# What is macroprudential policy for? Making it safe for central bankers

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Thank you very much for inviting me to this conference on central bank macroprudential policy. Most of the agenda is, rightly, devoted to the scientific study of interactions between the financial system and the macroeconomy, and to how policy might be able to provide a more secure base for private economic activity. I am going to step back from that to ask questions about the financial stability policy regimes that are emerging around the world. Do we even have clarity around what 'macroprudential policy' is for?

That question is rarely asked, even as 'macroprudential' has become the topic de jour amongst central bankers. If only everyone had heeded Andrew Crockett, the former leader of the Bank for International Settlements who, in one of many important contributions, reintroduced the term in the early 2000s, the Great Financial Crisis could have been avoided, or so the refrain goes. There is something in that. Certainly, it would have been a good idea if banks had had more equity. One of many problems with this turn of events, however, is that, somehow, it has left everyone free to fill in the largely blank macroprudential canvas to suit their own tastes, beliefs and, perhaps most of all, interests. Thus, from being a moment for refocusing on the resilience of the system, it risks becoming a vehicle for macroeconomists to invent a new set of instruments for themselves to research and use.

I have argued elsewhere that, given the state of knowledge, the priority should be resilience. I will reprise some of that here, but by way of urging the central banking community not to become too powerful. Put another way, the short-term attractions of accepting greater power in order to do good while other possible actors wait on the sidelines should be subordinated to the longer-term interest – of society, as well, more narrowly, as of central bankers themselves – of holding onto independence.

It is a timely caution because, at least in the West, threats to central bank independence are emerging for the first time in around a quarter of a century. I will start by enumerating just of a few of those challenges, which are a reminder that unelected power insulated from the politics of government is a delicate matter. I will then sketch the outlines of an approach to framing stability regimes, and to choosing whether to rely on regulatory policy or balance sheet operations. The analysis risks being the product of Western economic circumstances and democratic values. I conclude, therefore, with a few thoughts on how the conditions of emerging market economies challenge to my preferred approach, and how they might be addressed by a regime of 'whole-economy macroprudential policy' under the control of politicians.[2]

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[2] My remarks draw on broader forthcoming work on the legitimacy of unelected power, to appear in a book under contract with Princeton University Press on "The Design and Governance of Financial Stability Regimes: A Common Resource Problem That Challenges Technical Know-How, Democratic

## Four of the challenges to central bank independence

In the wake of the crisis and the painfully slow and uneven recovery that has followed, four of the broad issues confronting the current status and scope of independent central banks are:

- That monetary policy might, after all, involve long-term trade-offs and so political management needs to be reintroduced;
- That monetary policy is having big distributional effects, again requiring political input;
- That the results of central bank policy are not living up to their billing and prestige as *The Only Game in Town*; and
- That central banks are *Over-Mighty Citizens*, insufficiently constrained and too broadly empowered.

A few words on each, including contrasts and comparisons with stability policy.

### Non-neutrality: hysteresis and trade-offs

A central tenet of monetary economics is that money is, in the jargon, neutral and even super-neutral – which is to say that increasing the amount of money in the economy does not create more output and employment in the long run, and that increasing the growth rate of money simply translates into a higher steady-state rate of inflation.

While that has long been contested by commentators on the Left, recently some prominent US-based mainstream academic economists have begun to argue that monetary policy could (and should) be used to combat longer-run hysteretic effects of massive shocks to the economy.[3] In a nutshell, the proposal is to run what Janet Yellen described (before the 2016 US general election) as a "high pressure economy" in an attempt to recover lost ground and to restore something like the pre-crisis normality.[4]

Whether to do so would have to be weighed against the risks of rekindling inflationary expectations or of triggering a renewed wave of financial sector improvidence. The big question, however, which tends to be left hanging in the air, is who should make the decision whether to persist with a high-pressure policy. Can it be left to unelected technocrats?

It seems likely that the possibility of hysteresis persistently depleting economic capacity has little or no bearing on the familiar inflation bias of monetary policy under day-to-day political control. That makes a case for monetary policy remaining with

Accountability and International Coordination". CIGI Essays on International Finance, volume 3, Waterloo, ON: CIGI, 2016.

3 O Blanchard, E Cerutti and L Summers, "Inflation and Activity: Two Explorations and Their Monetary Policy Implications," Working Paper Series, WP15-19, Peterson Institute for International Economics, 2015.

4 J Yellen, "Macroeconomic Research After the Crisis", speech delivered at the 60th annual economic conference on "The Elusive 'Great' Recovery: Causes and Implications for Future Business Cycle Dynamics", sponsored by the Federal Reserve Bank of Boston, Boston, Massachusetts, 14 October 2016.

central banks. It also implies, however, that an independent monetary authority should have discretion to run a "high pressure economy" only if medium- to long-term inflation expectations remain in line with the target for inflation.

Contrast that with stability policy. No one in the mainstream is suggesting that looser monetary policy (and so higher inflation) in n years' time would generate more economic activity or welfare. By contrast, it is possible that a much tougher regulatory regime – one that, say, banned maturity transformation or leverage – might affect the dynamism and efficiency of the economy. We just do not know. This has major implications for how the goals of stability policy should be framed.

## Distributional considerations

A second challenge to post-crisis central banking has been more overtly political, not in the sense of straightforward party politics but in the sense of particular parts of society being either systematic winners or systematic losers from monetary policy since 2009. In a number of countries, perhaps particularly Germany and the United Kingdom, it is argued that a combination of persistently low official interest rates with quantitative easing and credit easing – prosaically, buying lots of government bonds and privately issued bonds – has pushed up asset prices, enriching the rich, and pushed down returns on savings, hurting those households and pensioners who are not remotely rich but who rely on income from a lifetime of saving. Since democratic politics is the forum in which sectional interests and preferences are debated and settled, this invites the protest that central banking has found itself stranded in foreign territory, losing its legitimate moorings.

There is no doubt that monetary policy has been having distributional *effects*. When a central bank raises interest rates to restrain demand, there will typically be some cost to debtors and asset holders and some uplift in the running return to savers. In normal circumstances, those effects are dominated for society as a whole by the benefits of maintaining sustainable growth and, separately, over time they tend to be offset by the obverse effects that kick in during periods of easy monetary policy. The distinctive thing about the current conjuncture is that super-low interest rates and asset purchases have gone on and on for years and years, so the distributional effects have been more pronounced and long-lived. Given the different tendencies to vote of the segments of society affected, it is not hugely surprising that these effects should prompt public debate and some disquiet.

For my theme today, the key thing here is that, give or take a bit, monetary policymakers were not, on the whole, making distributional *choices* when they kept their policy rate low and injected money by buying low risk government bonds. Contrast that with introducing limits on the access of households and businesses to particular products in order to quell a boom. In that case, the authorities could instead have raised equity requirements for banks and other intermediaries. A choice of who is constrained *is* being made.

## The Only Game in Town: central banking as false hope

Things start to come together in the third concern: that central banks have become the only game in town, but cannot deliver what the people want. The roots of this problem are deep, and alarming.

There exists a strategic tension between central banks and elected policymakers. The latter have few constraints on their powers but carry equally few legal obligations. In consequence, when short-term politics entail costs on acting themselves to contain a crisis or bring about economic recovery, they can sit on their hands safe in the knowledge that their central bank will be obliged by its mandate to try (within the legal limits of its powers). That can lead to a flawed policy mix, creating risks in the world economy and financial system. Central banks are, in effect, faced with a choice between implementing a flawed policy and abandoning their mandate in order to induce others to act.

At times, the Bank for international Settlements, the central bankers' bank and refuge, has got close to advocating the latter course. This has been irresponsible, not least because it has risked obscuring the important (and true) message that the heavy lifting of sustainable economic recovery is unavoidably in the hands of the governments, since only they can remove obstacles to greater dynamism in the supply side of the economy.

Constrained by law and democratic mandate to do as much as they can within their powers, central banks have ended up looking like something they are not: *the* macroeconomic policymakers. The upshot has been a central banking community that is liable to be held responsible for something it simply cannot deliver: prosperity. The only answer in the short term is for central bankers to get back to repeating, over and over again, the refrain of the 1990s: that they can buy time but cannot generate prosperity.

That fundamental truth is not diluted by the grant of new macroprudential and regulatory powers. Indeed, the expansion of responsibilities and instruments risks fuelling the perception that central bankers are the miracle workers of our time, which brings me to the core of my remarks.

## Over-mighty citizens?

In the decade or so before crisis broke in the summer of 2007, central banks' core objectives and functions seemed settled: price stability and monetary policy. But, as Paul Volcker had warned emphatically as the 1990s began, no good could come from the central banking community losing interest in or influence over the financial system. Disaster duly followed when they became, by doctrine, inclination and expertise, overly detached from the need for financial system stability.[5] The post-crisis reawakening to the significance of most monetary liabilities being issued by private businesses has prompted extensive regulatory reforms. They have left many central banks with powers and prestige not seen since the 1920s, if then.

The issue this will pose sooner or later, perhaps particularly in democratic societies, is whether central banks risk becoming *over-mighty citizens*, too powerful, essential or prestigious to be constrained. In democracies, that would be a disaster. Everywhere, it would leave central banks hostage to shifting expectations and standards: moving goal posts.

5 Paul A Volcker, "The Triumph of Central Banking?", Per Jacobsson Lecture, Washington DC, 23 September 1990. The presence of the question mark was underlined during Q&A.

## Macroprudential regimes: purpose and objective

In the monetary sphere, we have, at least, got used to central banks being constrained by a purpose (price stability) which enjoys broad support and an objective (typically, today, an inflation target) which is easily understood and monitored. In the macroprudential sphere, that base camp has not been reached.

Let me give you some European and global examples. When, over the past year or so, the European Commission (usefully) consulted on the EU's macroprudential framework and institutions, nothing was said (as far as I could see) about purposes, beyond the vague term 'financial stability'. When the European Systemic Risk Board and the G20 Financial Stability Board each published documents on financial stability, they were, by contrast, clear about the purpose (a resilient financial system) but similarly silent on objectives, or indeed on the need for a monitorable objective.

Meanwhile, much of the macro-finance research community is devoting effort and ingenuity to studying the 'effectiveness' of macroprudential instruments. One might reasonably ask, effective at what? That, by and large, is passed over in silence.

### Two types of social cost

In headline terms, we can think of the proverbial 'boom and bust' as bringing social costs of two broad kinds:

1) A misallocation of resources and, in particular, over accumulation of debt during 'booms', which matter whether or not boom ends in 'bust'.

2) A collapse in asset values and a withdrawal or severe tightening of the supply of essential financial services following crises, which together bring about a macroeconomic downturn.

Both are products of negative externalities. The private costs of financial system pathologies fall well short of their socially destructive costs, so society cannot sit back and rely on private virtue or prudence to ensure allocative efficiency or intertemporal stability. Nor have we found a way of reframing property rights that leaves financiers unambiguously incentivised to weigh the social costs of their choices and actions.

Beyond that, our understanding of the two types of social cost diverges. We know very little about how to recognise booms or the associated misallocation of resources. We do know something about avoiding the costs of 'bust'. Big picture, five things can be said:

- Equity capital absorbs losses without the dislocations entailed by a bankruptcy procedure, whereas debt does not;
- A shortage of liquidity or an erosion of equity in levered intermediaries prompts a fire sale of assets and contagion to other intermediaries;
- Those vulnerabilities, while canonically associated with banking, are not in themselves connected to legal form;
- The social costs of failure tend to be smaller if interlinkages amongst firms are fewer; and
- Social costs of failure are smaller if core services can be maintained by (a) resolution regimes, and (b) low barriers to entry.

## The de facto purpose: financial system resilience

Conscious of their ignorance of what drives booms and believing the social and political costs of the system collapsing are especially great, policymakers have, rightly in my view, concentrated on mitigating busts. Further, whereas previous generations concentrated almost exclusively on reducing the *probability* of failure, policy in the aftermath of the Great Financial Crisis has put as much weight (almost) on reducing the *impact* of failure.[6]

The implicit judgment is that a resilient system would be less likely to collapse and, crucially, in the event of crisis would be better at resuming the provision of core services, which would reduce the severity of the economic downturn and place less reliance on macroeconomic policy to generate recovery. That last point is important for where I am going.

## The proposed objective: a quantified Standard for financial system resilience

If the purpose is continuity of services from the system as a whole, and thus avoiding the worst costs of 'bust', the core objective of the regime must be a *Standard of resilience*. That is to ask, just how resilient should the system be?

Roughly speaking, policymakers need to determine the severity of shocks the system should be able to withstand. That is driven by three things:

(a) A picture (or model) of the structure of the financial system through which losses or shocks are transmitted around the system and via which substitute service-providers emerge;

(b) A view of the underlying stochastic process generating those shocks/first-round losses; and

(c) A tolerance for systemic crisis.

While all three are unavoidably part of the make-up of those existing regulatory regimes, such as the Basel III Accord for banks, designed to ensure resilience, they have tended to be implicit. I am arguing that they should be as explicit as possible, in the interests of both effectiveness and legitimacy.

That legitimacy is at stake can be seen by observing that the three components are different in kind. Inputs (a) and (b), the model/picture of the system and of the loss-generating process, are properly objects of scientific inquiry. But input (c) is different, as society's tolerance for systemic risk needs, somehow, to reflect a view of the people's preferences.

6 The substance of the reform programme was outlined and evaluated in Paul Tucker, "Regulatory Reform, Stability, and Central Banking", Hutchins Center on Fiscal & Monetary Policy, Brookings, 16 January 2014. One conclusion of that paper was that policymakers lacked a framework for the resilience of key markets. They still do.

As alluded to earlier, this marks an important difference from monetary policy, because we do not yet know whether there are serious long-run trade-offs.[7] For that reason, a goal of systemic stability is not quite the same as the established goal of price stability. Some residual risk of instability is tolerated (even when the regime is working as intended). Politicians must decide how much, either formally issuing or blessing the Standard of resilience that the financial stability authorities are required to apply. Reflecting cross-border interlinkages and spillovers make financial system resilience a global common good, something like that happened when a G20 Leaders' summit signed off the post-crisis Basel standard.[8]

## Unpacking 'tolerance for crises' in current macroeconomic circumstances

Of course, crisis/non-crisis is not binary but rather, if I might be excused a European metaphor, akin to Dante's Circles of Hell. 'Tolerance for crisis' should, therefore, be thought of as a vector covering the tolerance for a series of calamitous states of the world, including all core services ceasing and, less devastating, severe impairment of each broad type of core service (payments, credit, risk transfer and insurance).

The macroprudential turn, Andrew Crockett's insight, means that when applying the Standard, technocrats need to have a deep understanding of, in line with (a) above, the structure of the financial system: specifically, how viciously or mildly shocks are propagated, and how easy or hard it is for new entrants to substitute for failed or badly distressed firms. This means taking into account the following areas of public policy (which, other than the first, lie beyond central banking):

- The risk-sharing and allocation properties of the financial infrastructure;
- Policies on the structure of the industry, since they too materially affect interlinkages;
- Policies on competition, since they affect barriers to entry and so how readily the provision of services can revive; and
- The adequacy of macroeconomic institutions and, in particular, the fiscal framework and the flexibility of product and labour markets, since they affect how easily or not shocks to the economy are absorbed, and thus, the final incidence of losses to intermediaries.

The last consideration is important but, I suspect, uncomfortable. Here in Asia, it is probably one of the reasons authorities have elected to require banks to hold capital above the international minimum standards. Sadly, I do not see much recognition of it in Europe, where market inflexibility and a radically incomplete macroeconomic constitution in the euro area point towards banks carrying more, not less, equity: the opposite of what we read is going on in the Basel negotiations to complete the capital accord.

7 For a comparatively rare paper exploring possible long-run trade-offs, see R Ranciere, A Tornell and F Westerman, "Systemic Crises and Growth", *The Quarterly Journal of Economics*, vol 123(1), February 2008, pp 359–406.

8 Paragraph 29 of the communique of the G20 Seoul Summit, November 2010.

## Higher equity needed today to meet the Standard

In today's macroeconomic circumstances, however, that is not just a point for Europe or for some emerging market economies (EMEs). It is universally valid. No one knows when the next recession will come, but come it will. When it does, monetary policymakers will have less scope to cut policy rates and fiscal policymakers less scope to provide stimulus than they did during 2009. That being so, an unchanged Standard of resilience (tolerance for crisis) entails higher equity capital ratios than warranted in more normal circumstances.

That is a macroprudential policy for today. It ought to be pushed by the IMF, and actively discussed in Basel. When the current minimum standards were calibrated, no one was thinking interest rates would still be at or even below zero as the transition period for the new Accord was nearing its close. Certainly, whenever intermediaries are unusually profitable, retentions should, for the moment, be the order of the day.

# Macroprudential policy and central bank balance sheet operations

I want to return to where we began, the broad question of what macroprudential regimes should look like. I have proceeded as though they begin and end with regulatory policies of various kinds, but not a few economists, commentators and even central bankers themselves entertain the possibility, or in some cases push the idea, of using balance sheet policy for macroprudential ends.

At the level of political economy, the differences between regulatory policy and balance sheet policy are striking:

- *Regulatory policy*: subject to public consultation; might take time to finalise; open to challenge in the courts; and
- *Balance sheet policy*: rapidly agreed and effected; less likely to be challenged in the courts; subject to political oversight via hearings in the legislature; exposes the state to fiscal risks.

Balance sheet operations typically also target a different (intermediate) objective. Take the idea of selling a portfolio of mortgage-backed bonds to suppress exuberance. This does not work on the resilience of intermediaries directly. It is better thought of as trying to manage, even if only rough-tune, credit conditions. For the reasons given earlier, I think policymakers insulated from day-to-day politics would do better to focus on an objective that is more easily monitored (and, via independent stress testing, evaluated).

There is another way of getting to the same conclusion. In their attempts to revive economic activity and so achieve their inflation targets, central banks have been intervening in markets to compress risk premia, not just during the period of panic when they were too high but up to today.[9] If, then, they were ever to intervene directly

[9] To be clear, I was very much part of that from 2009 to 2013, and in 2004 spoke about it as an option that would be available at the zero lower bound. See P Tucker, "Managing the Central Bank's Balance Sheet: Where Monetary Policy Meets Financial Stability", Bank of England, *Quarterly Bulletin*, Autumn 2004.

in markets to push risk premia up to levels they thought warranted by fundamentals, they would face a difficult choice:

- Either central banks should operate in markets only to get risk premia back in line with (their judgment of) fundamentals; or
- If, when their risk-free policy rate is constrained at the zero lower bound, they are going to push premia below fundamentals to help support economic activity, they should not also exercise a right to keep premia in line with fundamentals at other times.

I say that because otherwise it will be almost impossible for politicians and the public to keep track of what central banks are doing and why they are doing it. The mandate becomes an unconstrained licence to do good. For balance sheet policy, the priority should be to re-establish confidence in the integrity of the lender of last function.[10]

## Missing regimes: a particular problem for EMEs

I have been advocating a setup where, at current levels of knowledge, stability policy should be directed at financial system resilience, not at managing credit conditions, and where balance sheet policy should be parsimonious. Also, although I shall not defend it here, I prefer monetary policy to stick to the job of maintaining nominal stability over the medium to long run.

I do not pretend that that is all society might need. Indeed, a need can be identified for at least five regimes:

- Nominal stability: monetary policy
- Financial system resilience: prudential policy (micro and macro)
- Internal macro-financial balance: ?
- National balance sheet vulnerabilities: ?
- International macroeconomic balance: ?

Surely, we have seen enough over the past 30 years to be left with an uncomfortable feeling that the first two regimes, however well designed and operated, are unlikely to suffice. In medium-sized EMEs with open capital markets, raising interest rates to lean against excess aggregate demand growth can act as a magnet for hot money, pushing up asset prices, easing credit conditions, and fuelling internal and external imbalances.

Guarding against external imbalances is a form of national balance sheet management or, if you prefer, 'whole-economy macroprudential policy'. So far as I know, we do not yet have an articulation of how such policies could be framed within a coherent regime, a pre-condition for delegation to (unelected) officials insulated from day-to-day political currents. Maybe the proper – or, more narrowly, safe – role

10 P Tucker, "The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction", *BIS Papers*, no 79, 2014.

for central banks in this field is to act as independent advisors, publishing their advice to political policymakers on external vulnerabilities.

Better still would be for central banks to work on the design of such regimes, with a clear purpose and transparent monitorable objective. EME central banks are in a good position to lead on this, with the West importing the ideas. Because, be in no doubt, the West too needs regimes for managing external imbalances and vulnerabilities in ways that serve the collective interest.

## Summing up

Thank you again for inviting me to this conference. My messages, for what they are worth, are simple. Do not be too ambitious with macroprudential regulatory policy, tempted by the over-ambitious goal of 'managing the credit cycle'. Ensure, instead, that financial systems are resilient. Use balance sheet operations to deliver nominal stability and in the inalienable role as liquidity reinsurer of last resort. Face up to the pressing problem of missing regimes. For the world, that last part is worrying. For EMEs, it offers an opportunity to provide intellectual and practical leadership.