International policy coordination: Macroprudential policies and the ‘new normal’

Russell Kincaid, St Antony’s College, Oxford
Max Watson, St Antony’s College, Oxford

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Introduction

The ‘New Normal’ refers to the prospect of relatively low nominal interest rates in major economies over an extended period, in a setting of low trend real growth. This global environment reflects monetary policies in key currency countries, often unconventional in form, that are being conducted against the backdrop of continuing balance sheet repair and gradual sectoral shifts in the real economy. It is recognised that this ‘New Normal’ may be disturbed by episodes of volatility – for example, if central banks and other bond market participants view inflation and real growth risks differently, or if central banks’ communication strategies are deficient or misunderstood.

The main focus in this policy note is on the potential role for macroproudential policies in containing problematic side-effects of monetary policy in this ‘New Normal’. Our focus is on both key currency economies and the countries subject to spillover effects from those economies. (Not all major economies are key currency economies – Germany being an obvious case in point.) Among the issues discussed are: the use of macroproudential policies for demand management as well as financial stability; the effectiveness of macroproudential measures, including on nonbank flows; and the need and scope for international coordination of macroproudential policies.

Policy challenges under the new normal

The ‘New Normal’ monetary environment may trigger challenges in key currency countries and the rest of the world, giving rise to broader problems of economic management owing to different conjunctural circumstances. Key currency economies benefit from a monetary policy that can be well matched to their domestic cyclical conditions, but those interest rate settings may unintentionally aid and abet undue financial risk-taking, asset price bubbles, and a global search for yield. Other economies may find that they ‘import’ monetary conditions that are cyclically too easy as well as encountering a wall of money, which encourages excessive risk-taking in their economies. Depending on the structure of their

1 A preliminary version of this policy brief was presented orally on March 13, 2014 at a Chatham House-IMF workshop, Managing Complexity—Global Economic Interdependencies and Coordination of Macroeconomic Policies.
economy, including its exchange regime, monetary conditions may contribute to policy dilemmas for the real economy, or the financial economy, or both.

The nature of spillovers has also changed to some degree. The transmission channels of monetary spillovers have shifted: bond markets have become increasingly important, transmitting impacts directly to domestic financial conditions and asset prices, perhaps especially when monetary easing in key currency countries is focused on lowering the slope of the yield curve (Bayoumi, Oxford, forthcoming 2014). This increases the risk that credit and asset price cycles will be triggered in spillover-affected economies. Foreign-denominated inflows also expand the scope for domestic corporates in these affected economies to take on exchange risk.

In the first quarter of 2014, the cyclical conditions in key currency economies are diverging with implications for their conduct of monetary policy. The U.S. and U.K. economies are experiencing robust real growth compared with real growth in the euro area and Japan. Tapering by the Federal Reserve is a reality. Market participants are anticipating increases in policy interest rates in both the U.S. and U.K. in 2015. Meanwhile, Japan is engaged in massive quantitative easing and the ECB is struggling to keep deflation at bay, with calls for unconventional monetary measures. This divergence could create tensions in bond and currency markets.

These are live issues, insofar as further waves of monetary spillovers from key currency economies may lie ahead. Growth and financial risks in China also cannot be ignored. A growth slowdown in emerging markets risks triggering a migration of financial exposure to their public sector balance sheets. And within EMU, an economy such as Germany may be ‘out of sync’ with ECB policy interest rates for an extended period. In such a setting the behaviour of international asset managers in embracing or rejecting asset classes may be abrupt. All in all, the case for strengthening the macroprudential policy architecture at all levels—national, regional and global—is very strong.

Monetary policy and financial stability

The experience of the global crisis has taught us that, while instrument-independent central banks can achieve successfully their inflation objectives, taming inflation is not enough to assure stable financial conditions. Financial stability cannot just be assumed to flow naturally from the risk management behaviour of the private sector. Light prudential supervision does not work. Moreover, microprudential regulation — which watches over individual institutions — needs to be combined with macroprudential oversight that protects the financial system. Both types of supervision must seek to rein in excessive private risk taking that derives from: (i) externalities — such as the financial accelerator; (ii) market imperfections — such as principal–agent problems; and (iii) moral hazard — which stems from government backstops. In the process, prudential supervision provides needed discipline over financial markets and thus helps to foster financial stability and to protect the government balance sheet.

We would also conclude from this experience that monetary policy is too blunt a tool to deal with credit-driven asset or sectoral booms. Indeed, the experience of targeting financial aggregates with the interest rate has not been encouraging – and that is what would be
involved in using monetary policy to guide the path of credit. Moreover, the political economy of inflation targeting has been very successful, and is best not overburdened by an additional financial stability goal. Placing all supervisory tasks with the central bank, or making it potentially subject to interagency co-ordination, have risks. (For a discussion of relevant theoretical and empirical considerations, see Kincaid and Watson, 2013a.)

Regarding the role and limitations of monetary policy, this policy brief starts from proposition that it is preferable to assign monetary policy (if available) primarily to the management of the unemployment/output gap in order to achieve an inflation target. Any associated macrofinancial tensions should be addressed in the first instance through the introduction or intensification of macroprudential, fiscal and structural measures. In the first instance, micro-and macro-prudential measures should be brought to bear to deal with credit-driven asset or sectoral booms. Closely related, capital flow measures may also be valuable in dampening foreign inflows that can fuel a credit boom and undermine monetary and prudential policies.

Prudential policies are obviously central to any effort to preserve the financial stability in the face of risks from boom/bust cycles. But exchange rate regimes and the design and stance of fiscal policies are both highly important tools that can be brought to bear to moderate boom and bust cycles. According to both the IMF and BIS, fixed exchange rates with open capital accounts are more prone to financial crises than floating exchange rates, or managed exchange rates with established capital controls (e.g., China, India). Exchange rate volatility—perhaps induced by unpredictable FX intervention—can make carry trades (based on value at risk models) too expensive, curtailing inflows. Fiscal tightening can also help deal with an inflow surge by lowering domestic interest rates and dampening aggregate demand expansion. Tax policy can target sectoral and asset price booms. In the bust, fiscal policy can stimulate aggregate demand in manner that monetary policy may not be able too. A more depreciated exchange rate that accompanies a sudden stop can help stimulate demand. International reserves build up during good times—by leaning against the inflow winds—can now be deployed to avoid exchange rate overshooting.

**Country situations and policy assignments**

The question arises how countries in different situations should assign policies to address these various kinds of tensions. In this regard, the role of macroprudential policies depends to a significant degree on a country’s exchange rate regime.

**First, floating rate economies.** With an exchange rate that is freely floating, as it is in all key currency economies, the central goal of macroprudential policy should be to address financial stability concerns. In particular, a credit and real estate boom can get underway at times when interest rates (in line with the domestic inflation and cyclical positions) are low and stable. Moreover, spillover effects from global markets may be taking place, for example, through channels such as risk premia and risk appetite even though a floating exchange rate provides some insulation from imported monetary conditions. In this environment, the motivation for implementing or intensifying macroprudential measures is not directly driven by goals of short-run demand management.
Second, economies with other exchange regimes. Where the exchange rate is not freely floating and thus the conduct of monetary policy is constrained, macroprudential policy – along with fiscal and structural policies – offers a route to influence macroeconomic conditions in addition to its more accepted role of preserving financial stability. It might be viewed as a surrogate monetary policy, since macroprudential measures effectively raise the cost of credit on the supply side (e.g., capital ratios), or make it more difficult to obtain on the demand side (e.g., loan-to-value ratios), or both. It should be noted that no consensus exists among international policy-makers as to whether macroprudential measures should be used for the purpose of macroeconomic management even in the absence of domestic monetary autonomy. Interestingly, however, this view seems to be gaining traction in the euro area.

The foregoing is not intended to arrogate to macroprudential policy an exclusive role in addressing various macroeconomic or macrofinancial concerns. There are indeed questions – discussed further below – about the effectiveness of macroprudential measures in different economic and policy environments, especially as regards the time-varying or ‘cyclical’ use of such measures. Moreover, political-economy questions abound related to the timeliness with which adequate macroprudential actions are implemented. These considerations underscore that (a) emphasis needs to be placed on having a strong microprudential regime in place, as well as a sound structural macroprudential regime (i.e., measures that are not varied over time); and (b) the discretionary use of fiscal policy should be a means of addressing macroeconomic and financial pressures – including of course when interest rates are at the zero bound and monetary policy may not be fully effective.

The nature and limitations of macroprudential measures

Macroprudential policy aims to promote ‘financial stability’ at the systemic level. This contrasts with the focus of microprudential supervision, which is on the financial health of individual financial institutions. Macroprudential has a top-down perspective, while microprudential takes a bottom-up perspective. A number of instruments can be found in the macroprudential tool-kit, and they can be applied in different ways. The main aspects for current purposes are:

- **Macroprudential tools are structural or time varying in nature.** Structural measures tackle issues such as too big to fail, too complex to fail, too connected to fail, and too big to save. Structural macroprudential measures would address issues such as market infrastructure including payments, settlement and clearing arrangements and counterparty risk from derivatives in particular OTC. Time varying, or counter-cyclical, macroprudential tools attempt to dampen the boom and ease the bust. Prevention of all future financial crises may be too much to expect, but the financial system can be made more resilient in the process.

- **Macroprudential tools are varied, overlapping at times with microprudential tools.** Counter-cyclical capital buffers (CCCB), loan-to-value ratios (LTV), debt-to-income ratios (DTI), and capital flow measures (CFM) are examples of time-varying macroprudential tools; the first three tools are also in the hands of microprudential supervisors. One instrument with two hands on the lever creates a domestic coordination issue. At the same time, counter-cyclical macroprudential tools could
pose a coordination challenge with macroeconomic policies, especially monetary policy. Examples of structural macroprudential measures include the Liquidity Coverage Ratio, the Net Stable Funding Ratio, the capital charge for systemically important financial institutions, and the leverage ratio.

- **How do macroprudential tools operate?** Essentially, they are either price/cost-based measures (CCCB, reserve requirements) that make it more expensive to borrow, or quantity-based measures (e.g., LTV/DTI, FX limits) that reduce the availability of credit. Both types of measures can build buffers to protect against losses. LTV and DTI ratios can target segments of the economy, such as construction. Raising these ratios makes it harder to qualify for loans, reducing spending pressures in the targeted sector. On the other hand, capital buffers and capital flow measures act to limit credit expansions, particularly those fuelled by foreign inflows in the case of capital flow measures. Structural macroprudential are intended to provide a more resilient financial system in the face of systemic stress and contagion (e.g. fire sales, market illiquidity), which may occur suddenly rather than building up more slowly like credit booms.

- **The effectiveness/calibration of various macroprudential tools has received considerable recent attention** (e.g., from the BIS, FSB, IMF, and central banks), although further research is necessary, particularly related to their counter-cyclical properties. Empirical evidence and case studies suggest that macroprudential instruments can be effective in addressing systemic risk if employed appropriately and well targeted. For example for counter-cyclical macroprudential measures, quantity-based measures (e.g., LTV) seem to be more effective than price-based measures (e.g., risk weights) in dampening housing price booms. These measures also take time (2-3 years) for their full impact to be realized. There may also be political obstacles to using some macroprudential tools because of their distributional consequences, or quasi-taxation properties. As discussed further below, it also needs to be borne in mind that macroprudential measures may have little or no ‘bite’ on nonbank flows.

- **Capital flow measures (CFMs) to cope with surges and sudden stops that can threaten both macroeconomic and financial stability have their own separate and controversial history.** Recently the IMF has taken a new “institutional view” finding in certain circumstances, that CFMs can be useful and appropriate to support macroeconomic policy adjustment, particularly to cope with inflow surges. Such measures can also be imposed after a crisis breaks to help the adjustment process as has happened in Iceland and Cyprus. However, introducing CFMs can risk triggering a rush to the exit, exacerbating outflows rather than controlling them. Beyond these temporary actions, in the Fund’s view certain CFMs can continue to be useful over the longer term run for safeguarding financial system stability. India and China may be examples. Unlike most macroprudential measures, CFMs can be structured to have an impact upon nonbank flows.

More broadly, macroprudential measures are like scalpels that need to be wielded carefully; their use has their own costs and risks. And one should remember the adage ‘Don’t bring a knife to a gunfight’. In addressing economic instability, fiscal, monetary and exchange rate
policies are the ‘big bazookas’. The potential role of macroprudential policies is clear, but their limitations—including in the ‘New Normal’ environment—remain to be fully understood. What is clear is that policy-makers should not overly rely upon macroprudential tools.

Macroprudential policy and ‘Shadow Banking’ under the New Normal

Intensified bank regulation and continued deleveraging by banks, against a backdrop of low interest rates and emerging economic recovery, is the seed-bed for bank disintermediation and the expansion of all forms of nonbank financial flows. From a European perspective particularly, development of the nonbank financial sector offers potentially great benefits in terms of diversifying the savings channels so that they better connect with vigorous sectors. Seen in this perspective, the pejorative connotations of the term ‘shadow banking’ seem unfair and inaccurate. Given the impact of bank deleveraging, greater financing intermediated, or arranged, by nonbanks would appear a safety valve or even a White Knight of economic recovery under the ‘New Normal’. That said, we are all aware of the risk management failures—credit and liquidity—exhibited in the opaque sub-prime securities market that also spread risk to those—often considered sophisticated investors—that in the end could not bear them.

From the point of view of financial stability, a shift of savings to nonbank channels – whether structural or cyclical – can pose challenges:

- These institutions are not supervised as banks even though they are regulated. Where they become involved in granting credit, and especially if their liabilities are so liquid that they function as quasi money—such as money market funds—the possibility of systemic funding risks cannot be ruled out. However, mutual funds in general and equity funds in particular are not typically viewed as “shadow” banks.

- Drawing on such sources of financing may pose additional challenges: if international asset managers move as a ‘herd’ to espouse or reject part of an asset class (such as emerging markets), very abrupt shifts may occur in financing conditions for that entire asset class – spreading to the most liquid market segments.

- Flows outside banking channels typically are not subject to macroprudential measures imposed by bank supervisors. If the goal of macroprudential measures is to dampen market excesses, then nonbank and portfolio flows can frustrate that goal. Thus, the far-side of the macroprudential perimeter must be scrutinized closely for problematic leakages. Interestingly, capital flow measures typically have a broad perimeter.

- Concerns about macroprudential risk have led central banks to review carefully the perimeter of the banking sector, to try to ensure that banking-like activities are brought under supervision. But expansion of the banking perimeter could perhaps entail risks that economically beneficial activities are curtailed, or simply do not take place. An alternative (as with money market funds) would be to address those specific features that are systemically risky.
From the specific standpoint of challenges inherent in the ‘New Normal’, the least tractable issue is perhaps the third point above. Expansion of non-banking financial activities may vitiate the effectiveness of macroprudential measures in dampening financial stability risks. In the EU, there is a question how the role of the ESRB might contribute in this area, particularly with the advent of the ECB as the Single Supervisory for systemically important banks. More generally, scope exists for supportive taxation or other regulatory measures. Ultimately though, in an innovative and diversified economy, this may mean that nonbank leakages substantially undermine the viability of macroprudential measures. Deep and durable responses to the shocks intrinsic in global inter-linkages may reside in structural flexibility in economies, large financial buffers, and ample global insurance through bodies such as the IMF and or regional arrangements (e.g., Chiang Mai, ESF). Still, a set of questions needs further exploration and thus the authors are working on: ‘Shadow banking, friend or foe? Macroprudential issues posed by the nonbank financial sector’.

**Domestic and international policy coordination**

Different models exist for domestic coordination of macroprudential policy with other economic policy instruments. For example, the Bank of England houses under one roof monetary policy, microprudential regulation, and macroprudential supervision. In contrast in the U.S., the Financial Stability Oversight Council (established (2010)) is chaired by the Treasury, and brings all financial regulators—bank and nonbank financial institutions—and the Federal Reserve together to ensure domestic financial stability. A consensus view has emerged that “One size does not, and should not, fit all” (Nier, et al (2011)). That said, it is recognized that effective coordination arrangements should (i) support prompt and accurate identification of risk through access to information and relevant expertise; (ii) provide incentives for timely, effective use of policy instruments; and (iii) ensure policy cooperation, while preserving the autonomy of established policy functions.

Calls for greater international coordination and cooperation have been triggered by the dilemmas posed by monetary policy spillovers under the New Normal. Such appeals sometimes urge the Federal Reserve to conduct a monetary policy that goes beyond its domestic U.S. mandate of “promoting maximum employment, stable prices, and moderate long-term interest rates”. Achievement of that mandate clearly has positive spillovers, while policy mistakes have adverse spillovers. Both types of spillovers can reverberate back—spillbacks—on the United States and need to be considered by the Federal Reserve in its policy-making decisions. However, a more direct consideration does not seem likely and maybe fraught with its own political spillback. In particular, difficult accountability questions arise—What does global interdependency mean for an independent central bank accountable to its national parliament and only backstopped by its sovereign? How would the voice, (but not the vote?) from the affected other economies be heard and from who? Nonetheless, the reality remains that the Federal Reserve is the lender of last resort for dollar liquidity. Its global role and responsibility remains a vital issue. In this connection, the establishment of a standing swap network with central banks of key currencies is a positive step.

Coordination and cooperation have other facets too, such as the advanced country, macroeconomic policy mix and the coordination of macroprudential policies. Regarding
policy mix, the nature of spillovers from advanced economies is more diverse than previously recognised. There is evidence of spillovers from monetary, fiscal and regulatory policies, so the impact of monetary policy spillovers needs to be seen in the context of the advanced economy policy mix (Bayoumi, in Oxford, forthcoming 2014). These various spillover influences can pull in different directions, and can pose differing policy challenges. For example, monetary easing or tightening in a major economy transmits directly to the domestic financial conditions and asset prices in EMDCs globally through asset markets, affecting risk premia and risk appetite. By contrast, fiscal easing or tightening transmits largely through trade channels, affecting goods and commodity markets, and its effect is mainly on direct trading partners. To the extent key currency economies have freedom of manoeuvre in determining their own overall policy mix, this freedom could be quite important in terms of the nature and direction of spillovers. For any desired degree of macroeconomic restraint or stimulus, a more active use of macroprudential and fiscal policy could tend to dampen monetary spillovers - which are generally more pervasive, probably more destabilising, and (because they do not have a regional footprint) perhaps more prone to be pro-cyclical from the standpoint of the receiving economy.

Turning to cross-border coordination of macroprudential policies, this is essential in order to cope with “regulatory (perimeter) arbitrage”. The FSB and the BIS/BCBS provide international cooperation forums, but members retain their autonomy and independence. Membership is typically limited to G20 countries, leaving most developing countries without a direct voice at those forums. The FSB covers nonbank financial institutions, while the BIS/BCBS is focused on banks. In a regional (EU) context, the European Systemic Risk Board (ESRB) provides macroprudential oversight for the entire EU financial system—banks and nonbank financial institutions—and is mandated to identify and prioritize systemic risks, issue warnings when those risks are significant, and make non-binding recommendations regarding remedial actions. All these international/supranational forums have only “soft powers”. In contrast, the ECB as the Single Supervisor will have mandatory powers over the banking system, leaving however no supranational European agency with mandatory powers over nonbank financial institutions. This imbalance is potentially problematic.

Cross-border coordination is especially needed in a currency union—a single financial market with no exchange rate risks. Why is this? Financial institutions, including their branches, are supervised on a consolidated basis by their home supervisor. Host countries supervise their domestic financial institutions, which includes subsidiaries of foreign financial institutions. Thus, macroprudential tools applied by a host country would not apply to branches located in the host country. Moreover, corporations and even households could borrow directly from financial institutions domiciled abroad. The latter is especially true in a currency union.

The Basel Committee on Banking Supervision has recognized this coordination issue in the context of the use of counter-cyclical capital buffers. Specifically, their guidance to national supervisors (see BCBS (2010)), established the principle of “jurisdictional reciprocity.” Under this principle, foreign supervisors must apply on their banks lending to the host country the same additional capital buffers posed by the host supervisor. All banks would be operating on a level playing field when lending to entities in the host country.
Unfortunately, this reciprocity principle only applies to counter-cyclical capital buffers and not to the entire range of macroprudential tools. Within the euro-area, counter-cyclical buffers for large banks would likely operate under the direction of the ECB, as the Single Supervisor. But banks face competition from capital markets and non-bank financial institutions. From a macroprudential perspective, this competition is a source of leakage, undermining the effectiveness of these tools. The ESRB monitors the entire EU financial system: it can issue warnings and recommendations to the relevant regulatory bodies should it deem that financial stability is at risk. Of course, coordination issues between the ESRB and ECB will also need to be addressed in due course.

Counter-cyclical macroprudential measures within a currency union such as the euro area can also be utilized to make monetary conditions at the national level better suited to a member’s economic circumstances. Thus, a “one-size-fits-all” interest rate policy can be tailored using macroprudential tools, to fit the needs of an individual national economy. Such tailoring could have helped, for example Ireland and Spain, to address their credit and housing booms, while ECB interest rate policy could have remained focused upon achieving its area-wide inflation objective. The effectiveness of time-varying macroprudential measures depends upon cross-country coordination within the euro area. The ECB, as the Single Supervisor, and the ESRB, as the EU-wide macroprudential agency, can contribute importantly to euro-area and EU coordination efforts. The roles of national central banks and macroprudential authorities in this process also require clarifications. For example, are they expected to initiate/request the use of time-varying macroeconomic tools to meet the needs of their national economies? Are others expected to reciprocate automatically as under Basel III? Or is this a collective decision under EU rules?

Even within a currency union, counter-cyclical macroprudential measures should not be the only policy recourse. In principle, national fiscal policy is available to address country-specific cycles that were not “in sync” with the euro-area average. But discretionary use of fiscal policy has proved in the past to be too challenging for a variety of reasons (see Kincaid and Watson (2013b)). The EU’s new Macroeconomic Imbalance Procedures could usefully identify emerging national problems and recommend a national fiscal policy response and other actions, including on the macroprudential front. However, a more active use of fiscal policy in particular runs counter to the philosophy underlying the rules-based approach of the SGP and efforts for transparent, easily explainable policy recommendations by the European Commission.

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About PEFM

The Political Economy of Financial Markets programme (PEFM) aims to shed light on the way in which institutions, including macroeconomic policy frameworks, interact with financial markets. In the wake of the global and euro area crises, it seeks to promote a better understanding of financial markets and to contribute to improved policy formulation in the future.

Its main activities are to carry out research, hold seminars, and publish findings in outlets that range from academic articles and books to policy briefings and op-ed pieces in the international press. Three initial research groups were set up at the outset, bringing together academics, officials and market participants:

- The first research topic is Financial Integration in Europe – why this has not lived up to expectations, and the implications for banking and fiscal union.
- The second research topic is Regulatory Capture. This explores how relations between the financial sector and regulators interacted with political and ideological influences in the ‘regulatory space’, during the run-up to the crisis.
- The third research topic is Macroeconomic Policies and Financial Stability – asking how monetary and fiscal policy regimes can respond to instability in the private sector, without jeopardizing policy transparency.

Several future research priorities have been identified. These include shadow banking, and also the impact of advanced economy financial policies on emerging market countries.

European Studies Centre

The European Studies Centre at St Antony’s College is dedicated to the interdisciplinary study of Europe. It has particular strengths in politics, political economy, history and international relations, and also brings together sociologists, social anthropologists and students of culture. The Centre is a meeting place and intellectual laboratory for the whole community of those interested in European Studies at Oxford. Beside its permanent Fellows, the Centre has Visiting Fellows from several European countries, as well as graduate students from around the world working on European affairs. The Centre also participates in several collaborative international research projects. Seminars and workshops on a wide range of topics are held regularly at the Centre. These involve Oxford scholars from all disciplines and their counterparts from abroad, often with the participation of students. A number of special lectures and international conferences, bringing both leading academics and distinguished practitioners to Oxford, are offered to a wider audience under the auspices of the Centre.

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