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Managing the risks of the new macro-prudential policy regime

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Abstract

The pursuit of a new "macro-prudential" policy agenda has become a call to arms for many central banks and multilateral institutions seeking to lean against financial factors that promote macroeconomic volatility. Cyclical use of prudential policy, such as variation in capital requirements, is fraught with risks. It should only be employed during extreme circumstances. In general, policy makers should focus on strengthening traditional monetary policy rules and micro-prudential policies.

Many observers argue that the recent financial crisis shows that the aggressive pursuit of macro-prudential policies — policies that vary bank capital requirements, mortgage leverage constraints, and other instruments on a cyclical basis to cool down or heat up the financial system as needed — are necessary to combat the cycles of financial boom and bust that have characterized developed and developing economies over the past three decades.

Skeptics, in contrast, believe that the pursuit of macro-prudential policies could produce more distortions and more macroeconomic volatility. Skeptics see excessive risk taking as primarily a symptom of ineffective or unwise monetary policies and micro-prudential policies, which if corrected, would remove much of the incentive to undertake excessive risks during booms. Excessive risk taking during booms, according to this view, is primarily the result of the combination of loose monetary policy, generous government safety nets for banks, and borrowing subsidies for consumers (especially in housing credit). Thus, the need for macro-prudential regulation to lean against the wind during booms would be substantially reduced if monetary policy followed a clear, time-tested rule, if micro-prudential regulation were reformed to be made effective, and if government subsidies for risk taking were absent. There is a substantial body of evidence in support of that proposition. The focus on macro-prudential regulation distracts from these more important policy reforms.

Furthermore, during recessions, relaxing prudential regulation on macro-prudential grounds (to stimulate lending and encourage investment) is likely to be destabilizing. The tolerance of inadequate capital ratios of troubled lenders is already an all-too-common discretionary reality known as "forbearance," which is usually accomplished through lax recognition of loan losses. The severity of many severe banking system disasters of the past three decades can be traced to relaxing regulatory standards in the name of preserving bank lending during contractions.

Problems of implementation also abound. The Basel III standards envision a 2.5 percentage point cyclical variation in minimum capital ratio requirements for banks. At the time that policy was announced, there had been no microeconomic studies of the effects of capital requirement changes on the supply of credit. The aggressive cyclical variation in capital requirements under Basel III seems to have been based on unreliable back-of-the-envelope estimates that suggested small loan-supply reactions to changes in capital requirements. More recent studies, using microeconomic data on bank reactions to capital requirement changes in the UK and provisioning requirement changes in Spain, suggest very large reactions: in

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the UK, a one percentage point increase in capital requirements (e.g., raising risk-based minimum capital ratios one percentage point, from the sample average of 11 percent to 12 percent) reduces the supply of domestic lending to nonfinancial firms by about 7 percent; in Spain, an increase in provisioning requirements (a form of capital front-loading, not a permanent increase in required capital, which should have a much smaller effect on lending) reduces loan supply by about 3 percent. Banks' reactions depend on a variety of circumstances (which reflect differences in the costs of raising equity capital, and differences in the value of preserving lending relationships), and these findings from the UK and Spain do not provide a reliable indicator of the magnitude of that variation for other banks operating in other countries. In short, macro-prudential policy tools are a bazooka, not a pea shooter, and using them as a cyclical tool, given the existing scant empirical knowledge about their effects, amounts to firing a bazooka without the benefit of a reliable sight.

Finally, an aggressive approach to macro-prudential policy can be destabilizing through its unintended consequences for other policy instruments, especially monetary policy. Pro-cyclical monetary policy (policy that cuts interest rates and expands money and credit during expansions) has been a major contributor to risk taking during booms. Monetary policy over the past century of U.S. history generally has been pro-cyclical, either because of flawed conceptual frameworks that have guided monetary targeting, or because of political pressures associated with the financing of government deficits.

A major part of the cure for the destabilizing pro-cyclical tendency of monetary policy is the establishment of a policy rule to constrain and guide policy makers. An observable rule that has a reliable track record for producing countercyclical policy and price stability insulates central bankers from the political pressure to use discretion to monetize deficits, and protects the public from discretionary policies that are based on faddish models.

Macro-prudential policy can undermine such a rule. First, in the presence of a new and powerful set of tools that affect the supply of credit in the financial system, it is quite likely that the responses of inflation and unemployment to changes in the federal funds rate will differ from what they were before, which makes the existing empirical basis for a reliable monetary rule obsolete. Second, adding numerous new tools and objectives risks undermining the central bank's accountability for following its monetary policy rule. If a central bank employs multiple tools at its disposal for achieving countercyclical objectives (the federal funds rate, time-varying capital ratio requirements, time-varying loan-to-value ratios on mortgages, etc.) it may be very hard − perhaps virtually impossible − for it to articulate any rule that will guide its actions, especially given the lack of knowledge of the impacts on the economy of these various policy levers.

These criticisms do not imply that macro-prudential policy is always a bad idea. The financial histories of many countries contain episodes in which extremely rapid growth of bank credit is followed by a severe recession. Monetary policy can be a weak tool to cool down excessive bank credit growth in such extreme circumstances. The recent experience of Colombia is an interesting example. In 2006−2007, rapid acceleration in credit growth, the current account deficit, and inflation led the central bank to raise interest rates dramatically, but this did not slow down credit growth. Only the combination of a substantial increase in capital requirements, provisioning requirements, cash requirements, and capital controls was able to cool credit growth, which led to a soft landing with no recession in 2008−2009. This is not an isolated example, but neither is it a constant occurrence.

What, then, is the appropriate rule to follow with respect to macro-prudential policy? Given the four problems mentioned above, I suggest that policy makers continue to rely on traditional monetary policy in almost all circumstances, and not employ macro-prudential policies except during extreme circumstances associated with the most severe credit booms. For example, one could set a threshold of, say, 20% annualized growth of banking system credit over a minimum length of time (say, eighteen months). If credit growth exceeds that threshold over that length of time, a pre-specified increase in capital ratio requirements per quarter would be imposed (say, 50 basis points per quarter) until credit growth slowed to an acceptable level; or else the regulator would have to explain why the increase in capital requirements should not be imposed. Once credit growth slowed, and following some pre-announced formula, requirements would return to their normal levels.

This approach would achieve much of what macro-prudential policy advocates have in mind, while minimizing potential costs. It would avoid making macro-prudential policy a constant source of uncertainty. It would avoid undermining micro-prudential policies during recessions through forbearance. Because the macro-prudential policy tool would be used so rarely, it would not undermine the effectiveness of the monetary policy rule established by the central bank. This approach, however, will only work to promote economic stability if it is combined with two other crucial long-term policies: a credible monetary policy rule, and an effective reform of micro-prudential policies to avoid the subsidization of risk taking. Much of the impetus for macro-prudential policy action is the result of the failure to do either.