

Remarks at the panel discussion on

Fitting macroprudential into the picture. Implications for central banks

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Introduction

My comparative advantage in this panel might be at discussing some of the attempts to develop new analytical frameworks suitable for policy design in this area but that might require more than the initial minutes of a panel discussion. So instead I will base this initial intervention on a scatter set of ideas about this new area of economic policy.

I will make no attempt to be comprehensive or systematic. I apologize in advance for the preliminary and provocative character of some of my thoughts. I also apologize for the lack of explicit references backing or acknowledging precedent to some of my claims.

On the governance of macro-pru

I believe in the need for setting independent authorities in this area as much as in the area of monetary policy. This is also true (perhaps especially true) if I think about the specificities of a multi-country area subject to a common monetary policy.

It will be important to isolate macroprudential policy from the influence of the political cycle. Which government is going to make "macro-pru" tighter in a boom if there elections ahead? Which government is going to assume the potential fiscal costs of prompt corrective action if there are elections ahead?

Indeed, decelerating credit or housing booms is likely to have a short term cost in terms of output and employment; there are interest groups that may lose in the near term and even wider segments of the population that may feel (however wrongly) damaged by the policy.

Likewise, resolving bank crisis (even if done early enough) will most likely continue to be costly to taxpayers, so there will be fiscal implications attached to macroprudential policies and their surroundings (e.g. lending of last resort (LLR)).

However, delegation of fiscal powers to independent authorities (even if limited to very specific goals) seems to go against principles deeply enrooted in modern democracies... But this is possibly the type of "anathema" that should be subject to reconsideration as history advances.

Who should be the new authorities?

If I had to choose between central banks (CBs) and treasuries, I will go for the former. (We could also create a totally new agency, but there is already a risk of excessive agency proliferation, of adding policy uncertainty and a new risk of inadequate coordination between the relevant authorities.)

On paper CBs are:

1) less sensitive to the political cycle (more supposedly long-term in their goals), and

2) endowed with greater analytical power

(and the positive correlation between these two features is, in my view, not coincidental).

The big minuses for CBs' involvement in macro-pru are:

1) the potential lack of accountability, and

2) the potential conflicts of interest & damage to their credibility coming from simultaneous responsibilities in the field of price stability

The negative impact of these minuses can be reduced if the CB in charge of macro-pru possesses enough instruments with which to deal with its various goals, an analytical framework with which to assess the situation and in which to judge the impact of the tools on the goals, and good communication policy. The experience of CBs in developing their monetary policy function within this paradigm makes them clear candidates to undertake the new role...

Analytical frameworks

But there are many observers who feel nervous about this. Macro-pru is a much more multidimensional policy and, at the current "state of the art" of its analytics there is no one (or even a few) commonly accepted variables to play the role of targets (or indicators of whether macro-pru is successful or unsuccessful) and the discussion on the range of tools under its control (or the reduction of the task to launching recommendations to the microprudential regulators) is still open.

Research efforts in this front, especially in central bank circles, include attempts to develop Early Warning Systems (EWS) as well as Dynamic Models (DM) capable of capturing the build-up of financial imbalances, the effects of financial crises and the impact of policy on each of them. The MaRs network in the Euro System is a good example of these efforts.

Both lines of advance are welcome... but (and perhaps I am distorted here by my background) my guess that that EWS will take us just a little bit further than the Financial Stability Reports of the pre-crisis era. Crises will remain hard to predict with enough certainty... except when they have already started. Acting at first sight of the next crisis is possibly acting already too late.

So it is better to think of macro-pru as striking the right balance between financial expansion and financial repression, and putting in place structural and short-term policies that improve the trade-offs between the roles of finance & intermediation in stimulating growth and their potential to destabilize the

economy. Those trade-offs are very much related to the amount of systemic & systematic risk taking that accompanies the normal course of economic activity (and is possibly lower in the initial phases of expansion periods and higher both at times of “exuberance” and, for different reasons, during deep recessions).

What should macro-pru be about?

Macro-pru is, in that sense, not so different or separable from micro-pru. It is, to some extent, a necessary improvement of micro-pru (in its narrower sense). The improvement has two dimensions:

First and foremost, incorporating into the picture general equilibrium effects that should have never been ignored (relevant feedbacks, interconnections, implications of aggregation, macroeconomic forces and effects).

Second, adding an explicit time varying dimension to prudential policies. One that goes beyond (or explicitly aims to counteract) the mechanical implications of the partial-equilibrium risk-sensitivity that characterizes existing practices and regulations (capital requirements, margin calls, and all sort of decision rules mechanically connected to mark-to-market accounting and value-at-risk calculations---which might make sense from an individual optimization perspective but not necessary when the potential aggregate systemic externalities are taken into account).

The explicit time varying dimension of macro-pru makes it tricky. Arguably, this dimension is what makes it “policy” rather than “regulation” (if the frequency of adjustment of the relevant parameters is an adequate way to distinguish one from another).

On paper, macro-pru might largely be “regulation” if the right policy could be expressed in terms of practically enforceable rules (e.g. an add-on to capital requirements such as the countercyclical buffer of Basel III written as a function of some suitable indicator of the evolution of the credit cycle; or a loan-to-value limit for home mortgages indexed to the evolution of house prices).

Rules versus discretion

This brings us to the classical debate on rules vs. discretion. I am not particularly inclined in favour of discretion in this field. But it is possibly unavoidable in the short run, if anything because we may still not know enough to write the right rules.

Yet, to enhance the predictability of the new policies (and to avoid the risk of pro-cyclicality coming from the likely forbearance & over-reaction cycles that may characterize discretionary policies in this field), I would be in favour of writing exploratory "by-default" rules intended to cope with the credit cycle. Discretion will then come in the form of suggesting either (open ended) revisions to the rule itself or temporary suspensions/amendments to its applicability.

And this gives me an excuse to touch on the issues of accountability and governance, so important when discretion is granted to some independent authority.

Accountability in practice

Open-ended revisions of the "by-default" rules would require a proper cost-benefit analysis. A document providing the trade-offs, empirical evidence, analytical results, model-based assessments or verbal arguments that eventually justify the social desirability of the change in the rule.

Temporary suspensions/amendments to the rules might be enacted with shorter notice and justified with briefer statements. Some of them might be explicitly exploratory (to check the reaction to fine-tuning adjustments whose impact is not well known). If a temporary adjustment leads to favourable supporting evidence, it might give rise to an open-ended revision.

So, although many of us are enthusiastic about macro-prudential policy, we might have to be instead enthusiastic about a new type of adaptive explicitly state-contingent macro-prudential rules (or regulations). Then the focus of the new authorities would be on monitoring the application of these rules, their real

effects and suitability to the situation, and suggesting or putting in place temporary or permanent revisions to them.

In fact, we are not distant from this type of model so my remarks may sound as a mere rephrasing of what is actually in the spirit of recent developments in this area. But it is possibly never late to state again the fundamental principles and the huge practical challenges of the task ahead.

CBs' internal challenge

One last point to conclude and in reference to the title of this conference ("CENTRAL BANK (R)EVOLUTIONS"). I have previously referred to the analytical capability of central banks (partly due to the large number of qualified economists in their staff) as a comparative advantage for CBs to play a role in macroprudential policy. But there is an aspect in the internal organization of CBs that makes (at least some of) them ill-designed for macroprudential policy: The separation between departments/divisions is too strict and the collaboration and communication between the individuals or teams working in them is (in my outside view) not as fluid as it should be.

Macroprudential policy requires the effective collaboration of those traditionally in charge of macro (and equipped with models to look at aggregate dynamic feedback) and those traditionally in charge of prudential surveillance of the financial system. It also requires access to micro-supervisory data that has been traditionally restricted to those in direct charge of the microprudential supervision.

New times require new rules, and new institutional arrangements. The new "macroprudential division" at central banks (if I can call it like that) should be transversal, integrated by members that operate (or belong) to each of the traditional divisions and do not need to report, for macroprudential purposes, to the general directors of their divisions. They might be embedded in them for various purposes (acquisition of expertise, career concerns, access to data, etc.) but should be part of a newer and more flexible structure, one that does not necessarily pass through the complex relationships at the top of the central bank hierarchy.