Monetary, Financial and Prudential Policy Interactions

In the Post Crisis World:

Conference Summary and Lessons Learned

By William R White

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Introduction

My summary will be in four parts. First, some comments on how the questions raised in the Agenda for this conference were "framed". The Nobel Prize winner, Daniel Kahneman, asserts that the way the questions are posed plays an important role in determining the answers they elicit. Second, I will make some general points pertaining to the conference as a whole. There were aspects that I found to be very satisfying, indicative of a growing understanding of the topics under discussion, but other aspects were less satisfying. Third, I will give brief summaries of each of the sessions, covering the essence of the papers and the following discussions, but with an emphasis on what they reveal about the need for still further analytical work. Fourth, recognizing that "boom-bust" cycles have become more recurrent, more serious and more global, I will propose some more radical (but politically fanciful) solutions to deal with them.

"Framing" the Issues

Looking back on policy in the post crisis period, the tone set by the Program documents and David Lipton's opening address is essentially that the "glass is half full". Monetary policy has been "instrumental" in supporting the recovery, which now seems (on the basis of recent data) to be accelerating. Yet, further support from monetary policy still seems required and "normalisation" should proceed only at a gradual pace. While it is clearly recognized that the stance of monetary policy has created some unintended consequences (for financial stability and potential growth), these dangers do not warrant a reversal of such policies. Indeed, it was suggested that macro prudential instruments might be used to curtail such side effects, thus allowing "lower for longer" policies to continue. Regulatory policies have also served to make the financial system more stable.

An alternative framing of the issues might have asked whether the "glass is half empty". Since the crisis, we have had unprecedented monetary and regulatory activism. Where is the evidence to indicate that monetary policy has stimulated aggregate demand in the manner intended? What can we say about the risks to future economic stability generated by these monetary and regulatory policies? What lessons might we learn from all this in preventing future crises? Perhaps most urgently, what steps should we now be taking to prepare for a new crisis that might already be in the making? Absent a willingness to accept that past polices might have increased such risks, these questions did not get the focussed attention they deserved. Similarly, there was effectively no discussion of future climate change and Fin Tech. Yet, both have the capacity to generate enormous instability in the financial system and in the broader economy.

Some General Comments

Notwithstanding concerns about focus, the program did succeed in raising many important analytical issues and associated risks. First, a number of participants noted that policies can have longer term consequences that differ from their short term consequences. Policy makers might then face intertemporal choices, of which they should be more aware. Second, different policies can have offsetting effects (at a moment in time) that also deserve more recognition. The fact that monetary policy has been resolutely on the "accelerator" for aggregate demand, while regulatory policy (albeit inadvertently) has been on the "brake", seems odd at best. Third, it was noted that macro prudential policies have down sides as well as upsides; for example, raising impediments to bank lending to corporations can divert corporations into offshore bond markets. Fourth, one person noted that easy monetary policies could affect aggregate supply as well as aggregate demand. If this created disinflationary pressure, and central banks responded with still more easing, a vicious downward cycle could easily ensue. Fifth, a number of participants noted that all domestic policies have international "spill overs", not just the conduct of monetary policy by the Federal Reserve.

The common element in all these points is a recognition that economic reality is generally much more complicated than extant models presume. This raises in turn the possibility that the economy might be better viewed as a complex, adaptive system rather than the rather mechanical apparatus assumed by the traditional Neo- Keynesian framework. There is actually a burgeoning literature on complexity in economics, with the Bank of England playing a notable role.

However, some aspects of the conference were less satisfying. First, in the papers and discussions it was often not clear which regulatory instruments were being assessed; micro-prudential, macro-prudential or capital controls?

Perhaps this was not surprising since many macro-prudential instruments are actually micro-prudential instruments used for a different purpose (systemic stability rather than the health of individual institutions). Second, when discussing the effects of monetary policy (e.g. the effectiveness of “leaning against the wind”), it was sometimes not clear whether participants were discussing the “boom” phase or the “bust phase”, or the “recovery” phase of the financial cycle. It matters. Third, a number of the papers were excellent in themselves, but had little to do with the session in which they were presented. Thus, if some of the papers summarized below seem out of order, it is because they are.

Summary of Topics Suggested by Individual Sessions

<u>Implications of low interest rates and regulatory reforms for the business models and risks of financial institutions</u>

Professors Metrick, Brunnermeier and Carletti, all referred to the possibility that lower policy rates might benefit bank profits in the short run, as lending margins widened, but hurt them over time as lending margins were squeezed. The general presumption was that the willingness of banks to lend would also decline over time. The rate below which monetary policy would actually become contractionary was referred to by Brunnermeier as the “reversal rate”. He also noted that the reversal rate need not be at zero, as many had previously seemed to assume, but depended on a variety of balance sheet factors. An important question arising from these discussions was whether the poor financial health of a bank would reduce its willingness to lend, as commonly supposed. Some even suggested that “gambling for resurrection” could lead to the opposite conclusion.

Professor Yogo raised similar issues with respect to insurance companies who offered “variable annuities”, essentially a mutual fund product plus a guaranteed return. He noted that, as policy rates fell and guaranteed returns became harder to achieve, insurance companies charged more for these products, took on more risks and sometimes even withdrew from the market entirely. With the shares of insurance companies publically traded, a sharp decline in share prices was not impossible which might have negative effects elsewhere in the financial system. He also raised the problem of companies changing business models, only to see financial conditions subsequently return closer to normal. This might then require another wrenching change.

Implications of low interest rates and regulatory reform for market liquidity and resilience.

In fact, this topic received very little attention. Only Professor Flannery raised it tangentially in the previous session. There, he referred to the growing importance of asset management companies, and asked whether they would be shock absorbers or shock amplifiers should a "fire sale" of corporate bonds begin elsewhere. He noted that such companies, when faced with redemptions, sell liquid assets first but might then have to turn to corporate bonds as well.

It is too bad this topic did not receive more direct attention, since in the current juncture it poses great risks. The prices of financial assets are "richly priced" according to surveys (though buying continues) and could easily be shocked downwards. These shocks could be amplified by the absence of collateral for dealing, and the restricted capacity of financial institutions to "make markets". In Mark Carney's last FSB report to the G20, he talks explicitly about these "unintended consequences" of financial regulation. The persistence of various market anomalies (covered interest parity has not held for years) all point in the same direction.

In a recent book, Hal Scott of Harvard has also noted that, while financial interdependence can amplify shocks, so too can contagion through "panic". The latter possibility implies that there will always be need for a lender-of-last-resort, even absent interdependence. Yet many provisions of the Dodd Frank act aim to prevent the Fed from responding as nimbly as in the past.

Professor Mian's paper was "off topic" for this session, but no less interesting for that. He makes the case that credit is created endogenously by the financial system, that the system often becomes too exuberant, and that the recipients are commonly found in the household sector (especially mortgages). These findings are consistent with work by Jorda, Shularick and Taylor, and also by Adair Turner. They are also consistent with the view that "financial stability" is not enough to ensure macroeconomic stability. Other sectors can run into trouble too; for example, the corporate sector in Japan in the 1990's and households in the United States early in this millennium. Professors Weber and Svensen underlined the point that we have to look beneath aggregate data to see signs of emerging problems.

Global coordination of monetary and prudential rules, and stemming contagion risk

A convincing empirical case was made by Professor Forbes for the existence of international spill overs (and/or common shocks), though Professor Svensen remained unconvinced. Professor Gopinath made the same point by referring to deficiencies in the standard Fleming- Mundell model which underpins the "no spill over" hypothesis. Professor Aizenman made the further case that policies can help to reduce spill overs and "sometimes" restore monetary independence.

But what policies would be most effective in this regard? The discussions following the presentations indicated little progress from the conclusions reached at this Forum three of four years ago. Spill overs are achieved through various links and there is the possibility of cutting each of them. Consider spill overs from US monetary easing: the Fed could be more conscious of the global impact of its polices; measures could be taken to restrain US leverage and capital outflows; affected countries should be more willing to let their exchange rates appreciate, and to use capital controls; macro-prudential polices should be used to minimize the domestic effects of capital inflows.

The discussion indicated that, for each country, a package of measures might be appropriate that reflected its own individual circumstances, including how its own policy measures might have spill over effects on others. No one size fits all. However, Professor Acharya, in another session, made the important point that a higher level of FX reserves levels could have the unwanted effect of attracting still more capital inflows. He proposed more reliance on capital controls in the first place to prevent this from happening.

On the broader issue of international coordination (cooperation?), to "internalize the externalities", there seemed broad agreement that this might be useful. However, precisely how this might be done remained to be specified. A number of participants felt that domestic political factors would impede such cooperation, not least the perception that central bank "independence" was being used to support foreigners. In a paper prepared for another session, Luis da Silva suggested that coordination of macro-prudential polices between a smaller and more tightly linked group of countries (the SMICs) might be more feasible. Given the general scepticism about the practicalities of cooperation, the fall-back lesson for most participants seemed to be the traditional one - keep your own house in order.

Also In this session, Professor Gopinath noted an even more pressing international problem. The dollar is still “the” international currency, and many borrowers will be short dollars in the next crisis. The BIS estimates that non residents of the US have ten trillion dollars of liabilities denominated in US dollars. Will the Fed respond if needed? Will Congress let it? These issues need urgent attention.

<u>Monetary policy and prudential regulation: Which tool to use when?</u>

As noted above, the answers to these questions might well depend on which phase of the financial cycle we are dealing with. Let me attempt to summarize some provisional conclusions pertaining to three phases; the credit boom period, the bust, and the recovery period (where we are currently?). The discussion dealt with not only, which tools when, but also governance questions. Who should be making these decisions, at various phases of the cycle?

Leaning against the wind in a “boom”

The conventional wisdom at the moment seems to be that credit bubbles should first be resisted with macro-prudential instruments. Professor von Thadden made the important point that the use of bank-based instruments, even if they did not reduce the amplitude of the upswing, might well leave the financial system in healthier shape later (e.g. dynamic provisioning in Spain and LTV measures in Hong Kong).

As well, the conventional wisdom seems to be that monetary instruments should be directed to resisting credit bubbles only as a last resort. Professor Svensen seemed to take the most extreme view, stating that financial stability should play no part in the objective function sought by monetary policy. However, most other participants, particularly central bankers, stressed the need for pragmatism; monetary policy should reflect concerns about financial stability, albeit in some “fuzzy” way. As is well known, the BIS has a minority view on this issue, arguing that early “leaning” with monetary policy can prove effective.

A recent joint paper by the FSB-IMF-BIS indicates three main models of Governance concerning macro prudential policies. Both Svensen and David Ramsden indicated their support for one of these; namely, the Bank of England model where two separate committees (for monetary policy and financial policy) have overlapping memberships. This is somewhat unconventional in that the same joint paper shows that most advanced economies (other than the UK) have adopted a Governance model based on an interagency committee. Most emerging markets also have a central-bank-based Governance structure, though frequently with all the power in the hands of the Governor or a Governing Board rather than two separate committees.

Leaning against the wind in a "bust"

In sharp contrast to the boom, the conventional wisdom seems to say that, after the bust, most reliance should be put on monetary policy to ease financial conditions. Some, like Claudio Borio, have suggested that both monetary policy and macro prudential policy showed be eased extremely vigorously to match the inherent violence of the bust. Yet Goodhart (and Linda Goldberg today) have suggested that any easing of macro-prudential instruments (much less an extreme easing) might be a shock to confidence in the health of the financial system. This could easily prove counterproductive.

In fact, the conventional wisdom actually seems to have coalesced around an even more extreme position. Macro-prudential policies should be tightened to allow "lower for longer" monetary policy. While tightening both monetary and macro-prudential instruments to lean against booms seems intuitively reasonable, the rationale in busts for easing the former while tightening the latter needs stronger justification. This is all the more the case since there are well known grounds for belief ("pushing on a string") that stimulative monetary policy loses its effectiveness over time, and that the unintended consequences might also increase over time. I have personally written at length on this topic.

As for Governance issues, Professor Svensen suggested that Treasuries should have a bigger influence in decision making during downturns. In my view, this would help focus the mind of Governments on issues having to do with debt "resolution" (bankruptcies, loan defaults and bank recapitalisation) and the possible need to spend taxpayers' money. In many jurisdictions, in Europe in particular, leaving the central bank in charge has allowed these important issues to be left on the back burner.

Policy "normalisation"

The sequencing issues here are still unresolved. Should policy rates be raised first (as has happened in the US) or should the growth of the balance sheet of the central bank be limited and eventually reversed (in part?) beforehand (as is planned in Europe)? The framework presented by Professor Brunnermeier seems to suggest reversing QE first, since this would put longer term bonds back into the banks. Then, as rates subsequently rose, the banks would take capital losses and cut lending as desired. Nevertheless, this issue also needs more attention. In the US, the FDIC has recently expressed concern that banks are already too exposed to the risks (capital loses on fixed term, long term loans) of rising rates.

A further question, assuming macroprudential instruments have been tightened during the "bust", is how quickly to ease them during the renormalisation process. While raised as a question in the Program, I do not recall any discussion of this issue.

<u>Financial stability risks: Have interconnectedness and procyclicality become more or less of a concern? What can be done?</u>

If the general mood at the conference was that monetary and regulatory policies since the crisis have reduced the risks of financial instability, lingering concerns were expressed. Much of the concern centred around structural changes in the financial system encouraged by the very same policies. There were explicit references to the growth of shadow banking prior to the crisis (a form of regulatory arbitrage, facilitated by easy monetary conditions) and the broader problem of "boundary drift". The still larger problem is that some financial institutions (say banks) are subject to "runs", thus safety nets are required to re-establish stability. But safety nets create moral hazard that calls for regulation, which in turn leads to evasion. Then the original problem recreates itself elsewhere in a never ending dynamic of widening safety nets, broader regulation and increased evasion/arbitrage.

I also would have appreciated more specific discussion of the main structural changes that have occurred in financial markets since the crisis. The growth of asset management companies and other forms of market finance, Risk-On/Risk-Off investment practices, the growing influence of ETF's and other forms of passive investment, and the growing acceptance by lenders of cov-lite loans all constitute important structural changes. The extent to which they might have reflected the influence of official policies also needs more discussion. So too does the possibility that these changes have actually increased the risks of financial instability in the future.

Time for a total reset?

It could be that there is no combination of monetary and macro-prudential policies that will adequately curb the “boom- bust cycle”. We must then think of more radical solutions, particularly since these cycles can have long lasting and even permanent (hysteretic) costs. I will be brief, since there was no discussion of these possibilities at the conference. Moreover, briefness is warranted given that the likelihood of radical change, barring an even more severe crisis, is politically limited.

1. Should capital requirements for financial institutions be both much higher and much simpler?
2. Should emphasis shift from regulation and supervisory oversight to more self-discipline (jail?) and market discipline?
3. Should we adopt the Narrow Money proposals of the Chicago School from the 1930’s, but ally them with the lending possibilities afforded by Fin Tech; as suggested by “The End of Banking” by Jonathon McMillan?
4. Should we use structural reforms to cut interdependencies that bring more (longer term) costs than (shorter term) benefits; roll back globalisation, consolidation and securitisation?
5. Should we reform an International Monetary (Non) System that imposes no discipline on countries pursuing a purely domestic agenda; what might be the eventual, global implications of so many central banks pursuing QE?

Finally, we also need to rethink whether our basic approach to analysing economic problems is valid. This is essentially an issue in the philosophy of knowledge. What If the global economic system is not a predictable and understandable machine, but a complex and adaptive system like those studied in many other disciplines? If so, then we need to approach the problems we face in a markedly different and significantly more humble way. Time for a total reset?