Pentti Hakkarainen: Finance cycles and macroprudential tools – the case of Finland within the euro area

Speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the Seventh High-Level Policy Dialogue of the Eurosystem and Latin American Central Banks, Madrid, 11 November 2015.

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Accompanying slides can be found on the Bank of Finland's website.

First let me thank the organisers for inviting me to this panel with a very topical theme. I am glad to share some experiences Finland as a small country has had relating to financial cycles and how we see the macroprudential policy and its tools to be implemented.

What do we know about financial cycles?

What does economics tell us about credit cycles, and their impact on the real economy? The topic is not new. We can find these issues already in late 19th century writings by Knut Wicksell the famous Swedish monetary economist. Later, Milton Friedman and other monetarists emphasized the impact of banking panics on the U.S. Great Recession in the 1930s. However, these contributions did not see the financial cycle as a regular phenomenon that would be different from the business cycle.

In the Post World War II era, many economists discussed phenomena very similar to what we now call financial cycles. Minsky's financial instability hypothesis and the way it sees financial markets as a self-destabilizing process is a narrative approach to the financial cycle phenomenon.

However, until recently macroeconomics paid little attention to the special role of financial markets. Many simulation and forecasting models had few if any financial markets related variables apart from the short-term interest rate. Such models are still being used by many central banks, although it has become commonplace to include financial frictions in them.

Financial liberalization in the late 1970s and throughout the 1980s was followed by extreme cyclical swings in many countries, for example in Finland, Sweden and Norway. First, there was a credit boom almost immediately after the liberalization. A serious banking crisis followed a few years later. This boom-bust type of instability in Northern Europe was obviously something else than a mere normal business cycle.

It may not be a random coincidence that the first academic publications that used the concepts "credit cycle" and "financial cycle" were published in the late 1980s and early 1990s, i.e. when a handful of advanced countries had reached the crisis phase of their boom-bust experiences after financial deregulation. This field of research has been mostly empirical. Theory has been slow to explain destabilizing behaviour in a way that would be applicable in practice.

Banking crises can be interpreted an extreme manifestation of the financial cycle phenomenon. There is a lot of empirical literature on their early warning indicators. Because no country has had enough banking crises to have a representative sample of them, this literature is almost exclusively based on panel data. For instance, recent working papers published by the European Systemic Risk Board and the Bank of Finland have systematically tested the predictive power of different early warning indicators.

Banking crises are in most cases preceded by three parallel phenomena, namely excessive credit growth, house price bubbles and large current account deficits. These three phenomena preceded the Scandinavian crises more than 20 years ago, as well as the most extreme recent crises in Europe and the Great Recession of the U.S. Banks' increasing reliance on money market funding other than retail deposits is also observed quite regularly in the development before crises.

Therefore, the archetypal banking crisis is preceded by a phase when banks finance the current account deficit by borrowing in international wholesale markets and channel this funding to the domestic economy by granting loans to customers who buy real estate. Although business loans are more likely to be written off as loan losses, macro level studies have found housing loans more destabilizing than corporate loans. (Detken et al 2014, Kalatie & al 2015)

According to Claudio Borio, we can measure the credit cycle phenomenon pretty well just by focusing on credit volumes and property prices. Judging by the results from standard filtering techniques, the credit cycle seems much longer than the ordinary business cycle, possibly about 15 years. If anything, financial cycles are becoming longer and more pronounced. Some academics, including Martin Hellwig and Charles Goodhart, have even argued that the capital requirements have actually amplified the financial cycle; banks restrict lending when capital adequacy requirements are about to be violated, which slows down economic growth and puts downwards pressure on asset prices, worsening credit risks.

Financial cycles in Finland (slide 2)

What has Finland learnt on the financial cycles as a small country and a member of the monetary union? At the moment, it seems that being a member of the monetary union has had a rather limited direct impact on the cycle in Finland. The Finnish financial sector has been rather well insulated from the instability experienced in some other member countries.

Three Bank of Finland economists, Adam Gulan, Markus Haavio and Juha Kilponen, have presented a decomposition of the fluctuations of the Finnish GDP since the 1980s. They analyzed which factors – financial or real, domestic or external – have moved the Finnish GDP. According to their results, the era of monetary union has been characterized by relatively stable domestic financial markets. Loan supply had a moderate stimulating impact on the economy in the mid- 2000s, but we cannot blame domestic financial instability for the deep recession that hit our economy in 2009. The reduction in export demand in particular and direct negative influences from global financial markets had a strong adverse impact on output, but these effects were direct, not transmitted through the national financial market.

These results obtained with sophisticated econometric techniques are consistent with what one can easily observe. The recession of 2009 hardly affected our domestic banking market, and e.g. loan losses remained at a historically low level. The solvency of banks was hardly affected. Simultaneously, the banking systems of some other countries within the monetary union were on the verge of collapse.

The stability of the Finnish financial sector is in strong contrast to the experience during the Nordic banking crisis 20 years earlier. We had in Finland a very pronounced financial cycle overheating in the late 1980s. Banks' lending grew too rapidly. Something needed to be done, but there were few previous examples of what we would now call countercyclical macroprudential policies. However, it was discussed back then that the problem could be solved with Pigouvian tax; lending growth could be subject to a tax to be paid by banks.

In March 1989, a new system of additional reserve requirements was introduced. The requirement was conditional on the lending growth rate of each bank. No interest was paid on these extra central bank reserves. During an era of high interest rates, this was a substantial cost burden for a bank that preferred to continue its expansion. Most banks kept the growth of their loan stocks below the threshold that would have triggered the extra requirement. The measure obviously helped to slow down credit growth, but in retrospect, it is easy to say that it should have been implemented earlier.

Finland experienced one of the worst banking crises in history only a few years later. Unsurprisingly, banks that chose to continue granting more and more loans despite of the costly extra reserve requirement were the first to end up in nightmarish problems a couple of years later. With hindsight, a sufficient macroprudential toolkit should have been created already when times were calm and their activation was not immediately not required.

Macroprudential policy in the euro area

Along with single banking supervision within the banking union, the European Central Bank was also given a mandate in macroprudential policy. The ECB can impose more – but not less – stringent requirements than the actions taken at national level on the basis of EU legislation.

(Slide 3)

The purpose of these asymmetric powers of the ECB is to prevent what is called the inaction bias in the conduct of macroprudential policy by national policy-makers. This bias towards inaction might arise because the deployment of macroprudential instruments is unpopular and tends to meet with opposition from the banks and their customers alike.

In the euro area, Governing Council of the ECB has an important, although a shared responsibility in the macroprudential field. This has the advantage that national analysis is complemented with independent ECB analysis and the state of the euro area as a whole being reflected in policy actions.

For example: In a monetary union where monetary policy is designed for the area as a whole, it may be unable to temper national credit cycles.Nationally targeted macroprudential policy is useful and it needs to take the limitations of monetary policy into account.

National credit cycles vary both in frequency and amplitude. For this reason, the development of macroprudential policy is of particular importance for the euro area countries.

National authorities' role is very important in the conduct of macroprudential policy within a monetary union. The analysis of the macroeconomic situation and the local conditions is the foundation for policy making. One function of national macroprudential policy is also to act as first line of defense against systemic risks. That benefits a country's neighbours as well: in integrated markets, systemic risks and problems spread rapidly across sectors and borders.

The macroprudential framework in Finland (slide 4)

The Finnish macroprudential framework is pragmatic. In a small country the framework was built on within the existing institutional structures. A close co-operation between the relevant institutions is of key importance and in particular the synergies between the central bank's maroeconomic expertise, [macroprudential analysis] and supervisor's regulatory and institution-specific expertise.

The decision making body is the Board of the Finnish Supervisory Authority (Fin-FSA), chaired by the Deputy Governor of the Bank of Finland. The Fin-FSA is the national macroprudential authority. Staff analysis and policy proposal, serving the decision making, are prepared jointly by the Fin-FSA and the Bank of Finland. The Bank of Finland, the Ministry of Finance as well as the Ministry of Social Affairs & Health are asked to express their opinions on the Fin-FSA Director General's regular quarterly policy proposals. All these institutions have also possibility to make initiatives of their own for the consideration of the Board of the Fin-FSA regarding the use of macroprudential tools.

Finnish economy and its outlook

Finland is a small open economy with a very good growth record in the long term. However, economic growth in Finland has now been slow for a prolonged period, both historically and by international comparison. Finnish exports have suffered a considerable loss of market share since 2009, the most severe year of the recession.

According to the last Bank of Finland forecast Finland will not soon catch up with the recovery foreseen in the other euro area countries.

Growth has been depressed by cyclical, sectoral and structural problems. The labour market situation has deteriorated rapidly during the past year. Unemployment is now higher than in the recession year 2009, the unemployment rate standing at around 9.5 %.

Over the past 5 years there has been a soft, if lengthy landing in the Finnish housing market, reflecting the protracted period of slow economic growth. The regional divergence, driven by both demand and supply-side factors, in house prices and household indebtedness is wide. Growth areas, mainly the biggest cities with universities, are characterised by increasing population, younger residents, a better employment situation and higher household income than the national average. This is also reflected in housing markets, as higher house prices and larger housing loans in these areas.

At current juncture, our financial cycle is lackluster. As required by legislation, we have made quarterly decisions on countercyclical capital buffer since the beginning of 2015. This has enabled us to gain some practical lessons on how macroprudential analysis is done and how the decision making with respect to financial cycles is managed.

Lessons learned

The diversity in economic history, the economic outlook and in the local conditions justifies the importance of national discretion in macroprudential policy making also in a monetary union.

However, one should go even deeper than the national level into the regional and sectoral differences. For example, we could foresee that urbanization drives housing demand to the extent that regional housing bubbles can become a systemic risk, with negative percussions on real economy, unless problems are appropriately addressed in time.

In addition, we have the well-known problems with data. Namely, the data is in many cases lagging, often revised afterwards and therefore backward looking. We should not make policy by looking at the rear-view mirror. Therefore, judgment, discretion and a holistic approach are essential in policy making.

Macroprudential policy is a new field of economic policy. Its creation is an outcome of the global financial crises. Monetary policy and good supervision were not sufficient for financial stability. One needs to see the forest from trees.

We need to learn the lessons of the crisis, while not fighting the last war. No crisis exactly repeats the previous one. Some more recent phenomena require also particular attention: increased importance of the debt securities market, re-emergence of shadow banking and the phenomenon digitalization.

To conclude, what is the biggest challenge for authorities? We have some new powers and a range of instruments for the conduct of macroprudential policy. We know that the direction is correct but we should also remember that these instruments are not properly tested yet. We do not know yet enough about their potential consequences and side effects. This advices caution. However, despite these difficulties, I believe these new powers and tools given to authorities are necessary. We are on a right track.