macroprudential policy : Central Banking reconsidered ?

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will macro prudential policy force to revisit Central Banking ?

- where do we stand ?
- the challenges
- operating macro prudential policy

where do we stand ?

- macro prudential tools well identified
- discussion about objectives well clarified (if not fully settled)
- governance and interactions remain uncertain :
  - Central Banks will play a pivotal role
  - what changes will that bring ?

Mechanisms \ Purpose	Systemic risk	Adjustment to macroconditions
Automatic	➢ buffers (capital and/or liquidity) ➢ Loan to Value ratios ➢ accounting framework	➢ time varying capital ratios ➢ dynamic provisioning
Discretionary	➢ stress tests ➢ pillar II of Basel 2	➢ discretionary adjustments to capital ratios, provisions or margin requirements

an ideal world

- a well defined mandate for financial stability
- an independent macro prudential authority (“take the punchbowl away”)
- with full authority on micro supervisors
- macro an micro tools fully consistent with each other
- [an independent monetary authority]
- macro prudential and monetary tools fully independent : no assignment problems (Tinberghen)

The policy rate is a poor tool to deal with excess leverage, excessive risk taking, or apparent deviations of asset prices from fundamentals. Even if a higher policy rate reduces some excessively high asset price, it is likely to do so at the cost of a larger output gap. Were there no other instrument, the central bank would indeed face a difficult task, and this has led a number of researchers to argue against reacting to perceived asset bubbles and other variables.

Claessens and al. Lessons and Policy Implications from the Global Financial Crisis

But there are other instruments at the policymaker's disposal. To reduce leverage, capital ratios can be increased; to increase liquidity, regulatory liquidity ratios can be introduced, and, if needed, increased; to dampen housing prices, loan-to-value ratios can be decreased; to limit stock price increases, margin requirements can be increased. In this light, it seems better to use the policy rate primarily in response to aggregate activity and inflation, and to use these specific instruments to deal with specific output composition, financing, or asset price issues.

Claessens and al. Lessons and Policy Implications from the Global Financial Crisis

the real world

- no specific - quantified –mandate : politics ; analytics: bubble identification
- no appetite for a fully independent macroprudential authority
- monetary and macroprudential instruments are **not** independent (credit channel, liquidity)
- possible contradiction between micro and macro prudential objectives

challenges for Central Banks

- two separate missions with two different accountability regimes : by itself manageable
- but more difficult if two interacting sets of instruments
- how can independence of monetary policy be preserved ?
- can independence of instruments be restored ?

- credit and asset price cycle : a conjunction of time varying leverage and maturity transformation (Adrian and Shin)
- independent control of leverage (relatively) easy
- independent control of maturity transformation and liquidity more difficult

macroprudential control of leverage

- better done at the securities than investor level (Geanakoplos) : avoid evasion; capture embedded leverage ; measurement issues; independent of equity fluctuations

- leverage ratio should be an indicator (trigger macro prudential review) not a standard

- still a problem with coordinating various entities

liquidity

- “private” liquidity created inside the financial system (counterparty relationships, repos) [Brunnermeier , Gorton]
- an ingrained incentive to excessive “private money “creation and maturity transformation [Stein] which fuels the expansion of leverage
- in ordinary times, impacts the transmission mechanism of monetary policy (risk taking channel ; variable multipliers)
- in crisis times, private liquidity transforms into broad and Central Bank money (LOLR)

liquidity :macro prudential and monetary policies

- can interest rate setting be dissociated from liquidity provision ?

  - Conventional answer is “yes” (corridor)

  - What about those fluctuations in money demand originating inside the financial (not real) sector ?

- a conjecture : portfolio choices, leverage and asset prices influenced not only by expectations of “price” (interest rates) but also future quantities (liquidity constrained investors and financial institutions)

macroprudential control of liquidity

- a potential tension between micro and macro prudential objectives and tools

- an area for research : quantities (ratios) or prices (taxes) relative efficiencies

conclusion

- preserve priority to price stability mandate
  - a necessary, if not sufficient condition for financial stability
  - could be compromised by inadequate governance arrangements on financial stability
- flexible control of leverage at the instrument level (coordination)
- more work to be done on liquidity and maturity transformation

thank you