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

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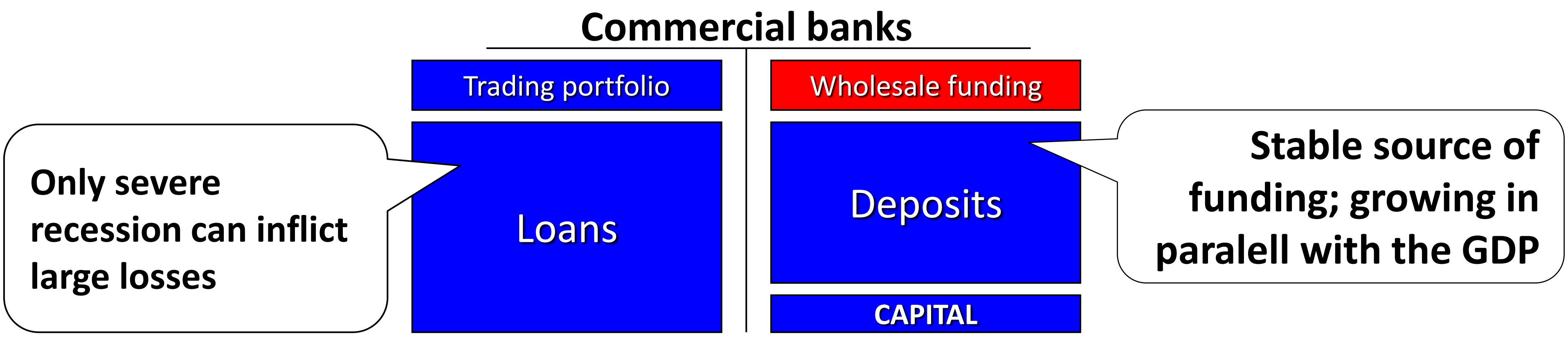
Should macroprudential policy be ambitious in setting its goals?

There are hardly other options

1.
The changing model of banking brought about the global banking crisis

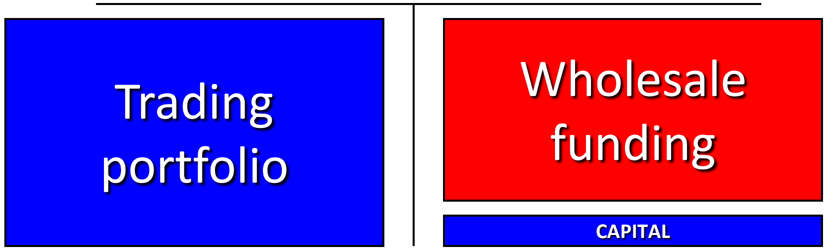
Commercial banking

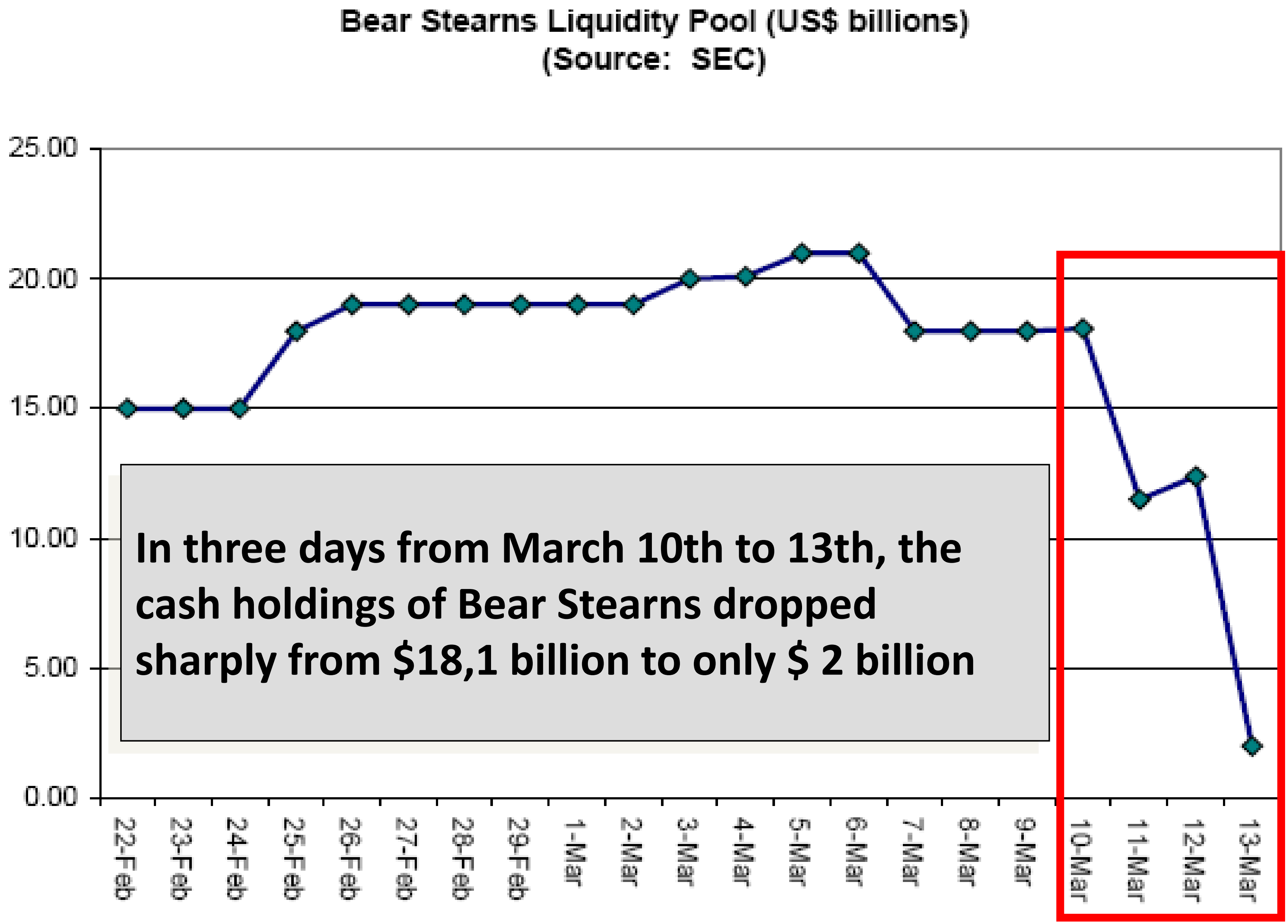


- **weak procyclicality**

Investment banking

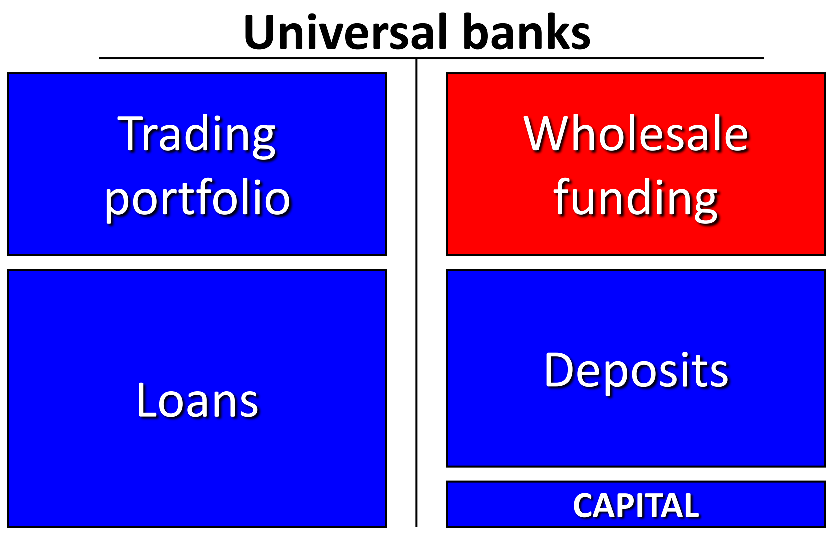
Investment banks





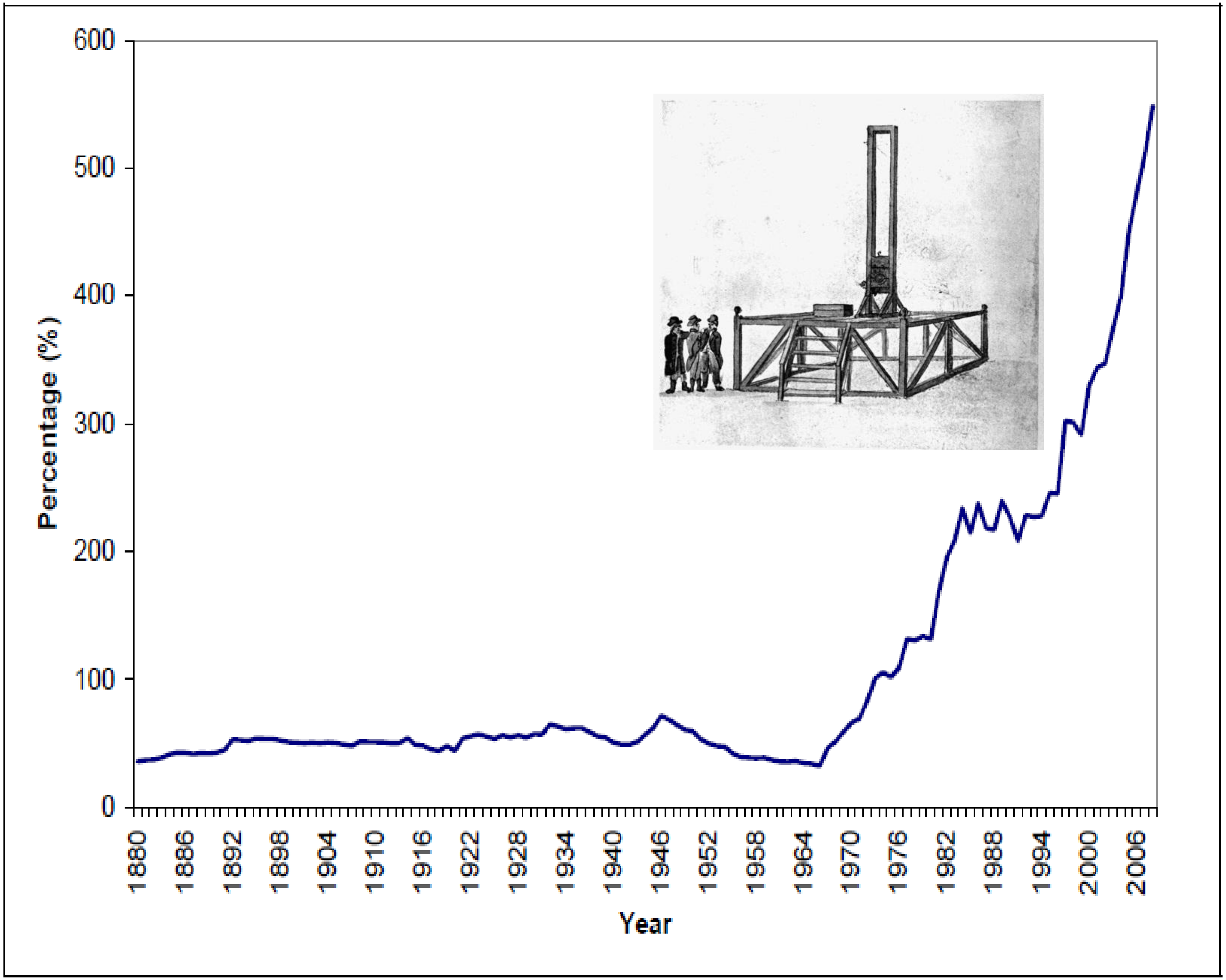
S. Morris, H. S. Shin, *Financial Regulation in a Systemic Context*, „Brooking Papers on Economic Activity”, Fall 2008, p. 1-29

Universal banking



- **enhanced procyclicality**

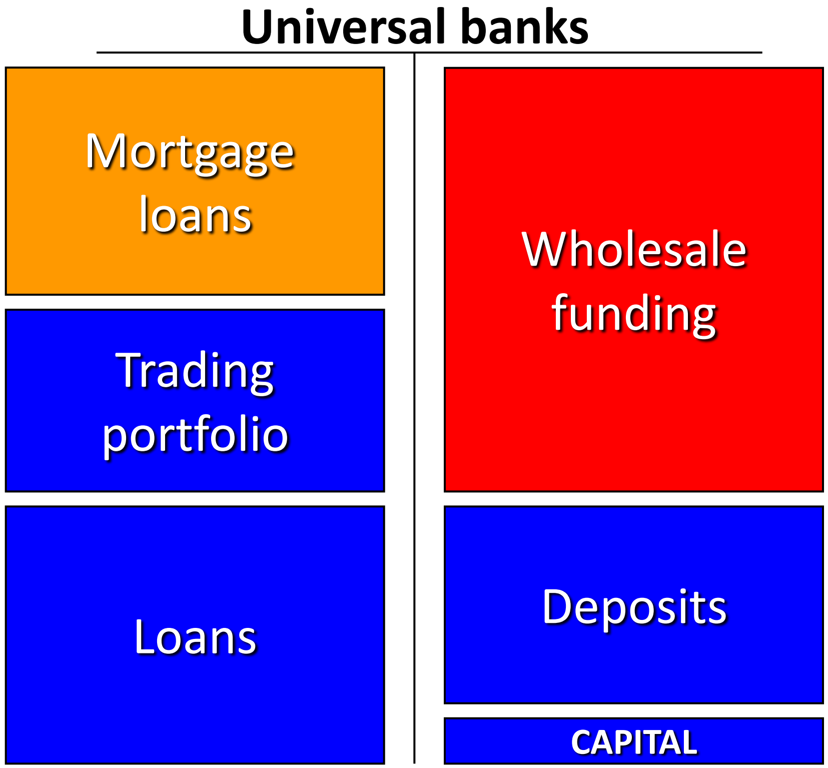
The inflated universal banks: banks assets depart from GDP rate of growth



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

Banks enter mortgage lending (1990s)

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

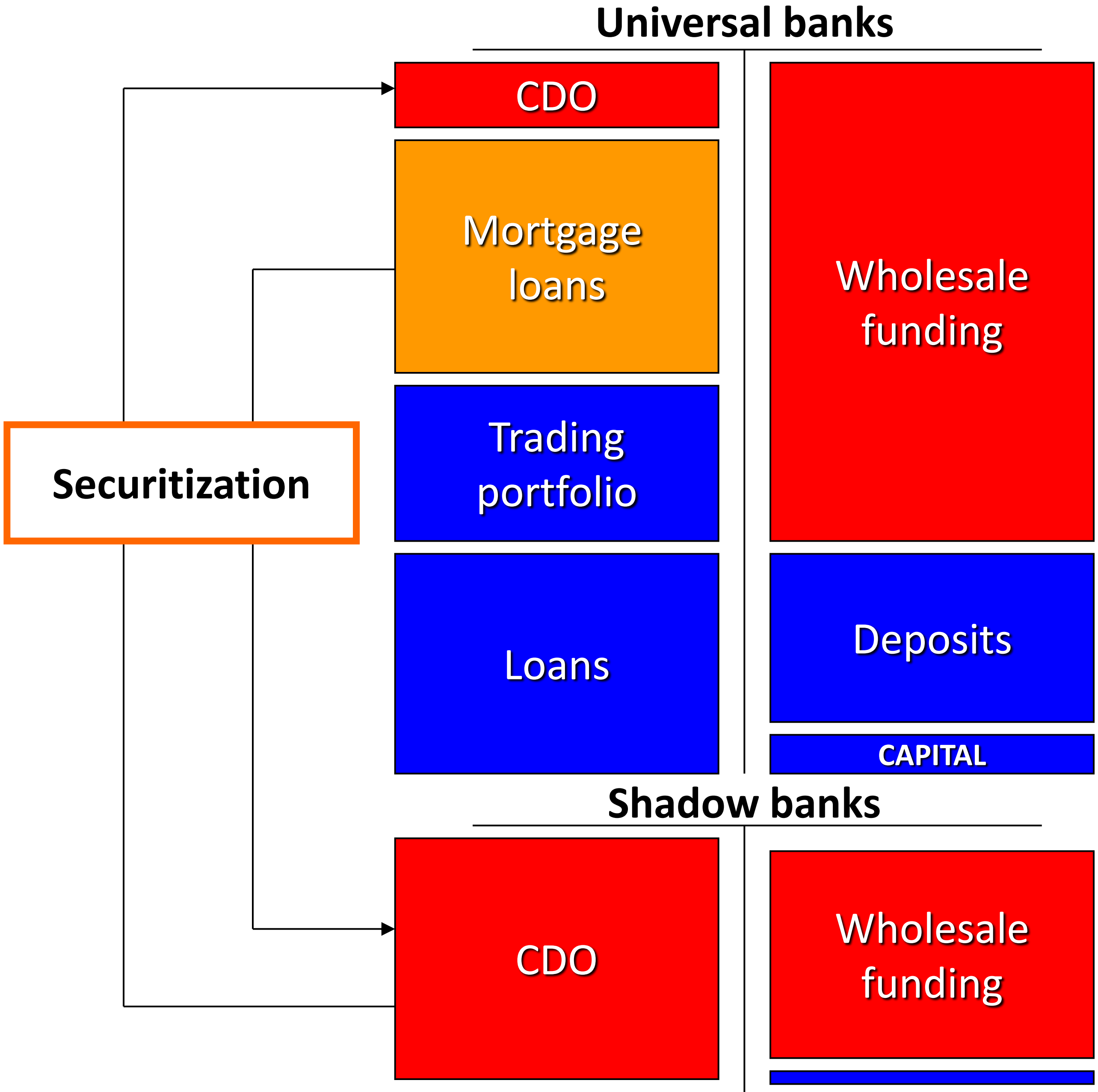
- „The **bubble** was a **supply side phenomenon** attributable to an excess of mispriced mortgage finance” /Wachter, 2009/

- „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.

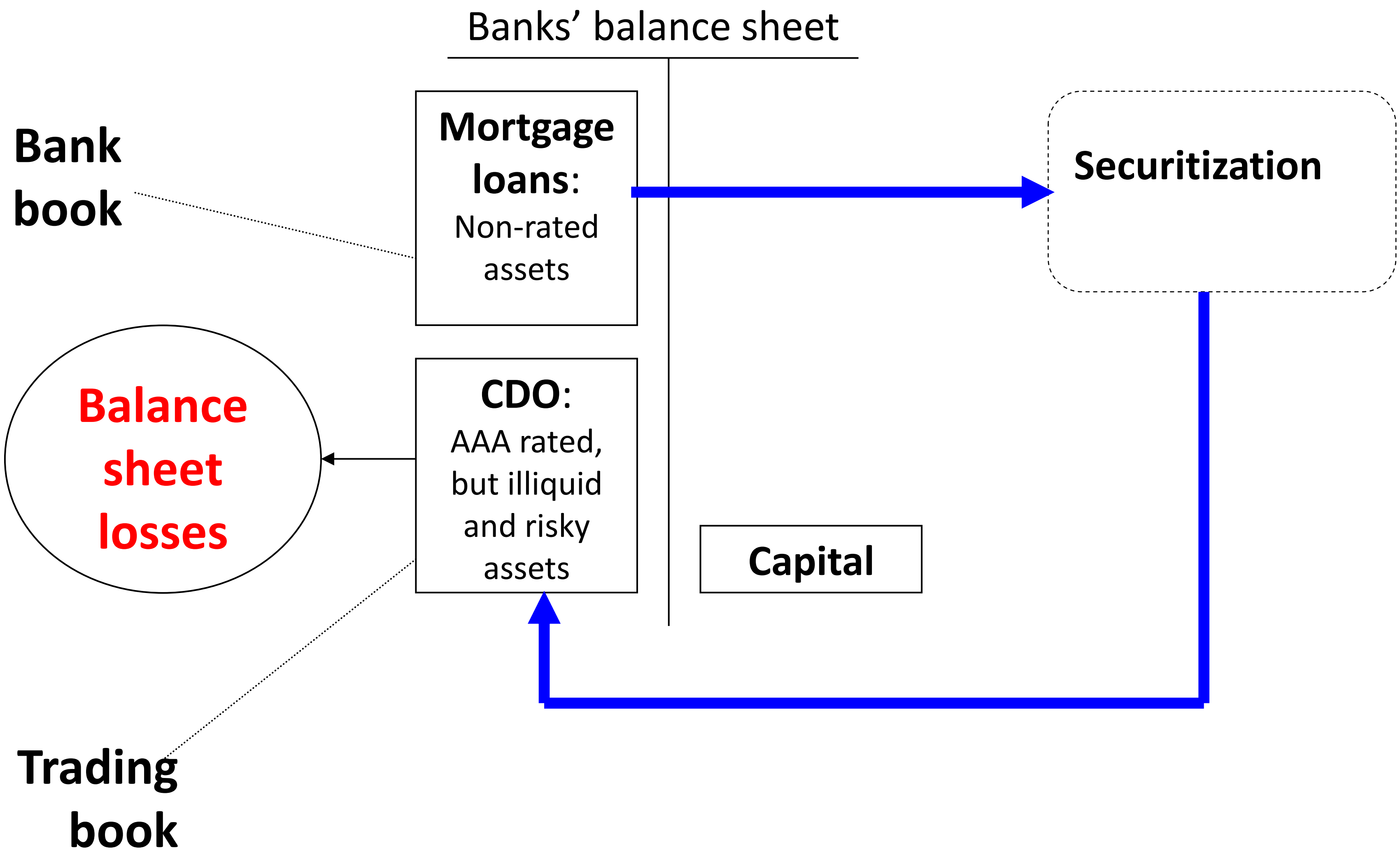
- This allowed aggressive and **seducing proposals** for loan mortgages. The maximum maturity of housing loans was extended beyond 30 years. The maximum **LTV ratio increased considerably from 75% to 95%-100%**. The requirement for down payments were reduced in particular for subprime borrowers".

Baudouin Lamine, "Estonia: analysis of a housing boom",
ECFIN Country Focus, vol. VI, Issue 07 European Commission, 2009

The rise of shadow banking



From regulatory arbitrage to balance sheet losses



Lehman Brothers

rabbitsagainstmagic.blogspot.com

Assets	Liabilities
Securities **45%** — **Structured ABS (e.g. CDO)**	REPO **37%**
Reverse REPO **44%**	Short sales **42%**
Short-term claim/ cash **11%**	Long-term bonds **18%**
	Capital 3%

S. Morris, H. S. Shin, Financial Regulation in a Systemic Context, „Brooking Papers on Economic Activity”, Fall 2008, p. 1-29

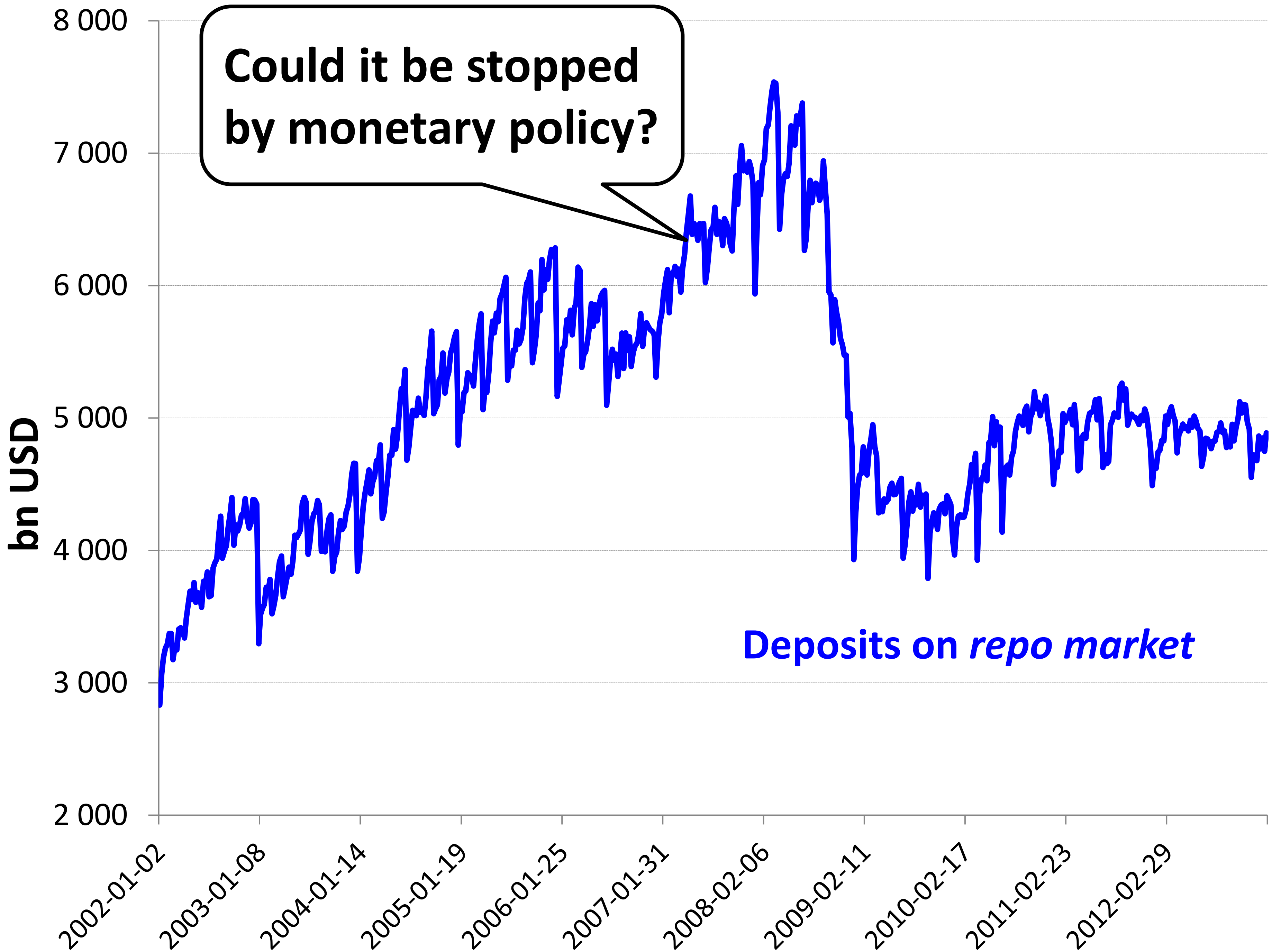
2.
The role of macroprudential policy

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?



Could it be stopped by monetary policy?
Deposits on *repo market*
bn USD
8 000
7 000
6 000
5 000
4 000
3 000
2 000
2002-01-02
2003-01-08
2004-01-14
2005-01-19
2006-01-25
2007-01-31
2008-02-06
2009-02-11
2010-02-17
2011-02-23
2012-02-29

Universal Humpty Dumpty banks

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

Universal banks

Trading portfolio	Wholesale short-term funding
Consumer and business loans	Deposits
	Capital

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?

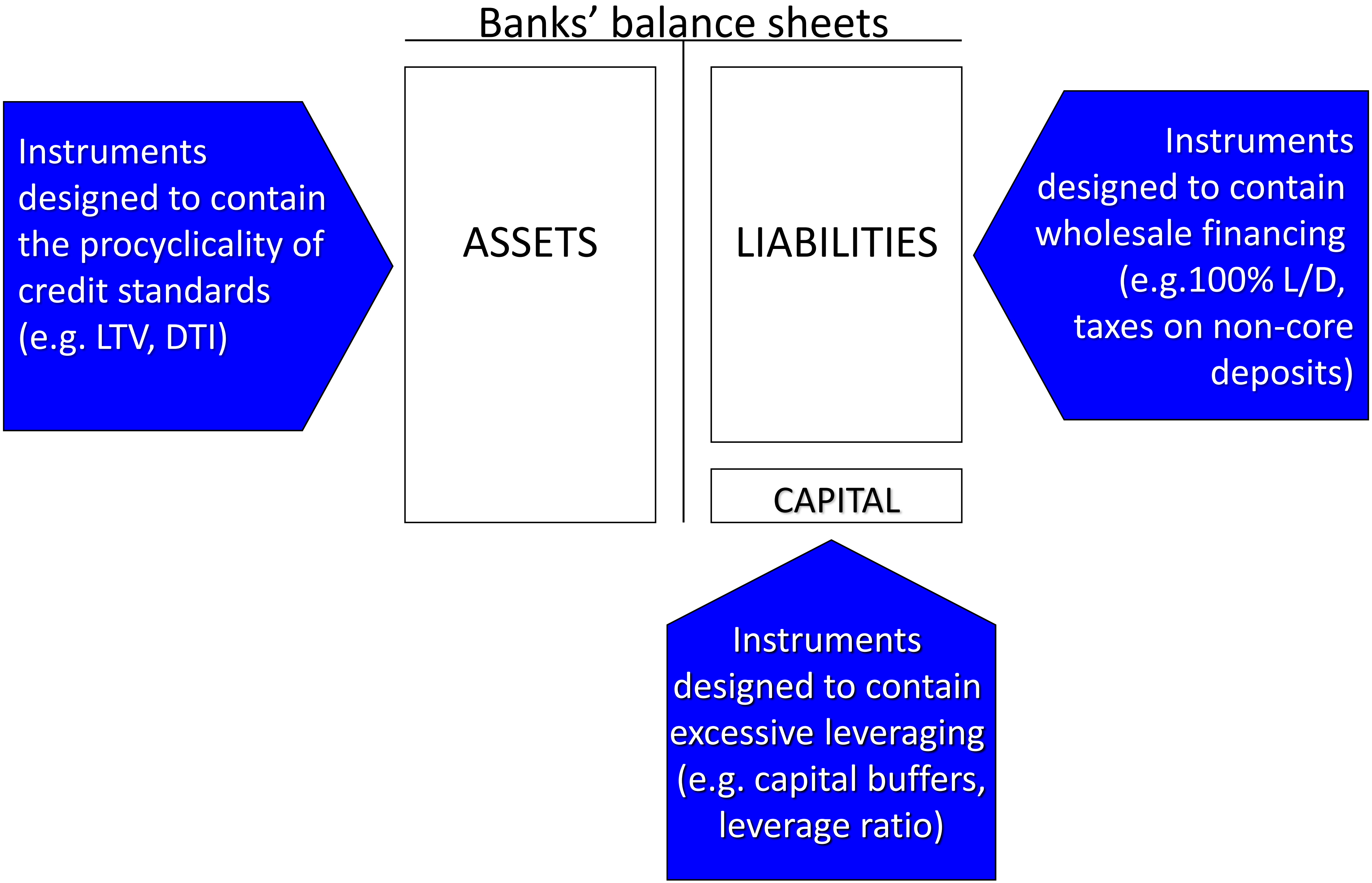
Maybe Alice would know.

http://jadens-dad.deviantart.com/art/Alice-and-Humpty-Dumpty-120502346

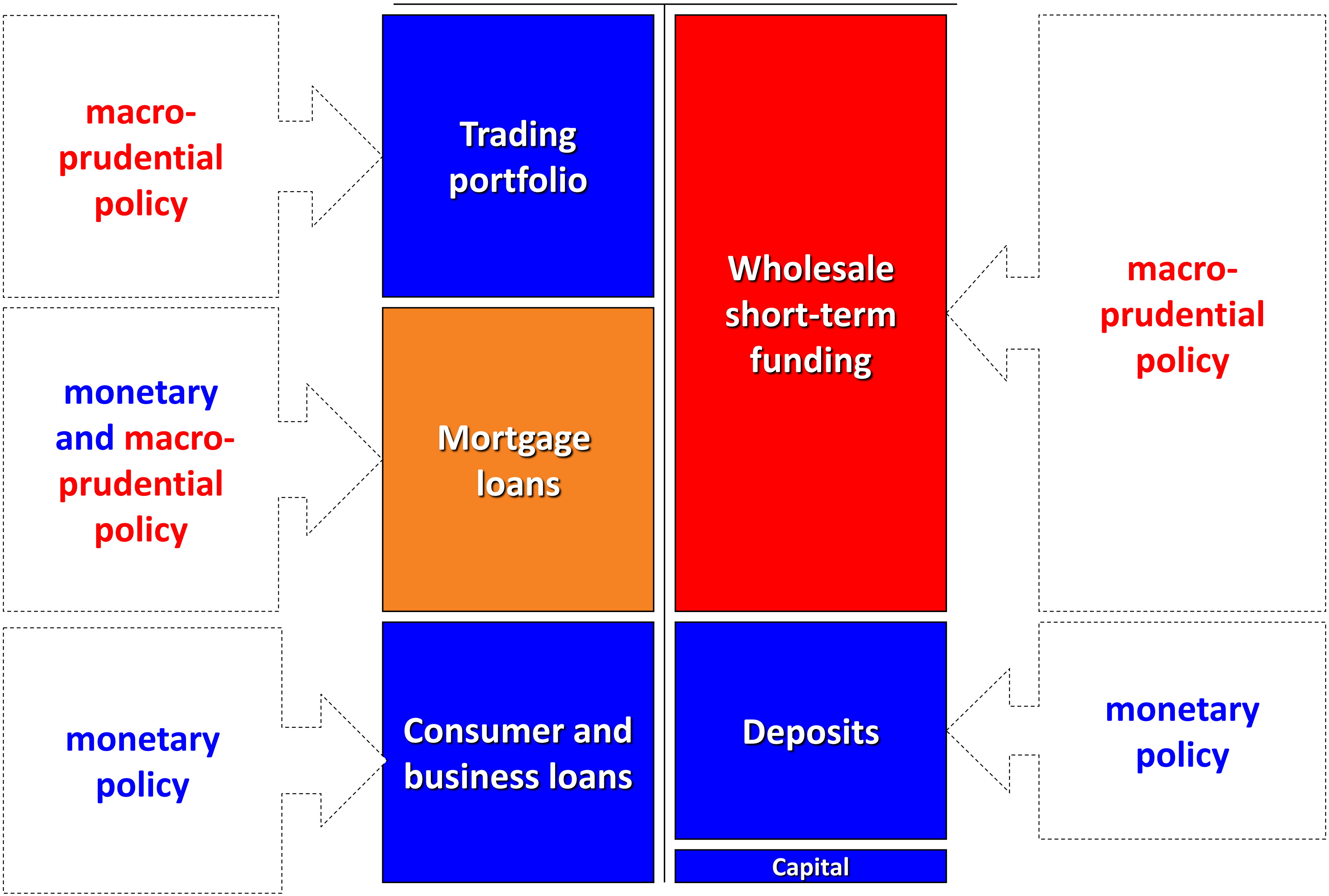
What is leveraging the TBTF banks' rate of return on trading?

- 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



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 by transferred to kids from elementary school.

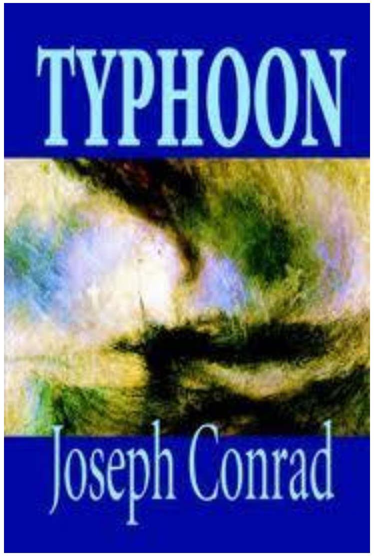
Will the Volcker rule or the Vickers Commission be ring fencing enough to civilize TBTF ?

3.
Can macroprudential policy focus exclusively on systemic (tail) risk?

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

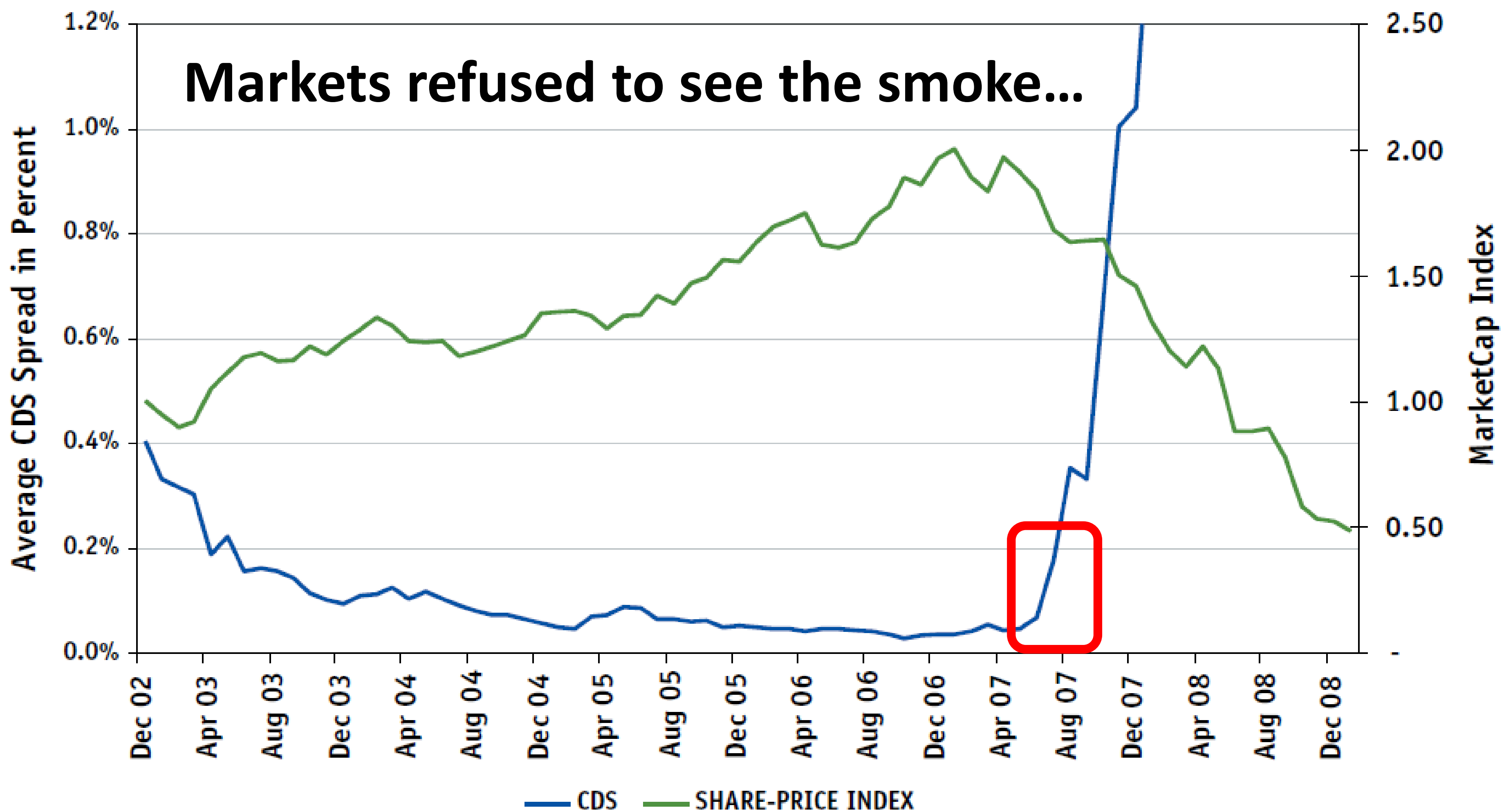
- „Systemic risk has so far resisted a formal definition and qualification.
- **It is unrealistic to expect that a single measure of systemic risk** will suffice. A more plausible alternative is a collection of measures, each designed to capture a specific risk exposure.” (Lo, 2008)

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



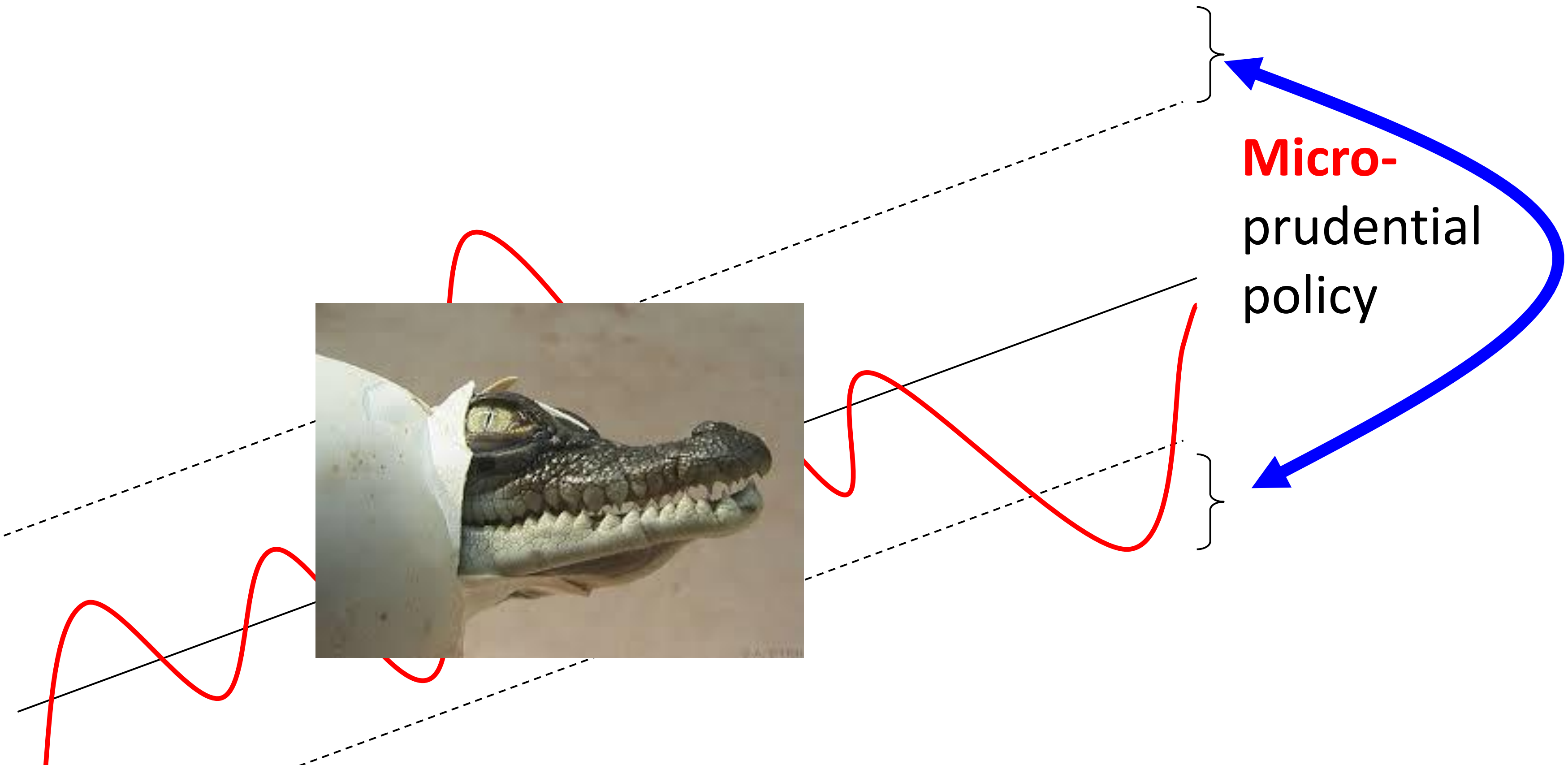
Firms included: Ambac, Aviva, Banco Santander, Barclays, Berkshire Hathaway, Bradford & Bingley, Citigroup, Deutsche Bank, Fortis, HBOS, Lehman Brothers, Merrill Lynch, Morgan Stanley, National Australia Bank, Royal Bank of Scotland and UBS

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

magellinadad.blogspot.com

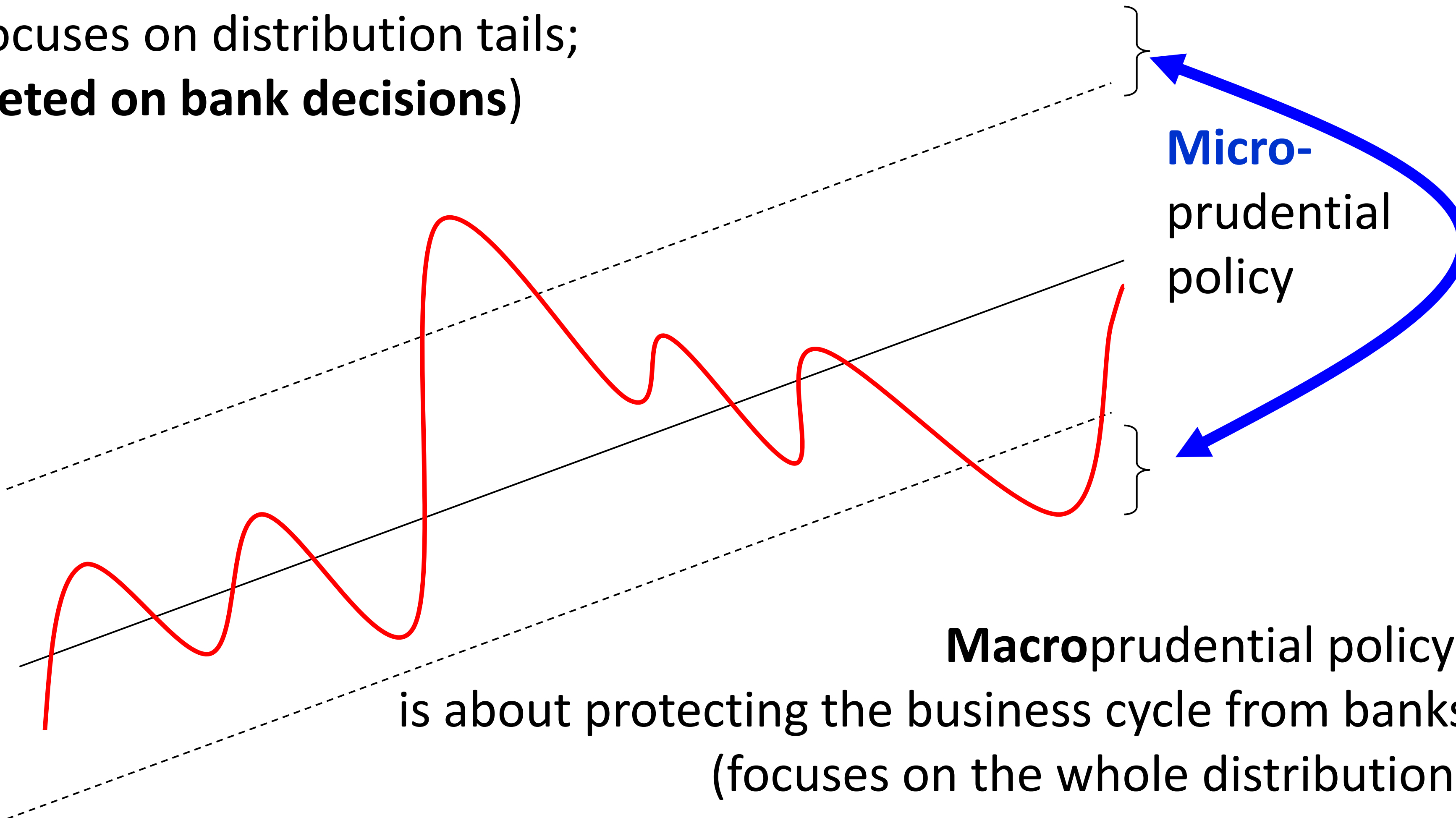
Systemic (tail) risk is usually born in the middle of the distribution (e.g. unstable lending boom)



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)



Macroprudential policy:
is about protecting the business cycle from banks
(focuses on the whole distribution;
targeted on households and corporate sector decisions)

4.

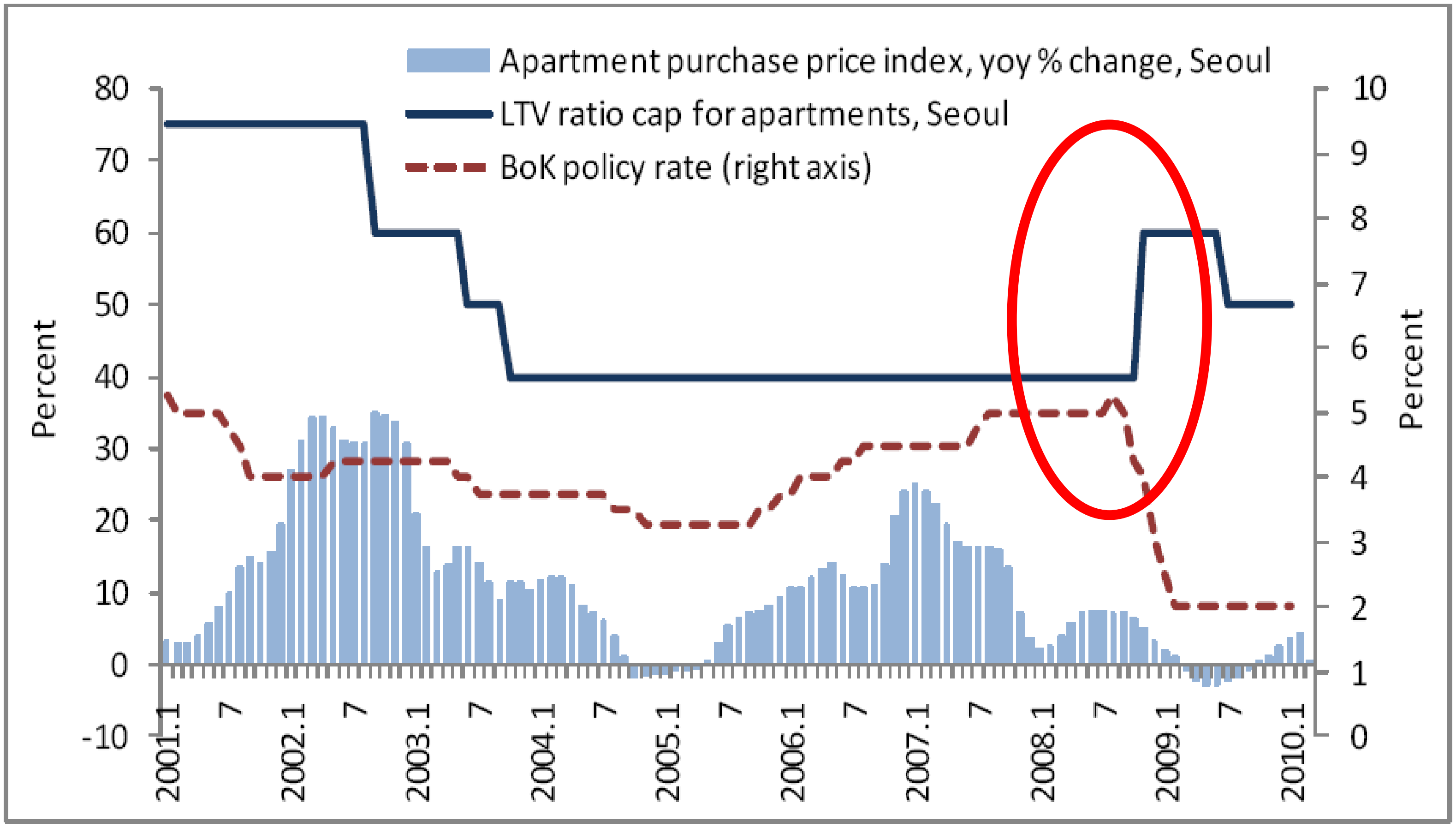
What should be the division of labor between monetary and macroprudential policy?

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

http://busandadmin.uwinnipeg.ca/Strategy/StrategyGraphics/StrategyGraphicsFall2009.htm

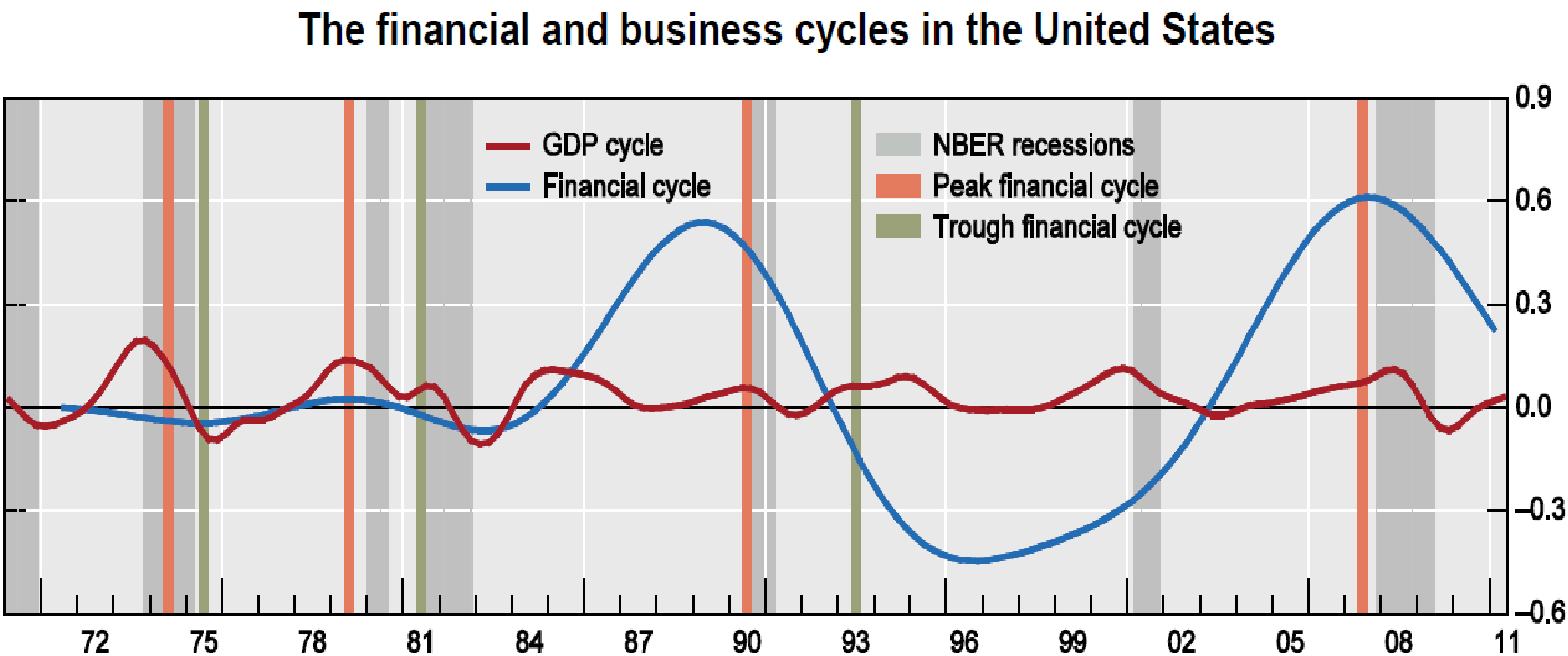
Macroprudential policy should assist monetary policy in controlling the rate of credit growth

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



Source: Chang (2010)

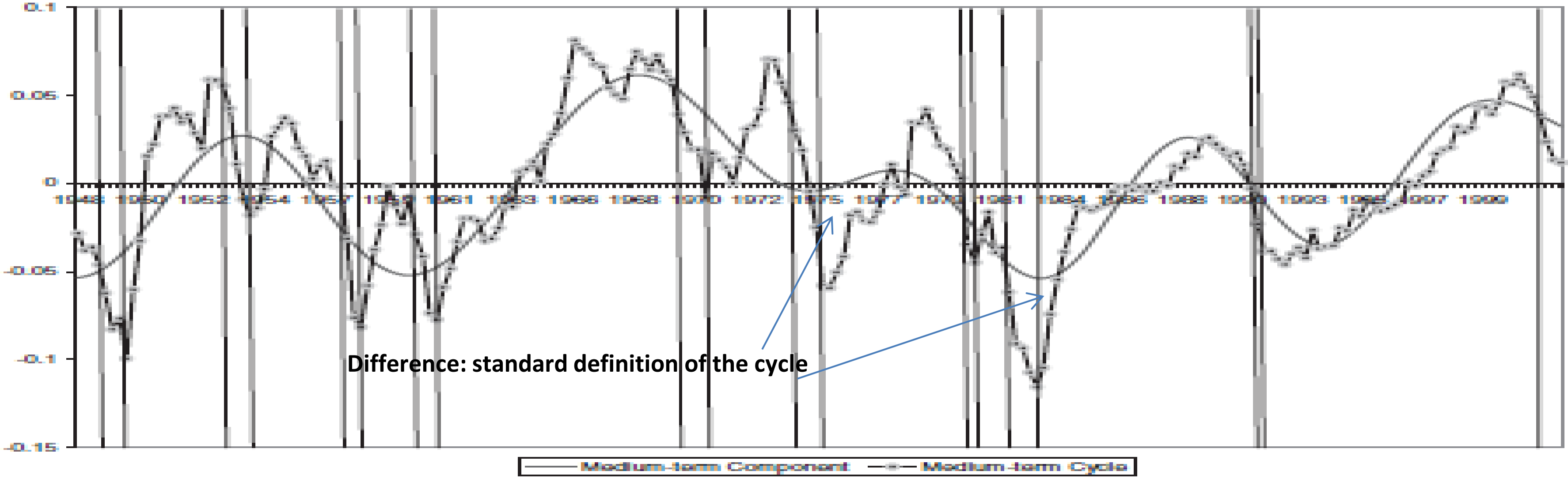
Monetary policy must deal with the business cycle. Macroprudential policy should deal with the financial cycle



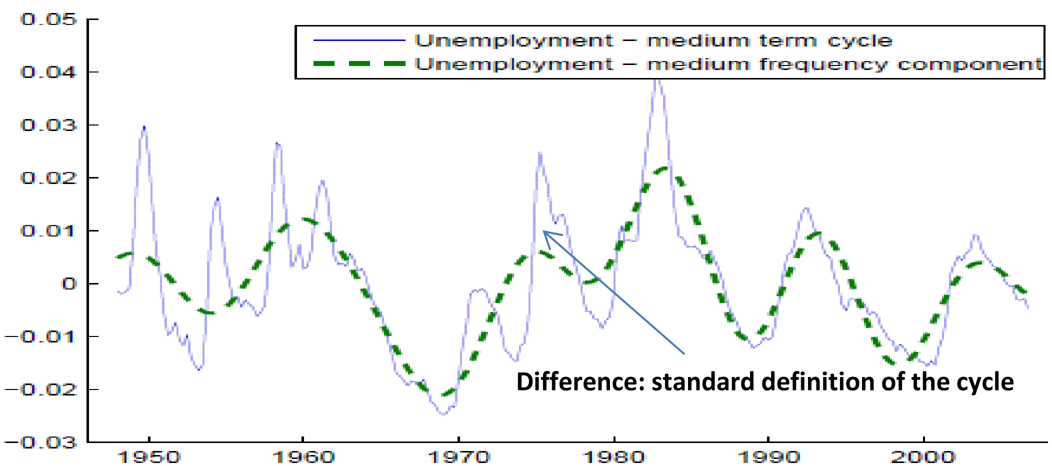
Orange and green bars indicate peaks and troughs of the financial cycle measured by the combined behaviour of the component series (credit, the credit to GDP ratio and house prices) using the turning-point method. The blue line traces the financial cycle measured as the average of the medium-term cycle 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**

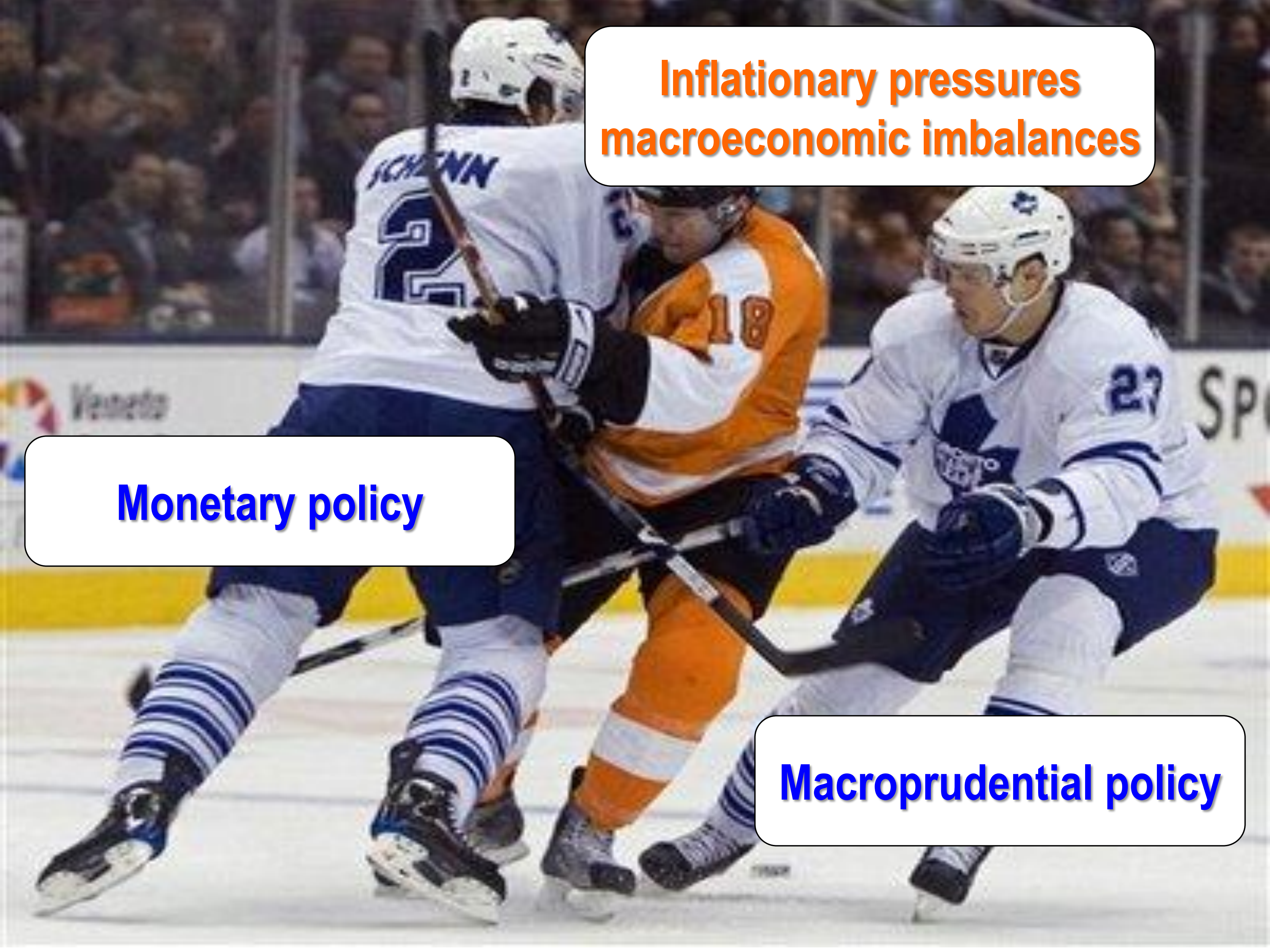
- **Macroprudential policy** influences the rate of credit growth and the **money supply**

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


Inflationary pressures
macroeconomic imbalances
Monetary policy
Macroprudential policy