

Klaas Knot: Are we all macroprudentialists now?

Keynote speech by Mr Klaas Knot, President of the Netherlands Bank, at a seminar entitled “Tomorrow’s banking and how central banks have developed in last 15 Years”, organized by the Bank of Finland, Helsinki, 16 January 2017.

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It is a great pleasure for me to speak at this conference at the Bank of Finland, in which we pay tribute to Pentti Hakkarainen. As Deputy Governor and Chairman of the Finnish FSA, Pentti has played an important role in the areas of monetary policy and macroprudential policy.

In my remarks, I would like to focus on the increased importance of macroprudential policy for central banks, and elaborate on some of Pentti’s main insights.

I want to raise three main points.

My first point is that financial crises have always happened and will always happen. And they do not result from some exogenous, extreme event. Rather, to use Pentti’s words, financial crises can “be interpreted as an extreme manifestation of the financial cycle phenomenon”.¹ By financial cycle we understand systematic patterns over time in the financial system that can have important macroeconomic consequences.

Typically, financial crises are preceded by booms characterized by a combination of intensified financial innovation, robust and widespread appetite for risk, and a favorable economic environment. This favorable environment could for example reflect new growth impulses from technological innovation, international trade, and mobile and volatile international capital flows.

These patterns are indeed not specific to the Global Financial crisis, nor – if we look back in time – to the Great Depression. In fact, the first truly global financial crisis in modern history – the South Sea Bubble of 1720 – originated in England, France and the Netherlands.²

All key ingredients of an extreme financial cycle gone wrong can be found here. (The famous tulipmania that hit the Dutch Republic in 1636-37 shared some but not all of these elements, and its dynamics can be compared to the dotcom bubble rather than a global financial crisis.)

The burst of the South Sea Bubble followed a period of strong economic growth. The discovery of the economic potential of the New World had led to a shift in global trade towards the triangle that brought manufactured goods to Africa, Africans as slaves to the New World, and commodities to Europe.

There had been rapid innovation in financial engineering, spurred by some form of deregulation. This allowed greater risk sharing and supported exuberance in the financial sector. “Shadow banking” (the English insurance companies and international investors) played a pivotal role.

As liquidity stress morphed into solvency problems, the bubble burst with a dramatic international stock market crash.

You can see how the mechanics of this crisis do not differ much from those of the recent Great Financial Crisis, and all other crises traced through history by Charles Kindleberger.³

¹ P. Hakkarainen (2015) [Finance cycles and macroprudential tools - the case of Finland within the euro area](#). Speech at the Seventh High-Level Policy Dialogue of the Eurosystem and Latin American Central Banks, Madrid, 11 November.

² R. Frehen, W. Goetzmann and G. Rouwenhorst (2013) [New evidence on the first financial bubble](#). Journal of Financial Economics. Vol. 108 (3), pp. 585–607.

My second point is that there is a consensus that macroprudential policy is an essential toolkit but its effects and transmission channels are still not fully understood.

Since the 1930s, policymakers have used prudential means to enhance system-wide financial stability, with a view to limiting macroeconomic costs from financial distress. Some measures taken in the 1930s, 1950s and 1960s to support the domestic financial system and to influence the supply of credit have been viewed as macroprudential tools.⁴ Still, when Andrew Crockett pleaded for a macro perspective on prudential policy in 2000, the idea was controversial.⁵

It took the Great Financial Crisis to forge a consensus on the importance of macroprudential policy. As Pentti put it, “Macroprudential policy is needed in addition to other economic policies.

It is very important that authorities have also macroprudential instruments available. Now, after the Great Financial Crisis, we have instruments and framework in place.”⁶

But in his usual sharpness Pentti also highlighted the challenges to using macroprudential tools: “the effects of the said instruments are uncertain and second, processes for their usage are unnecessarily complicated. These points are intertwined.”⁷

My third point – and here I would like to elaborate a bit – is that we should not look at macroprudential policy and its effectiveness in isolation. As Pentti argued in a speech last year, it is important to coordinate macroprudential policy and monetary policy.⁸

Let me elaborate. The effectiveness of macroprudential policy depends importantly on its interaction with monetary policy. In particular, it hinges on the “side effects” that one policy has on the objectives of the other.

On the one hand, monetary policy can thwart the intentions of macroprudential policy. We all agree that the monetary policy stance affects risk taking of the financial system as a whole. While macroprudential instruments typically target specific vulnerabilities, monetary policy affects the cost of finance for all financial institutions – including the shadow banking sector. As such, in the words of Jeremy Stein, it “gets in all of the cracks and may reach into corners of the market that supervision and regulation cannot”.⁹

This is most evident in a crisis situation, such as the one we are still witnessing in the euro area. Standard and non-standard monetary policies that provide ample liquidity may avoid a collapse of the banking sector. But they can come at the expense of reduced incentives for

³ C. Kindleberger and R. Aliber (2015) *Manias, Panics and Crashes: A History of Financial Crises*. Palgrave Macmillan. 7th edition.

⁴ A. Haldane (2011) [Risk off](#). Speech delivered on 18 August.

⁵ A. Crockett (2000) [Marrying the micro- and macroprudential dimensions of financial stability](#). BIS Speeches, 21 September.

⁶ P. Hakkarainen (2016a) [Capital-based macro-prudential instruments - what type of policy tools are needed to address macro-prudential risks in the banking sector?](#) Notes for the panel discussion on “Capital-based macro-prudential instruments - what type of policy tools are needed to address macro-prudential risks in the banking sector?” EU Commission's Public Hearing on the Review of the EU macro-prudential framework. Brussels, 7 November.

⁷ Ibidem.

⁸ P. Hakkarainen (2016b) [Monetary policy - which road ahead](#). Notes for the session “Monetary Policy: Which Road Ahead?”. Frankfurt European Banking Congress, Frankfurt am Main, 18 November.

⁹ J. Stein (2013) [Overheating in Credit Markets: Origins, Measurement, and Policy Responses](#). Speech at the Federal Reserve Bank of St. Louis research symposium on “Restoring Household Financial Stability after the Great Recession: Why Household Balance Sheets Matter”, 7 February.

banks to recapitalize and restructure. They may actually promote the evergreening of non-performing loans and regulatory forbearance.

It is argued that targeted macroprudential policies can offset these side effects. But I do not side with this Panglossian view and am afraid that there are limits to what macroprudential tools can achieve in practice.

On the other hand, macroprudential policy can thwart the intentions of monetary policy. Changes in (micro and macro) prudential policy will affect banks' risk-taking, their financing conditions and balance sheet composition. They will therefore have an impact on the real economy and on price stability.

The fact that the ongoing unprecedented monetary policy stimulus does not translate into rapid credit growth in the euro area might then not imply that monetary authorities are not doing enough. Rather, banks are reacting to stricter regulatory rules that have been introduced in the wake of the global financial crisis in an attempt to make the financial system more resilient. These regulatory changes therefore weaken the pass-through of monetary policy measures to the supply of bank credit and, ultimately, to aggregate demand and inflation.

Let me conclude. The claim that “we are all macroprudentialists now” seems to suggest that macroprudential policy has become fashionable.¹⁰ Are we then all macroprudentialists? In the spirit of Pentti's thinking my answer is: Yes – as long as we stay eclectic, pragmatic and flexible. And we take the interactions of monetary and macroprudential policies into account, and coordinate the two policies.

Thank you.

¹⁰ C. Borio (2009) [The macroprudential approach to regulation and supervision](#). VoxEU, 14 April.