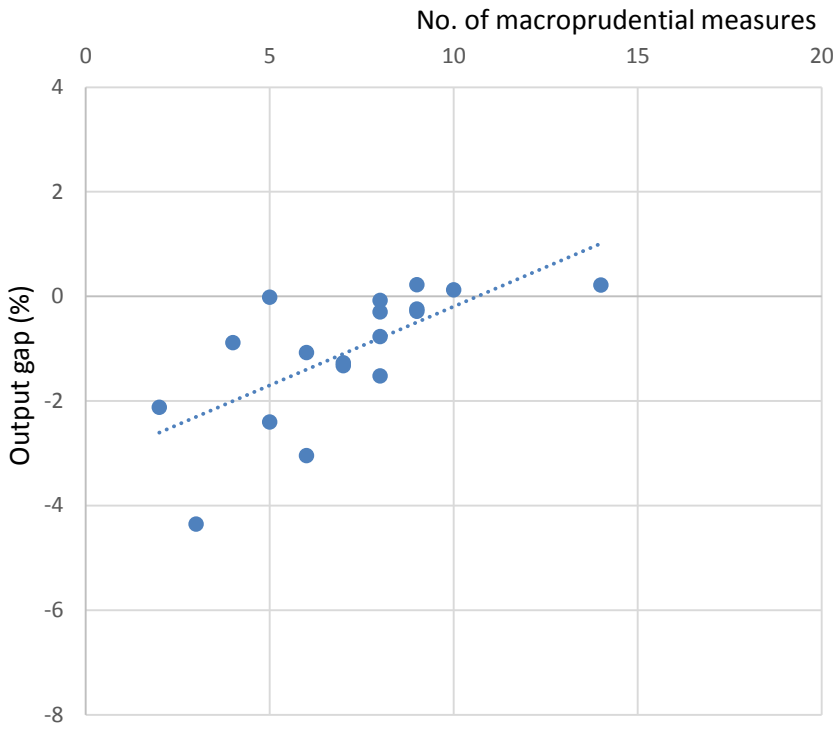
Trade-offs between monetary policy and macroprudential policy

1. Higher domestic interest rates could encourage FX lending if differential between local and FX interest rates is positive
   - A large share of FX loans in banks' balance sheets could jeopardize the stability of the financial system directly or indirectly
2. Lower domestic interest rates encourage risk taking
   - If risk taking reaches excessive level, it could fuel asset prices. Risk of assets price bubble may emerge.
3. Caps on LTV, DSTI, higher banks' capital requirements reduce access to credit and impairs transmission of monetary policy.

Trade-off between monetary and macroprudential policies

No. of macroprudential measures and the outputgap in EU countries (2014 – 2016)

Catching-up economies



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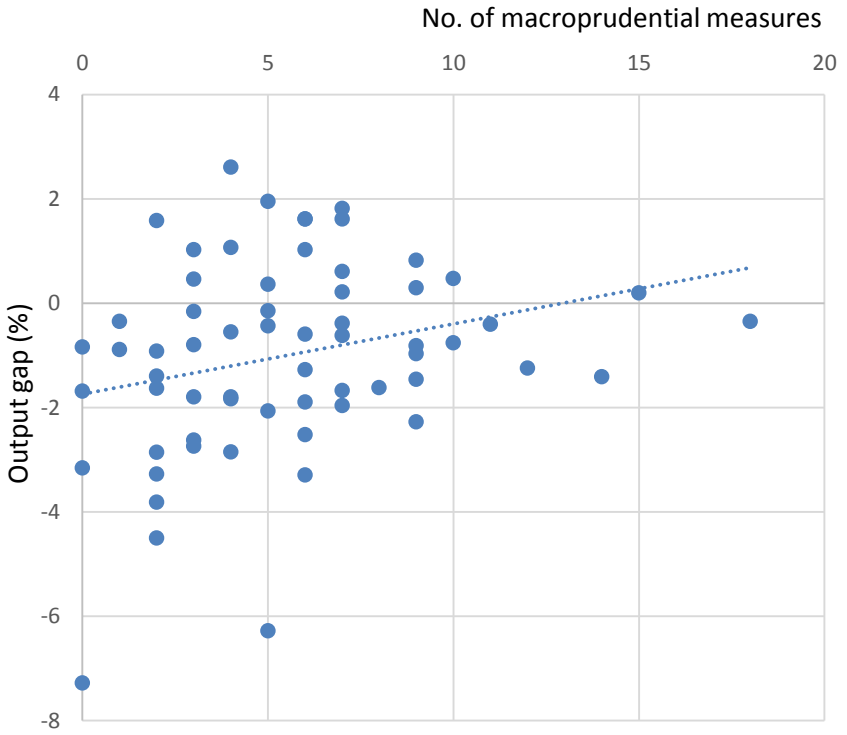
Source: AMECO, ESRB

Developed economies



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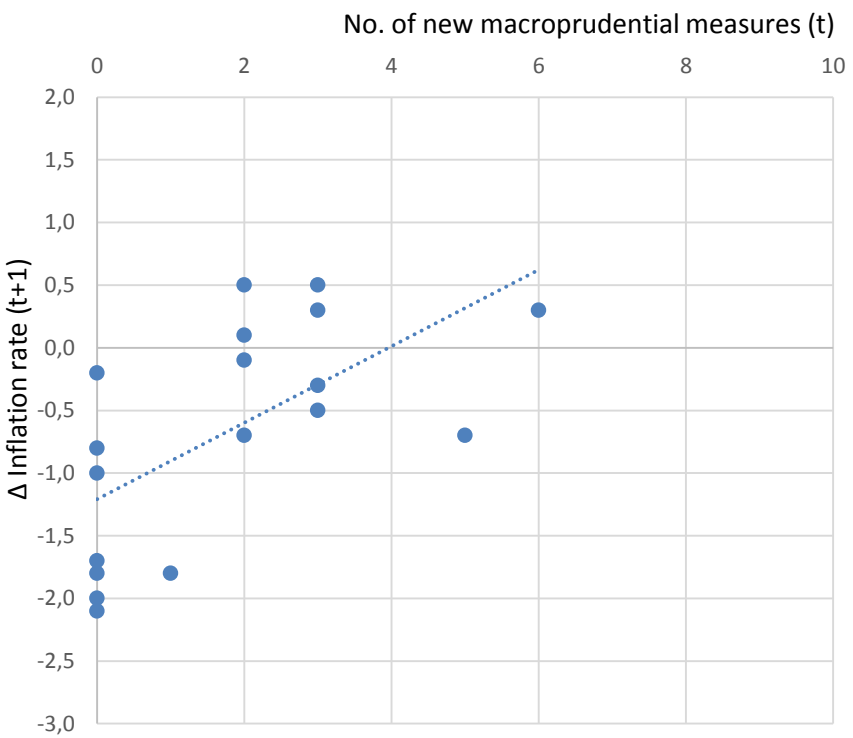
Trade-off between monetary and macroprudential policies (cont.)

No. of new macroprudential measures and variation of inflation rate in the subsequent year (2013 – 2016)

Catching-up economies



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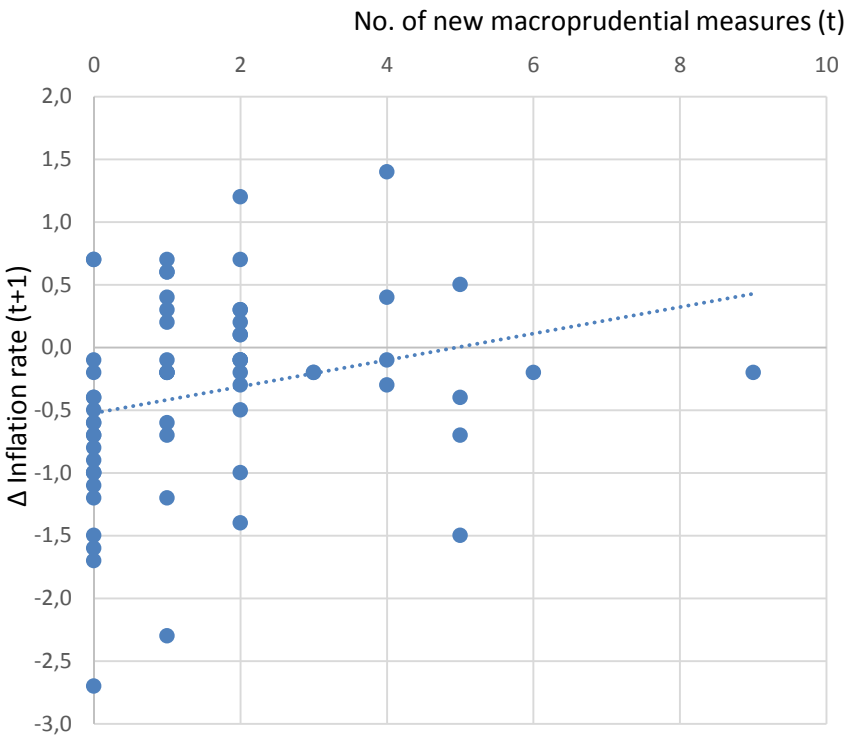

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Trade-off between monetary policy and microprudential supervision…

- Higher local interest rates put pressure on over-indebted borrowers. Part of them could enter default, threatening financial stability
  - Microprudential supervisors would ask banks for additional capital to cover losses, in case current micro and macro-prudential capital requirements do not cover all risks.
  - Financial stability can also be threaten by high NPL ratio due to the consequential losses for banks and potentially less credit supply

… but also between monetary policy and monetary policy

- Higher domestic interest rates could encourage FX lending if differential between local and FX interest rates is positive
  - FX lending alters the transmission of monetary policy, which has no impact on FX loans
  - Central banks are less able to respond to a financial shock by lowering interest rates when the share of FX loans in banks' balance sheets is significant

Trade-off between macroprudential policy and macroprudential policy…

- Macroprudential measures encourages financial services to migrate towards less regulated and supervised sectors (shadow banking). Such developments could impair financial stability.
  - Extending regulatory coverage to all financial sectors and activities mitigates migration risk to shadow banking. However, risk of financial innovation remains. Moreover, the trade-off between regulatory and supervisory costs, on the one hand, and benefits for financial stability, arises.

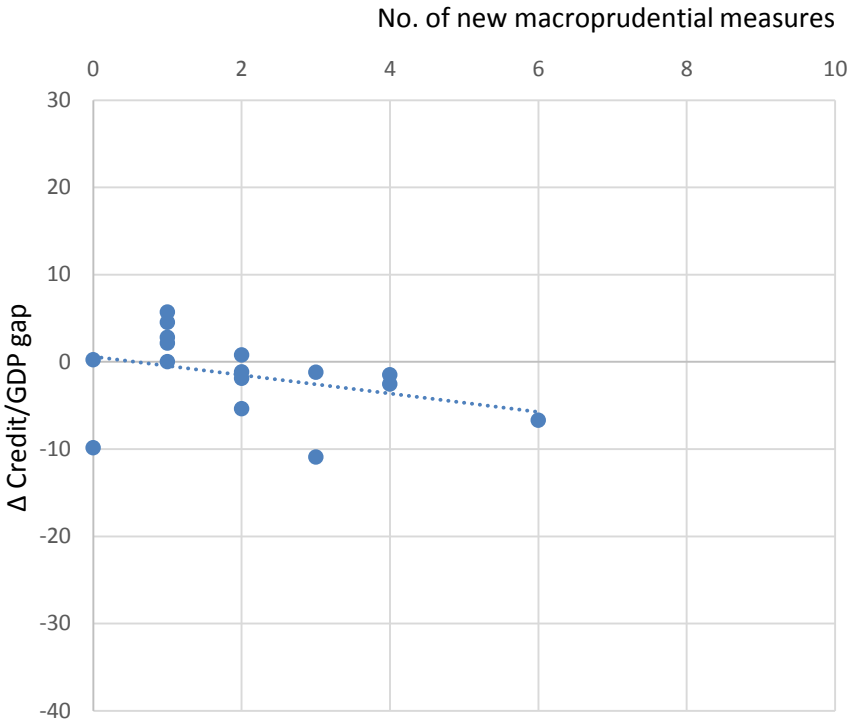
… but also between macroprudential policy and financial intermediation

- Capital buffers restrict lending capacity, therefore affecting profitability (for banks) and inclusion (for debtors)
- An efficient consumer protection supports financial intermediation. At the same time financial stability must be preserved.

Adoption of new macroprudential measures is associated with lower financial intermediation in chatching-up economies

No. of new macroprudential measures and variation of credit/GDP gap (2014 – 2016)

Catching-up economies



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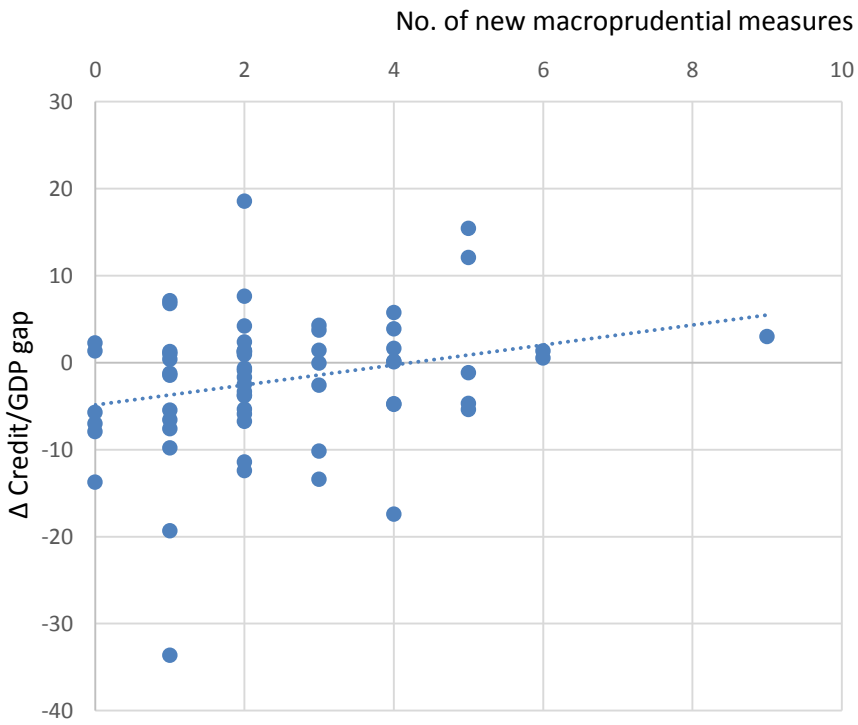
Developed economies



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Key messages

- We need a new consensus on the trade-offs of central banking, which is not constrained by economic and financial cycles
- Trade offs:
    - rules vs. discretion,
    - national vs. supra-national,
    - monetary policy vs. exchange rate policy,
    - monetary policy vs. macroprudential policy,
    - monetary policy vs. microprudential supervision,
    - monetary policy vs. monetary policy,
    - macroprudential policy vs. macroprudential policy,
    - macroprudential policy vs. financial intermediation
- Dogmatism and populism are equally detrimental to financial stability
- Central Banks have to fight them with common sense and a broader understanding of the trade-offs of their policies.

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