Macro-financial stability frameworks and external financial conditions

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Outline

- Introduction
  - Macro-financial stability frameworks (MFSFs): Nature and origins
- MFSFs and external financial conditions
  - Nature of policy trade-offs raised by swings in external financial conditions
  - Implications for MFSFs
  - Macroprudential features of FX intervention

MFSFs: Nature

- Policy frameworks designed to durably safeguard macro-financial stability by…
  - …mitigating the build up of vulnerabilities
  - ….building policy buffers to enhance resilience

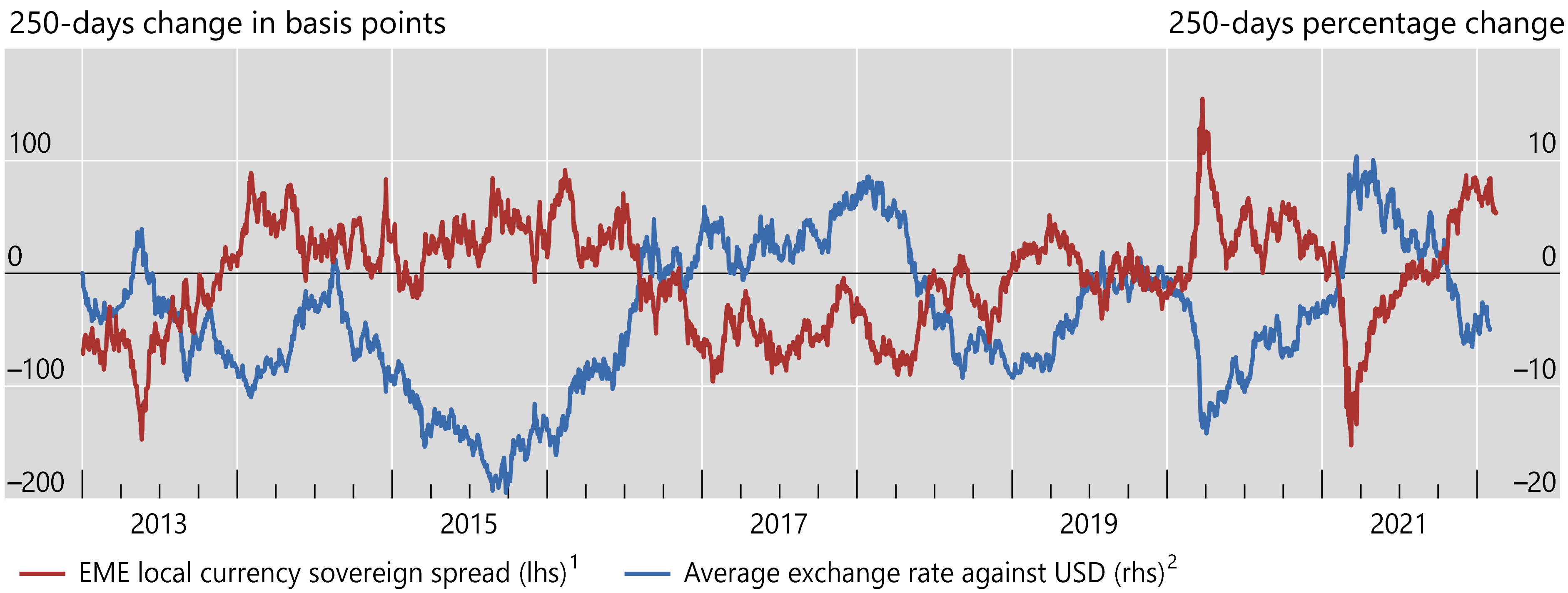
- Elements of an MFSF
  - Monetary and fiscal policy (BIS (2023))
  - Complementary policies
    - Macroprudential policies (MaPPs)
    - FX intervention

MFSFs: Origins

- Long tradition of work on MFSFs at the BIS
  - Crocket (2000), BIS (2004, 2005, 2008)

- Recent work on MFSFs and external financial conditions
  - BIS (2019)
  - Subsequent reports by member central banks (ACC (2020), CCA (2021))
  - BIS report to the G20 FMCBG (2022)

MFSFs and external financial conditions



[1] JPMorgan GBI-EM Broad diversified index spread over the 10-year US Treasury yield. [2] Weighted average using the country weights (excluding EG, DO, RO and UY) of the JPMorgan GBI-EM Broad diversified index as of 31 January 2022.

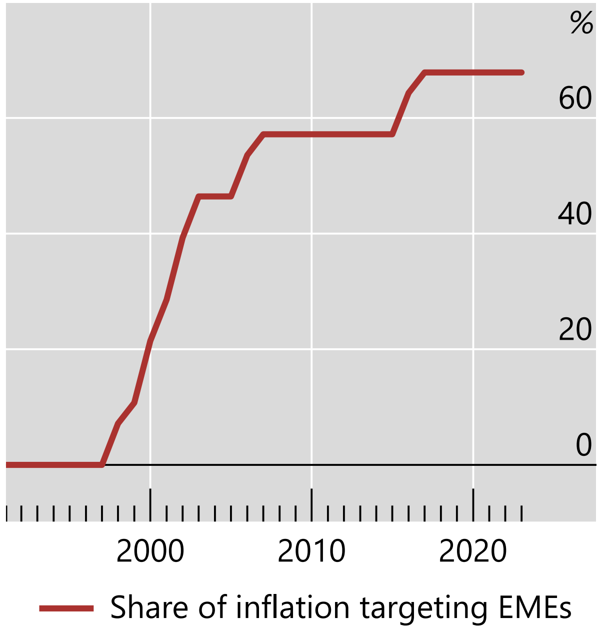
Sources: Bloomberg; JPMorgan Chase; BIS calculations.

External financial conditions and monetary policy trade-offs

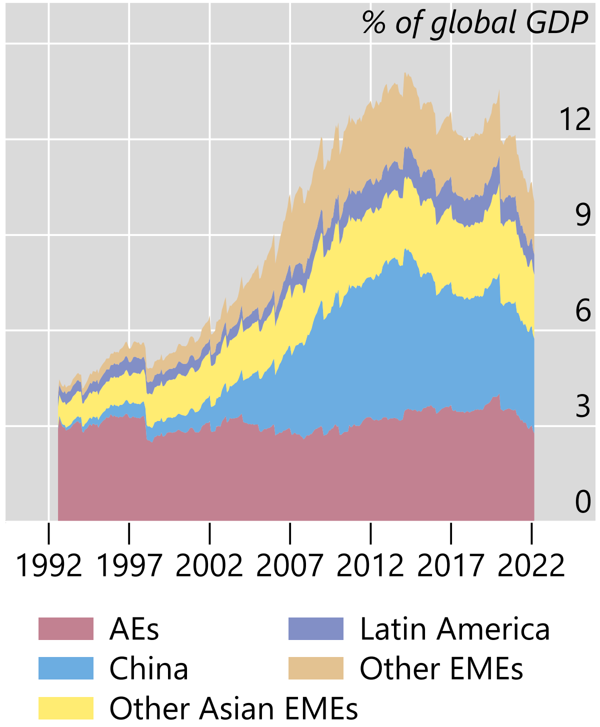
- Impact on domestic financial conditions gives rise to monetary policy trade-offs
  - Intra-temporal: inflation and output may be pushed in opposite directions (e.g. capital outflow may be inflationary and contractionary)
  - Inter-temporal: short- and long-run risks to price stability may be affected differently (e.g. capital inflow may be disinflationary but promote financial imbalances)
- MaPPs and FX intervention can improve trade-offs
  - Lean against imbalances and enhance resilience

Inflation targeting, FX reserves and macroprudential policies

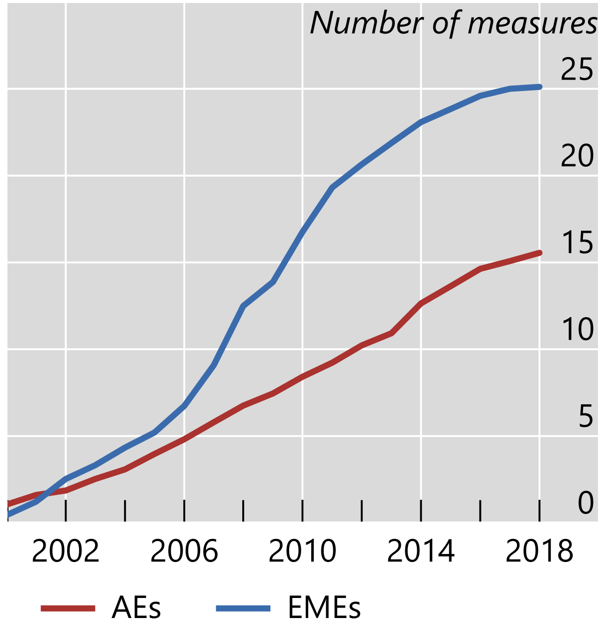
Inflation targeting



FX reserves



Macroprudential regulation

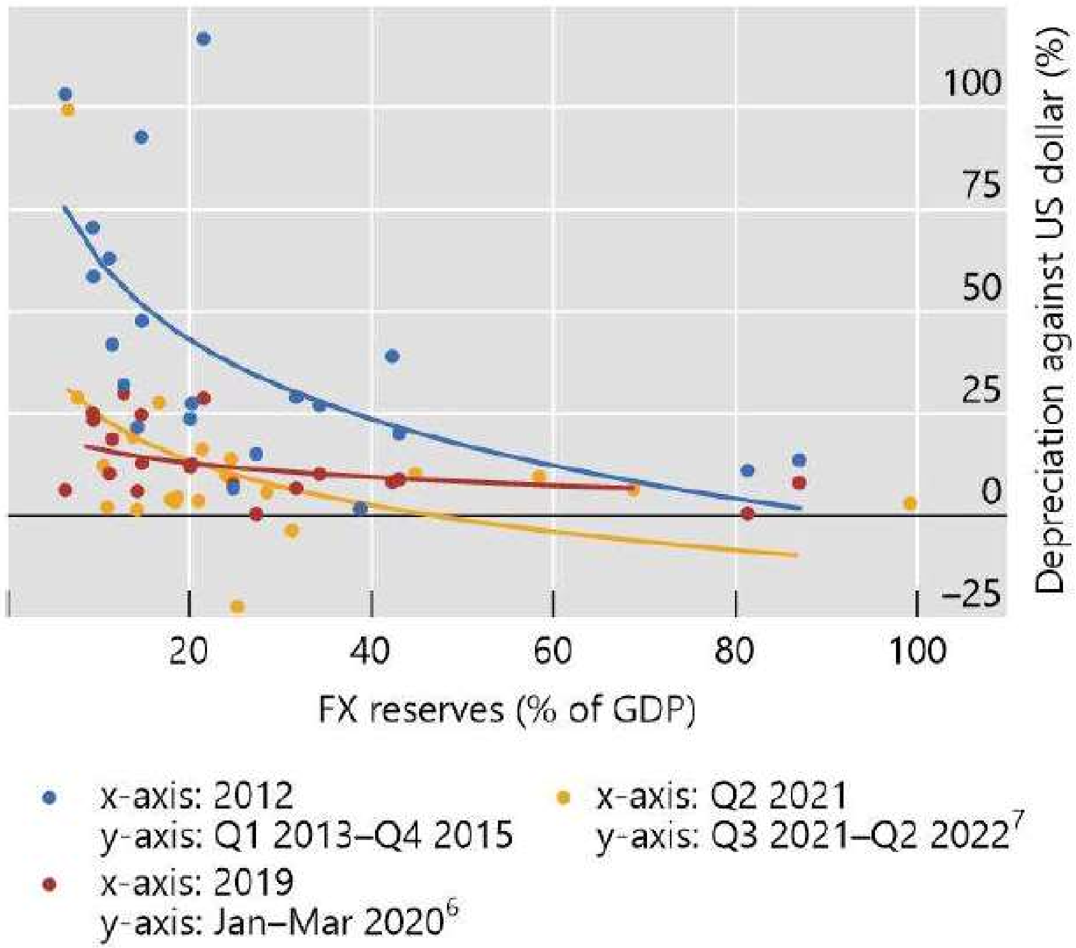


The macroprudential features of FX reserves

- Reserve accumulation for precautionary motives
  - Self-insurance against large devaluations and capital outflows and their repercussions on macro-financial stability

- FX intervention for stabilisation motives
  - FX intervention leaning against unwanted swings in the exchange rate and capital flows and their repercussions on domestic credit conditions

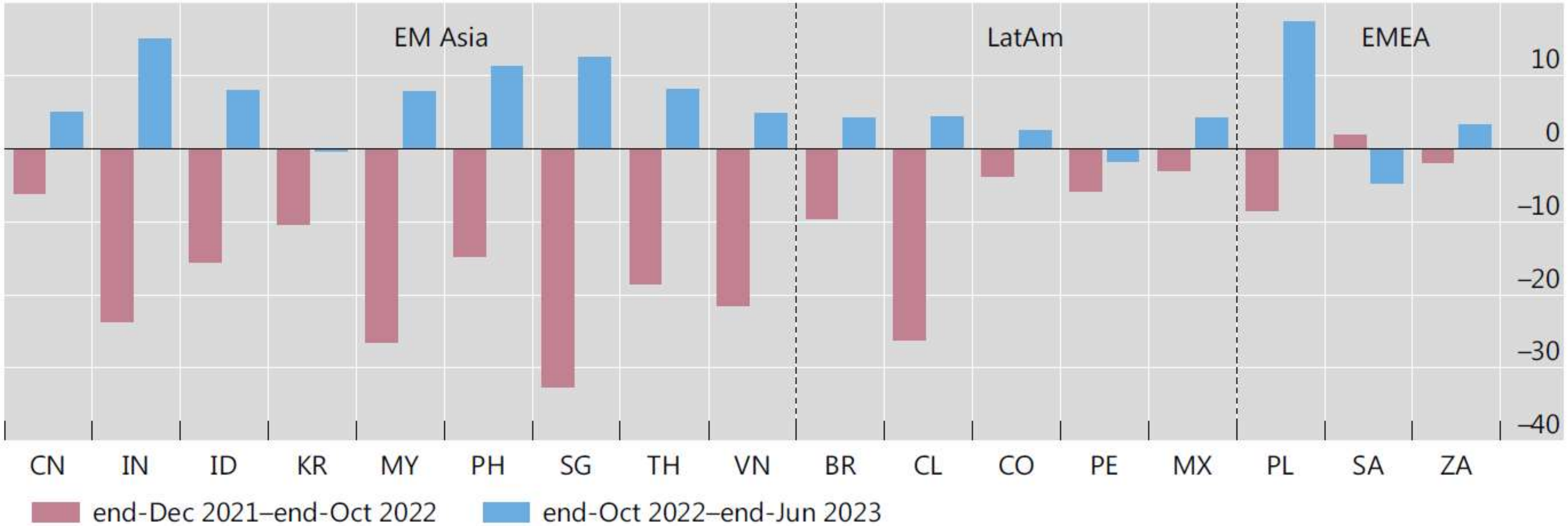
FX reserves cushion impact of major shocks in EMEs



Recent FX interventions

Change in FX reserves in 2022–23

In per cent



FX reserves include net forward positions.

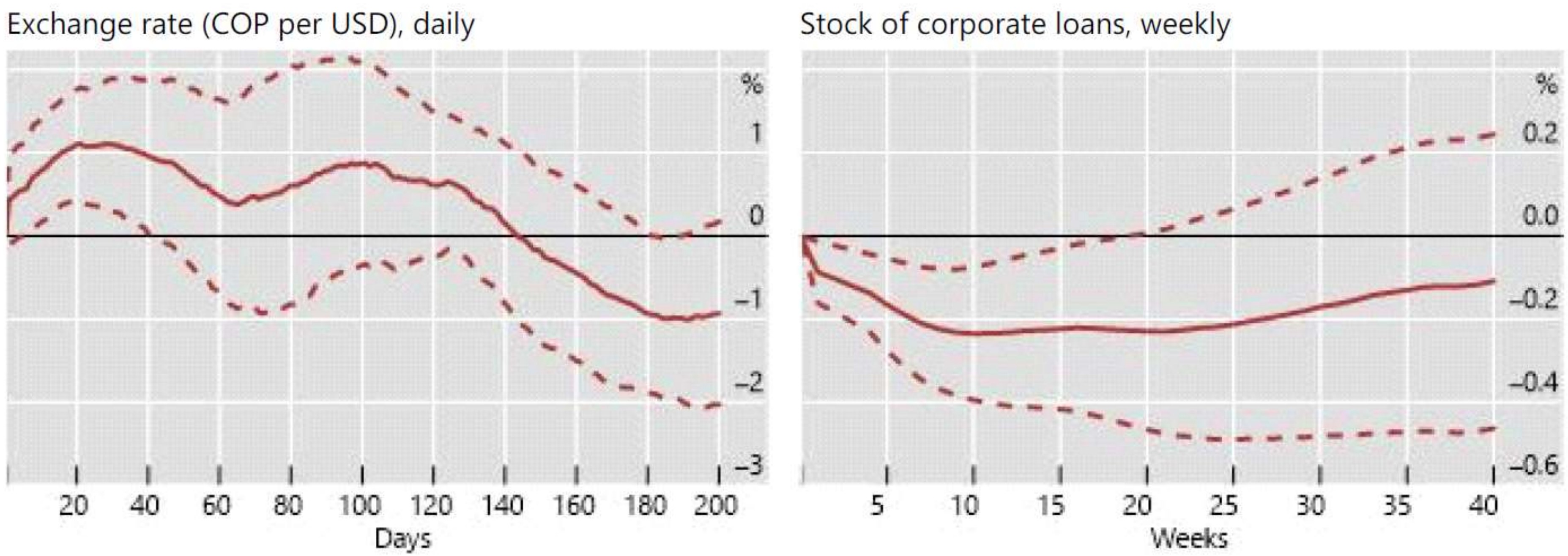
Sources: IMF; BIS.

FX intervention and credit conditions: Channels

- Exchange rate channel
  - FX intervention affects credit through exchange rate via currency mismatches (original sin/original sin redux)
- Sterilisation channel
  - Sterilisation operation altering bond supply affects credit supply through bank balance sheet constraints
- Sterilised FX purchases dampen credit expansion through two effects (Hofmann, Shin and Villamizar-Villegas (2019)) :
  - Exchange rate depreciation tightening financial conditions
  - Increasing the supply of bonds to be absorbed by banks limiting their balance sheet capacity

Dynamic impact of FX purchase shock

- Daily data for Columbia (Hofmann, Shin and Villamizar-Villegas (2019))



FX intervention and credit conditions: testing the channels

- Firm-level analysis testing the channels through firm-level FX debt and bank-level capitalization (Hofmann, Shin and Villamizar-Villegas (2019))

- The negative effect of FX purchases on new firm loans…
  - ….increases with FX debt of the firm (consistent with exchange rate channel operating through borrower balance sheets)
  - ….decreases with bank capitalisation (consistent with sterilisation channel)

Conclusions

- "Macroprudential" goes beyond MaPPs
  - Whole policy framework should incorporate macroprudential features (MFSFs)
- Swings in external financial conditions raise difficult trade-offs for monetary policy, making the case for activation of complementary policies
  - MaPPs
  - FX intervention
- FX intervention has macroprudential features that can help mitigate trade-offs (together with MaPPs)