

Macro-prudential policy: expanding the central bank's countercyclical arsenal

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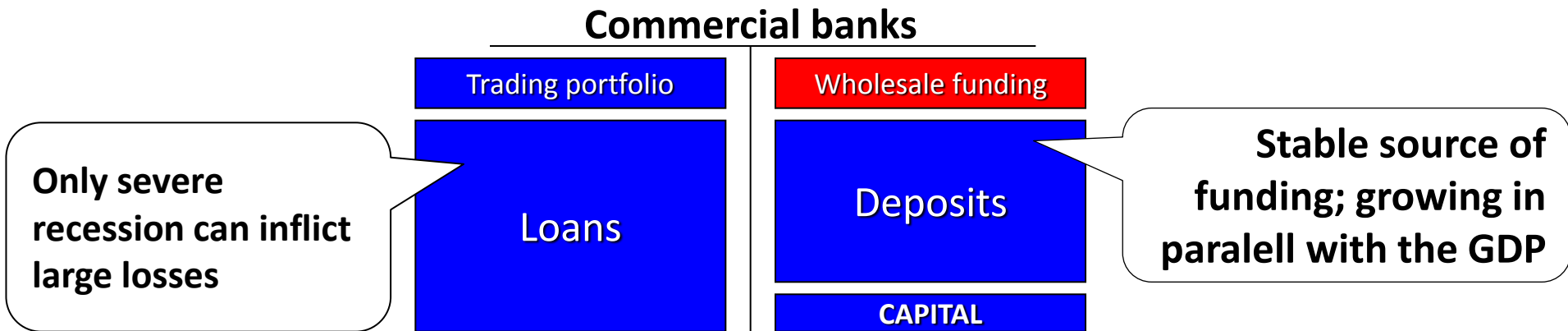
**Should macroprudential policy
be ambitious in setting its goals?**

There are hardly other options

1.

The changing model of banking
brought about the global banking crisis

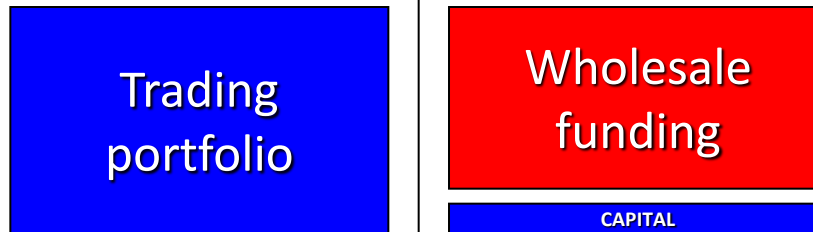
Commercial banking



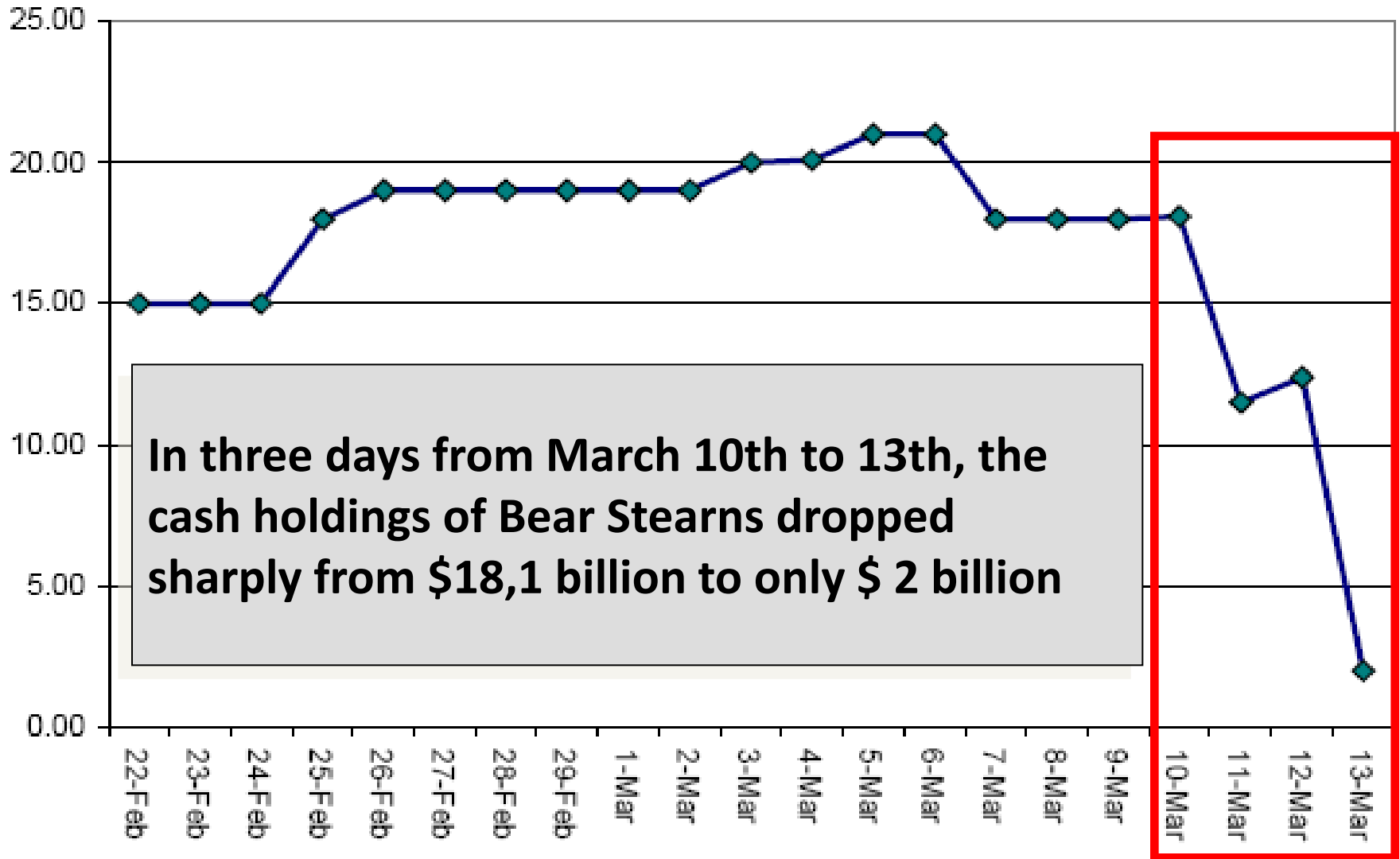
- **weak procyclicality**

Investment banking

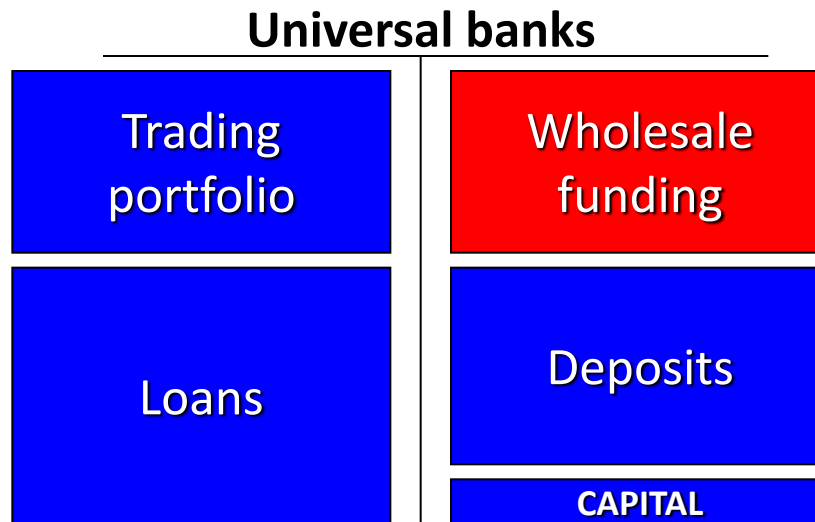
Investment banks



Bear Stearns Liquidity Pool (US\$ billions) (Source: SEC)

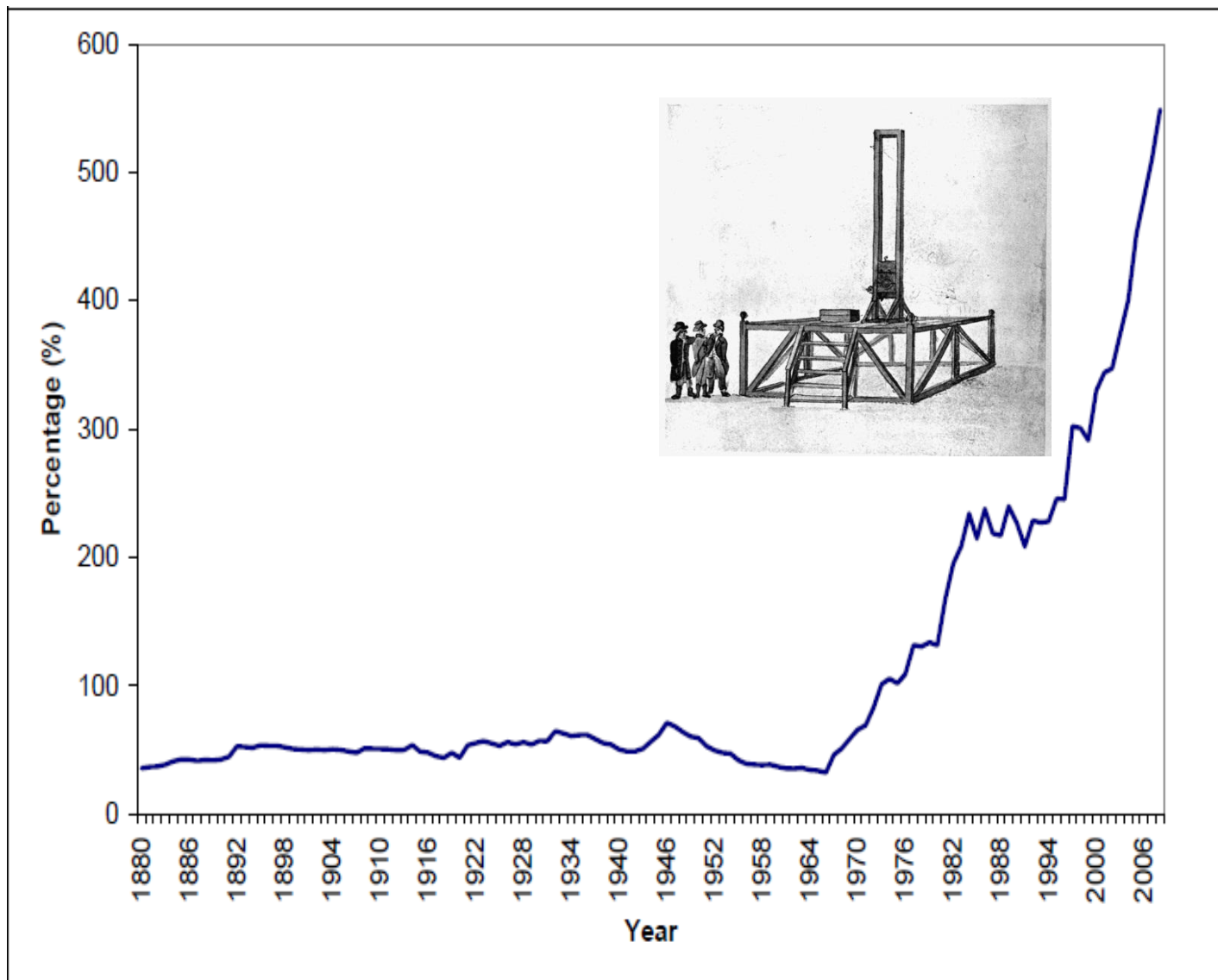


Universal banking



- **enhanced procyclicality**

The inflated universal banks: banks assets depart from GDP rate of growth



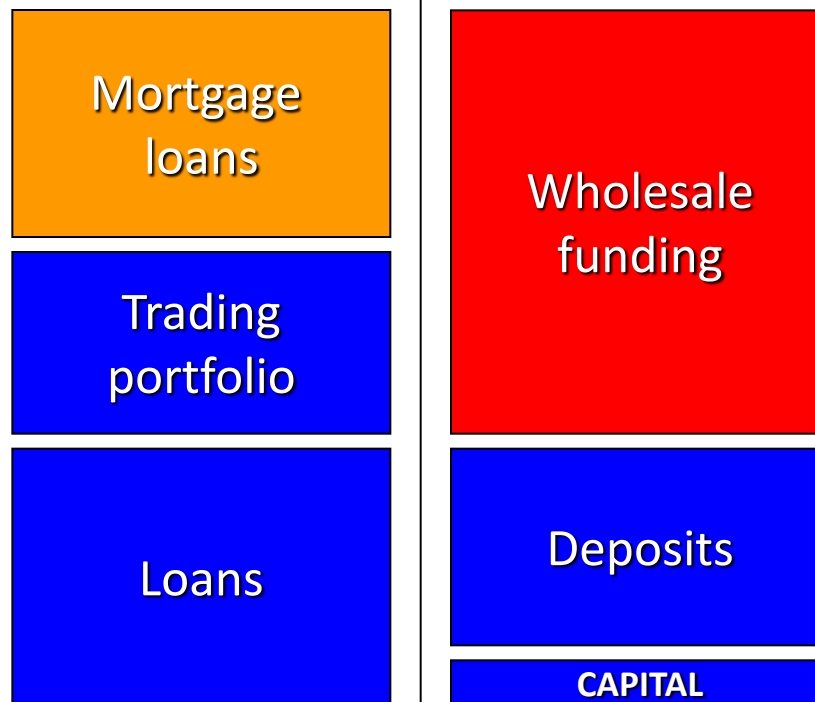
Source: A. G. Haldane, P. Alessandri, „Banking on the state”, Federal Bank of Chicago, 25 September 2009

Banks enter mortgage lending (1990s)

Universal banks



http://pl.123rf.com/photo_13945218_domy-w-masowej-produkcji-niebieski-bialy.html

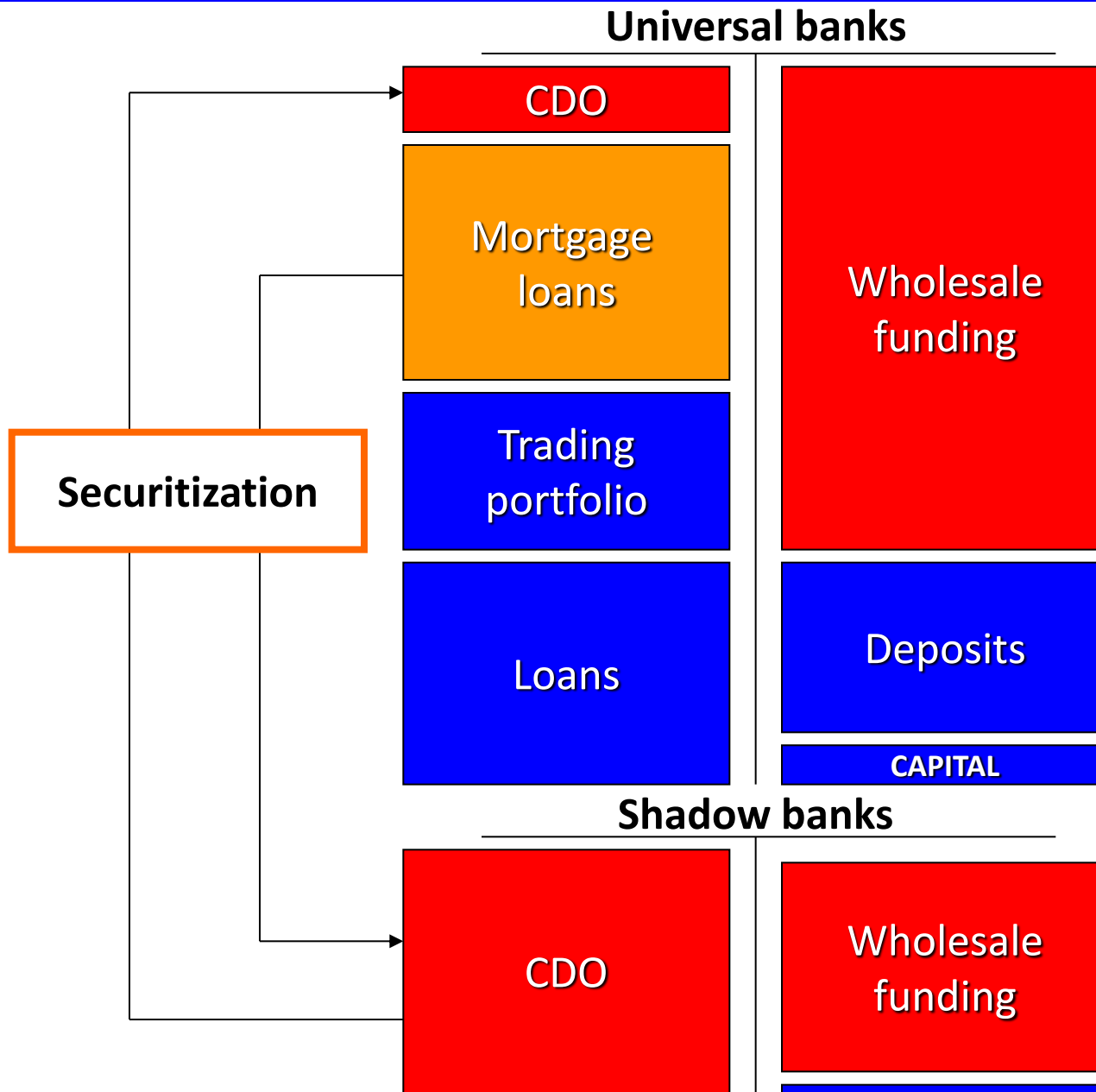


- **strong procyclicality**
- the 'lean against the wind' policy might be neutralized by the deterioration of lending standards

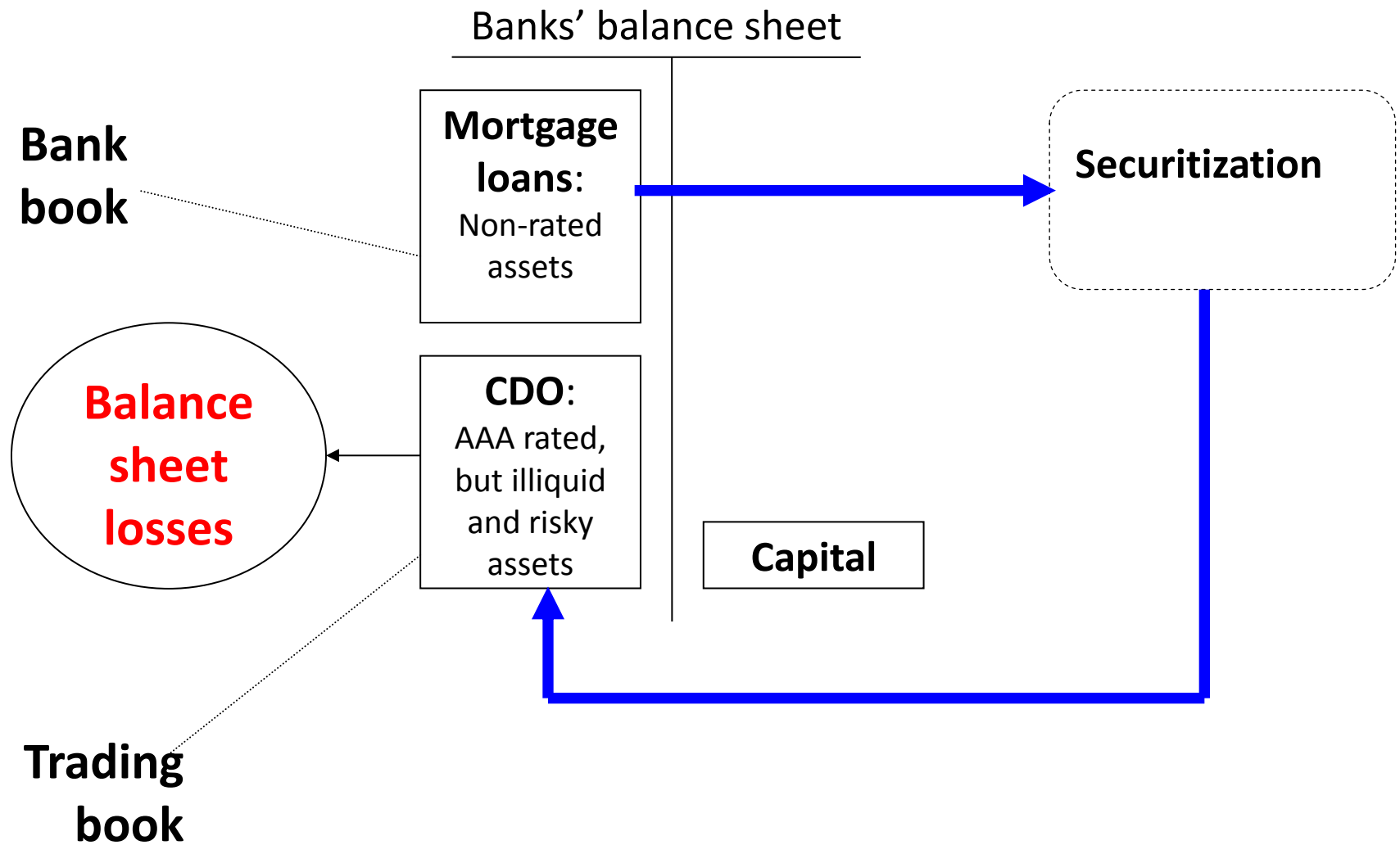
- „The **bubble** was a **supply side phenomenon** attributable to an excess of mispriced mortgage finance” /Wachter, 2009/

- „The 2000-2005 period was a period of credit market liberalization. The Estonian financial market was opened to the foreign owned banks with strong retail banking expertise.
- This allowed aggressive and **seducing proposals** for loan mortgages. The maximum maturity of housing loans was extended beyond 30 years. The maximum **LTV ratio increased considerably from 75% to 95%-100%**. The requirement for down payments were reduced in particular for subprime borrowers”.

The rise of shadow banking



From regulatory arbitrage to balance sheet losses



Lehman Brothers



rabbitsagainstmagic.blogspot.com

Securities

45%

**Structured ABS
(e.g. CDO)**

Reverse REPO

44%

Short-term claim/ cash

11%

REPO

37%

Short sales

42%

Long-term bonds

18%

Capital 3%

2.

The role of macroprudential policy

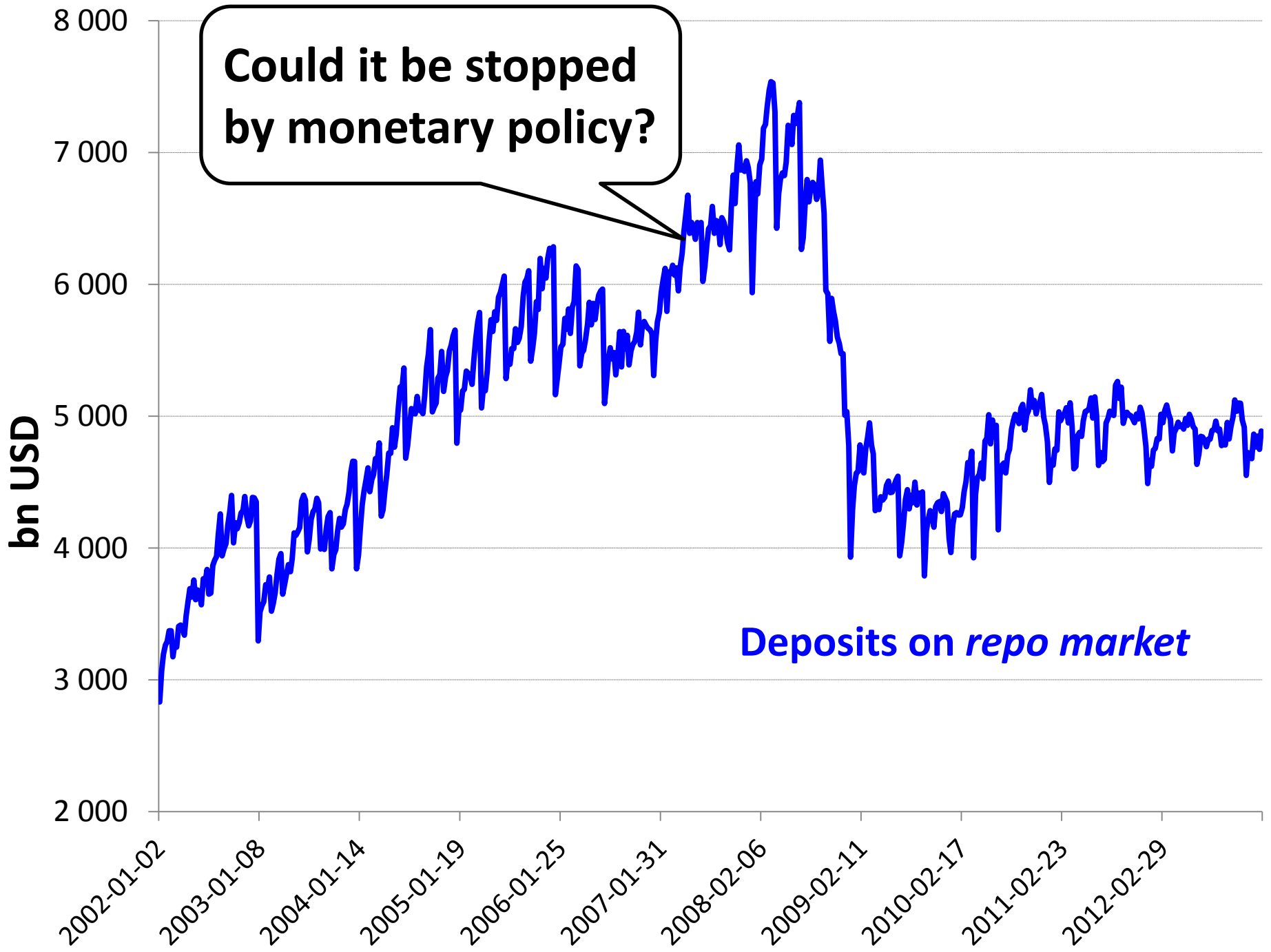
What was the main cause of the global banking crisis?

The emergence of the TBFT financial conglomerates and the **irrational exuberance** of using wholesale short-term funding for inflating banks balance sheets



<http://mutantreviewers.wordpress.com/2010/09/19/monty-python-and-the-meaning-of-life-piratey-retro-review/>

Can it be stopped by monetary policy?

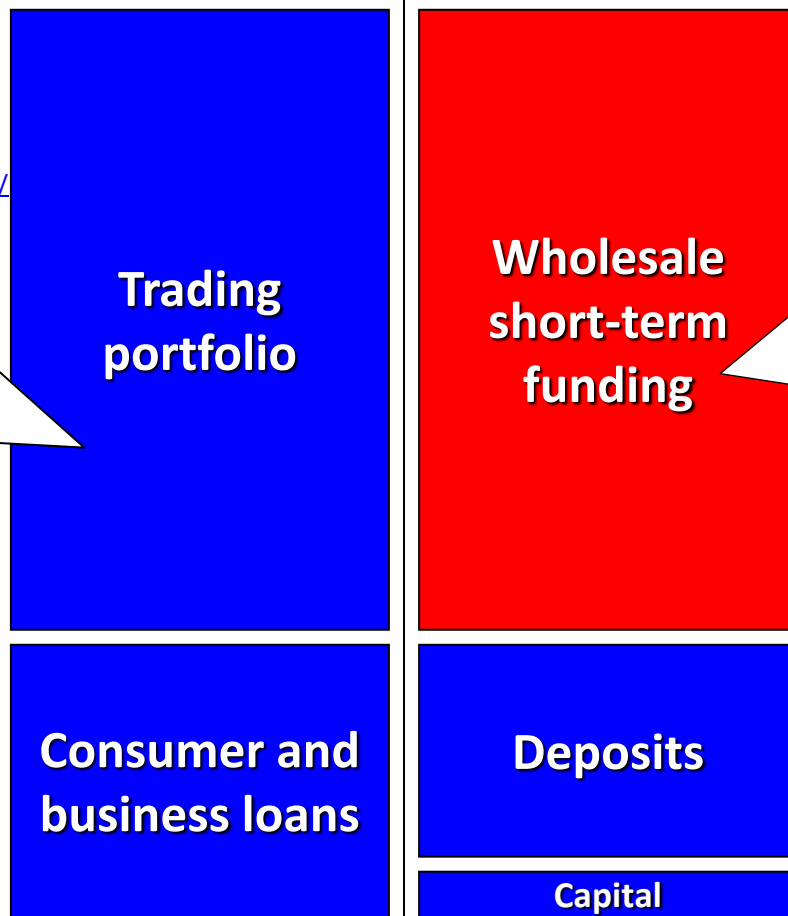




<http://themurraymadhouse.blogspot.com/2012/07/putting-humpty-dumpty-back-together.html>

Universal Humpty Dumpty banks

Universal banks



Lots of opportunities to take balance sheet losses

Source of bank interconnectedness; i.e. systemic risk (bank runs on the repo market; 2008)

What is the social utility from preserving
Humpty Dumpty banks?

Maybe Alice would know.



What is leveraging the TBTF banks' rate of return on trading?

- Leverage
- Artificially low cost of funding (subsidized by taxpayers)
- Artificially low risk weight on trading
- Informational edge on the OTC markets

Macro-prudential tools for containing procyclicality

Banks' balance sheets

Instruments designed to contain the procyclicality of credit standards (e.g. LTV, DTI)

ASSETS

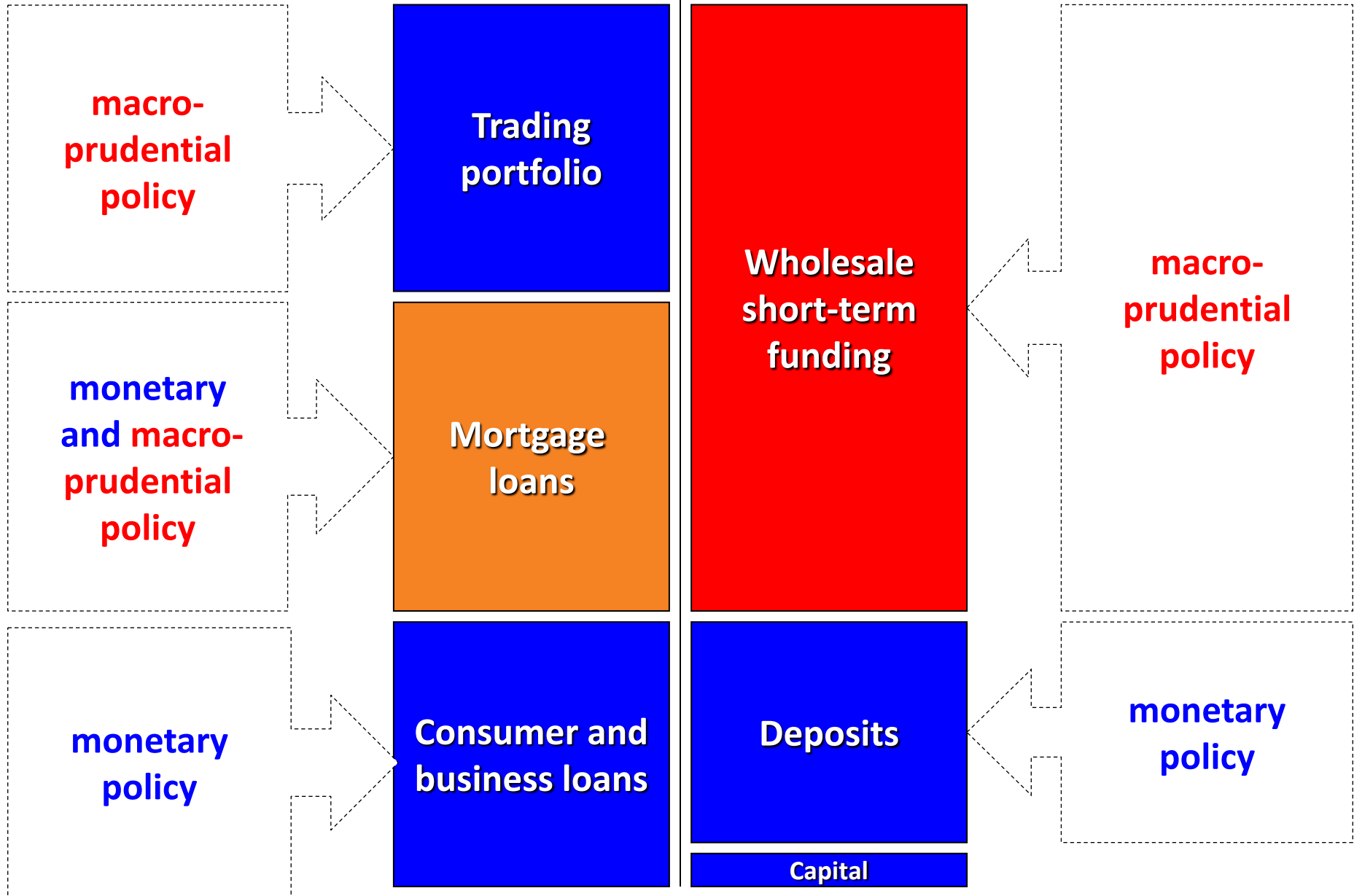
LIABILITIES

Instruments designed to contain wholesale financing (e.g. 100% L/D, taxes on non-core deposits)

CAPITAL

Instruments designed to contain excessive leveraging (e.g. capital buffers, leverage ratio)

Universal banks



- Potentially, macroprudential policy could civilize even the (in)famous *carry trade* that imposes limits on monetary policy autonomy in emerging economies.
- *Carry trade*, due to its unique „sophistication” (sell low yielding currency, buy high yielding currency and complain on markets when high yielding currencies go down) might be transferred to kids from elementary school.



Will the Volcker rule or the Vickers Commission
be ring fencing enough to civilize TBTF ?



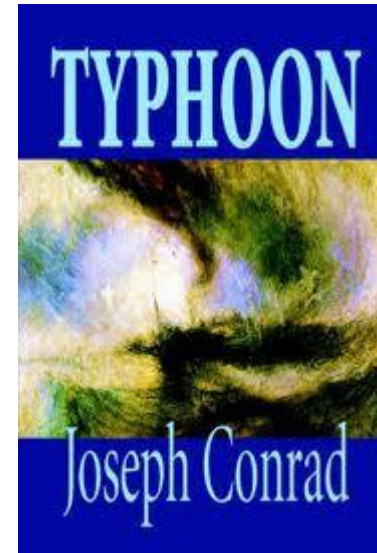
3.

Can macroprudential policy focus exclusively on systemic (tail) risk?

There is no reliable aggregate indicator (of systemic risk) to be followed

- „Systemic risk has so far resisted a formal definition and qualification.
- **It is unrealistic to expect that a single measure of systemic risk** will suffice. A more plausible alternative is a collection of measures, each designed to capture a specific risk exposure.” (Lo, 2008)

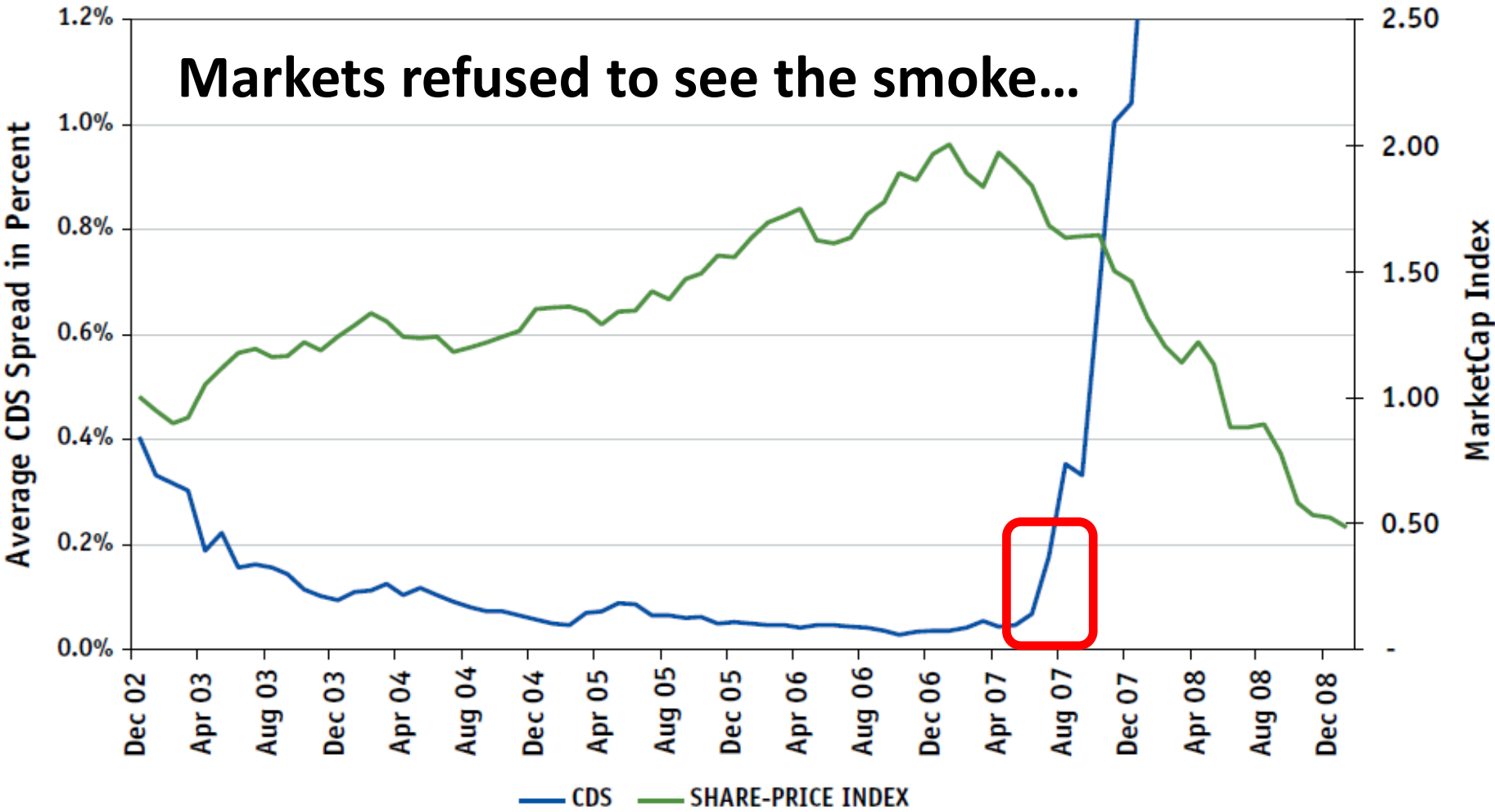
Systemic risk indicators work rather as thermometers than barometers





**Fall in
house
prices**

Exhibit 1.27: Composite Time Series of Select Financial Firms' CDS and share prices



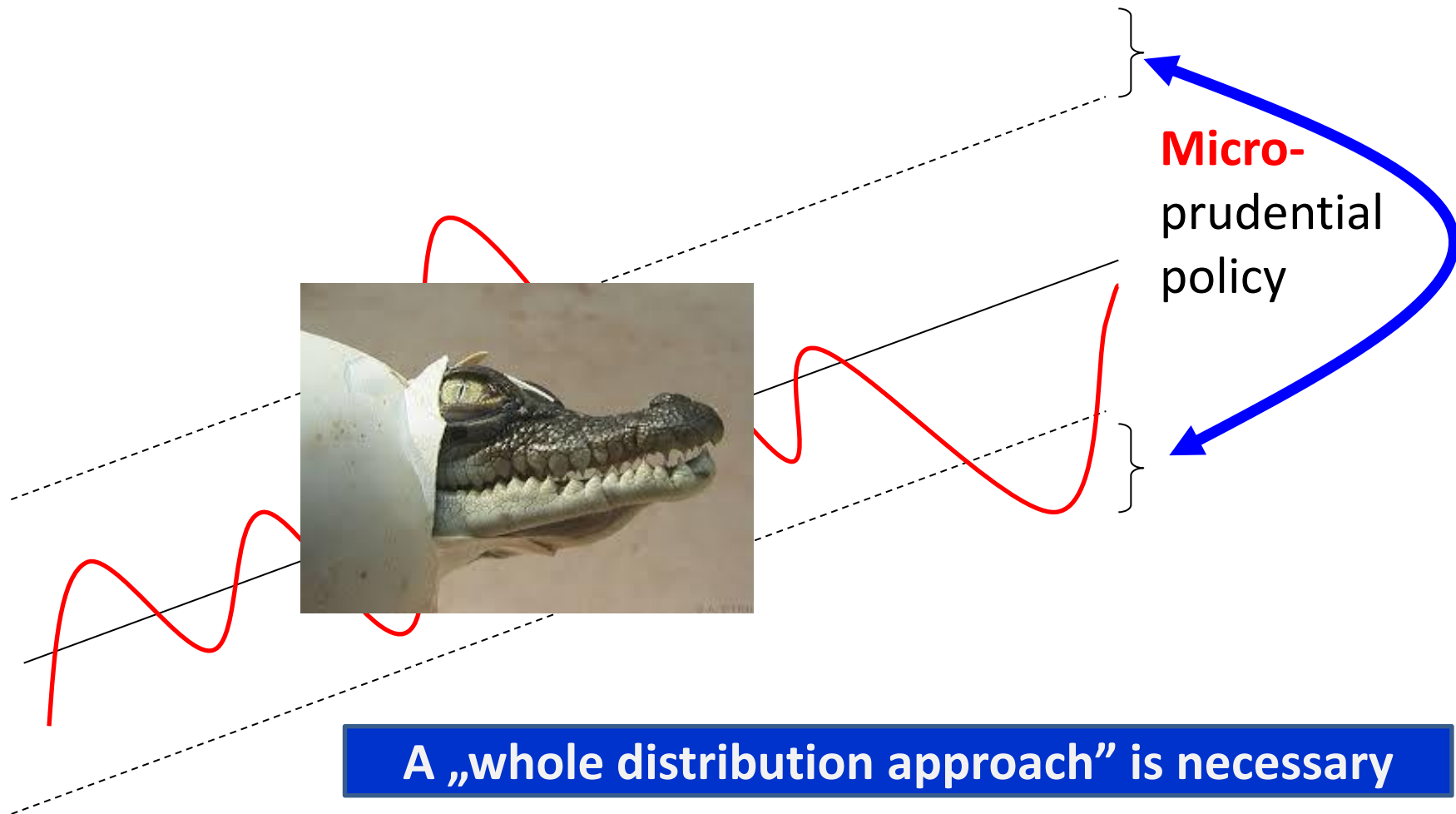
Firms included: Ambac, Aviva, Banco Santander, Barclays, Berkshire Hathaway, Bradford & Bingley, Citigroup, Deutsche Bank, Fortis, HBOS, Lehman Brothers, Merrill Lynch, Morgan Stanley, National Australia Bank, Royal Bank of Scotland and UBS

The Turner Review. A regulatory response to the global banking crisis,
Financial Services Authority, March 2009, p. 46

- How to make macroprudential policy forward looking?
- It should use macroeconomic imbalances as its indicators



Systemic (tail) risk is usually born in the middle of the distribution (e.g. unstable lending boom)

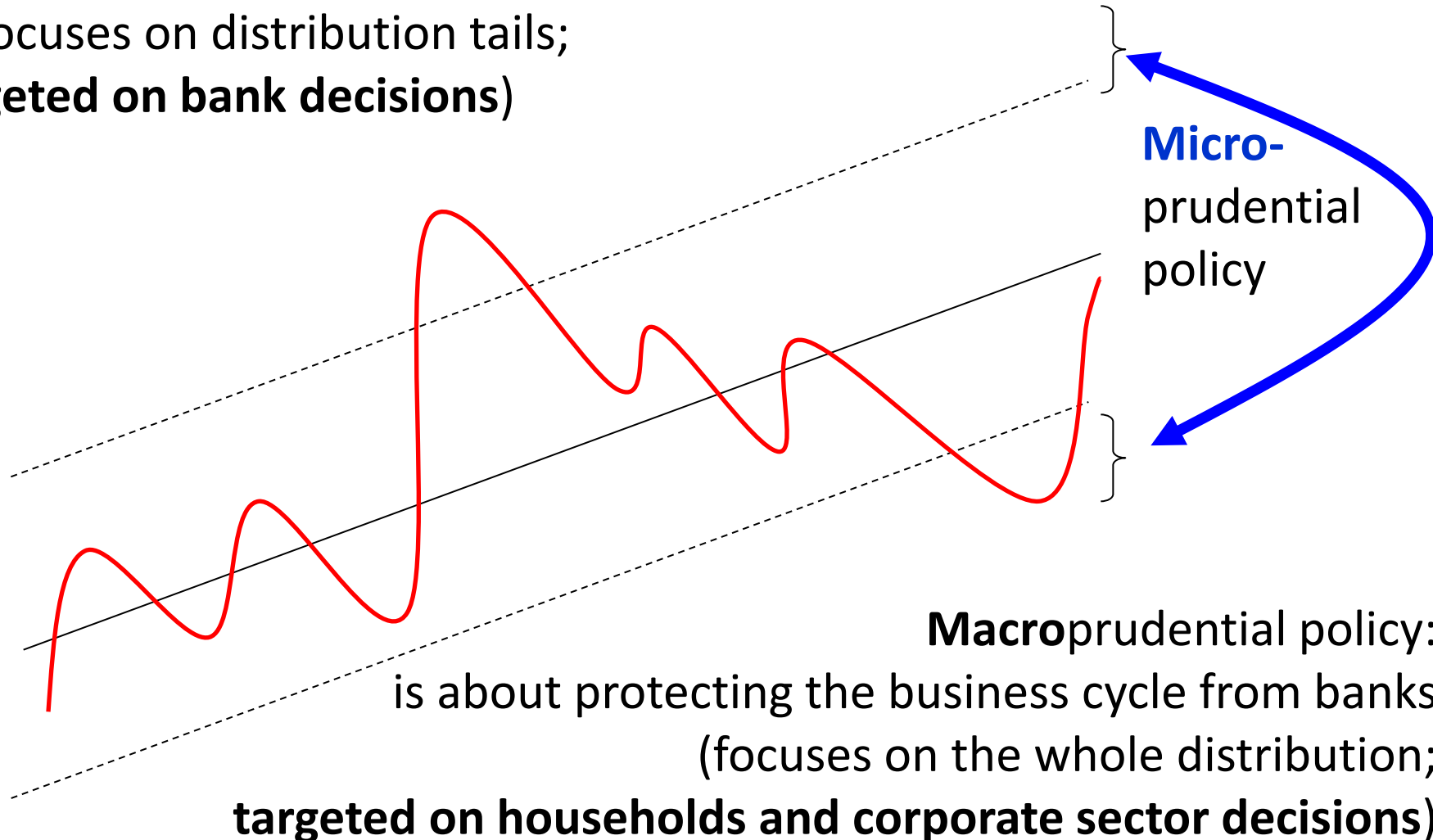


A „whole distribution approach” is necessary

The division of labor between micro- and macroprudential policy

Microprudential policy:

is about protecting banks from the business cycle
(it focuses on distribution tails;
targeted on bank decisions)



4.

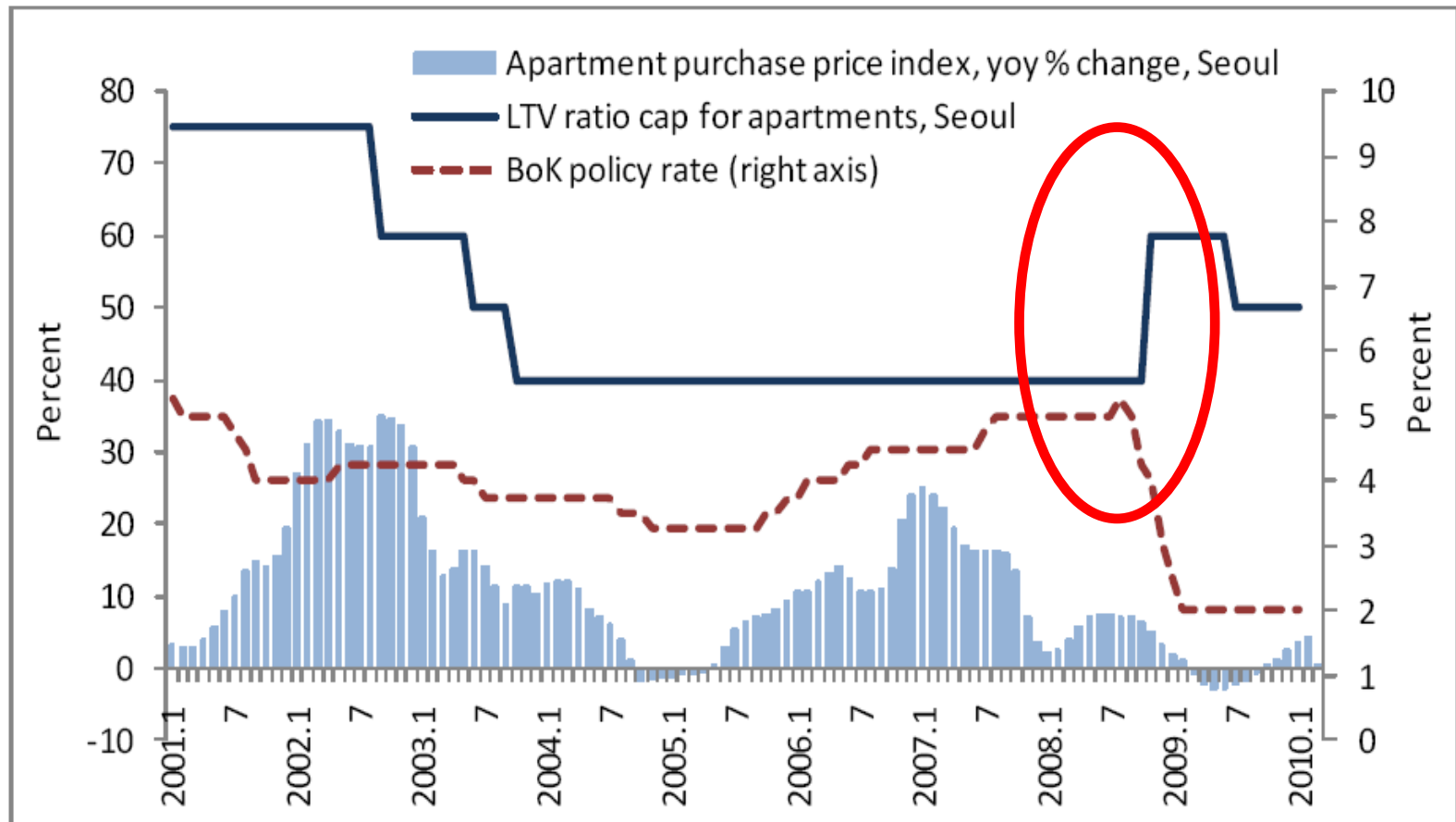
What should be the division of labor between monetary and macroprudential policy?

Macroprudential policy should shield the autonomy of monetary policy from excessive cross-border capital flows



Macroprudential policy should assist monetary policy in controlling the rate of credit growth

Korea: Change in Apartment Price Index and LTV Cap in Seoul and Bank of Korea Policy Rate

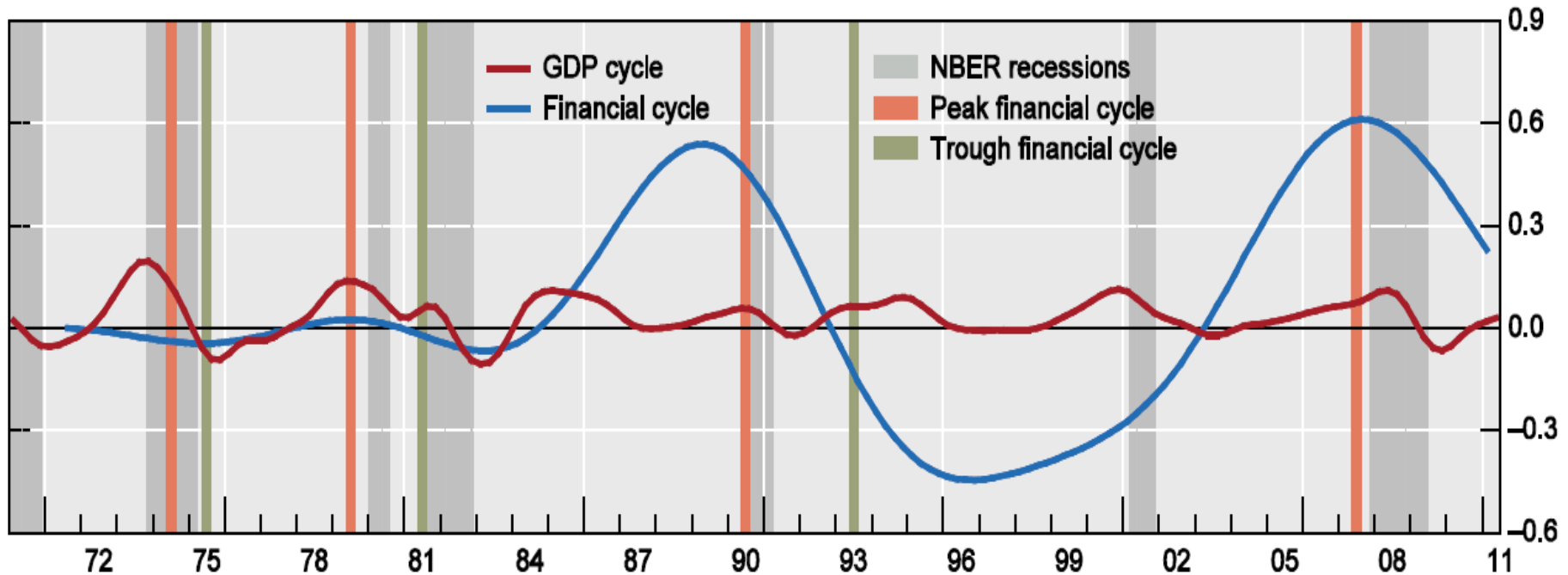


Source: Chang (2010)

Monetary policy must deal with the business cycle.

Macroprudential policy should deal with the financial cycle

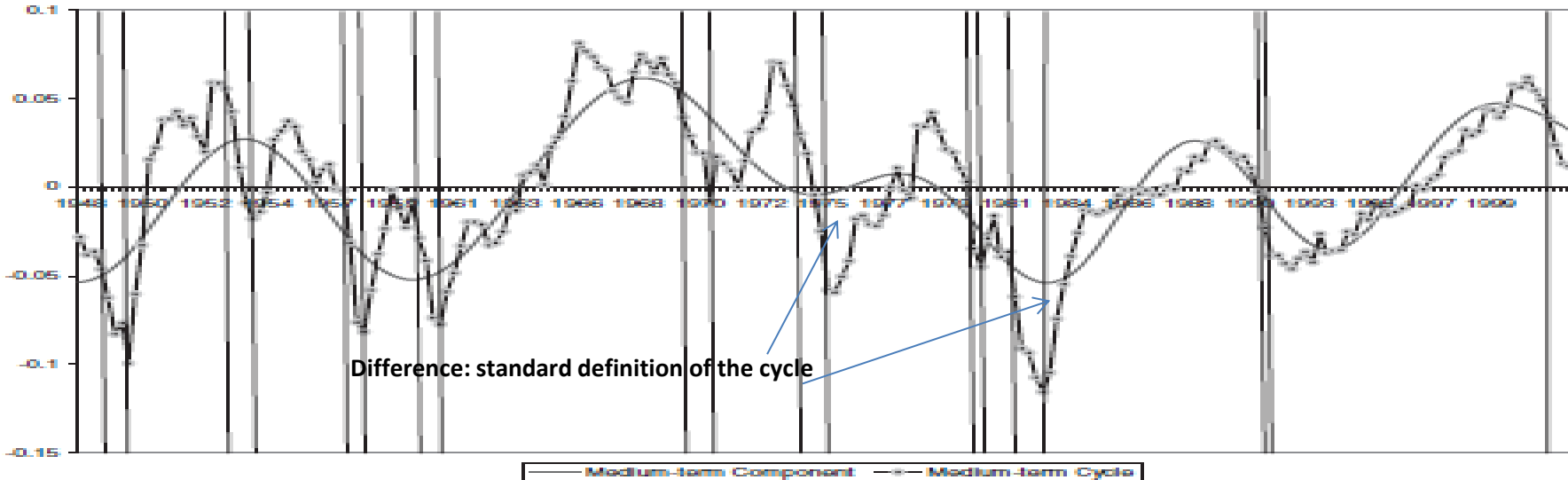
The financial and business cycles in the United States



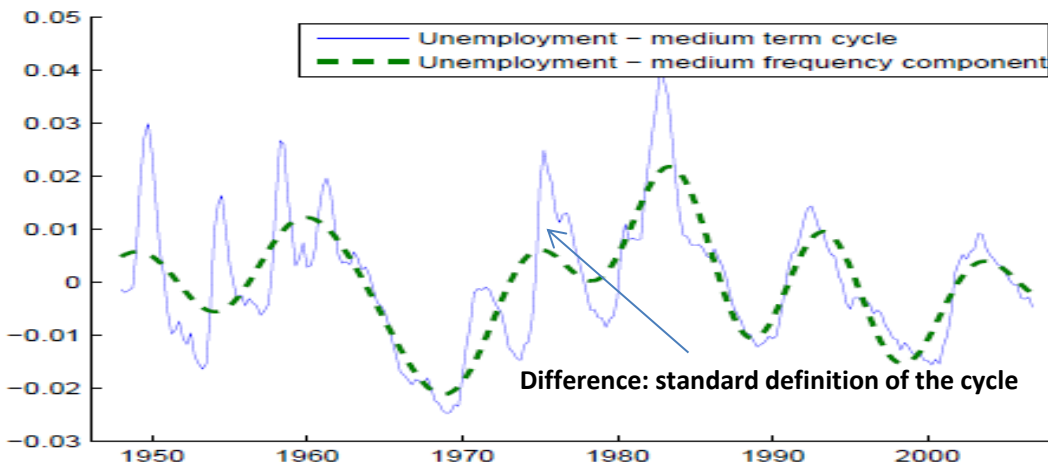
Orange and green bars indicate peaks and troughs of the financial cycle measured by the combined behaviour of the component series (credit, the credit to GDP ratio and house prices) using the turning-point method. The blue line traces the financial cycle measured as the average of the medium-term cycle in the component series using frequency-based filters. The red line traces the GDP cycle identified by the traditional shorter-term frequency filter used to measure the business cycle.

Source: Borio (2012), *The financial cycle and macroeconomics. What have we learnt*, BIS Working Papers 395

...and prevent financial sector from augmenting longer-term cycles initiated by real factors



Source: Comin, Gertler (2006), *Medium-term Business cycles*, AER



	Share of specific frequency components in overall variation		
	Higher [2, 32]	Medium [32, 200]	Low [200, ∞]
Output	0.16	0.52	0.31
Consumption	0.06	0.43	0.51
Investments	0.41	0.49	0.10
Interest rate	0.31	0.48	0.20
Wages	0.05	0.22	0.73
Unemployment	0.25	0.38	0.37
Vacancies	0.26	0.33	0.41
Employment	0.25	0.38	0.37
labor share	0.11	0.37	0.52
Job finding probability	0.32	0.55	0.14

Source: Gradzewicz (2009), *Endogenous growth mechanism as a source of medium term fluctuations in the labor market. Application to the US economy*, NBP Working Papers 57

Similarities

between macroprudential and monetary policies

- **Monetary policy** tools exert a direct influence on bank behavior but their **ultimate goal** is to impact **household and corporate sectors behavior**
- Macroprudential policy tools exert direct influence on bank behavior but their **ultimate goal** should be to impact on **household and corporate sector behavior**

Similarities

between macroprudential and monetary policy

- **Monetary policy** influences the rate of credit growth and the **money supply**
- **Macroprudential policy** influences the rate of credit growth and the **money supply**

Challenges faced by monetary and macroprudential policy are exactly the same:

- „I don't know what the natural rate is, neither do you, and neither does anyone else” (Friedman, 1995)
- „As regards the so-called neutral rate, **we do not guide** our policy on the basis of neutral rates, **we do not guide** our policy on the basis of the output gap, **we do not guide** our policy on the basis of the NAIRU. It is not the way we operate. We embark on a large array of analyses and we do not exclude any concept but we do not take our decision on that basis.” (Trichet, 2006)

Concluding remarks:

What kind of solution is needed?

- There is no simple solution to a complex problem
- Macroprudential policy is not a panacea, but it should be a part of the solution
- especially under the circumstances when the source of the problem, i.e. the leverage, will continue to be subsidized

An action shot from an ice hockey game. In the center, a Pittsburgh Penguins player in an orange and white jersey with the number 18 is being checked by a Toronto Maple Leafs player in a white and blue jersey with the number 27. To the left, another Toronto Maple Leafs player in a white jersey with the name 'SCHENN' and number 2 is visible. The background shows a blurred crowd in an arena. Three white rounded rectangular boxes with black borders contain text: 'Inflationary pressures macroeconomic imbalances' at the top right, 'Monetary policy' on the left, and 'Macroprudential policy' at the bottom right.

**Inflationary pressures
macroeconomic imbalances**

Monetary policy

Macroprudential policy