DeNederlandscheBank

EUROSYSTEEM

Macroprudential modesty

Introductory remarks by Klaas Knot, at the 82nd Plenary Meeting of the Group of Thirty

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At the G30 meeting, hosted by the Federal Reserve Bank of New York, a panel session was held on 'The Future of Macroeconomic Policies'. Klaas Knot was one of the panelists. In his opening statement he discussed the role of macroprudential policies in addressing financial vulnerabilities. He stressed the need to be realistic in our expectations on what macroprudential policies can deliver under the current circumstances. The macroprudential toolkit, Mr. Knot said, is limited in scope and impact to mitigate systemic risks. He stressed that financial stability has to be a relevant factor to take into account in the overall macroeconomic policy mix.

Introduction

What a difference a year can make. In December 2018, the ECB decided to end its net purchases under the Asset Purchase Program and it was believed that 2019 would focus on steps towards monetary policy normalization.

Now, one year later, rates have been cut both in the US and in Europe and net asset purchases have restarted in Europe. The main theme in international discussions at the FSB and IMF is the prolonged nature of low interest rates. These discussions focus on the structural level of the natural interest rate and are reflected in terms as 'low-for-long' or even 'low forever'. The weakening of the economic outlook and shift in financial conditions have increased stability risks in the global financial system.

I will argue today that we need to be realistic in our expectations on what macroprudential policies can deliver under the current circumstances to safeguard financial stability. The macroprudential toolkit is limited in scope and impact to mitigate systemic risks. Following this observation, it also raises important (and sometimes new) questions on the implications for the overall macroeconomic policy mix.

I. Vulnerabilities in the financial system

In order to discuss the role of macroprudential policies in current economic circumstances, let's first take a look at the main pockets of vulnerabilities featuring prominently in the FSB's semi-annual exercises. As my goal is to map macroprudential policies onto these vulnerabilities, I will abstain from geopolitical risks such as trade disputes and Brexit.

Credit growth / leverage

First of all, the low-interest rate environment leads to a search for yield, which can lead to a situation where returns no longer reflect underlying risk fundamentals. For example, at the FSB, we are closely monitoring developments in leveraged finance and the CLO market. This market has grown to an estimated total of 3.2 trillion USD and has been accompanied by declining lending standards and higher corporate leverage. Covenant-lite loans were rare prior to the crisis, but since 2009 its share of issuance has increased to 50-80%. Moreover, there has been an increase in leverage and deterioration in credit quality. Over 60% of outstanding loans has a single B credit rating or lower. Needless to say, such lending activities are vulnerable to a sudden change in market sentiment, a rise in interest rates or deterioration of the economic situation.

Public and private indebtedness

A second important effect is that the low interest rate environment has led to a strong increase in total debt, both within the public as well as the private sector. Total debt-to-GDP ratios stand at 350% for Japan, and around 250% for the US, the UK and the Euro Area.

Higher debt levels may reflect a response to structurally lower interest rates and therefore structurally higher sustainable debt levels, but they can also create vulnerabilities. For example, despite the favorable economic conditions in recent years, very few countries have actually reduced their public debt ratio. In the current environment, governments do not face financing constraints. Debt sustainability issues could however resurface when market sentiment shifts and risk premia were to increase.

Sovereign debts are particularly prominent in Europe, where the preferential treatment of sovereign exposures effectively implies zero-risk-weighting at the banks.

Corporate indebtedness in advanced economies has also been rising and has peaked over 160% of GDP. This might result in a debt trap where corporates can only service their debt because of the low interest rates, but do not have sufficient underlying earning capacity to cope with an unexpected rise in interest rates (zombification).

Real estate markets

The third systemic risk that I want to mention is the strong increase in both residential housing prices and commercial real estate in recent years. Real estate markets have traditionally been an important factor in the development or amplification of financial crises. Several jurisdictions show increased signals of overvaluation in significant segments of the market.

II. Macroprudential toolkit

Given the current stance of monetary policy and the outlook of a prolonged period of low interest rates, it is logical to first look to what extent macroprudential policies would be able to mitigate these systemic risks. The figure below provides for a mapping of our current macroprudential toolbox, based on EU/Dutch legislation. The green boxes indicate the instruments that most central banks have at their disposal. The salmon colored boxes are measures that can be applied by macroprudential authorities, but whose effectiveness in mitigating systemic risks is generally perceived to be limited. The red boxes indicate instruments that could be applied, but are currently not within the remit of most central banks. Finally, there are several white boxes which indicate that no specific macroprudential instrument is available.

Figure 1: Curent macroprudential toolbox based on EU/Dutch legislation

SYSTEMIC RISKS		Banks	Non-banks	Households/ corporates
Cyclical	credit growth / leverage	• CCyB • Leverage ratio	• Leverage ratio (AIFMD)	• Tax regime
Cyclical	public / private debt	• Sectoral risk-weights • Sovereign risk-weights/ concentration limits	-	-
Cyclical	real estate markets	• Discretionary measures (flexibility package)	-	• LTV/LTI/DSTI • Supply measures • Subsidies / tax regime
Structural	Systemic relevance / concentration	• SIB-buffer • SRB	- • SII-framework	-

available | Limited effective | Not available | - Non-existent

Source: based on brochure DNB's financial stability task

So what do we conclude from this overview? Allow me to make three observations.

First, the macroprudential framework does not provide a fully-covered system. Contrary to monetary policy that 'gets into all the cracks', macroprudential policies are limited to specific parts of the financial system. Available measures are also almost exclusively targeted towards banks, which implies a potential for risk-shifting beyond the banking sector.

Second, macroprudential measures are mostly targeted at strengthening resilience, but not at addressing the build-up of underlying vulnerabilities. Current available instruments create buffers to better absorb losses when they occur, but they neither improve the functioning of the real economy, nor do they stem the origination of losses. For example, an important systemic risk like corporate indebtedness cannot be directly addressed by macroprudential authorities.

Thirdly, potentially very effective measures often do not fall within the remit of macroprudential authorities. Such measures are often considered too important from an electoral perspective to delegate their activation to independent authorities. These include sovereign risk weights, borrower-based limits and preferential tax incentives. They are often part of broader economic trade-offs, thereby however creating a reality that macroprudential authorities cannot employ full ammunition to address systemic risks.

III. Policy implications

So my main message today is that of macroprudential modesty. Although important frameworks have been developed in the aftermath of the global financial crisis, we cannot regard them to be at par with

monetary or fiscal policies. The impact of macroprudential measures are unlikely to be as forceful as monetary policy, as they at their very best slow down the build-up of stability risks within the financial system.

This has several important policy implications. For one, despite of the limitations I sketched, we should remain committed to full implementation of the international reform agenda. Limitations in scope and impact cannot be an argument to deregulate. But on top of this, we should continue to work on structural challenges within the economy and its financial system.

Importantly, we should also continue to think about the implications for the overall macroeconomic policy mix. The observation that macroprudential policies cannot be fully relied upon to contain systemic risks would also have to be taken into account in the conduct of monetary and fiscal policy. To be clear: it should not have an impact on the mandate or direction of monetary policy, which would continue to be fully geared towards price stability. However, financial stability would have to be a relevant factor to take into account within the design and the proportionality of policy measures.

Obviously, these are complex observations that require further analysis. I look forward to discuss these and related matters in our quest for further operationalization of effective macroprudential policies.