ŁUKASZ KUROWSKI
Warsaw School of Economics, Poland

MONETARY POLICY AND FINANCIAL IMBALANCES

Abstract:

Before 2008 there was a consensus that achieving price stability also ensures financial stability. Yet, the global financial crisis revised this paradigm and showed that price stability is a necessary, but not a sufficient condition to maintain financial stability. Therefore there is a need for macroprudential policy to constrain systemic risk and strengthen the resilience of the financial system. The objective of the article is to analyze monetary policy stance towards financial imbalances. Thus, we compare our financial imbalances index calculated for 20 countries over the period 1999Q2 to 2017Q2 with real interest rate gap (as a proxy to monetary policy stance, see Holston-Laubach-Williams 2017). The index covers 4 sectors (financial sector, financial markets, real economy and global factors) proxied by different variables, which are commonly used in early warning models of financial crises. We aggregated variables into index using different approaches. For the index we draw receiver operating characteristic curve to check performance of the index in crisis prediction. We found that monetary policy strengthens financial imbalances in almost 14% of observations. However the results point to high heterogeneity across countries. The share of observations when monetary policy could strengthen financial imbalances is higher in euro area countries (PT, IT, ES) and less prominent in economies with independent monetary policy (JP, KR, SE). One of the reason could be too expansive ECB's monetary policy in the analyzed period.

Keywords:

Monetary policy, financial stability, financial crises

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