

**The relationship between the objectives and
tools of macroprudential and monetary policy**

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**The relationship between the objectives and tools of macroprudential and
monetary policy**

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What is the relationship between the tools and objectives of monetary and macroprudential policy? The narrow question formally put to us to debate today is “Are macroprudential regulatory measures just another way of adjusting interest rates and hence clash with monetary policy?” My answer is, broadly speaking, yes to the interest rate question and yes to a potential clash with monetary policy, at least if monetary policy is taken to be inflation targeting.

This particular debate started from consideration of the familiar proposition that policy makers should not use one tool to meet two objectives and that interest rates should be used to meet inflation targets and hence should/could not be used to meet macroprudential or financial stability objectives.

I will argue that this distinction is a false one because the main cycle-related macroprudential tools affect interest rates of necessity .

I start from the observation that all economic activity (except barter) passes through the financial system, always through payments, but usually also through changes in positions in financial intermediaries and non-intermediated investments. Whatever happens in the economy, whether in terms of volume of activity or price – inflation – will be reflected in the financial system. Equally, the structure of financial intermediation constrains whatever can happen in the real economy. The main purpose of the core financial imbalance-related macroprudential tools is to change the structure of financial intermediation from what it otherwise would have been by changing the volume or price of financial intermediation or, almost certainly, both.

¹ The views expressed here are entirely my own and not those of any of the organisations with which I am, or have been, associated.

Thus the use of macroprudential tools is likely to mean that interest rates will be different from what they would otherwise have been. In all probability this will constrain the ability to use interest rates to achieve other objectives. This will not necessarily be the case, but it could be. Indeed, it seems intuitively likely. For significant parts of the last decade in a number of countries inflation targets were met, with satisfactory levels of growth, while at the same time financial imbalances, of the kind macroprudential tools are intended to prevent, were rapidly developing, typically involving rapid rates of credit expansion. As the Bank of England noted in its November 2009 paper on *The Role of Macroprudential Policy*, “Monetary policy would not have been able to curb these emerging financial balances without diluting the commitment to its inflation objective. An attempt to curb banks’ balance sheet growth through monetary policy may have been seriously destabilising for the real economy over this period”. It seems difficult to believe that, if rates of credit growth had indeed been constrained by the use of macroprudential tools, inflation and growth figures would not have also been significantly different. But in such counterfactual territory, proof is not available.

I have used the term “macroprudential” without defining it and indeed it is difficult to be confident that there is a commonly accepted definition.

The term was almost certainly coined in 1979 in the Bank of England, very likely by the late David Holland, a macroeconomist working on international matters. At that time, it seems more to have referred to a way of thinking, an approach to information assembly and analysis, rather than an instrument of supervision, even when it was used in an expression such as “macroprudential supervision”.

There appear to be three quite different ways in which it is used. These are (1) macroprudential analysis, (2) macroprudential supervisory approach and (3) deployment of macroprudential supervisory tools and instruments, perhaps best described as macroprudential regulation. The expression “macroprudential policy” perhaps encompasses all three.

The term “macroprudential” arose by contrast to the term “macroeconomic” and referred to analysis focussing on the financial system in aggregate, rather than the

economy in aggregate. It referred to looking at what was happening beyond the individual financial firm or instrument to common influences on such firms or markets, arising either from external economic developments or from interactions within the financial system arising from common concentrations or network effects. Such analysis can identify factors not otherwise visible in isolation, either to a financial firm or to the supervisor, and can be used to forecast potential problems. At the time that the term was coined it principally referred to likely unsustainable aggregate credit exposures to emerging market countries, not visible to, or at least not recognised by individual market participants

This macroprudential analysis does not become macroprudential supervision until the analysis is actively used to seek to change the behaviour of firms. This may not require any compulsion, but merely informing market participants of the analysis, whether in public through speeches, financial stability reviews or “Dear CEO” letters, or privately, whether in groups, as some supervisors or central banks do (e.g. Bank of England discussions with chief risk officers) or in supervisory discussions with individual firms, with varying degrees of pressure to change behaviour. By analogy with the term “soft law”, this might be regarded as a form of “soft” macroprudential supervision.

Then there are macroprudential tools, which involve compulsion, informed by macroprudential analysis, in relation to the behaviour of individual firms. These tools are, in fact, pretty much perfectly familiar tools for capital and liquidity supervision, but deployed in the light of macroprudential analysis.

A large literature has sprung up, not just on the identification and assessment of macroprudential risks, often used interchangeably with the term systemic risk, but also on the toolkit available for macroprudential regulation.

These tools are quite diverse in character. Some of them are structural in character, whilst others deal with the evolving financial and economic conjuncture. Examples of the former include:

- Moving derivatives trading onto central clearing counterparties.
- Introducing procedures for orderly resolution, including requiring living wills.
- Providing more information about the distribution of risks.
- Enhancing capital for counterparty exposures or requiring capital to be permanently higher to take account of the systemic importance of a firm.

All of these, and they are only part of a longer list, will require some kind of change to the structure of financial intermediation, but may perhaps not have very much overall impact on economic activity one way or the other. Whether this is indeed the case, though, probably needs further reflection.

Other tools, however, are explicitly intended to influence the volume, maturity and price of financial intermediation and are generally aimed at preventing or mitigating the build up of widespread imbalances and/or their sudden unwinding – cycles of risk appetite and credit as they are defined in the HMT paper on “A new approach to financial regulation” (Feb 2011), perhaps the most practical attempt so far to put flesh on how macroprudential tools are to be deployed.

These instruments include:-

- countercyclical capital requirements and dynamic provisioning.
- limiting leverage, maturity and currency mismatches.
- limiting loan-to-value ratios, debt-to-income limits or margin requirements.
- imposing lending limits, whether sectoral or currency.

In most cases, the intention is that these ratios or limits should be varied over time in the light of circumstances, either of the firms regulated or their customers, though

they could also be left unchanged for extended periods. It seems difficult to see how such imposed changes to the volume of financial intermediation will not also change its price from what it would otherwise have been.

The consequence of changing these ratios or limits is also that, just as the balance sheets of the individual intermediaries will change, so inevitably, one for one, will the balance sheets of their counterparties, including notably those of counterparties outside the financial system. As a matter of identify, for instance, if the financial sector, or part of it, is required to become more liquid, other economic agents will of necessity become less liquid. Or, if the net financial position of the financial sector changes, so does that of the rest of the economy, with the opposite sign.

It seems difficult, therefore, to escape the conclusion that use of macroprudential regulation to change the structure of financial intermediation will of necessity change the behaviour of the real economy. Indeed, often this is its express purpose.

In doing so, such action is bound to influence relative interest rates and quite likely also the absolute average level of interest rates, so it will affect the transmission mechanism of monetary policy, if monetary policy is taken to be action by the central bank to influence interest rates through its own operations and, hence, through the transmission mechanism, inflation.

Is this a problem? Not necessarily. The striking thing about the second list of tools, those concerned with imbalances, is that most would be entirely familiar to central bankers of earlier decades as part of their monetary policy toolkit, alongside ones nowadays less familiar, at least in Western economies, such as interest rate ceilings, variable reserve requirements, “window guidance”, “corsets”, monetary aggregate targeting or capital controls. What central bankers of the past would find much odder was the fact that “monetary policy”, at least in some countries, is now much more narrowly defined than in the past, including by legal mandate, so as to focus purely on price stability, regardless of the condition of the financial system.

A consequence of this narrowing of the understanding of what constitutes monetary policy and, in some jurisdictions, of separation of monetary and supervisory

responsibilities, is that the tools once regarded as part of the monetary policy toolkit have in effect been recategorised as non-monetary policy related.

The February HMT paper (page 18) sets out what is envisaged for the UK. Leaving aside the structural tools, the Bank of England's Financial Policy Committee is charged with taking action to remove or reduce system risks including, in particular, "unsustainable levels of leverage, debt or credit growth". This, the paper explains, could involve leaning against the tendency of the financial system to magnify the fluctuations of the economic cycle, fuelling booms and exacerbating busts.

HMT explicitly accept that the use of the tools which affect the scale of financial intermediation will very likely affect economic growth, though curiously there is no mention of inflation. So the FPC is not authorised "to exercise its functions in a way that would in its opinion be likely to have significant adverse effects on the capacity of the financial sector to contribute to the growth of the economy in the medium or long term".

The challenge here is that the financial sector is also the medium through which monetary policy is transmitted. A problem could arise if there were hard targets for the use of macroprudential tools, e.g. a required or desired pattern of financial balances that might then be inconsistent with meeting an inflation target (or a growth target, if there was one, as seems also now to be envisaged). The way it is currently suggested that this potential conflict should be resolved appears to be for macroprudential targets never to be allowed to interfere with either growth or inflation objectives. This is one way of squaring the circle, but it leaves open how macroprudential objectives are going to be formulated, given that they have to be quantitative in order to calibrate the tools, or raises the question as to whether there are ever going to be action-oriented objectives at all.

A possible way out, at least in a unitary central bank, would be to seek to maximise as many of the objectives as possible, without having any of the objectives strictly quantified. This could mean being prepared to modify the inflation target if there was a threat of unsustainable levels of leverage, debt or credit growth (just as it is being effectively modified now in the UK where this is a threat to growth). Lest we

think there is not a potential risk of conflict, we simply need to recall that the imbalances which caused the crisis were created during a period when inflation targets, as specified, were being met.

The HMT paper (2.103-2.105) suggests addressing the question of potentially conflicting objectives in a number of ways. It asserts that “The objectives of price stability and macroprudential are sufficiently distinct that they should be kept separate and different sets of tools should be used in pursuit of these two objectives”. It can be seen from the analysis above that it is at least possible that the objectives might conflict, as they have in recent past.

The paper goes on to say, apparently accepting after all that there might be potential conflicts in objective, that these could be handled by virtue of the partial “cross membership between the FPC and the MPC and careful sequencing of meetings”. It is difficult to feel that cross membership is an adequate solution where the mandates themselves turn out to conflict. And the sequencing of meetings argument seems unlikely to help very much in practical terms given the long and variable lags in monetary policy and the lag between decision on use of a macroprudential tool, its subsequent implementation and its ultimate effect.

One way of resolving this, in addition to having cross membership, would be to have greater symmetry in terms of objectives. Thus, the proposed requirement for the FPC to have regard to real activity could be balanced by a requirement for the MPC to have regard to the structure of financial intermediation.

It is worth noting that in the euro area all an individual national central bank (NCB) has to direct at credit imbalances is macroprudential tools, since for most jurisdictions monetary and exchange rate policy is a given and may well not be supportive of potential local macroprudential objectives, as evidenced recently in Spain or Ireland. If the NCBs and supervisors were to start deploying the cyclical macroprudential tools actively, then a question will arise as to how the ECB is to take account of this in reinterpreting the functioning of the monetary transmission mechanism for monetary policy purposes. However, from the target or objective point of view, the ECB already has a more flexible policy framework for monetary

policy available, given its two-pillar approach and its less rigid approach to inflation targets than in some other jurisdictions.

What the current debate will certainly do is bring forward in more acute and practical form the challenge of fully integrating the behaviour of the financial sector into macroeconomic models. In earlier periods, there were attempts of various kinds to do this, as was the case in the UK in the late 70s where Treasury and Bank sought to generate macroeconomic and financial system forecasts that were mutually consistent. Such attempts were for the most part abandoned because the challenge seemed too difficult and the data available too intractable for modelling purposes.

But that does not mean that fresh attempts are not needed. Indeed a central bank charged simultaneously with objectives related both to the structure of the financial system and to the economy has no alternative.