Macroprudential and Monetary Policies

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OUTLINE

- Views Before the Crisis
- Macroprudential Policy
- Monetary Policy

Views Before the Crisis: Dichotomy between Monetary and Financial Stability Policy

- M-policy focuses on stabilizing inflation and output

- Prudential supervision stabilizes financial system by focusing on individual financial institutions (micro-based)

Views Before the Crisis: Monetary Policy and Asset Price Bubbles: “Lean” Versus “Clean” Debate

- Some economists (particularly at BIS) argued that monetary policy should “lean” against asset-price bubbles
- “Greenspan doctrine”: monetary policy should not lean but should “clean” after the bubble bursts generally accepted
  1. Bubbles hard to detect
  2. Monetary policy may be ineffective in stopping bubbles
  3. Monetary policy is too blunt a tool
  4. Pricking a bubble may be too costly
  5. Cleaning up after bubble not too costly

Macroprudential Policy

- Key Lessons from Crisis:

  - Costs of financial instability and cleaning up afterwards can be huge

  - Market failure in credit markets can be systemic

Macroprudential Policy

- Suggest Macroprudential Policy as First Line of Defense
  - Not only need good microprudential regulation that focuses on individual institutions
  - But need macroprudential policies that focus on overall financial system

Macroprudential Policy Focus

- Limiting leverage cycles and restricting credit booms
- Overall capital levels not capital ratios
- Countercylical capital requirements
- LTV, DTI limits
- Taxes or restrictions on growth of non-core liabilities

Monetary Policy: Lean Versus Clean Debate

- Two types of asset-price bubbles
  - irrational exuberance
  - credit-driven bubbles, which are the dangerous ones
- Suggests debate on lean versus clean has been miscast
- Strong arguments for leaning against credit bubbles (but not asset-price bubbles per se)

Monetary Policy: Lean Versus Clean Debate

- Although macroprudential policies should be first line of defense, there is case for monetary policy to lean against credit bubbles
- Easy monetary policy can promote excessive risk, dubbed "risk-taking channel of monetary policy"
  - search for yield
  - valuation effects can cause leverage cycle
  - predictable policy lowers risk premiums
  - Greenspan put can create form of moral hazard

Monetary Policy: Lean Versus Clean Debate

- Should monetary policy be used to lean?

- Objections:
  - Ones earlier
  - Violates Tinbergen principle that monetary policy should be used to stabilize economy while macroprudential polices should stabilize financial system

Monetary Policy: Lean Versus Clean Debate

- But macroprudential policies may not be effective and so monetary policy may be needed
  - prudential policies more subject to political pressure than monetary policy because they affect bottom line of financial firms more directly (e.g Basel 3)
  - problem of loophole mining
  - expectations of leaning against credit market bubbles will work to make this policy more effective.

Monetary Policy Strategy Implications: Lean Versus Clean Debate

- Low interest rates do not always imply excessive risk taking
- Need to monitor credit markets to assess if it is taking place:
  - credit spreads
  - credit growth
  - underwriting standards
- Research on what to monitor is starting but should have high priority at central banks

Monetary Policy: Lean Versus Clean Debate Today

- Are low US interest rates leading to credit bubbles now?
  - An argument to raise rates
  - No: problem in US is not leveraging but deleveraging
- Is serious potential problem in emerging market countries
  - monetary policy to lean is often not available because of fixed exchange rate or because tighter monetary policy would just lead to capital inflows
  - macroprudential policies may be needed

Monetary Policy and Macroprudential Policy Interactions

- Monetary and financial policies are intrinsically linked: No dichotomy between the two

- Need to coordinate monetary and financial policy provides another argument for central bank to be systemic supervisor and regulator