

Macroprudential Regulatory Policies: The new Road to Financial Stability

Panel Remarks by William White: “Where to from here?”

A. The Pursuit of Financial Stability in the Past

The various financial crises of the late 1980s and 1990s confirmed to policymakers the importance of “financial stability” issues. Moreover, given that some of these crises seemed to affect the financial system as a whole, the need to augment the previous “bottom up” approach (focussed on the health of individual institutions) with a “top-down” approach (focused on systemic interactions) became much more evident. In the wake of these crises, a number of central banks set up separate Financial Stability Departments. As well, there was an explosion of Financial Stability Reports by a variety of national central banks, independent regulatory agencies and international financial institutions. The establishment of the Financial Stability Forum in Basel provided a more formal recognition of the importance of this subject for the global economy as a whole.

The ongoing economic and financial crisis has drawn still more attention to the need for financial stability. One reason for this sharpened focus was that the crisis began in the financial sector, specifically in the markets for subprime mortgages and the structured products based upon mortgages and other assets. Moreover, as these bad credits increasingly threatened banks and other financial institutions, there were increasing fears that concerns about insolvency would lead to a general tightening of credit conditions with effects on the real economy. More pernicious, a focus on problems in the financial sector also made it more convenient to blame the crisis on greedy bankers. In this process, attention was also shifted away from other involved parties who might have contributed in different ways to the debacle; not least, regulators and central bankers. I will return to this.

In the light of these accumulating concerns about financial stability, a number of "macro prudential" measures to promote stability have recently been decided upon. These measures are designed to make the system as a whole healthier, not least by “leaning against the wind” of excessive credit growth

during economic upswings. The announcement of the Basel 3 agreements in September 2010 indicated that both the quality and quantity of bank capital will be raised. As well, an additional "conservation" capital buffer will have to be built up by regulated financial institutions. Since this buffer will presumably be built up from earnings in good times, this provision should have a countercyclical effect. In addition, Basel 3 stipulates that an explicit "countercyclical" capital buffer can be demanded by national regulators if credit growth appears to them to have been excessive.

It also seems clear from the Basel 3 documents, and subsequent statements from the Financial Stability Board (an upgraded Financial Stability Forum), that much more attention will be paid in the future to Systemically Important Financial Institutions (SIFI). Policy measures will be introduced both to reduce the probability of failure as well as the systemic costs should a SIFI nevertheless fail. Indeed, the Swiss National Bank has already announced that the two largest Swiss Banks will have to hold capital significantly in excess of the norms determined by Basel 3. Further, the Committee on the Global Financial System, which also has its Secretariat at the BIS in Basel, has in the last few months issued reports on the related issues of haircuts, leverage and experience with the use of macroprudential instruments to lean against perceived credit bubbles. In sum, a great deal of work has already been done.

Casting the net beyond Basel, the documents prepared by the Financial Stability Board for the forthcoming G20 Summit in Seoul, Korea, also give a clear commitment to the pursuit of financial stability, in particular through resisting systemic threats.

"A clear lesson from the crisis is the need for much stronger focus on systemwide or macroprudential risks. They threaten the safety and soundness of the financial system as a whole".

All these developments to date are surely welcome. Financial stability is a good thing, as is the insight that systemic issues constitute a particularly grave threat to financial stability. Nevertheless, the question I now wish to raise is whether financial stability is "enough"¹ to ensure macroeconomic stability? Or, rather,

¹. This is a parallel question to one I raised a number of years ago; "Is Price Stability Enough" to ensure macroeconomic stability. See White (2005). The answer given to both questions is no.

whether there is a danger that focussing policy on developments **within** the financial sector might be causing us to take our eyes off developments **outside** the financial sector. In particular, developments affecting private sector spending and balance sheets could potentially be an even greater threat to sustainable global growth.

B. Is Financial Stability “Enough” to Guarantee Macroeconomic Stability?

Reinhart and Rogoff (2009) have recently published persuasive evidence from economic history that credit driven “booms” are very common, and that they generally end in “busts”. Moreover, Reinhart and Reinhart (2010) document that “busts” associated with financial crises are particularly costly in terms of lost output, and these effects can last as long as a decade or even more. The fact that most of these downturns look very similar, in spite of policy responses which are generally more aggressive than in normal downturns², would seem to indicate that ex ante policy responses are not very effective. This would seem to put a premium on avoiding credit booms in the first place.

Both on the way up, and on the way down, the real and financial sectors are intimately interrelated during the credit cycle. In the upswing, some piece of “good news” (an advance in technology, newly discovered resources, etc.) leads to an increased demand for credit which fuels both spending and asset prices. These developments generate both more optimism, and more collateral, and more lending in turn. This process ends when the initial “rational exuberance” becomes “irrational” and eventually is seen to be so. Credits thought good on the way up are then revealed as bad in the downturn, which can then lead to significantly tighter credit conditions. Moreover, any economic downturn, regardless of its cause, will also cause bad loans to increase and in turn credit conditions to tighten as well.

The importance of these real-financial interrelationships being agreed, it is important to note as well that prior financial instability is not needed to generate deep economic slumps. In fact, Reinhart and Rogoff (2009) note that most deep downturns in history began on the real side, with the financial system being only sometimes hit badly at a second stage. Moreover, they also note that, in many cases, deep slumps occurred even though the financial

² For documentation of these policy responses, see International Monetary Fund (2008) and International Monetary Fund (2009).

system stayed healthy; e.g., Canada, Mexico and Indonesia during the 1930's, and Hong Kong on many occasions.

If it is not necessarily financial instability that causes deep slumps, what does? I think we have to go back to preWar economic thinking (especially the Austrians) with their emphasis on credit driven booms that create "imbalances" of various sorts. To be sure, it is now agreed that some of these imbalances are financial³. Elevated asset prices, and excessive leverage that exposes financial institutions to losses of various sorts, must clearly be highlighted. Yet many of the "imbalances" generated by a credit boom are not financial but real. Think of household saving rates in the United States, the United Kingdom and a number of other countries that over recent years fell to zero or even less, under the influence of easy credit. Consider too that the ratio of fixed investment to GDP in China has now risen to almost 50 % of GDP, again under the influence of easy (and politically driven) credit. Even at the height of the Japanese boom, this ratio never exceeded 25 percent. By definition, "imbalances" are unsustainable. It is when they revert towards historical means, generally under the influence of the debt burden associated with credit driven spending, that the slump deepens and widens⁴.

A further real side imbalance, associated with credit driven demand, is that sectoral production capacities in well functioning economies speedily respond. Thus, when demand collapses, there are excessive resources in areas where they are no longer needed. Today, among the industries that have gotten too big, we would have to include financial services, construction, automobiles, trucks, global distribution networks (etc.) and many other industries (like steel and concrete) that support them. These industries will have to shrink. Moreover, if global trade imbalances are also "unsustainable", as I think they are, we have many countries (China, Japan and Germany among others) that are all geared up to sell to people who are now so indebted they no longer wish to borrow and buy. As all these resources have to move to alternative uses,

³ The Austrian focus was almost entirely on imbalances in the real economy. There was generally little recognition of how the financial institutions themselves could be threatened by the inability of lenders to repay loans. For these kinds of insight, see Minsky (1992).

⁴ It is often asserted that the "Great Recession" in Japan was a by product of a severely weakened banking system. Koo (2009) makes a very convincing case that the problem was not an adequate supply of credit. Rather there was inadequate demand as corporations ran down debts for over a decade in response to excessive (unprofitable) investment spending in the preceding boom period.

there will be an increase in frictional or even structural unemployment that could go on for a very long time.

To summarize, financial stability is important to support economic growth and financial instability can be costly. But the underlying problem of excessive credit growth has important implications, not only for the health of the financial system, but also for the real economy. Perhaps, in consequence, we should then focus more on the underlying macroeconomic problem rather than primarily on those particular symptoms arising in the financial sector.

c. Two Important Practical Implications

Accepting that deep slumps have their roots in both real and financial imbalances, and that these in turn are driven by credit excesses, has two very important practical implications. The first has to do with the number of policy agencies that might be optimal to help prevent deep slumps from happening. The second has to do with the role of monetary policy, if any, in measures that might be taken to prevent deep slumps. Should monetary policy “lean against the wind” of the credit upturn, thus moderating both the upturn and the subsequent downturn, or not?

On the first issue, if financial stability is a means to an end (macrostability), rather than an end in itself, then it is hard to see the logic of having two "independent" agencies pursuing separately the two sub-objectives of price and financial stability⁵. This point has recently been made in the context of some proposed institutional changes in the United Kingdom. Suppose that the Bank of England has two separate committees, as is being currently suggested, to deal with monetary and financial stability respectively. The point to emphasize is that the instruments used by each committee will have an influence on credit growth and, in turn, will affect both the real economy and the financial system. Policy changes made by one committee will then change the conditions presumed in the decisions taken by the other committee. Concerns have been raised in the UK that, in extremis, this could lead to a “fight to the death” as to whose priorities will prevail. I will return in a moment

⁵ Laidler (2007) reminds us about much earlier “monetarist” prescriptions (dating from the origins of central banking) for avoiding crises. He states (p8) “These regimes, in short, have a long intellectual pre-history during which the stabilisation of inflation was by and large not treated as a policy goal separate and distinct from mitigating the cycle and maintaining financial system stability, but as a key means of promoting precisely these ends.”

to how a single agency might use the various instruments under its control, both monetary and macroprudential, to best effect.

Evidently, the view that I espouse has not received a lot of political support to date. The United Kingdom, where responsibility for systemic oversight has been given to the Bank of England, is closest. However, as just noted, they will have two internal committees and not one. The Euro area system next best approximates my preferred system, since the European Systemic Risk Board is at least chaired by the head of the European Central Bank. The proposed Financial Stability Oversight Board in the United States deviates the most from what I would prefer. The Secretary of the Treasury will head up a committee made up the Federal Reserve and many regulators with competing priorities. Such an arrangement seems the least likely to produce timely decisions to reduce concerns about financial stability that are also broadly consistent with the stance of monetary policy.

The second important issue is whether monetary policy has an important role to play in leaning against credit bubbles, or whether this can be left entirely to macroprudential instruments⁶. My basic argument for the use of monetary policy is simple. If policy rates are set too low for too long, the potential gains from “carry trades” will provide irresistible incentives to avoid whatever macroprudential instruments might have been relied upon. Further, macroprudential measures applied to the regulated financial system will encourage credit granting to migrate outside the regulated system. While this might help avoid systemic damage to the core financial system, excessive credit would still be able to generate real side “imbalances” which also have significant potential to create economic damage.

Another good reason for using monetary policy to “lean” against the upswing of the credit cycle is that its capacity to lean against the downswing, to “clean” up afterwards, is looking more and more limited. Consider that we are three years into the current downturn, and that in most countries the degree of monetary easing has been unprecedented. Nevertheless, profound concerns remain about the sustainability of what has been (in the Advanced Market Economies) only a relatively weak economic recovery. As already noted, Reinhart and Reinhart (2010) document that downturns after financial crises

⁶ I have written more at length on this. See White (2009).

are especially deep and long lasting, and IMF research (2008, 2009) indicates that such downturns have typically met very determined monetary resistance.

Indeed, I would go even further. The use of monetary policy since 1987 (the Greenspan “put”) to clean up after relatively minor busts has made a significant contribution to the debt centred problems we are currently facing. Luigi Zingale asked yesterday why micro supervision seems to have failed. My view is that the almost continuous extension of the public safety net (including extraordinarily easy monetary conditions) over successive cycles has had a huge cost in terms of moral hazard. It has encouraged lenders to lend imprudently, and it has encouraged borrowers to borrow imprudently. In short, we have been on an unsustainable path for years. As implied just above, I also believe we may now have come to the end of that particular road⁷.

D. Impediments to the Introduction of a Macrofinancial Stability Regime

Transforming the current policy system (of cleaning up after) into what we really need (leaning against the credit boom) will not be easy. Important transitional issues have to do with how quickly to raise interest rates, and how quickly to tighten macroprudential requirements (like capital ratios under Basel 3) against the background of a continuing deep slump in the Advanced Market Economies. Unfortunately these issues are both too important and too complex to be dealt with today.

Let me rather discuss three sets of impediments to introducing a future regime that would use both macroprudential and monetary policy instruments, in a coordinated way, to lean against the credit cycle. I define such a regime as one directed to **Macrofinancial Stability**. These impediments are ; the acceptance problem, the identification problem, and the will to act problem. Fortunately, some suggestions can also be made as to how these impediments might be overcome.

⁷ I say this with some hesitation, having said similar things in previous downturns and having been proved wrong. This time, the biggest danger would be that unprecedented monetary easing in the Advanced Market Economies would stimulate a bubble in Emerging Market Economies. Recent sharp increases in capital inflows and property prices indicate that this may currently be a very valid concern.

(1) The acceptance problem

Without wishing to go too deeply into macroeconomic theory, the idea that credit driven bubbles can have profound effects on the production structure of the economy over time-and ought to be avoided-is hardly mainstream economics. Such a focus on outcomes which emerge only over long time horizons has much more to do with Austrian (multiperiod) thinking than the Keynesian (essentially one period) way of thinking which is dominant in the United States and the United Kingdom⁸. The acceptance of a different analytical framework will be a hard sell, although the failure of mainstream economics to foresee the current crisis must surely be causing some second thoughts somewhere⁹.

The work of Reinhart and Rogoff (2010) has been instructive in reminding us how common these crises have been throughout history. I believe that, even with the most efficient “leaning” possible, such crises will continue to happen. Thus, as a corollary to the acceptance problem, we should put much more effort into being prepared to manage such crises. We need ex ante preparations to ensure appropriate deposit insurance schemes, bank resolution mechanisms, debt burden sharing, international memoranda of understanding etc.. Evidently, making such preparations implies an element of moral hazard. But, absent the right kind of preparations, a crisis will inevitably be met with massive and ill thought out extensions of the safety net, with even greater implications for moral hazard. By way of evidence, think back to what happened to government guarantees for bank liabilities (not least deposit insurance) in Europe once the current crisis hit in 2007. Decisions taken under duress by Ireland had massive and unfortunate implications for a host of much larger countries across the whole Euro area.

(2) The Identification Problem

⁸ On these different schools of thought, see Laidler (1998).

⁹ In this regard, the establishment by George Soros of the Institute for New Economic Thinking is important. This is particularly the case since the advisory board comprises some of the world’s most prestigious academic economists, including a number of Nobel Prize winners. They all believe that change in our current analytical frameworks is required, though they differ on where to go from here. On some policy perspectives given by one alternative view of macroeconomic theory, see White (2010)

How can the authorities know when the credit cycle is threatening to inflict significant damage on some combination of the real and financial sectors? And how should the authorities respond? Neither issue is easy.

On the former question, I was struck by the potential usefulness of the work that Philip Davies referred to yesterday. Moreover, it is clear that more and more research on “indicators” is being undertaken to answer such questions. Personally, I believe that many market based indicators can systematically point in the wrong direction, although Viral Atcharya yesterday and Professor Hart today convincingly indicated that this was not true of all market indicators. As for Philip Davies finding, that “credit growth” gets systematically driven out of equations (for predicting crises) when other measures of “imbalances” are introduced, that does not surprise me. Imprudent credit may be the underlying problem, but its manifestations are precisely the “imbalances” that I mentioned earlier. And it is the imbalances that trigger the downturn, as unsustainable trends eventually revert towards the mean.

As for the second issue, which combination of monetary and macroprudential instruments best addresses emerging credit problems, that is still more complicated. It will clearly vary country by country, depending not least on the authorities assessment of how the credit transmission mechanism works, and where there are thought to be “fault lines”¹⁰ in the system. This insight, of course, also raises the issue of how far we can push the use of internationally adopted macroprudential standards. Perhaps it was in response to such thinking that the Basel 3 process concluded that the “countercyclical” capital buffer should be activated by national supervisors in light of national credit developments.

A particularly troubling problem for everyone has to do with the failure of Uncovered Interest Parity (UIP) to hold, except over very long time periods. Thus, the use of monetary policy to lean against credit bubbles in Small Open Economies is particularly problematic. In the absence of UIP, monetary tightening could induce capital inflows and eventually ease monetary conditions rather than tighten them. The case of New Zealand in

¹⁰ By “fault lines” I mean elements of the economy that, if put under pressure, might well yield highly non-linear results. For a fascinating discussion of these types of problems in the scientific domain (epidemics, volcanic eruptions, earthquakes, extinctions, financial markets and the like), see Buchanan (2002).

recent years immediately comes to mind. Moreover, it could be that the problem applies to bigger countries as well. Indeed, looking back at the pattern of capital inflows and outflows to the United State, international interest rate differentials do appear to have played an important role over long periods. This raises in turn some fundamental questions about the functioning of the international financial system. These issues were touched upon last night in the presentation by Tommaso Padoa Sciopa.

(3) The Will to Act Problem

This issue has come up repeatedly over the last two days. Leaning against credit bubbles, with the associated threat to asset prices and perceptions of easy wealth, is likely to be even harder than taking away the traditional “punch bowl” of inflation. This seems to me to have two implications. First, it reinforces (as Paul Volker said yesterday) the desirability of putting independent central banks at the heart of this process. Second, it implies that rule-based responses should be relied upon more than otherwise. John Taylor, at a meeting at Jackson Hole in August of this year, made an important point quite effectively¹¹. He argues that it was decisions taken by the Federal Reserve between 2001 and 2007, to deviate significantly from the Taylor Rule, which contributed materially to the most recent bubble and bust¹².

E. Conclusions

Price stability and financial stability are two sides of the same coin. Both are strongly influenced by credit conditions and each contributes to economic growth and employment. There must then be joint and coordinated use of monetary and macroprudential instruments to moderate the credit cycle. Ideally, this coordination would be carried out by the same agency, and preferably, that agency would be the central bank. Evidently, there would have to be great concern to maintain the “instrument” independence of such a central bank. Just as evidently, the mandate and accountability of such a central bank would have to be commensurately strengthened.

¹¹ Taylor (2010)

¹² Taylor concludes that interest rates were lowered too aggressively between 2001 and 2003, and then they were not raised aggressively enough from 2004 to 2007. These arguments are consistent with those made in White (2009).

Bibliography

Buchanan M (2002) "Ubiquity: Why Catastrophes Happen" Three Rivers Press, New York, November 73

International Monetary Fund (2008) "Financial Stress and Economic Downturns" Chapter 4 of the World Economic Outlook Washington D.C., Fall

International Monetary Fund (2009) "From Recession to Recovery: How Soon and How Strong?" Chapter 3 of the World Economic Outlook, Washington D. C., Spring

Koo R C (2009) "The Holy Grail of Macroeconomics" John Wiley and Sons, Singapore

Laidler D (1999) "Fabricating the Keynesian Revolution" Cambridge University Press, Cambridge, UK

Laidler D (2007) "Financial Stability, Monetarism and the Wicksell Connection" University of Western Ontario, Working Paper # 20007-3, London, Ontario, October

Minsky H (1992) "The Financial Instability Hypothesis" Jerome Levy Institute, WP74, May

Reinhart C M and Rogoff K S (2009) "This time is different" Princeton University Press, Princeton and Oxford

Reinhart C M and Reinhart V (2010) "After the Fall" Presentation at the Symposium "Macroeconomic Challenges: The Decade Ahead" Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August

Taylor J B (2010) "Commentary: Monetary Policy after the Fall" Presentation at the Symposium "Macroeconomic Challenges: The Decade Ahead" Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August

White W R (2006) "Is Price Stability Enough?" BIS Working Paper 205, April, Basel

White W R (2009) "Should Monetary Policy 'Lean or Clean'? " Federal Reserve bank of Dallas, Globalisation and Monetary Policy Institute Working Paper 34, Dallas, August

White W R (2010) "Some Alternative Perspectives on Macroeconomic Theory and Some Policy Implications" Institute for Monetary and Economic Studies, Bank of Japan, Discussion paper No. 20110-E-15

