The Architecture of Financial Stability Policy: Unfinished Agenda

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(*) The views in this presentation are the author’s and do not represent those of the Bank of England.
“[A] critical question for regulators and supervisors is what their appropriate "field of vision" should be. Under our current system of safety-and-soundness regulation, supervisors often focus on the financial conditions of individual institutions in isolation. An alternative approach [...] would broaden the mandate of regulators and supervisors to encompass consideration of potential systemic risks”

Bernanke (2008)
Widening the field of vision

Macroprudential  Microprudential

systemic stability

safety & soundness

“In the pursuit of financial stability, we should strive for a better marriage between the microprudential and macroprudential dimensions of the task”.

Crockett (2000)
“We need to be realistic about what macroprudential tools can and cannot accomplish. [...] The word macroprudential is becoming very popular, and we run the risk of using “macroprudential” as a catch-all term to cover all manner of policies. I think we should be careful. [B]road definitions unnecessarily widen the objective to be pursued by supervisors and lessen accountability. [...] Confusion about a policy may undermine its effectiveness”.

Caruana (2010)
"The global financial crisis highlighted the need for dedicated macroprudential policy"
IMF-FSB-BIS (2016)

Macroprudential policy can ‘provide guidance, ‘demand more forceful action,’ and ‘correct biases’ in prudential regulation, bank resolution, and monetary, tax, competition, and housing policies.
IMF (2013)
A few things to consider:

Macroprudential policy

• The policy goal (financial stability) is not well-defined
• The operational target (systemic risk) is non-observable
• There are trade-offs between financial stability and growth (and social preferences are neither well defined nor stable)
• Uncertain link between policy tools and outcomes
• Substantial redistributive implications

“Too much of the ongoing debate relates to details and technical features [while] much less attention has been paid to viewing the subject [of financial stability] top down and examining how the various difficult areas hang together”

Sir Andrew Large (2015)
Unfinished business

Shift the focus from macropru to financial stability

- Define goal and risk tolerance
- Establish boundaries
- Introduce proper governance arrangements
Financial stability policy: goal

Yardstick for measuring success, setting risk tolerance, ensuring accountability

• Practical way #1: agree on a model-based measure of systemic risk, define risk tolerance, stress test, repeat

• Practical way #2: establish a process of challenging the decisions of financial stability authority, forcing it to explain its rationale, and act upon the comments

  ‘Discursive accountability’ (Gehring 2004)

• Practical way #3: ?...
Financial stability policy: boundaries

Which policies/tools should come under the ambit of financial stability policy?

Criteria:

- Goals are intrinsically connected
- The combination delivers better results
- The combination is better at limiting incentives for evasion

Financial stability as a ‘common good’ (Tucker 2018)
Financial stability policy: boundaries

Which policies/tools should come under the ambit of financial stability policy?

- Structural rules
- Recovery & resolution
- Deposit insurance
- ELA/LOLR
- Crisis management

Financial safety nets
Macro-prudential policy
Microprudential supervision
Financial stability policy: boundaries

Monetary policy (‘leaning against the wind’) can mitigate FS risks

**BUT**

- only in some states of the world
- at substantially higher economic cost than macroprudential measures, both now and in the future

Ajello et al. (2016); Svensson (2017); Fell & Fahr (2017); Aikman et al. (2018); IMF (2015)
Financial stability policy: governance

Default option

Assign responsibility for FS to central bank (preferably) or to separate council (with CB playing a leading role), give them “independence”

Is the default option appropriate?

- Goal (criteria of success) can be specified ex ante
  - Alesina-Tabellini ‘Principles of Delegation’

- Social preferences (risk tolerance) are stable

- Time inconsistency is an issue

- There are no serious redistributive consequences
  - Alesina-Tabellini ‘Principles of Delegation’

## An Integrated Financial Stability Policy Framework

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Decision level</th>
<th>Policy component</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td><strong>Macroprudential policy</strong></td>
</tr>
<tr>
<td>Design</td>
<td>Political</td>
<td>Definition of financial stability objective, risk appetite, perimeter</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Agency monitoring and accountability</td>
</tr>
<tr>
<td>Prerequisites</td>
<td>Political and technical (agency)</td>
<td>Operational and budgetary autonomy of relevant agencies</td>
</tr>
<tr>
<td>Analytics</td>
<td>Technical (agency)</td>
<td>Systemic risk assessment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>System-wide stress tests, spillovers, contagion, Market monitoring Data gaps</td>
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<td></td>
<td></td>
<td>Data gaps</td>
</tr>
<tr>
<td>Operations</td>
<td>Technical (agency)</td>
<td>Macropudential tool design and calibration Designation of systemically important firms Communication with industry and public, FSR</td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
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References


