Macro Prudential Policy is Not a Magic Bullet

WILLIAM WHITE

«Our problems can only be resolved through actions taken by governments, not by central banks.»

Governments must recognize that ultra-easy monetary policy will not restore sustainable growth and that its undesirable side effects will not be adequately mitigated by macro prudential polices. A column by Bill White.

Since the crisis began, the principal instrument used to fight it has been ultra-easy monetary policy to stimulate demand in the advanced market economies. Policymakers have generally been unwilling to admit this policy might also have undesirable medium term consequences – bubbles in domestic asset prices and further increases in debt levels among others. To the extent that such possibilities are admitted, it is also contended that «macro prudential» policies can be used effectively to reduce these spill overs. Such measures as raising the capital requirements of financial institutions or lowering loan to value ratios are claimed to both restrain unhealthy forms of lending and to preserve the good health of lenders. This

belief in the effectiveness of macro prudential policies has contributed to the continuation of «lower for longer» monetary policies. This belief is dangerously misguided.

About the authorWilliam White was Chief Economist of the Bank of International Settlements until 2008.First, it is important to make the distinction between the role of macro prudential policies in preventing crises and in helping manage them once begun. Most of the analytical work concerning macro prudential policies has pertained to crisis prevention, not crisis management. Even in this former context, it has become apparent that macro prudential policies have serious shortcomings. Their efficiency in preventing bubbles is questionable. Higher provisioning for prospective loan losses in Spain, and higher loan to value ratios in Hong Kong, clearly failed to avoid massive house price increases in both cases. Evasion and corruption are also natural side effects of all such regulatory measures. Moreover, these tendencies will strengthen over time, as attested to by the growth of «shadow banking» in the period before the crisis. Finally, the use of macro prudential instruments almost always has distributional implications. This invites political involvement and threatens the «independence» of the official agencies involved in applying these measures, central banks among them.

Monetary policy vs. regulatory policies

Given these shortcomings, it is not hard to imagine that a tightening of monetary policy might also be envisaged as a complementary measure to «lean» against excessive credit expansion and help prevent future crises. In this case, monetary and macro prudential policies would at least be tightening at the same time. In contrast, in the current mode of crisis management, these two policies are working decidedly at cross purposes.

The incentives provided by ultra-easy monetary policies severely amplify the downsides of macro prudential policies described just above. Further, it adds to the confusion of monetary policy being set firmly on the accelerator while regulatory policies are set firmly on the brake.

Second, easy money since the crisis has generated a wide variety of imbalances. It is difficult to imagine macro prudential policies that could significantly cope with all of them. Debt levels are much higher than in 2007, with emerging market issuers having accounted for over 50 percent of the increase. The prices of most financial assets also seem highly extended, and potentially prone to reversal. Banks are increasingly concerned about narrowing lending margins, while insurance companies and pension funds are also suffering greatly. Everywhere there is concern that still more imprudent lending – gambling for resurrection – could well be the result.

Finally, the misallocations of real resources, which occurred in the advanced market economies during the previous boom, have not been reversed. In many countries, «zombie» banks have been tempted by low interest rates to evergreen loans to «zombie» companies. Both new investment and productivity have suffered as a result. Worse, huge new misallocations have emerged since the crisis began, not least in China and in commodity producing countries. The disinflationary, perhaps even deflationary forces, unleashed by these developments could haunt us for years to come.

Effectiveness of macro prudential policies doubtful

Third, it is worth noting that many countries faced with these undesired side effects have already turned to macro prudential tightening. Yet, the effects of these measures are hard to discern to date. In Canada, Switzerland, the Nordic countries and elsewhere, public sector officials still

remain seriously concerned about record high levels of household debt and record high property prices. Indeed, both are still rising. In the emerging markets, in spite of using macro prudential measures to moderate both capital inflows and outflows, many economies have already slowed significantly and they remain seriously exposed to possible rate increases elsewhere.

In sum, it is not at all clear how effective macro prudential policies might be. This applies to their use in crisis prevention but especially in the current mode of crisis management. Indeed, in the current 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. Rather, our problems are much deeper and can only be resolved through actions taken by governments, not by central banks.

What could governments due to restore effective demand in a sustainable way? One set of proposals might be deemed «Keynesian». Countries with fiscal room for manoeuvre should use it. Public sector investment should be encouraged. In many countries, governments should encourage faster wage growth with a view to stimulating consumption. Nevertheless, the practical limitations of such demand side policies must also be recognized.

Swapping debt for equity

This leads to a more radical set of proposals which might be deemed «Hayekian». The overhang of financial leverage and debt is holding back both lending and spending. Rather than forbearing further, these problems must be definitively resolved through debt restructuring of some sort. To this end, swapping debt for equity should be relied upon much more

significantly than it has been. Evidently, lenders would take a hit, and this would demand firmer action to either recapitalize them or to recognize their insolvency in turn. Finally, structural reforms to support faster potential growth and debt servicing capacity should also be strongly encouraged.

It is time for governments to recognize that ultra-easy monetary policy is not an effective means of restoring sustainable growth. Moreover, it is also time to recognize that its undesirable side effects will not be adequately mitigated by macro prudential polices. Governments do not wish to recognize these unpleasant realities, because to do so implies the need for them to make some hard political decisions. Unfortunately, wishful thinking is no adequate substitute for the policy actions now required

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