

MACROPRUDENTIAL CAP ON DEBT-TO-INCOME RATIO AND MONETARY POLICY

Pasquale Filiani (Ph.D Luiss University of Rome)

pfiliani@luiss.it

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EXTENDED ABSTRACT

The recent financial crisis has sparked many debates concerning the main cause that presumably led the financial system to collapse in such tremendous way. Undoubtedly, one of this cause is the credit boom that occurred prior to the crisis. In this regard, a macroprudential policy like a countercyclical rule for the cap on debt-to-income (DTI) ratio is explicitly designed to avert a likely credit boom and therefore mitigate the risk of financial instability. In the paper, I study the effects of this macroprudential policy in a New Keynesian DSGE model, which is estimated over the period of the build-up of household debt occurred in US before the financial crisis.

Following some prominent literature, I assume that the shock that triggers the credit boom is an housing preference shock, that leads to an increase in house prices which in turn translates into an appreciation of the collateral constraint and therefore generates a credit boom. Model estimates suggest that over the years of the credit boom credit supply has been tied to real estate values to a far larger extent than labor income. Therefore, I show that an optimal macroprudential policy would call for enlarging the role of labor income in credit supply decision, which would eventually lead to greater financial stability both in the long-run and in the short-run. Moreover, the optimal macroprudential cap on debt-to-income ratio helps stabilize the economy

and is beneficial in terms of social welfare if the cap on DTI is targeted to reduce the deviation of household debt.

The implementation of an efficient macroprudential policy leads to an important discussion about the role of monetary policy during a credit boom. To this end, I first consider optimal macroprudential policy in combination with the optimal conduct of monetary policy, when this is enforced as a standard Taylor rule. It turns out that the standard Taylor rule performs noticeably better when accompanied by a macroprudential policy like the countercyclical rule for the cap on DTI.

But should central bank be also concerned about financial stability ? To answer to this question, I consider a monetary policy rule augmented with financial variables, so that central bank may “lean against the wind” of a likely credit boom. Remarkably, the analysis shows that this policy is welfare-dominated by the strategy of assigning the goal of financial stability to a macroprudential authority committing to optimally implementing a countercyclical rule for cap on DTI. However, the best-performing policy is a combination of "leaning against the wind" strategy and macroprudential policy, which ensures the largest stabilization of household debt .