MACROPRUDENTIAL POLICIES BEYOND THE BOOM AND BUST PARADIGM

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PLAN OF THE INTERVENTION

- MONETARY POLICIES AND MACROPRUDENTIAL POLICIES
- THE BOOM AND BUST PARADIGM
- WAYS FORWARD

MONETARY POLICY AND MACROPRUDENTIAL POLICIES

THE DEBATE BEFORE THE GLOBAL FINANCIAL CRISIS

- **Before GFC, monetary policy & financial stability debate focused on whether or not to address asset price bubbles**

- **The “lean” versus “clean” opposing views:**
  - **Lean against the wind**: asset prices should have special role in conduct of MP beyond their immediate impact on consumer price indexes
  - **Clean after bubbles burst**: swift accommodative MP response to limit economic costs from bursting of bubbles

- **“Clean” view dominant (Greenspan doctrine):**
  - impossible to identify bubbles until they burst
  - attempts to prick them may do more harm than good (e.g. Great Depression)
  - MP can manage at low cost the effect of bubble burst (e.g. dot-com bubble)

- **Bottom line: cost of “lean” is high while cost of “clean” is low**

Lessons from the Global Financial Crisis

- **Credit-driven bubbles actually are very dangerous:**
  - Negative feedback loops: asset prices & credit constraints
- **The costs of financial crises are very high:**
  - slower recoveries and permanent losses of GDP
  - increases of public debt and possibility of sovereign crises
  - hampering of transmission and objectives of MP
- **Credit driven bubbles can emerge in presence of price stability**
  - indeed, price stability may encourage them by reducing risk perception
- **Necessary to address financial stability risks**

NEW POLICIES AND THE AFTER CRISIS

- **Macroprudential policies (MAPs) to address systemic risk in the aftermath of the crisis. The toolkit for the banking sector:**
  - structural capital buffers
  - cyclical capital buffers: to be built in booms & released in busts
  - borrower based constraints on access to credit

- **The debate revisited: which policies to “lean against the wind”?**
  - Only macroprudential policy (Svensson)
    - Tinbergen separation principle: each objective must have own tool
  - Also monetary policy (Stein, Borio)
    - MAP might not do its job (policy circumvention, inaction bias)
    - MP instead “gets in all the cracks”

WOULD MAPS HAVE AVOIDED LAST CRISIS?

- **Back-of-the-envelope estimation of MAP measures sufficient to avoid past crisis in US (Aikman et al., 2019, JEP):**

Main factors in crisis run-up	Required corrective action
Excessive leverage financial sector	CCyB: 3.1%-4.7%
Excessive household debt growth	Loan-to-income limit: 4

- **Could such policies be implemented with current frameworks?**
  - **US: No**, because FSOC lacks sufficient powers
  - **UK: Maybe**, because FPC has powers on (and has used): capital & borrower based tools, STs, comply-or-explain recommendations
  - **EA?**

- **Reassuring, but…**

THE BOOM AND BUST PARADIGM

HISTORIA MAGISTRA VITAE

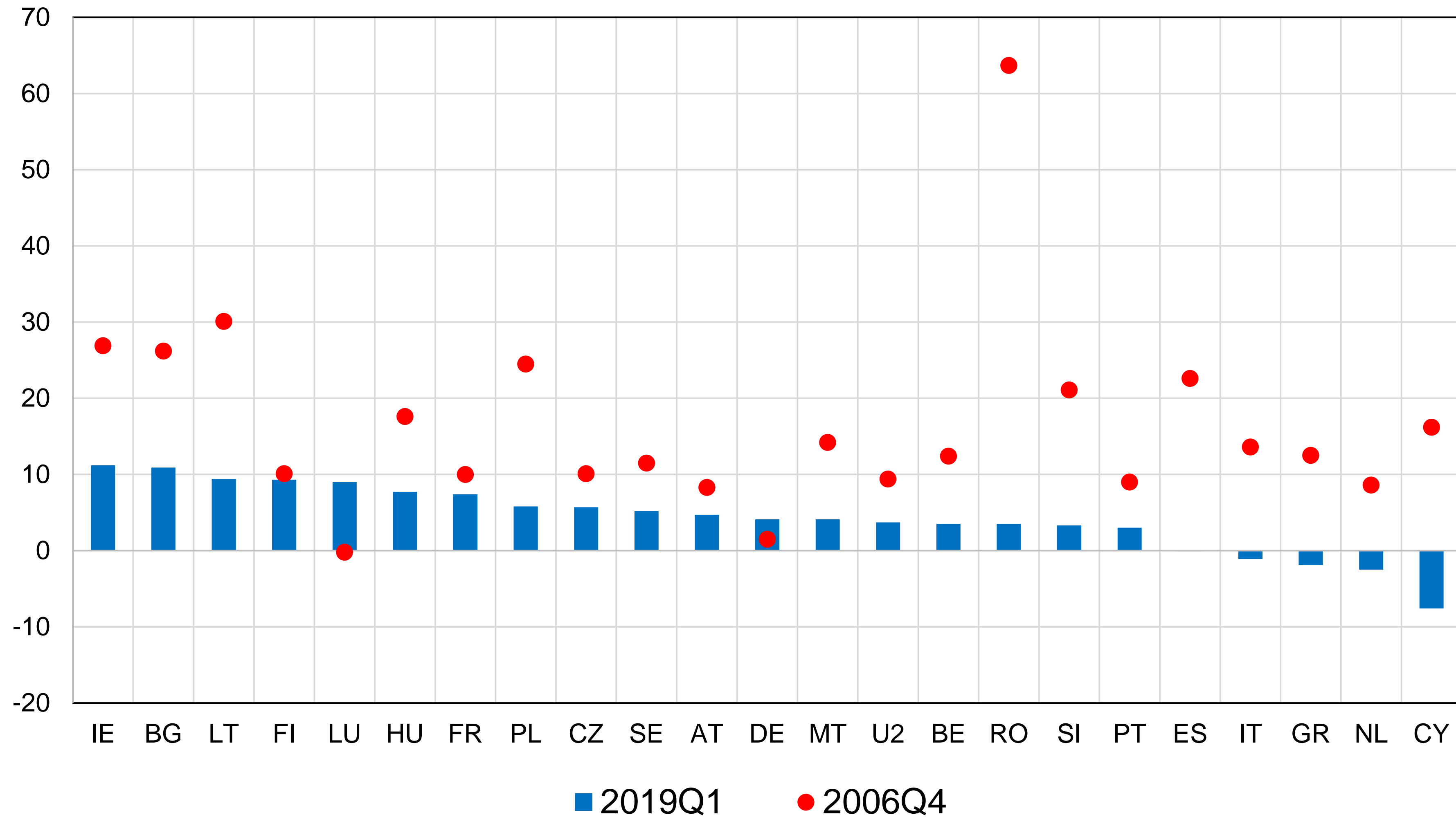
"[T]he main message of this book: we have been here before. The instruments of financial gain and loss have varied over the ages, as have types of institutions that have expanded mightily only to fail massively. But financial crises follow a rhythm of boom and bust through ages."

Reinhart And Rogoff (2009), p. XXVIII

"The primary aim of the countercyclical capital buffer regime is to use a buffer of capital to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build up of system-wide risk."

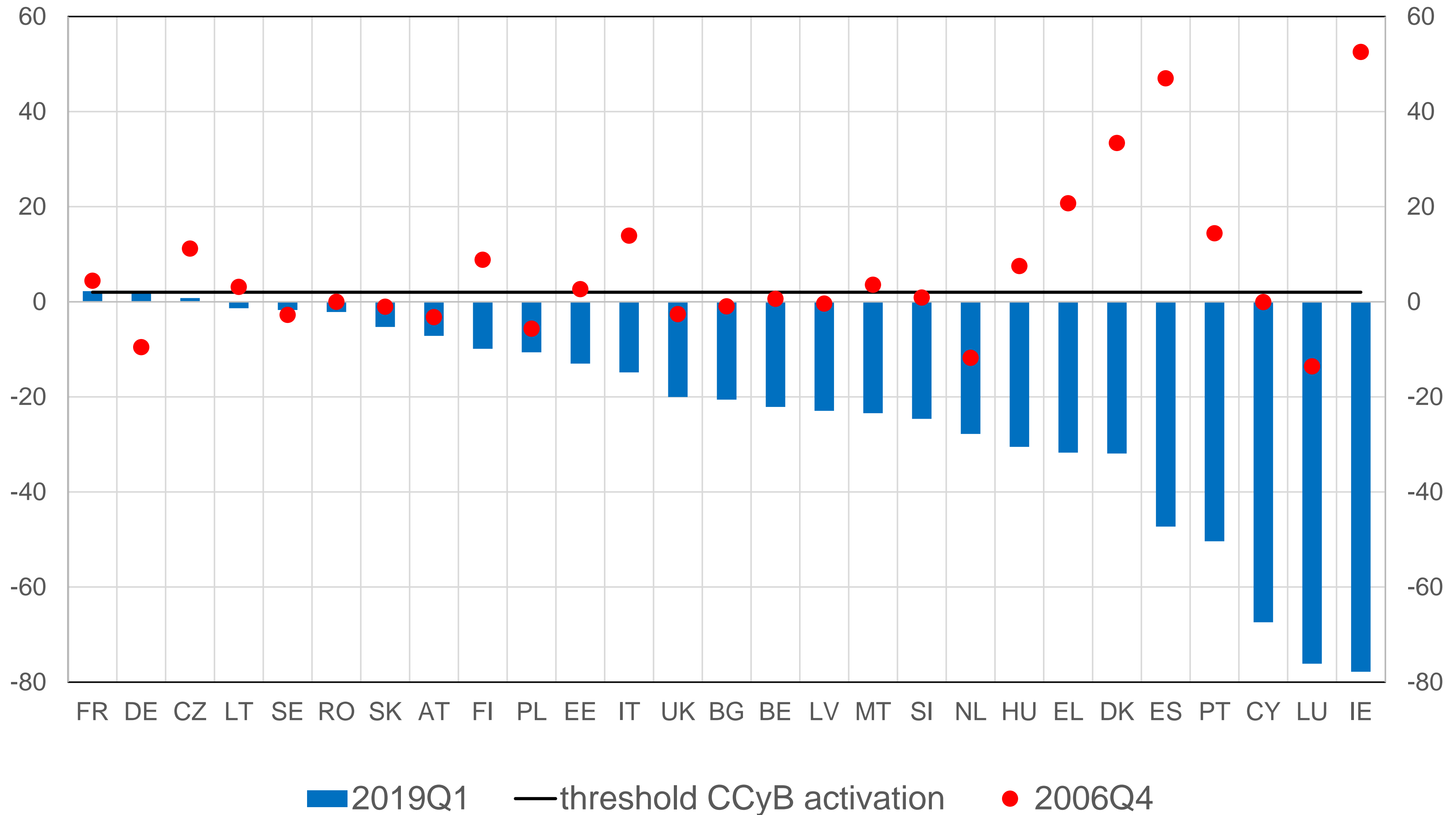
Basel Committee on Banking Supervision (2010), p. 1

WHERE ARE CREDIT BOOMS?



Source: ECB Statistical Warehouse, ESRB.

Are Financial Cycles Picking Up?



Source: ECB Statistical Warehouse.

Low for long interest rate environment

- **Interest rates expected to remain low for long. Financial stability implications?**
  - Low rates lead to:
    - Search for yield and increase in risk-taking
    - Easing of funding conditions and increases in leverage
  - The two are intended effects of MP…
  - Financial stability risks if:
    - Credit fueled bubbles: currently, not clear signs of that beyond some specific markets
    - Some GSIIs get in trouble, e.g. because of complex, opaque risk-taking and/or high leverage

- **How to best tackle emergence of vulnerabilities?**
  - Low for long rates may reduce banks' profitability, hampering their capability to build cyclical buffers
  - Borrower based measures more convenient: need to extend their perimeter to non-bank intermediation
  - MAP should complement micro supervision of GSIIs by bringing a systemic risk perspective

WAYS FORWARD

GUIDANCE FROM EMPIRICAL EVIDENCE ON MAPS

- **Summary evidence of effect of MAPs based on cross-country survey data on use of MAPs in last decades (IMF, BIS, FRB):**
  - MAPs tend to reduce growth rate of credit and house prices
  - Borrower based policies (LTV, DTI) seem more effective
  - Policies more effective in booms than in busts
  - Policies less effective when deeper/more open financial markets
  - MAP tightening more effective when contemporaneous to MP tightening

- **Suggestive evidence that MAPs do their job, but many questions still unanswered because:**
  - dummy-type data does not allow for quantification of policy effects
  - endogeneity problems might drive results

MACROECONOMIC STABILIZERS IN A CURRENCY UNION

- **Limited role of MP as macroeconomic stabilizer in a currency union hit by country-specific shocks**
  - MP sets rates consistent with average price stability

- **Which other stabilizing tools against idiosyncratic shocks?**
  - National fiscal policy: requires sufficient fiscal slack
  - Fiscal risk-sharing: requires common fiscal budget
  - Private risk-sharing: requires deep & integrated financial markets
  - Macroprudential policy set at national level

- **Currently most of stabilizing burden would lay on MAPs: a too heavy burden!**

RISK-SHARING TO COMPLETE MACROECONOMIC FRAMEWORK

- **Progress on fiscal risk-sharing in EA unlikely in short term**
- **To increase private risk-sharing, necessary & feasible to foster financial markets integration**
  - In US the financial markets provide 65% of idiosyncratic shock smoothing
  - In Europe they provided close to no smoothing during crisis
- **The three still incomplete initiatives**
  - Banking Union: EDIS + backstop to SRF
  - Capital Markets Union: harmonization of securities legislation & supervision
  - Euro area safe asset creation
- **Completing them will enhance cross-border financing flows, leading to:**
  - More risk-sharing & macroeconomic stability in face of national shocks
  - No bank-sovereign nexus & more effective accommodative national MAPs
  - Need to develop a MAP framework for market based financing (CMU)

Thank you for your attention

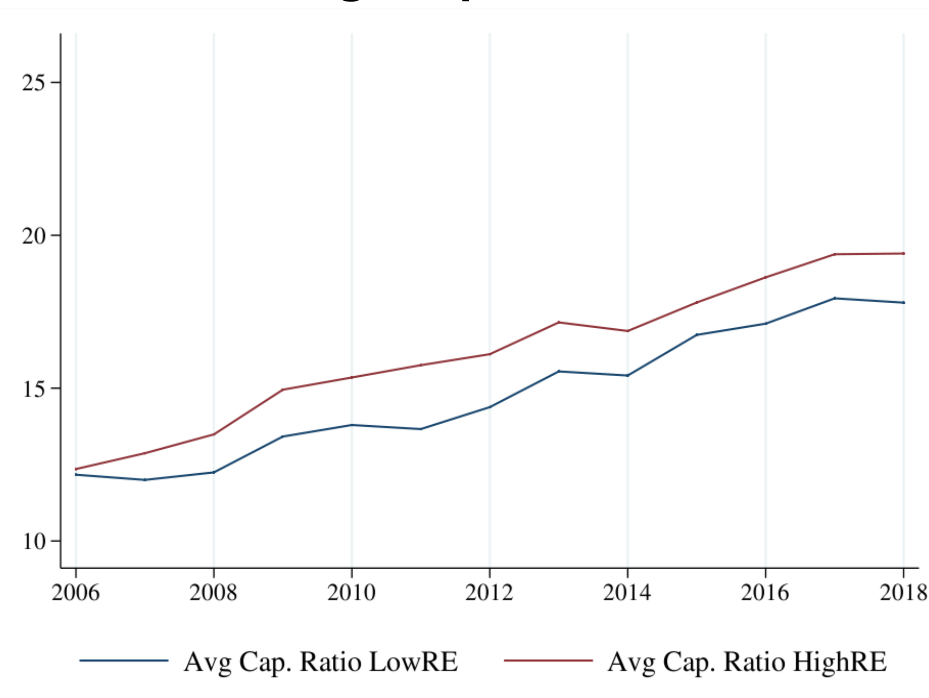
ADDITIONAL MATERIAL

REAL ESTATE PRICE GROWTH AND BANK CAPITAL RATIOS

- **Capital ratio in countries with high real estate price growth similar to that in low growth (Gallo and Palazzo, 2019)**

Average real estate price

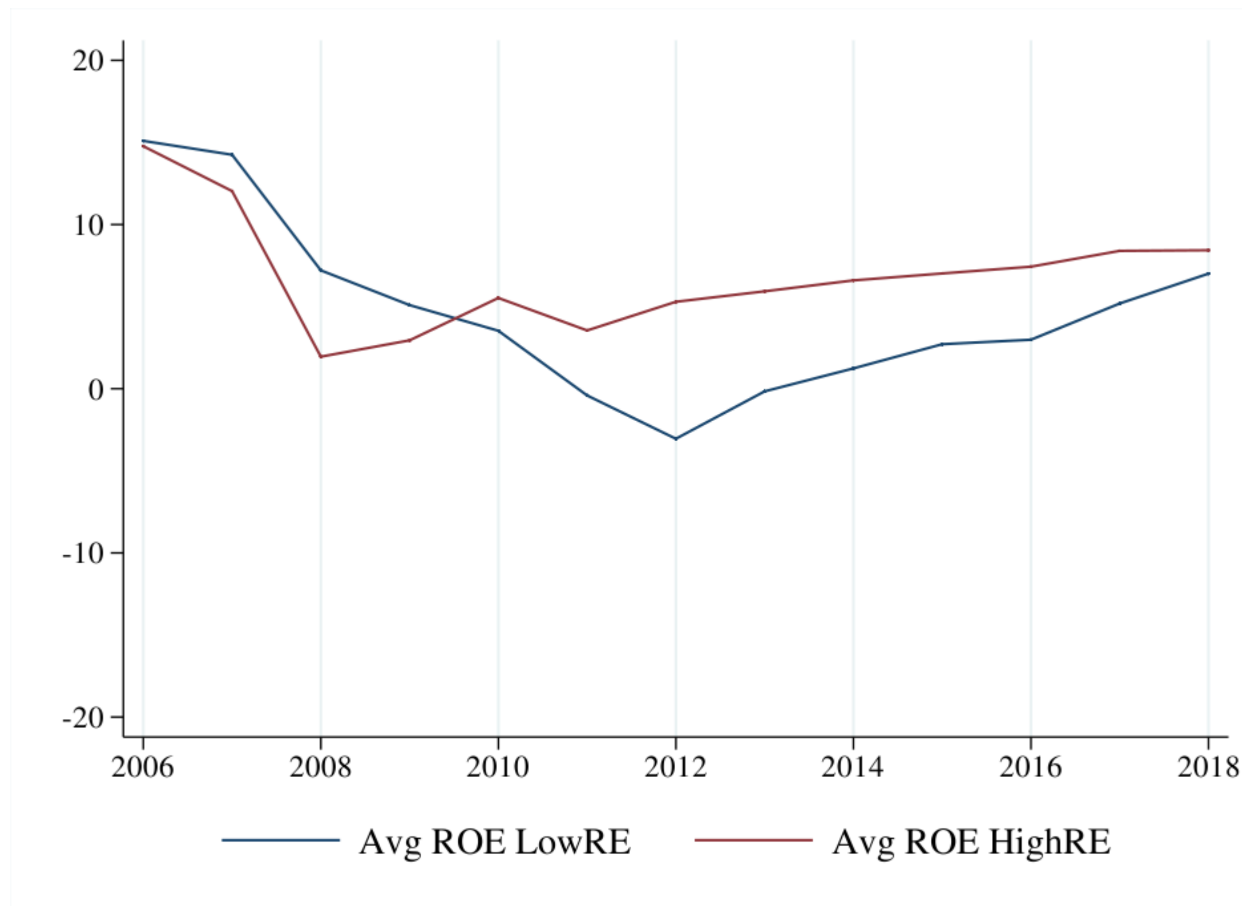
Average capital ratio



REAL ESTATE PRICE GROWTH AND BANK PROFITABILITY

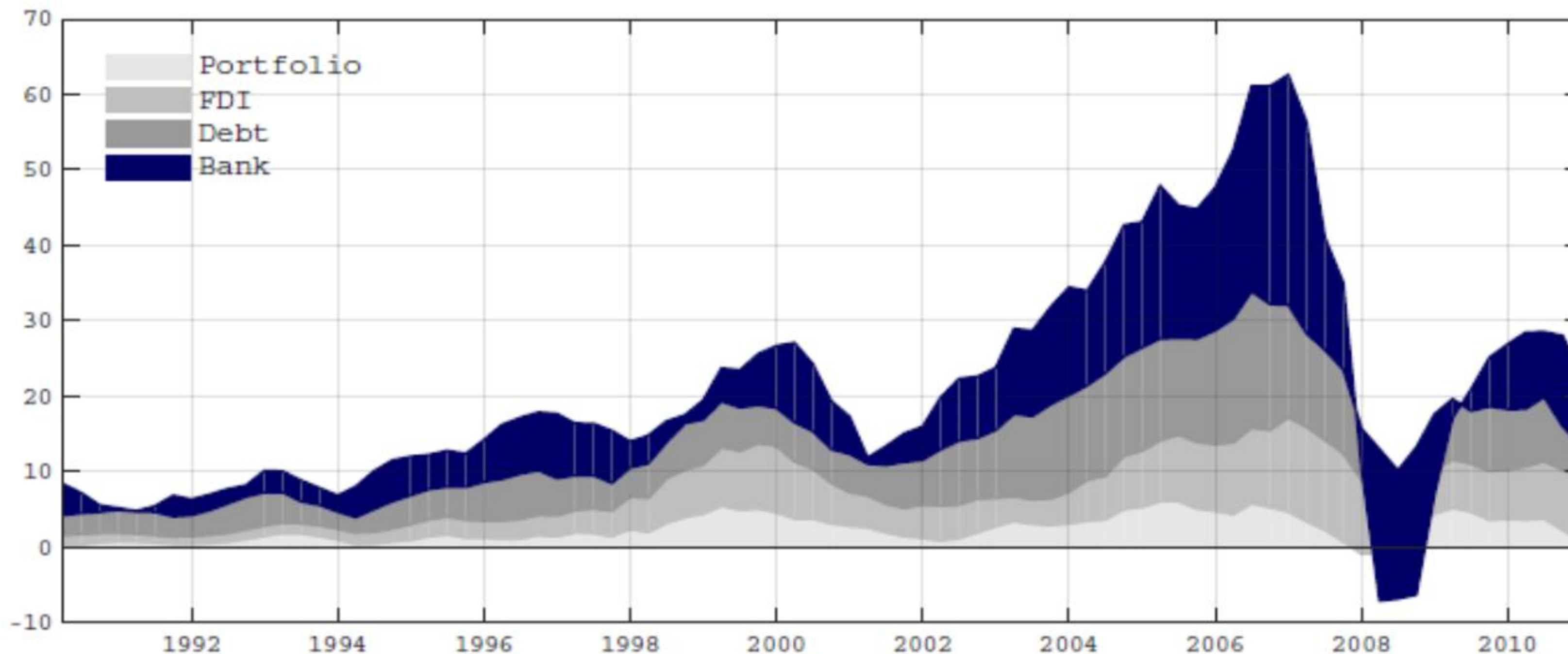
- **Yet, bank profitability has been significantly higher in countries with strong real estate price growth**

Average ROE



THE GLOBAL FINANCIAL CYCLE

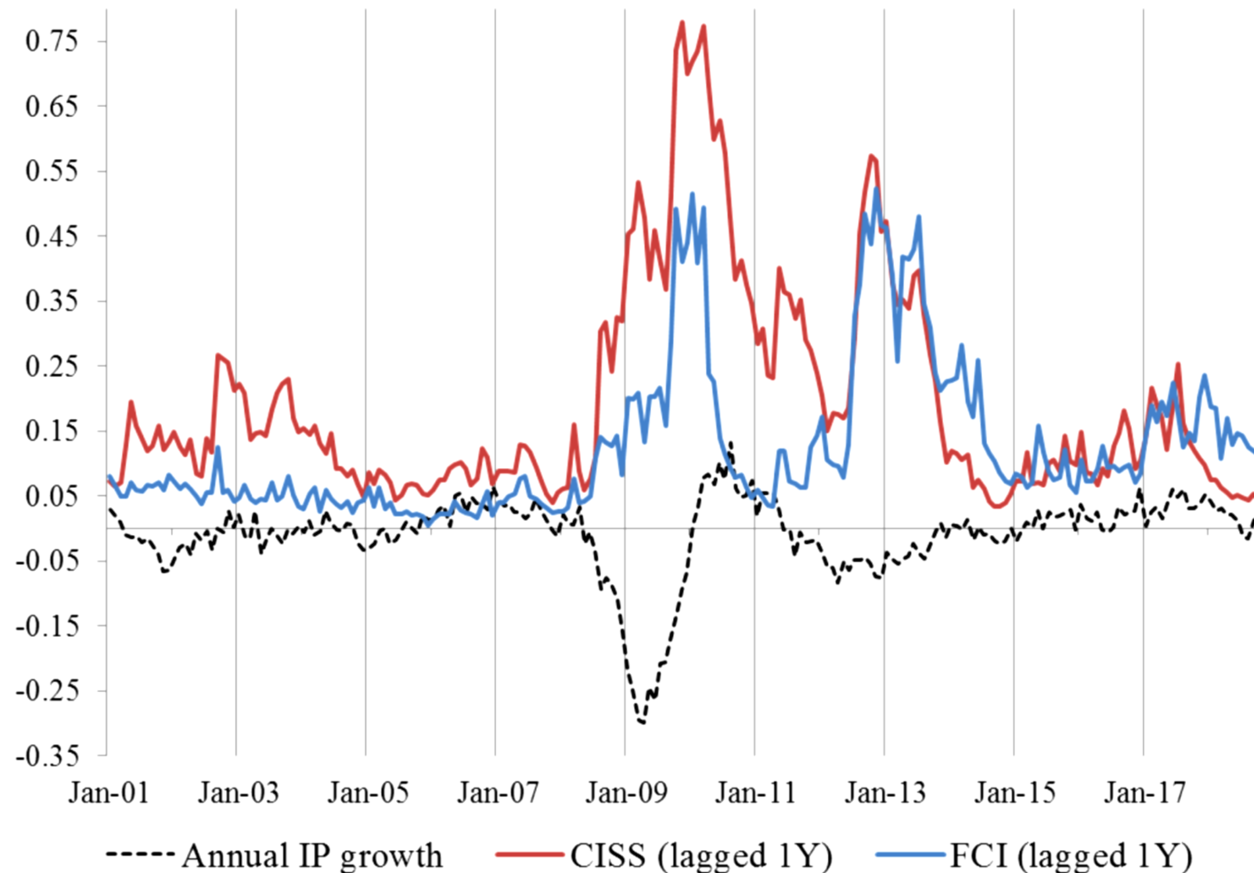
- **Evidence financial cycles have become more global since 90s (Rey, 05)**
  - Increase correlation capital flows and asset prices across countries
- **US Monetary policy most important global factor (Miranda, et al., 2019)**
  - Exported worldwide through global banks' leverage



ITALY'S EXPOSURE TO GLOBAL FACTORS

- **Economic activity in Italy better predicted by CISS index relative to domestic FCI when shocks are global (Alessandri et al., 2019)**

Industrial production growth versus lagged CISS and FCI



IMPLICATIONS FOR THE MP AND MAP DEBATE

- **Existence of global financial cycle raises new & challenging questions for the future:**

- **What implications for the use of structural vs cyclical buffers?**
  - Risks to financial stability likely to be decoupled from domestic conditions
  - Rationale for increasing resilience through structural buffers
  - Consistent with more frequent use of SRB than CCyB in EU (13 vs 10 countries)

- **Does it affect effectiveness of MP in EA, and how can MAP support it?**
  - In small open economies, existence of global financial cycle makes active use of MAP a necessary condition for MP autonomy (Rey's dilemma)