

Special Feature B

Monetary And Macroprudential Policies: Their Roles In Promoting Sustained Growth

by Donald Kohn¹

Introduction

Policymakers around the world have learned a number of lessons from the Global Financial Crisis (GFC) about requirements for a policy toolkit that will prevent the next financial crisis—or at a minimum make financial cycles much less painful for the real economy. We have learned that medium-term price and economic stability is not enough to guarantee financial stability and the absence of financial stability—as during the GFC—can cause considerable and prolonged deviations from inflation targets and full employment.

Monetary policy, by itself, has not been powerful enough to restore price and economic stability quickly once they have been disturbed by a major financial crisis. Clearly more is needed to prevent such crises from occurring in the first place. Improvements in institution-by-institution risk management and capital and liquidity buffers would help, but viewing each institution separately is not sufficient to preserve financial stability. Externalities to the behaviour of individual institutions means that the authorities need to look at the whole system, devising and administering regulations to take account of the interactions and spillovers, and dampen the procyclicality that seems naturally to be built into financial markets and their feedback on the economy.

Macroprudential regulation—the extra regulatory perspective that does take account of systemic effects—had been a feature of policy in the US and many other industrial economies in the 1950s, 60s, and 70s, and it has remained a key aspect of the regulatory approaches in many emerging market economies in the 2000s. But it had fallen out of use in most economies with open and highly developed financial markets, which were seen as both undermining its effectiveness and as making such regulation less necessary because markets were perceived as having gotten better at distributing and diversifying risks.

Now, in the wake of the GFC, macroprudential regulation has been reborn in advanced economies, mostly as a “macroprudential finish” to standard microprudential tools—like capital and liquidity requirements, applied to a wider range of institutions that are judged to be systemically important—but also with changes in market structures, for example the central clearing of derivatives, and, in many jurisdictions, with direct attention to terms and conditions for lending, especially in residential real estate markets.

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Policy Interactions

This means there are now two “macro” policies focused on preserving economic stability in the interests of maximising sustained long-term growth. These two types of policies interact in a number of important ways, raising questions about their coordination, their governance, and their optimal combination.²

Both work mainly through affecting financial conditions—primarily through changes in the price and availability of credit. Monetary policy does that mostly by affecting the actual and expected level of short-term interest rates, though also, following the decline of short-term rates to about zero after the GFC, through the effect of securities purchases on term premiums at longer maturities.

Macroprudential policy is used primarily to build the resilience of the financial system—the ability of both borrowers and lenders to withstand shocks, reducing the odds that the effects on the economy of a downswing in asset prices is amplified by a failure of intermediation; in the process it may also dampen the upswing and

cushion the downswing in financial imbalances and prices of assets. Macroprudential adjustments in capital and liquidity requirements and in permissible terms of lending affect the cost of intermediation and the availability of credit.

Because both affect the cost of credit, the instruments used by each policy can have important effects on the objectives of the other policy. For example, added risk-taking and increased credit availability is an important channel for easy monetary policy to return the economy to potential and achieve inflation targets. But easy monetary policy can put financial stability at risk by encouraging leverage that may prove dangerous when capital gains reverse, or a “search for yield” in which lenders and investors do not give adequate consideration to potential defaults when rates eventually rise or the economy slows. Analogously, the effects of macroprudential policy on intermediation costs can affect the incentives to borrow and spend and therefore the level of aggregate demand relative to potential supply and prospects for inflation.³

Policy Roles

Clearly, the makers of monetary and macroprudential policies need to have a clear understanding of the objectives and strategies of the other type of policy and the likely effects of actual and expected instrument settings in order to calibrate their own policies.

But some analysts go further. They argue that monetary policy, in particular, itself needs to take explicit account of financial stability risks in setting policy interest rates; in other words, the objective function for monetary policy should include a financial stability argument in addition

to medium-term expectations for inflation and employment. In this view, monetary policy should regularly consider whether it needs to steer away from medium-term objectives for inflation and employment in order to safeguard longer-term stability objectives, and many of these analysts would expect the financial stability argument not infrequently to impinge on monetary policy considerations. Only in this way can the authorities be adequately assured of avoiding financial instabilities that would deflect the economy from sustained growth and inflation at near their target levels over the longer run.⁴

² IMF (2013) has a useful review of many issues concerning the intersection of monetary and macroprudential policy.

³ The effect of macroprudential policy on the cost of credit might also influence the capital intensity of production and hence the level of potential GDP, but these effects are likely to be small.

⁴ See Stein (2014), BIS (2015) and Menon (2014).

This argument rests on two premises. One, that monetary policy settings can have major effects on financial cycles—by potentially creating bubbles and imbalances when policy is easy, and by preventing such risks from developing, whatever their origin, when policy is tighter. Second, that microprudential and macroprudential policies are not themselves sufficiently robust to contain or prevent the build-up of risks or to prevent disruptive financial crises. In particular, macroprudential and microprudential policies can make banks and other heavily-regulated intermediaries more resilient, but might be weak in tackling bubbles and imbalances in securities markets and at less-regulated entities. By altering risk-taking incentives quite broadly, changing interest rates can be effective in preserving financial stability.

Another school of thought sees monetary policy only as a “last line of defence” to protect financial stability—to be used for this purpose very rarely and only after macroprudential tools have been activated and found wanting.⁵ Monetary policy is a blunt instrument, operating through multiple channels to affect aggregate demand and inflation. Many risks to financial stability are focused in particular markets and types of borrowing and lending (the residential real estate market and mortgage credit in the 2000s in the US would be a prime example). Moreover, the effects of changes in monetary policy settings on asset prices, leverage, and maturity mismatches—the sources of much financial instability—are unclear and could be quite small. As a consequence, using monetary policy to deal with threats to financial stability could well involve major costs; the monetary authority might need to steer considerably away from its medium-term objectives for output and prices to deal with financial stability risks, and the collateral damage to employment and inflation, even the credibility of its inflation target, might be considerable.⁶

Protecting financial stability efficiently and effectively requires a different focus and different set of tools than does achieving an inflation target. Macroprudential policy is targeted on the particular intermediaries or types of lending that could threaten financial stability. And macroprudential policymakers are largely trying to build resilience against tail risk—the small odds on a major disruption to intermediation—rather than trying to influence the modal or most likely outcome that largely occupies monetary policymakers. In the process of building systemic resilience, macroprudential policies most likely would have some, albeit small, effects on the average cost of credit; the effects of the increase in the cost of capital on the output gap can be offset by the monetary policy authorities as they calibrate policies to achieve inflation or output objectives. So it would seem that, given the tools available to each type of policy, cost-benefit calculus would keep monetary policy focused on aggregate demand and overall inflation, while macroprudential policy would focus on reducing the odds that disturbances in the financial sector could have major and disruptive feedbacks on longer-term growth prospects, with monetary policy acting as a “last line of defence” in protecting financial stability.⁷

⁵ See Bernanke (2015) and Yellen (2014).

⁶ In Sweden, during the recovery from the GFC, the Riksbank tightened policy in recent years to discourage household borrowing, but the effects were muted and the consequences for achieving its inflation target sufficiently adverse that it had to back off (Milne, 2014).

⁷ See Svensson (2015) and Eichengreen (2015).

Policy Tools

But where the last line of defence is depends on the effectiveness of macroprudential tools, which in turn depends on their range and type. Limited or ineffective tools affect the cost-benefit calculus in a way that would suggest greater weight for financial stability in monetary policy. Singapore has a varied kit of macroprudential tools, including the ability to raise and lower the countercyclical capital buffer for banks, as well as several tools aimed at promoting sound practices and leaning against potential asset and lending bubbles in the real estate markets.⁸ So too has the UK. There the FPC can vary the countercyclical capital buffer for banks; it also has a variety of approaches to countering potential vulnerabilities in real estate, including changing sectoral capital requirements for banks and also authority to tighten loan-to-value (LTV) and loan-to-income (LTI) standards for loans on owner-occupied housing.⁹

Unfortunately, the toolkit in the US is not so broad and diversified. Macroprudential policy in the US has concentrated on building through-the-cycle resilience in the banking sector, including bank holding companies and the investment banks they control, and identifying and regulating a few systemically important non-bank players. Considerable progress has been made in putting in place capital and liquidity buffers and structural reforms to make these participants much more resilient to shocks, and that success will take some pressure off monetary policy to take account of potential financial cycles that do not align with medium-term macroeconomic goals.

But the capacity in the US to raise or alter macroprudential policies to protect against building vulnerabilities in particular sectors or markets is limited. In general, they do not extend to imbalances building in securities markets or in more lightly regulated intermediaries, and tighter regulation on core banks can induce activity to migrate to these less regulated corners of the system. The fragmented US regulatory system makes getting at these corners exceptionally difficult; it requires buy-in and cooperation from multiple agencies with other legislated priorities.

Countercyclical macroprudential policies are useful for pushing back the frontier at which monetary policy becomes the last line of defence. The US does have the countercyclical capital buffer for banks and their holding companies at its disposal, and it can build stress test scenarios with countercyclical characteristics for these institutions and a few other Systemically Important Financial Institutions (SIFIs). So, in boom times the US can build resilience in these core institutions, but these tools are likely to have only limited effect on an upswing in credit growth and asset prices, and they do not apply to securities markets and many of their participants. The US needs more countercyclical tools that can be aimed directly at loans or credit wherever granted. In that regard, lending on residential real estate has often been the cause of financial instability in the US as it has been elsewhere. The US has taken some steps to strengthen the securitisation process for mortgage loans, but the steps are limited. And there is no plan or allowance for countercyclical policy with respect to the terms of mortgage lending—LTVs or LTIs. This could be a serious omission that might pressure monetary policy to respond to a housing boom in the future, even if inflation and employment are falling well short of goals.

⁸ See MAS (2012).

⁹ See Bank of England (2015).

Policy Governance

It is important to have the right organisational and governance structures to appropriately take account of the complex interactions of monetary and macroprudential policies, especially if countercyclical macroprudential policy will be in use with its effects on monetary policy objectives. The different types of policies have different primary objectives, use different tools, and require a somewhat different background and expertise, so separate committees would seem to be called for. But the policymakers for each policy must have a good understanding of the goals, strategy and tactics of the other. Both types of policies require some degree of independence from short-term political pressures, within a framework that facilitates democratic accountability. This final characteristic is well known for monetary policy, but it applies as well to macroprudential policy, where decisions can affect the profits of the financial sector and the committee will need to restrain risk-taking when times are good—which may not be popular.

Singapore and the UK have approached these challenges by housing both monetary and macroprudential policy in the central bank, in separate committees with some overlap in membership. Because the committees are in the central bank, they tend to have some insulation from short-term political pressures; because they have overlapping membership, each can be well

informed about the plans of the other; and because the membership is not entirely overlapping, there is opportunity to bring specialised expertise to bear on the issues. A challenge is that this concentrates considerable authority and responsibility in the central bank, so the framework for accountability needs to be carefully constructed as well.¹⁰

The US took an important step towards better organisation for macroprudential regulation with the formation of the Financial Stability Oversight Council (FSOC) under Dodd-Frank. FSOC has a financial stability mandate and it includes the heads of all the (many) relevant regulatory agencies, but it has some serious shortcomings. These arise importantly from the fragmented regulatory structure of the US. Many people see the Federal Reserve as quite powerful in macroprudential policy, but its authority is limited mainly to bank holding companies and a few SIFIs. The other agencies on FSOC generally have little expertise in macroeconomics or emphasis on overall financial stability in their mandates. FSOC, the coordinating agency, is headed by the secretary of the Treasury, who is not independent of the politics of the day, and whose presence complicates consideration of the interactions with monetary policy, especially with regard to countercyclical aspects.

Conclusion

In sum, we have much to learn about how macroprudential and monetary policies will and should interact in highly developed, globally integrated economies. We do know that there will be more opportunities for both monetary and macroprudential policies to pursue their primary objectives the more effective the macroprudential tools are. And those interactions—the choice of tools and how they relate to the other policies—are more likely to be fruitful when decision-making is set up with these goals in mind.

Singapore has done a good job of devising tools and establishing promising governance structures to use them. The US toolkit and governance structure were improved by Dodd-Frank, but there are potentially serious deficiencies in terms of coordinating across multiple agencies and of having the required tools. That is troubling for the world's most important reserve currency and financial markets; we have seen how problems in the US can reverberate around the globe.

¹⁰ See Kohn (2013).

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