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# Monetary Policy, Macroprudential Policy, and Financial Stability: Session Discussion

Rochelle M. Edge  
Office of Financial Stability  
Federal Reserve Board  
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## Session papers

- Risk Channel of Monetary Policy  
Oliver de Groot, Federal Reserve Board
- Intermediary Leverage Cycles and Financial Stability  
Tobias Adrian, Federal Reserve Bank of New York  
Nina Boyarchenko, Federal Reserve Bank of New York
- Imperfect Information, Lending Standards and Capital Requirements  
Pedro Gete, Georgetown University  
Natalie Tiernan, Georgetown University



# Macroprudential policies and systemic risk

- Macroprudential policies:
  - Aim to *prevent* episodes of financial instability from occurring
  - Foster financial stability by *limiting* the build-up of risks that are conducive to crises erupting – called “systemic risks”
  - Differ from crisis management policies in being *preventative*
- Limiting the build-up of systemic risks is the *principal* objective of macroprudential policies
  - Although other policies – such as, monetary policy – that have broader objectives can also affect systemic risk
- Systemic risks can be:
  - *Structural* – present irrespective of macro conditions
  - *Cyclical* – emerge in buoyant macro conditions



## Macroprudential policies and systemic risk, cont'd

- The papers in this session consider both structural and cyclical systemic risks
- De Groot considers how the systematic component of monetary policy influences banks' use of leverage *in the steady-state* and how this in turn affects the impact of shocks to the economy
- Adrian & Boyarchenko (A&B) and Gete & Tiernan (G&T) consider vulnerabilities that build up *under buoyant conditions*
  - A&B consider banks' increased use of leverage in good times – when the volatility of the return to holding capital is low
  - G&T consider banks' declining lending standards in good times – after a long sequence favorable income shocks



## Macroprudential policies and systemic risk, cont'd

- All three papers consider important macroprudential policy questions
- Adrian & Boyarchenko show how intermediary distress probability and consumer welfare are affected by different (time-invariant) risk-based capital constraints
- Gete & Tiernan show how banks' capital levels could be varied based on how favorable the underlying state of the economy is perceived to be so as to curb declining lending standards
- De Groot shows how adding macroprudential elements – such as leverage and credit spreads – to a monetary policy rule can impact steady-state leverage and the economy's response to shocks



## Modeling financial intermediation

- In all three papers banks/FIs issue non-contingent riskless short-term debt (and in two papers explicitly to households)
  - Banks/FIs issue a security akin to deposits
- However, in all three papers banks/FIs ultimately hold a security – issued by nonfinancial firms – that represents a state-contingent claim to the firms' future returns on capital investment
  - Banks/FIs do not hold loans *per se*
  - This simplification seems to have become standard
  - A&B also allow households to hold this security (that is, directly-granted financing), though households cannot make new capital
- Does the state-contingent security simplification detract from any of these papers' conclusions?

## Modeling financial intermediation, continued

- The simplification may be less of a concern if the liabilities side of banks'/FIs' balance sheet is the main the focus of a paper
  - That said, the simplification may make some comparisons between model and empirical results less persuasive
  - For example, Adrian's & Boyarchenko's comparison of cyclical movements in the share of intermediated credit
- The simplification may be more of a concern if the assets side of banks'/FIs' balance sheet is the main the focus of a paper
  - In Gete & Tiernan the simplification affects the relation between (estimated) aggregate income shocks and bank profits, a bank's choice of standards, and potentially more of the paper's results



## Modeling financial intermediation, continued

- The papers take various approaches to introducing bank equity
- In G&T, banks/FIs face a fixed leverage constraint
- In A&B, banks/FIs face a risk-sensitive leverage constraint, where equity is required to cover a fraction of losses on assets
- In De Groot (as in Gertler *et al.*), banks/FIs hold self-owned (inside) equity to offset the fact they can divert a fraction of their assets
  - The model also has household-owned (outside) equity, although this raises the fraction of assets that banks/FIs can divert
- In practice, banks/FIs hold equity even without regulatory risk-based requirements and there are *ad hoc* elements to Gertler *et al.*'s modeling of the fraction of assets that banks/FIs can divert
  - Motivating bank equity in an optimizing way is clearly difficult

