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Macroeconomic and financial stability in a monetary union: The case of Lithuania

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Highlights

- We study the implications of macroprudential policies for macroeconomic and financial stability in Lithuania and the rest of the euro area.
- We consider two different scenarios for macroprudential policies: one in which the ECB extends its goals to also include financial stability, and a second one in which a national macroprudential authority uses the loan-to-value ratio (LTV) as an instrument.
- The results show that both rules are effective in making the financial system more stable in both countries, and especially in Lithuania
- We find that an extended Taylor rule is indeed effective in reducing the volatility of credit but comes with a cost in terms of higher inflation volatility.
- The simple LTV rule does not compromise the objective of monetary policy.

Abstract

In this paper, we study the implications of macroprudential policies in a monetary union for macroeconomic and financial stability. For this purpose, we develop a two-country monetary union new Keynesian general equilibrium model with housing and collateral constraints, to be calibrated for Lithuania and the rest of the euro area. We consider two different scenarios for macroprudential policies: one in which the ECB extends its goals to also include financial stability and a second one in which a national macroprudential authority uses the loan-to-value ratio (LTV) as an instrument. The results show that both rules are effective in making the financial system more stable in both countries,