

Minouche Shafik: The interaction of monetary and macroprudential policy

Speech by Ms Minouche Shafik, Deputy Governor for Markets and Banking of the Bank of England, at the IMF panel on “Revisiting Monetary Policy Frameworks”, Lima, 10 October 2015.

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- The “lean or clean” debate used to be one of the most contentious in monetary policy until the crisis. Should monetary policy “lean against the wind” in the expansion phase of the credit cycle? Or should it remain solely focused on delivering the inflation target and “clean up” after the credit cycle contracts? The crisis taught us that cleaning up afterwards is a very expensive proposition. But are we confident enough in macroprudential tools to prevent the emergence of unmanageable risks during the credit cycle? The debate remains very much live, in part because macro-prudential policies are still nascent and we have not yet accumulated sufficient evidence through a credit cycle to make definitive judgements about optimal policy. “Lean versus macropru” remains an area in which perfectly reasonable people can have very different opinions.
- At one end of the spectrum there are those – such as Lars Svensson – who argue that the cost-benefit calculus is likely to be tilted heavily away from directing monetary policy at credit bubbles. At the other end of the debate there are those such as Jeremy Stein who argue for the active use of monetary policy to lean against the wind because it “gets in all the cracks.” Or Jaime Caruana and his colleagues at the BIS who argue that it would be appropriate for advanced economy monetary policy to begin to normalise in order to head off emerging macroprudential risks.
- I will aim to show that there are merits to elements of all of these arguments. But where the institutional set up and full spectrum of macro-prudential tools are available, there is strong case for using monetary policy only as a last resort for tackling financial stability risks. I will try to illustrate this argument with experience from the UK.
- ***Let me start with a simple question: can monetary policy be used to lean against the wind?*** The answer to that question is “yes”, because monetary policy and macroprudential policy both affect financial conditions and clearly have implications for one another.
- To illustrate the implications of monetary policy for macroprudential policy, consider the example of Hong Kong, where the unusually low interest rates since 2009 (as a result of their peg to the US dollar) have fuelled sharply rising prices across a range of residential and commercial properties (He 2014). Attempts to attenuate the financial stability risks from this broad property price boom with targeted macroprudential measures resulted in a large number of measures being applied, even including LTV restrictions on stand-alone car parking spaces, to which the boom had spread.
- If loose monetary policy can lead to a build up of financial stability risks, then the converse must also be true – tighter monetary policy can be used as a means of reducing financial stability risks. Most empirical estimates show that a temporary tightening of monetary policy can be expected to reduce real debt levels – and

hence the probability of crisis – by discouraging households and firms from increasing leverage in the medium term, even if the transmission (through reduced aggregate demand and a higher interest burden) involves a short-run move in the opposite direction (for example, Goodhart and Hofman (2008)).

- This was recognised in the design of the UK Monetary Policy Committee’s 2013 guidance that it intended to maintain a highly accommodative stance of monetary policy until economic slack had been substantially reduced. Recognising the financial stability risks that could emanate from a commitment to maintain low interest rates, the MPC set a “knockout” whereby their guidance would cease to hold if the Financial Policy Committee judged that the stance of monetary policy poses a significant threat to financial stability that could not be contained by the combination of macro and micro prudential policy tools available.
- ***What about the more difficult question of whether monetary policy should be used to lean against the wind.*** The answer is a more obfuscating “that depends.” Specifically, it depends on the efficiency and efficacy of the macroprudential tools and institutional framework available, a point eloquently made by my colleague Don Kohn recently (Kohn 2015).
- Take the extreme case in which there are no macroprudential tools. In such circumstances monetary policy may be the only means of tackling system-wide financial risks, but it would come at the cost of significant effects on the real economy – precisely because monetary policy “gets in all the cracks.” For example, some empirical work by former Deputy Governor Charlie Bean suggests that setting Bank Rate around 200 basis points higher than it was over the over the period 2003–2006 would have reduced the growth in the ratio of household debt to GDP by just 2 percentage points from 2003–2007 at a cost of GDP growth over this period being 2.6 percentage points lower (Bean et al 2010).
- By contrast, the targeted nature of the tools available to the Financial Policy Committee under the current institutional framework in the UK makes them a natural first line of defence for dealing with build-ups in financial system vulnerability while minimising the knock-on effects to the rest of the economy – as was recognised in the financial stability knockout built into the MPC’s forward guidance. These tools can be broken into two groups:
 - Those that are intended to directly affect the build-up of imbalances: for example, the FPC’s ability to impose sectoral capital requirements and its power to limit loan-to-value and debt-to-income ratios in the residential housing market.
 - Those intended to improve the resilience of the financial system in the event of shocks and thus reduce the severity of a cyclical downswing, including the power to affect bank balance sheets through a counter-cyclical capital buffer, and a leverage ratio.
- The Bank’s actions in the residential housing market in June 2014 provide an illustration of the benefits of directing targeted macroprudential policy tools at sectoral financial stability risks vis-à-vis raising interest rates. Motivated by concerns over the growth of household indebtedness, the FPC recommended that no more than 15% of mortgages originated could have a loan-to-income ratio above 4.5. And in response to fears that households on variable rate mortgages could struggle to meet mortgage repayments if interest rates rose significantly in future, the Bank recommended a minimum 3 percentage point interest rate stress be applied at origination. ***So in a first best world where the institutional set up and macro-prudential tools are available, I would let them do the leaning first rather than***

wield the heavy hammer of monetary policy. So far, this is the approach we have taken in the UK.

- **Let me finish with a few words on the development of macro-prudential frameworks across the globe.** For the most part good progress has been made in setting up effective macroprudential frameworks at a national level. However, many emerging macro prudential risks are cross border in nature – for example the GFSR has identified global factors as having played an important role in the quadrupling of corporate debt across major emerging economies, much of which is in foreign currencies. The risk inherent in this build up of leverage has motivated calls for a normalisation of advanced economy monetary policy sooner rather than later – a global leaning against the wind.
- But tightening advanced economy monetary policy solely to discourage further borrowing could make the job of getting inflation back to target more difficult. So, just as using a targeted macroprudential tool is preferable to using monetary policy to tackle domestic financial stability risks, so too would it be preferable to use efficient and effective international macroprudential tools to target global risks to financial stability. The framework for international macroprudential co-ordination is currently still in its infancy, and there is much room for improvement by way of surveillance, design and implementation of global macroprudential tools. This perhaps is the next frontier for macro-prudential policy and an important one for the FSB and IMF to take forward given the potentially significant negative spillovers that might result.