Macroprudential Policies: What Next?

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Introduction

We tend to think of macroprudential policies as being something new and very likely to be effective. They are neither. The first mention of macroprudential policies was by Peter Cooke in 1979, at a meeting of banking supervisors at the Bank for International Settlements (BIS) . He was worried about the systemic impact on both borrowers and lenders of the large scale capital inflows into emerging markets associated with the increase in oil prices. More specifically, he was concerned that these systemic weaknesses would not be picked up by a supervisory process that was focussed on the health of individual financial institutions. This focus on systemic issues was a subsequent feature of the Holland (1980), Cross (1986), Promisell (1992) and Brockmeijer (1995) reports coming out of the BIS. So, not so new.

As of 2007, when the current crisis began, not much had happened in terms of serious efforts to reduce systemic concerns. While there were certainly lots of Financial Stability reports warning about risks of various sorts, practical measures to reduce those risks were in short supply. One reason was that there was continuing uncertainty about what precisely the problem was, and even more uncertainty about what to do about it. I was asked to summarize a day's discussion of these issues, by top officials and leading academics, at IMF meetings in 2013 and 2014. Even given that we were ready well into the current crisis, there was no agreement as to its cause, how to manage and resolve it, or how to prevent new crises of similar kinds. So, no agreement on the effectiveness of macroprudential policies either. On reflection, there seem to be no magic bullets.

Let me take a few minutes to give my views on some of these issues. It is important to make a distinction between the role of macroprudential polices in preventing crises and in helping manage them once begun. Most of the analysis has gone into the former, but most of the recent use of such policies has been in response to the latter. My view is that we have not thought hard enough about this latter issue. If macroprudential policies simply allow interest rates to stay "lower for longer", with many unintended consequences, might they not be making things worse not better?

Crisis Prevention

What is the problem? How did we get into this current mess? I want to assert that the problem has been excessive credit and debt creation, reckless lending and borrowing, due both to new financial innovations and to too easy monetary and regulatory conditions. Moreover, historical studies of earlier crises indicate that this has almost always been the case. Further, history teaches us that when both the real and the financial sides of the economy have been weakened, the crisis can go on for a decade or more. In this context, it is important to note that the financial weakness need not be the trigger for the problem. Reinhart and Rogoff have noted that, in fact, most serious crises begin with a recession in the real economy that then feeds back on the financial side.

This last observation is very important, since it indicates that financial stability is not sufficient to avoid serious economic downturns. Consider Canada in the 1930's. It suffered a serious depression in spite of the good health of the banking system. Perhaps more arguably, Koo argues that the Great Recession in Japan was much more due to deliberate and extended corporate deleveraging than to weakness in the banking system. Similarly, it must be noted that price stability is not sufficient to avoid serious economic downturns. There was no inflation in the United States prior to the Great Depression, nor in Japan prior to their Great Recession, nor prior to the South East Asia crisis and so on. The implication is that we must look beyond the avoidance of price and financial instability, which are mere symptoms, to the underlying problem of excessive credit and debt creation and to all of the dangerous imbalances that this can lead to.

What is the solution? The old Fed view that we cannot use policies to "lean" against the credit cycle but we can easily "clean" up afterwards must now be totally discredited. Seven years into the crisis, after unprecedented polices of monetary easing, the crisis rolls on and indeed has gone global. Many fear that we are as exposed to future turmoil as we were in 2007, and note in addition that our macroeconomic policy instruments are effectively all used up. No Easy cleaning here.

What might have been done, and what might we do to prevent future crises? I suggest that we should "lean" against the credit cycle with a view to reducing the Expected Loss arising from any subsequent crisis. This implies reducing

both the Probability of the Crisis and the Loss Given a Crisis. Many different policy measures can affect both of these elements, though to date the former (eg, higher capital requirements) has received more attention than the latter (eg, cutting complex ties between financial institutions). “Leaning” has the merit that, in reducing the size of the “boom”, it also tend s to reduce the amplitude of the “bust.

How best to “lean”? The problem is that both monetary policy and macroprudential instruments have their shortcomings. Higher interest rates have widespread effects and may hurt sectors that we do not wish to hurt. Some contend that the lack of responsive of credit issuers might imply interest rates would have to rise very far indeed. For small open economies, the implications for capital inflows and the exchange rate might be very uncomfortable. In contrast, as Governor Stein recently said, tighter money “gets into all the cracks”, perhaps not least the financial cracks of excessive leverage. Thus, tighter money might be more efficient in leaning against the credit cycle than many think.

As for macroprudential instruments, they too have shortcomings. Evasion and corruption will be a natural side effect, and these tendencies will grow over time. Think of how regulations on banking led to the growth of the “shadow banking system” prior to the crisis, which proved an even more procyclical provider of credit than the banking system itself. If these tendencies then lead to regulatory reactions, the end product is likely be a system of such complexity that in the end no one understands how it works. This is a recipe for both inefficient finance and eventual chaos.

It is also a fact that macroprudential instruments almost always have distributional implications. This invites political interference which has many unwanted implications, not least for the ”independence” of the official agencies involved. Finally, it should be noted that recent studies of the efficiency of macroprudentail instruments shows very mixed results. For example, dynamic provisioning in Spain and higher Loan-To- Value ratios in Hong Kong clearly failed to avoid massive increases in house prices in both cases. Admittedly, the banks that made the loans were in much better shape when the crisis hit.

What do I take from all this? We will likely have to use both monetary measures and macroprudential instruments to lean against excessive credit and debt creation. Moreover, for two reasons, this will have to be done in a

coordinated way, across responsible agencies. First, both sets of measures affect lending/borrowing decisions and the level of aggregate demand. We cannot therefore split up the mandates for price and financial stability, even supposing that achievement of these mandates would be sufficient to avoid broader macroeconomic problems. Second, it is a fact that most macroprudential tools are actually just microprudential tools (eg varying capital ratios over the cycle) being used for macroprudential purposes. Evidently some form of coordination will be essential.

Given this, what are the implications for the choice of an institutional framework for the pursuit of systemic stability? Today, the "financial stability" mandate is based on a very different institutional structure in the major advanced economies. It ranges from the UK, where the Bank of England plays a central role in the pursuit of both price and financial stability, to the Eurozone, where the European Central Bank has microprudential responsibilities but not macroprudential respsonsibilities.

Note further that the problem of "who should do what" extends well beyond the issue of monetary policy and macroprudential instruments. Governments are also responsible for microprudential supervision of banks, securities market oversight, insurance and pension fund oversight, conduct of business issues and a host of other things. The IMF recently looked at the institutional structure for financial oversight in a large number of countries, and it then classified them as belonging to seven different models. In short, there was no overall model derived from some theory of how things should be organized. Indeed, in virtually every country, the model chosen seemed to be nothing more than an historical accident.

Against this backdrop, I recognize that I am brave (foolhardy?) to suggest we can say something more about the organizational structure that might best contribute to systemic stability. Assuming that we begin with the institutions we currently have, the "Who should do what" question might be best answered by applying the "should, could and would criteria". What institution seems best placed to determine what **should** be done to ensure systemic stability? Here the central bank would seem best prepared to think systemically. Especially in emerging market, it might already house much of the more limited analytical capacity available. Which institution **could** act in the most efficient way because it has the power to do so? Given the different institutional approaches noted above, this criteria might seem to call for

changes in legislation to some more optimal model. Finally which institution **would** be more likely to act, to take away the punch bowl as the credit cycle entered a dangerous stage. Again, central banks would seem to me to get the nod.

I do not wish to say the Bank of England model is perfect. There are convincing grounds for being worried about putting too much power in the hands of unelected officials. As well, distributional issues associated with the use of macroprudential instruments threaten political interference with the central bank and a loss of its independence. To paraphrase Winston Churchill, this arrangement might only be less bad than all the others. In any event, given the variety of institutional arrangements still out there, the unfolding of events might soon show us which arrangements work better than others.

That is enough on crisis prevention. Let me only remind you that, what might have been done, was evidently not done. The proof is that we continue to muddle through the worst economic and financial crisis since the 1930's.

Crisis Management

Since the crisis began, the principal instrument used to fight it has been ultra easy monetary policy. To the very limited extent that policymakers have been prepared to admit that these policies might have undesirable medium term consequences – say bubbles in asset prices – they also contend that macroprudential policies might be used to reduce these spillovers. In effect, macroprudential policies become a mechanism allowing "lower for longer" monetary policy to continue. Personally, I believe this is a dangerous misperception.

First, if monetary policy and macroprudential policies were to be used to help prevent credit bubbles, they would be tightening at the same time. In contrast, in crisis management mode the two policies are working at cross purposes. I think this would severely amplify the downsides of macroprudential policies described above. Further, it would add to the confusion of the current world in which monetary policy is set firmly on the accelerator whereas microprudential policies seem set firmly on the brake. Overall, we do not have our act together.

Second, easy money since the crisis has generated so many imbalances, it is difficult to imagine macroprudential policies that could significantly cope with all of them. Debt levels are much higher than in 2007, with emerging market

issuers accounting for over 50 percent of it. House prices and household debt have soared in virtually all countries that maintained a healthy banking system. The prices of financial assets also seem highly extended, and potentially prone to reversal. Insurance companies and pension funds are also suffering, with still more imprudent investing often the result. Finally, real side misallocations of resources have grown even further, not least in China and in commodity producing countries. If the prospective use of macroprudential policies has allowed these imbalances to widen, then the costs exceed the benefits.

Third, it is worth noting that many countries faced with these undesired side effects have already turned to macroprudential tightening but the effects of these measures are hard to discern. In Canada, Switzerland, the Nordic countries and elsewhere, public sector officials remain seriously concerned about the prospects for the household and housing sectors. In the emerging markets, in spite of using macroprudential measures to moderate both capital inflows and outflows, many economies have already slowed significantly and they remain seriously exposed to possible rate increases in the advanced market countries.

Conclusion

I end where I began. Macroprudential policies are not new, and it is not at all clear how effective they might be. This applies to their use in crisis prevention but especially in crisis management. Indeed, in the latter case, these instruments get in the way of crisis resolution because they help perpetuate the myth that monetary policy is the key to restoring the "strong , sustained and balanced " growth desired by the leaders of the G20. In fact this can only be assured if governments take steps to resolve the overhang of debt in many countries. Central banks can help solve illiquidity problems but they cannot solve problems of insolvency.