Erkki Liikanen: Macroprudential policy in Europe and the world – challenges, experiences and institutional structures

Remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at the First annual ECB macroprudential policy and research conference, jointly organised with the International Monetary Fund, Frankfurt am Main, 27 April 2016.

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Macroprudential policy – goals and definitions

Before the Global Financial Crisis, the term "macroprudential" was not commonly used even among experts. Organisations such as the IMF, and notably BIS, may take credit for its early projection.

The concept has now of course received much more attention among experts after the financial crisis. In this conference, for example, we have been analysing macroprudential issues from different angles. There have been many insightful presentations yesterday and today. To mention one, my colleague Vitor Constâncio yesterday presented six guiding principles of macroprudential policy in his interesting speech.

Still, "macroprudential policy" or its sister-term "systemic risk" are hardly "household names". My recent experience with the editorial process of a book chapter that I wrote suggests that these terms are not established. (The experienced language consultant used by the publisher had marked the words "macroprudential policy" and asked: "Is it widely known what it means? and the words "systemically important banks" in my text and asked: "What are these?"). So I agree with Don Kohn about what he spoke about communication.

We must keep in mind that we have entered a new important area of policy, with its own terminology, which is unfamiliar to the public. For legitimacy and accountability, we have to make sure that we explain and talk about these new things to the public in a comprehensible manner.

The experts are also still in search for the best definitions of macroprudential policy and systemic risks. In general terms, macroprudential policy can be understood as measures to control systemic risks which can threaten financial stability.

Judging by the recent literature, we can think of at least two concrete objectives of macroprudential policy.

According to the first objective, the goal of macroprudential policy is to control the effects of a credit crunch or, more generally, a large-scale balance-sheet contraction of financial institutions on the society.[1]

According to the second and perhaps more ambitious objective, the goal of macroprudential policy is to prevent an excessive build-up of risks in the financial sector as a whole. In other words, it is about mitigating the financial cycle especially in booms.[2]

Below I will mainly focus on the second objective.

As we focus on the prevention of excessive build-up of risks in the financial sector, it is essential to note that macroprudential policy complements microprudential policy. Both use the same tools, especially capital requirements. But macroprudential policy also uses other tools such as loan-to-value caps.

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1 Cf. Kashyap, A. (2013). Notes for Northwestern Advanced Workshop for Central Bankers.

2 Cf. Freixas, X., L. Laeven, J-L. Peydro (2015): Systemic risk, crises, and macroprudential regulation. The MIT Press.

When defining the confines of macroprudential policy, it is also important to understand its relationship with monetary policy. In the long term, financial stability is a prerequisite for price stability. Hence the two policy areas are clearly intertwined.

However, in the short- and medium-term the economic cycle and the financial cycle can behave quite differently. To deal with the latter, a separate set of macroprudential policy instruments is needed. This way the two policy areas can best advance their common long-term interests.

Next I will talk about

1. the challenges of macroprudential policy in the current juncture and especially in the European context.
2. To illustrate the current challenges, I will also look back to history in Finland in the late 1980’s, few years prior to the dramatic banking and financial crisis of Finland in the early 1990s, and
3. try to draw some macroprudential lessons of those experiences for today´s policy-makers.
4. I will finish by discussing the emerging challenges from the growing shadow banking activities, and draw some conclusions.

Challenges of macroprudential analysis, policy, and implementation

Successful macroprudential policy is a sum of three things: 1) good and timely analysis, 2) sufficient and effective policy instruments (tools), and 3) effective implementation.

We are on our way in Europe to get this done. Still a number of challenges can be identified in each of the three elements.

The analytical challenges come in two parts.

First, this has been a timely conference. We must admit that academic research still has a lot to do in terms of developing better models and establishing empirical facts. One contributing factor to the global financial crisis may even have been the scarcity of systemic risk elements in leading macroeconomic models used in policy work prior to the crisis. Promisingly, that gap has now started to narrow.

Second, macroprudential analysis faces an imminent challenge in improving our understanding of the potential risks to financial stability involved in the current low interest rates environment and the use of unconventional monetary policy measures. For example, there are again potential risks related to “searching for yield” and the related migration of banking-like activities to the less regulated shadow banking sector. I will return to this below.

Concerning macroprudential policy instruments, the set of necessary tools for the banking sector is already at the disposal of competent authorities. On the other hand, we may lack sufficient tools to address potential systemic risks in the less regulated shadow banking sector.[3]

High-quality analysis and a well-designed toolkit need to be complemented by the third element of successful macroprudential policy: a timely and forceful implementation of the appropriate policies. The implementation may be particularly challenging because of three types of implementation lags.

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[3] See Constancio, V. (2015): “Macroprudential policy in Europe: ensuring financial stability in a banking union”, ECB speeches, 28 October.

First, there is often a lag between the build-up of systemic risks and the observation of those risks, especially when the risks develop outside of the radar of supervision, as they have often done.

Second, macroprudential policymakers may not have the necessary tools to address the identified risks. In most countries, the available macroprudential tools and the limits on their use are given by the national legislation. Usually, a lengthy legislative process is needed to add any new tools into the toolbox.

Third, similar to many other policies, there is a lag between the point of time at which some macroprudential measure is taken, and the time at which the measure will start to have an impact.

A case study of macroprudential policy implementation: Finland in the 1980's

To illustrate the difficult challenges in macroprudential policy implementation, let me make a brief digression to the financial history of Finland.

The deregulation of the Finnish financial markets took place in 1986 and even before. In the spring of 1987 I became the Minister of Finance. In autumn 1987, the rate of growth of lending rose above 15 %. By summer 1988, the growth rate had surpassed 25 %. At the end of 1988, the growth rate was a stunning 31 %

In a hindsight, Finnish policymakers reacted much too slowly to this increase in lending. Why?

1. The Bank of Finland was reluctant to return to the old days of administrative regulations. In addition, the central bank had no statutory right in Finland to demand cash reserve deposits from the banks.
2. The Ministry of Finance proposed to end the tax-deductibility of interest expenses. This was heavily opposed by political parties. Some gradual progress was made, but it was too modest.
3. And of course, the macroprudential tools of today – like the Countercyclical Capital Buffer requirement or the loan-to-value cap – were not available then. And obviously, there was no designated authority with the macroprudential mandate.

Finally, in late 1988, the Ministry of Finance proposed a solution in which a ceiling would be imposed on the growth of lending and a progressive tax imposed on lending in excess of that amount.

The Bank of Finland first regarded the proposed tax as a return to a repressive regulation. But finally it used the proposed tax as a threat to pull the banks into a voluntary agreement that gave the Bank of Finland a right to raise the cash reserve requirement of banks to a maximum of 12 %. This would be an additional non-interest bearing deposit requirement, which would be imposed on the whole banking sector on the basis of combined credit growth.

Ultimately, this system of supplementary non-interest bearing cash deposits had the desired cooling effect on bank lending. While the agreement was in force in 1989, lending grew at less than a half the rate of 1988. But, as you know, it was too late.

The experience illustrates that macroprudential policymakers need to have the necessary tools and mandates well in advance of any trouble. It is too late to build the tool-set in the middle of the crisis.

Our experiences also demonstrate that policymakers need to be aware of the costs of macroprudential inaction. A rapid rise in, say, house prices may serve both politicians and house-owners in the short-term. But, in the longer term, everybody hurts from the policymakers' failure to act.

The European framework for macroprudential policy

The macroprudential framework in Europe and in the euro area is specifically tailored to reflect the European institutional features and financial architecture.

As elsewhere in the world, also in the European countries the national macroprudential authorities play the key role in macroprudential analysis and policy-decisions: they are, or at least should be, best informed of the cyclical and structural macroprudential risks and vulnerabilities in their countries.

In the countries belonging to the banking union, the macroprudential powers are shared between national designated macroprudential authorities and the European Central Bank. More specifically, the ECB has a right to apply stricter requirements for certain macroprudential tools than those proposed by the national macroprudential authorities.

The role of the European Systemic Risk Board (ESRB) is, in turn, to monitor cross-border and cross-sectoral systemic risks in the whole EU area, and provide macroprudential warnings and recommendations to national authorities and European bodies. Last but not least, the European Capital Adequacy framework (CRD IV/CRR) provides a common regulatory rulebook directing also the use of most macroprudential tools.

The European macroprudential set-up is generally appropriate for Europe's bank-based, highly integrated and thereby potentially fragile financial system. Research suggests that banking oriented financial systems – like that in Europe – may be particularly prone to systemic risks and crises.[4] In highly integrated markets these risks and crises can rapidly spread across borders and markets.

One of the strengths of the euro area macroprudential policy, as I see it, is that the joint responsibility between the ECB and national authorities is likely to reduce the inaction bias inherent in taking unpopular and intrusive macroprudential actions. The ESRB, by closely monitoring and evaluating national macroprudential frameworks and policies, plays a similar role in the whole EU area.

There are also weaknesses in the European framework. Some EU-level regulatory rules and procedures concerning the use of macroprudential tools are, as I see them, overly complicated and bureaucratic. For example, the European capital adequacy framework does not yet provide national authorities with fully satisfactory ways to increase residential mortgage risk-weights for macroprudential reasons.

Given the inherent inaction bias in macroprudential policy-making, a too complex regulatory rules may provide national macroprudential authorities a convenient excuse for deferring necessary macroprudential actions.

The challenge of new players and new technologies

Finally, let me share a few thoughts on the potential changes in banking and financial intermediation.

Recently, there has been a lot of discussion on the increasing role of new players and technologies and the diminishing role of traditional deposit banks in financial intermediation. And indeed, banking-like activities have increasingly shifted to the shadow banking sector. The credit intermediation has also to some extent shifted away from the banking sector to the debt securities market.

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[4] See e.g. ESRB (2014): Is Europe Overbanked? Report of the Advisory Scientific Committee.

When evaluating these changes, it is useful to recall the history of major technological breakthroughs. One of the lessons of history is that we tend to overestimate the impacts of new players and technologies in the short term but underestimate these in the long term.[5]

In the light of this observation, we may end up exaggerating the short-term effects of the much-discussed potential game-changers like shadow banks or digitalisation on the financial system and financial stability. Still, we may underestimate their impact in the long term. To illustrate, Nokia wanted to beat Motorola and Ericsson in the mobile terminal market and it did. But the more dangerous competitors, Google and iPhone, came from a completely new direction which did not exist before.

Another lesson in history is that changes always bring new risks (or old risks in new disguise). The macroprudential policy-makers are well aware that we must, for example, build sufficient information collection systems and tools for macroprudential policy to deal with systemic risks building up in and migrating to the shadow banking sector.

One factor that keeps us on guard concerning financial stability is the prolonged low interest rate environment. The current record-low global real interest rates reflects the weak global economic growth and abundancy of global savings relative to profitable investment opportunities.

It is clear that low interest rates may be generating search-for-yield and risk-taking incentives in some asset markets. To counteract these pressures, the role of a well-functioning macroprudential framework and policy will be quite central in the future.

Conclusions

Finally, let me conclude by commenting on the argument by some that we have already gone too far in micro and macroprudential regulation. For instance, could it be that the strengthened regulation is currently hampering the transmission of monetary policy in the euro area?

Focusing on bank capital, there is ample evidence suggesting that a solid banking sector is a key to unimpeded credit flows. Banks struggling with debt overhang or non-performing loans lend less.

In accordance with this, experience strongly suggests that a swift recapitalisation of the banking sector in response to crises is a key measure to restore economic growth.

So, the regulatory measures we have taken after the crisis, and their implementation must be done properly.

[5] This is the so-called Amara´s law, named after the futurologist Roy Amara.