

Financial variables in a policy rule

Does it bring macroeconomic benefits?

Context

- The recent financial crisis of 2008 has started discussion about a **connection between monetary policy and financial stability**.
- **Financial variables can signal** potential difficulties and **future developments**.
- Financial variables may convey useful information. Therefore, MP can react accordingly.
- Potential candidates: house prices, **asset prices**, spreads, **credit volume**,...
- **Augmented Taylor rule** with financial variable:

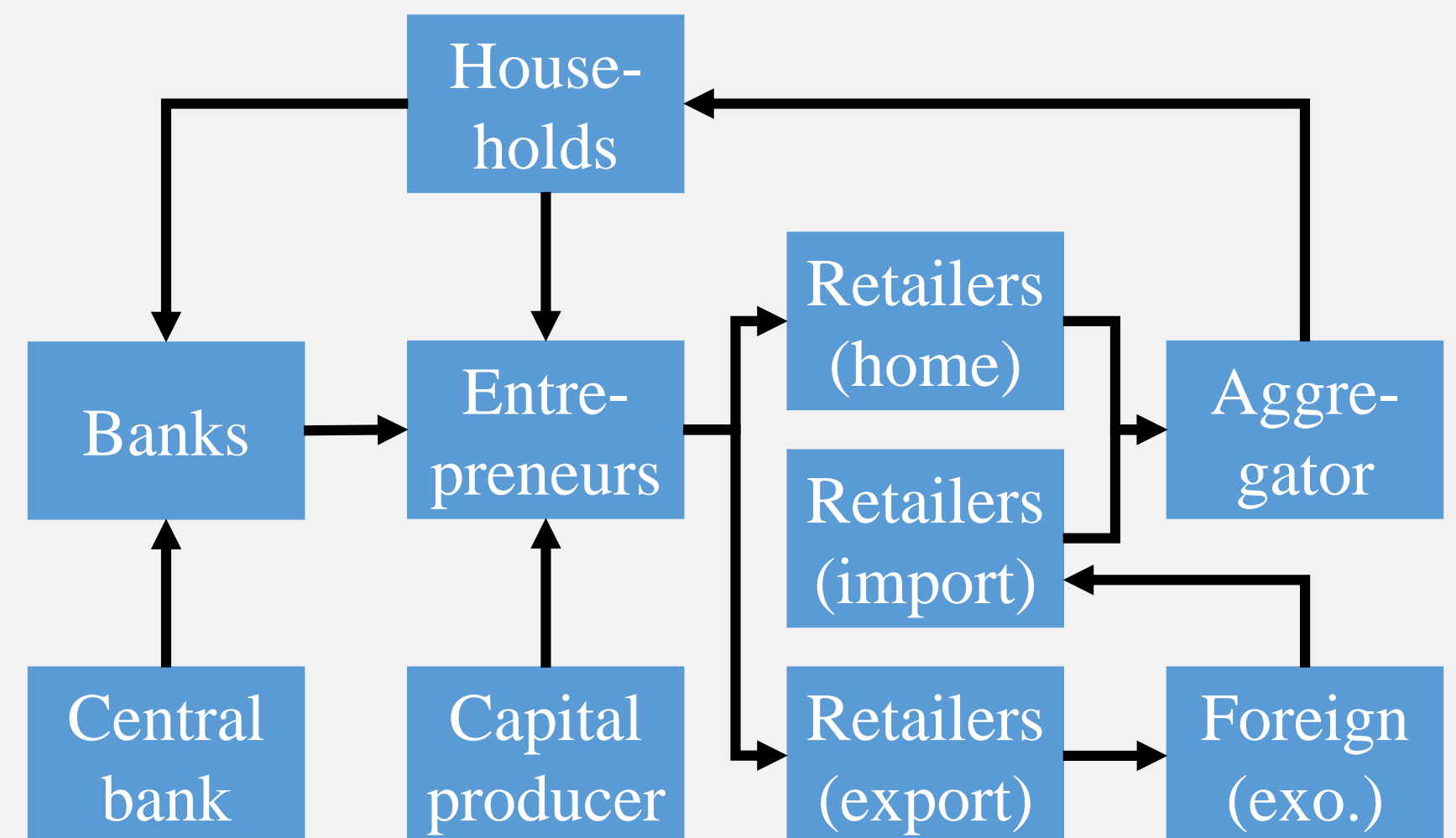
$$i_t = \rho i_{t-1} + (1 - \rho)(\rho_\pi \pi_t + \rho_y y_t + \rho_f f_t)$$

i_t ... the policy rate y_t ... output

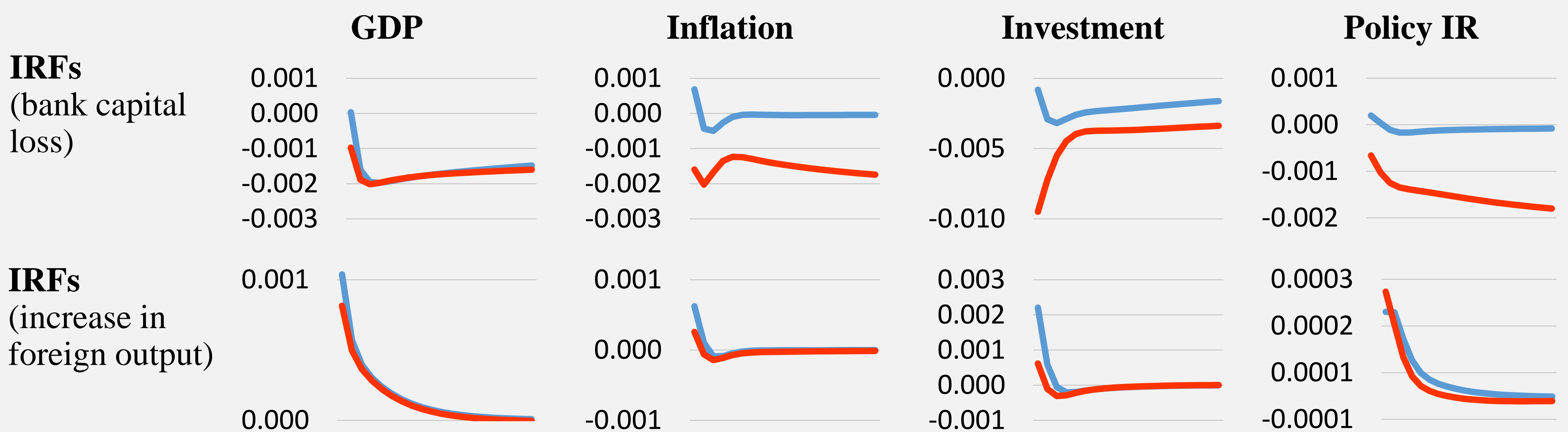
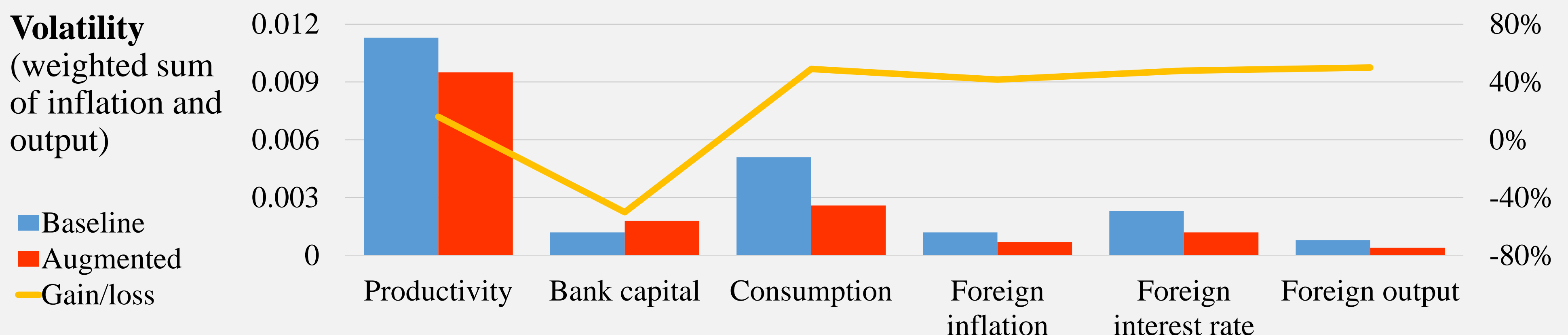
π_t ... inflation f_t ... financial variable

Methodology – model

- **NK DSGE model** for open economy – calibrated.
- Two **financial frictions** – collateral constraint, bank capital regulation.
- **Rigidities** – capital adjustment costs, capital utilization, Calvo pricing (all retailers).



Results



1 **Reacting** to developments of financial variables is **beneficial**.

2 The most apparent differences are in case of the **shocks originating abroad**.

3 There is a **strong link between the financial and the real side** of an economy.

4 **Conventional tools cannot deliver macroeconomic stability** in case of a sharp decline in bank capital.