Making Macroprudential Policy Practical in the US and Beyond

September 30, 2015
For Federal Reserve Bank of Boston
59th Economic Conference

Adam S. Posen
With Tomas Hellebrandt and Jan Zilinsky
Peterson Institute for International Economics
Making Macroprudential Policy Practical in the US and Beyond

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

- 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 jawboning 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

- 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

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

FRB Boston 10/15 Conference Draft Posen
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