Peterson Institute for International Economics

Making Macroprudential Policy Practical in the US and Beyond

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Making Macroprudential Policy Practical in the US and Beyond

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1. Macropru must be pre-emptive and countercyclical to achieve anything (structural reform is separate)
2. Tools seem to require massive simultaneous use to work, but are treated as fine-tuning instruments
3. Argument for *rules-based* institutionalized Macropru are at least as strong as for Monetary Policy
4. Targets should be primarily real-estate and primarily on credit demand side, not supply or liquidity
5. International coordination is currently insufficient, and should be linked to capital flows
6. Current US institutional set-up is likely to fail in a crisis and will do less to prevent one than it could

Macropru must be pre-emptive and countercyclical

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- The concern is build-ups of bets all in one direction and unsustainable growing indebtedness
  - Can gain self-feeding expansionary momentum
- While some asymmetry exists, crises are worse than cutting off expansions, one-sided approach is not viable economically or politically
- Macropru is genuinely more like monetary policy and less like normal forms of regulation than recognized
  - Even « Network Industries » are more like micropru
  - Credit aggregate forecast targeting seems plausible
- The concern must not be about specific institutions
- The cycle is by definition out of sync with GDP or inflation or we would not have this problem

Tools seem to require massive simultaneous use to work

- We have already seen the repeated failure of jaw-boning and of interest rate increases
  - Interest rate hikes actually make things worse for open economies by attracting greater capital inflows
- Capital requirements of whatever level are subject to gaming and to pro-cyclicality
- Those economies where multiple tools are available needed them all vs. major bubbles
- If shadow-banking or more broadly substitute forms of credit exist, need to have multiple/broad attacks
- Information disclosure and finely calibrated adjustments have a poor record vs. Demand side

Argument for rules-based institutionalized Macroprudential Policy

- We spent decades debating MP rules vs discretion
- Yet the political pressures for holding off on macropru measures are far more compelling
  - And the reputational damage of time-inconsistency greater
  - Even good intent has insufficient deterrence if discretion
- The information uncertainties are of lesser importance given the costs of failure involved
  - Meanwhile deviations from tightening should be clear
- Distrust of central bank discretion is high
  - Especially in the US, especially for market interventions
- Rules can be set by legislatures in simple form, keeping ex post evaluation and accountability clear

Targets should be primarily real-estate and credit demand side

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- Real estate boom-busts are *sufficient* to cause financial crises with substantial macro impact
  - They are almost *necessary* for crises to be severe
  - They are present in the majority of crises seen
- There is no benefit to allowing sustained real estate appreciations as there is for equities and innovation
  - There are huge external costs to real estate boom-busts
- There is a decent benchmark for real estate prices
  - Albeit more reliable for residential than commercial
- The macropru tools for which there are proven results are DTI/LTV type limits, as well as taxes
  - Accountable clear methods for narrowing targets (region, ownership status, land use…) and capabilities in place

International coordination is currently insufficient

- Capital inflows are a huge contributor to booms
  - Even for US, what is the savings glut hypothesis but that?
  - Credit from external lenders can always be available if you do not directly limit it (even US is small vs world savings)
  - Common capital standards do nothing to prevent shifts
- One supervisor's systemic risk is another supervisor's healthy diversification
  - That is, until the capital gets trapped, which reverses flows
- There is no one global liquidity measure or one interest rate that can smooth all
  - Another reason to confront the accumulation of excess reserves and seek more symmetric policies

Institutional Possibilities Abound

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	US	UK	Euro Area	Hong Kong	Australia
Who has FS Responsibility	Fragmented FSOC+	Bank of England	ESRB (ECB + National CBs)	HKMA primarily	RBA chairs CFR
Role of government	Treasury chairs	Non-voting observer	None	Finance Secretary chairs	Treasury one of four votes
Degree of discretion	Designation of SIFIs+	All tools	Carve outs & temporary	All tools	Prudential tools in APRA
Policy instruments available	Facilitating coordination & monitoring	CCRs, SCRs, LTV/DTI ratios, leverage	ECB can tighten stnd; NCBs can go both ways	CCRs, SCRs, LTV/DTI, Bank reserves, Stamp Tax	Prudential tools in APRA
Decision making body	FSOC 10 voters 5 observers	FPC 10 voters 1 observer	ESRB 38 voters	FSC 5 voters Rare votes	Coordination via CFR RBA chairs
Public accountability	"Transparent meetings," Chair testifies	*FSR* ,press conferences, All testify	Chair ESRB testifies to EP ECON	Chair FSC testifies to Legis. Council	Not specified

Current US institutional set-up is likely to fail

- Responsibility is fragmented and interagency
  - The least politically independent actor chairs FSOC
- Discretion is huge over individual financial institutions which is a recipe for creating uncertainty
- No clear rules or definitions come out of D-F
- There are no policy tools in the box
  - Besides designation of SIFIs and the like
- The decision making process does nothing to provide common targets or forecast, just lists risks
- Accountability is upside down
  - FSOC meetings are too transparent to function well
  - Accountability to Congress is insufficient to legitimize