Macroprudential Policies – When and how to use them

Andy Haldane
Bank of England

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Macroprudential policy is the new kid on the block, perhaps even the next big thing. Hopes are high. Reflecting that, we have new macroprudential agencies, and policies, popping up all over the world in both developed and developing economies (see for example, Aikman, Haldane, and Kapadia, 2013). But that begs the question – what actually is "macroprudential policy"? How should it be executed? And how effective will it be?

This session is well positioned to answer these questions, coming after the one on monetary policy, because I think there are direct parallels between, and lessons that can be learned from, monetary policy in the design of a macroprudential framework.

The state of knowledge about macroprudential regimes today is roughly where monetary policy was in the '40s – and if I am being charitable, that would be the 1940s rather than the 1840s. It is easy to forget that 70 years ago there was still a great deal of uncertainty about the key tenets of an optimal monetary policy framework:

- What were appropriate <u>objectives?</u>
- What <u>instruments</u> should best be deployed?
- What was the appropriate <u>governance and accountability</u> framework?

In the period since, all three of those design features have been, if not resolved, then much better articulated for monetary policy frameworks.

When it comes to macroprudential policy frameworks, all three features are, if not undefined, then poorly articulated at present. Let me touch briefly on the each of them in turn, as framing for the three discussants who will explore them in more detail.

First, <u>objectives</u>. Macroprudential is, as its name implies, about the interaction or interface between prudential policy and the macroeconomy. But how exactly does that translate into a macroprudential objective? In particular, should we think of macroprudential objectives as being:

- To protect the <u>financial system</u> from swings and cycles in the real economy? That would give macroprudential policies a purist financial stability objective.

Or, more ambitiously, are macroprudential policies:

- To protect the real economy from swings and cycles in the financial system? This would give macroprudential policies a more overtly macroeconomic focus.

Put differently, should macroprudential policy be about providing power to the elbow of the microprudential supervisor? Or is macroprudential policy a legitimately distinct arm of macroeconomic policy, working alongside monetary and fiscal policy?

This question has a direct parallel with the monetary policy debate about appropriate mandates – a debate that to some extent still exists today (see for example, Woodford, 2012). What is the appropriate balance between a purist price stability mandate on the one hand, and a dual mandate that also weighs output and employment objectives on the other? Most countries' monetary mandates these days tend to weigh wider (than price stability) objectives.

Existing international experience suggests some important differences in the scope of macroprudential mandates. For example, the recent U.S. stress tests focussed on the implications of a severe macroeconomic downturn for U.S. banks' financial resilience. In other words, stress-testing provided a macroprudential overlay to – or power to the elbow of – microprudential supervision (Bernanke, 2013). This is consistent with a type 1 macroprudential mandate.

By contrast, in the U.K. the Bank of England's new Financial Stability Committee (FPC) has a statutory macroprudential mandate with a clear lexicographic ordering of objectives. This places financial resilience as the primary objective, but then weighs output and employment stabilization as a secondary objective. There is a dual, but ordered, mandate – a type 2 mandate.

That mandate has had an important bearing on the actions of the FPC. For example, in the middle of 2012 the FPC *reduced* U.K. banks' liquidity requirements. This was an overtly countercyclical attempt to stimulate bank lending and output in the wider economy. More recently, the FPC has asked U.K. banks to boost their capital with an explicit eye to lowering funding and lending rates and thereby supporting the economy. In other words, macroprudential policy has operated as an extra arm of macroeconomic policy.

The macroprudential actions recently undertaken by Brazil, Hong Kong SAR, India, Korea, and Israel, among other countries, are also consistent with a type 2 macroprudential mandate. In each case, the objective appears to have been to modulate fluctuations in asset markets – for example, the housing market – and thereby the wider economy. Suffice it to say, internationally the jury is still out on appropriate objectives for macroprudential policies and their scope and ambition.

Second, instruments. Here, again, there is a parallel with monetary policy debates of a couple of generations ago. Back then, monetary theorists and practitioners actively debated the relative merits of price-based instruments (such as the setting of short-term interest rates) and quantity-based instruments (such as the setting of targets for base money supply or selective use of credit and capital flow controls). In the period since, that debate has settled firmly on the side of price-based instruments, certainly during normal times.

Today, one key strand of the macroprudential debate is about whether it should be executed using price-based instruments (such as the setting of capital and liquidity ratios or by taxing certain financial transactions) or quantity-based measures (such as setting loan-to-value (LTV) or debt-to-income (DTI) limits for mortgages, or margining requirements for secured financing transactions). Or, indeed, by a combined toolkit of both.

Existing international macroprudential practices differ sharply on this question. A recent survey by Lim and others (2011) makes clear the extent of these differences, summarized in Table 1. In the U.K., the Bank of England's FPC has expressed a preference for using capital and liquidity tools – price-based instruments – at least when it issues directions to other regulators (Bank of England, 2013)). This was partly on the grounds that price-based instruments will tend to be less distortionary in their impact on behavior.

On the other hand, a number of emerging markets have instead used LTV or DTI interventions – quantity-based interventions – as their macroprudential instrument of choice (Table 1). This was partly on the grounds that these measures are likely to have a more direct and immediate impact on, for example, the housing market or creditor flows. A number of countries have employed both price- and quantity-based macroprudential instruments. Once again, the jury – academically and practically – remains out.

Third, governance and accountability. Here, there is an interesting difference between monetary and macroprudential policy mandates. Monetary policy is not, by its nature and in normal times, granular; it is, if not blind, then blindfolded to its distributional consequences. Central banks cannot set different interest rates for the North versus South of a currency area, for those with and without a mortgage, for small firms versus large.

Macroprudential policies can do just that – and in practice sometimes have. For example, LTV or DTI interventions have sometimes been targeted at particular regions or cities or loan types. In that role, they are overtly distributional in their impact and, at least in principle, almost infinitely granular. While this can have benefits in targeting selective areas of risk for policy intervention, this comes at a political-economy cost. Because of their distributional impact, macroprudential policies raise questions about appropriate governance and democratic accountability.

These tensions are clearly evident in existing governance structures for macroprudential policy around the world. Table 2 provides a summary of the governance arrangements for macroprudential policy in a selection of countries. Some regimes have placed the central bank in the driver's seat, as in the United Kingdom. Others have the lead role played instead by the Finance Ministry or Treasury as part of a college of regulators, as in the United States.

Even when in the driver's seat, a central bank assuming macroprudential responsibilities is likely to face additional pressures on its independence. A larger set of powers, which have a direct impact on the distribution and levels of GDP, raise important questions about democratic legitimacy. Accountability practices may need to ratchet upward accordingly. For central banks, that may be a price worth paying for having an extra degree of macroeconomic freedom, but it is a price nonetheless.

Resolving all of these macroprudential framework questions will take time. For academics, time to conduct research on the efficacy and design of macroprudential policies. For policymakers, time to execute and adapt these policies in the light of experience. As with monetary policy half a century ago, both academics and policymakers have an important role to play in developing an intellectually coherent, yet operationally practicable, framework for macroprudential policy. Doubtless, as with monetary policy, this will be a slow, evolutionary process of trial and error. But the biggest error we could make would be not to try.

Table 1: Cross-country use of macroprudential instruments (2000–2010)

	Limits on LTV	Limits on DTI	Capital requirements	Deposit reserves	Limits on credit level
Individual use	5	2	3	5	2
Used in conjunction with other measures	15	11	8	14	5
Broad	6	5	1	11	1
Targeted	14	8	10	8	6
Fixed	11	7	0	7	3
Time varying[1]	9	6	11	12	4
Rule	0	0	2	0	0
Discretion	9	6	9	12	4
Coordination with other policies	13	6	8	14	5
No coordination	7	7	3	5	2
Countries that use this instrument	20	13	11	19	7

Source: Lim and others (2011).

[[**move footnote here as table note, not part of running text]]**

[1] This includes instruments originally used as a response to the cycle, although they were not necessarily reversed in response to credit weakness following the 2008 crisis.

Table 2: Macroprudential decision-making frameworks by country

[[move note callouts outside commas; spell out US; remove South from Korea; in notes, remove colons and add comma after Italy]]

	Authority lies at the central bank	Multiple agencies **not** including the Ministry of Finance	Multiple agencies including the Ministry of Finance
Committee for action	India, South Africa, Ireland, Czech Republic, Lithuania, Cyprus, Belgium, Greece, Estonia, Malta, United Kingdom, Portugal[1], Italy[1], New Zealand[1], Finland[2]		France, Germany, Bulgaria, Poland, Denmark, Netherlands, Brazil, Hong Kong
Committee for coordination		Sweden	Spain, US, Canada, Australia
No committee	Singapore, Switzerland	Japan, South Korea, Turkey	China

[1]: Portugal, Italy and New Zealand are currently discussing their framework.
[2]: In Finland, the macroprudential authority is the banking supervisor, not the central bank.

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