Macroprudential policy: working towards a new consensus

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It is a great pleasure to address this high-level meeting. I would like to thank our co-hosts, the IMF and the Financial Stability Institute, for the opportunity to share this opening session with John. We have thought through and discussed these topics many times, and it is a pleasure to work together again on this occasion. The topic of today's meeting is "The Emerging Framework for Financial Regulation and Monetary Policy". This title is full of promise, as it suggests that we are making progress in addressing the problems that have been ailing the global financial system.

I think the progress is real, and in my remarks today I shall discuss what we at the BIS see as the emerging framework for system-wide stability and the role of macroprudential policy within this framework. I shall then discuss some of the challenges we face in turning this macroprudential concept into a reality, and provide some concrete examples based on the experience of different countries. I shall close by sounding a note of caution about understanding the limitations of macroprudential policy, and the practical challenges that lie ahead.

The emerging framework for financial stability

Following the financial crisis, the shortcomings of market discipline and microprudential policies focused on individual financial institutions have become clear to everyone. A host of regulatory reforms across a wide range of policy areas are under way, coordinated by the G20 and the Financial Stability Board (FSB). A key plank of this reform effort is to put in place macroprudential policies designed to increase the stability and resilience of the financial system as a whole, not just individual institutions or markets.

While there is considerable agreement in principle that a new framework for financial stability is needed – a framework that deals properly with system-wide risks – there is still no consensus on what this framework should look like and how it should operate.

What do we mean by the emerging framework for financial stability? At the BIS, we view this framework as engaging many interrelated parts and players (see Annex). A first consequence is that we need to ensure that macroeconomic policy areas make their proper contributions to the stability of the financial system. Second, in the regulatory framework, perhaps the novel element is the macroprudential orientation of regulation and supervision to address systemic risk. Finally, the institutional framework needs to be adjusted nationally to pay more attention to the monitoring and control of systemic risks and internationally to ensure cooperation and consistency across borders.

I will concentrate on just a few of these elements.

Prudential policies are not enough to achieve financial stability

We need a new consensus on how macroeconomic, fiscal and monetary policy can help to mitigate the build-up of financial imbalances, including credit booms and asset price bubbles. The financial crisis demonstrated that a monetary policy aimed at achieving stability of consumer prices is not sufficient to ensure financial stability and therefore economic stability. This also lends some support to a perhaps neglected channel of monetary transmission: the "risk-taking" channel.

Monetary policy should not treat asset price and credit cycles as exogenous when they, in fact, are inherently influenced by the policy stance. Monetary policy must be more symmetric, responding during the boom and bust phases of financial and business cycles. It is not sufficient to wait and clean up during the bust phase: monetary policy also needs to lean against the build-up of financial imbalances during the boom.

If we accept this view, it follows that the goal of monetary policy should not narrowly aim at controlling inflation over the short run. Rather, it must also take account of credit growth and asset information, with the aim of promoting financial and macroeconomic stability over the medium term. In the long run, the two goals are indeed likely to be consistent. As we have just witnessed, the unravelling of financial imbalances tends to result in unwelcome disinflation and can cripple the effectiveness of monetary policy given the zero lower bound. Any trade-off between financial stability and monetary stability may be more apparent than real when the appropriate time horizon is considered.

The crisis has also shown that fiscal policy must play a supporting role in a financial stability framework. One obvious mechanism is to let fiscal automatic stabilisers play their part in difficult times. Moreover, government can play the role of a kind of insurer by building fiscal room for manoeuvre in good times. When bad times come, these "reserves" can be used for financial stability purposes. While many countries offset the worst impacts of the financial crisis by rescuing the banking sector and by boosting domestic demand, this fiscal response needs to be carefully unwound. Otherwise, the intersection of fiscal sustainability concerns and fragilities in the financial system may present significant risks to financial stability. Today this is an area that certainly requires attention and credible action.

Before moving on to the macroprudential section, one word about the importance of international cooperation mechanisms so that national authorities can act together in a timely way to reduce global imbalances and to ensure consistency.

The BIS view of macroprudential policy

Macroprudential policy is my second point. At the BIS, we define macroprudential policy as "the use of prudential tools with the explicit objective of promoting the stability of the financial system as a whole, not necessarily of the individual institutions within it".[1] The objective of macroprudential policy is to reduce systemic risk by explicitly addressing the interlinkages between, and common exposures of, all financial institutions, and the procyclicality of the financial system. That is, systemic risk is to be reduced in its cross-sectional dimension and its time dimension, respectively.[2]

Recent BIS analytical work designed to make the macroprudential approach operational suggests several guiding principles.[3] First, we should aim to calibrate prudential tools to

1 P Clement, "The term 'macroprudential': origins and evolution", *BIS Quarterly Review*, March 2010.

2 J Caruana, "Grappling with systemic risk", International Distinguished Lecture to the Melbourne Centre for Financial Studies, 10 February 2010.

3 J Caruana, "The international policy response to financial crises: making the macroprudential approach operational", panel remarks, Jackson Hole, 21–22 August 2009.

individual institutions' contribution to system-wide risk, regardless of the institution's legal form – every important firm must be included inside the perimeter of regulation. Second, we need to find a way to reduce procyclicality in the financial system. One approach is to build up countercyclical capital buffers in good times, when it is easier and cheaper to do so. This build-up can also act as a brake, restraining risk-taking. In bad times, running down the buffers allows the financial system to absorb emerging strains more easily, dampening the amplifying mechanisms. Third, we need to study carefully the different tools available, their potential use and the empirical evidence of their impact and effectiveness.

National experiences with macroprudential tools

At this stage, it is important for us to recognise that macroprudential policy has never been used comprehensively; it has only been used on an ad hoc basis. We are still learning. Asian central banks have taken the lead in implementing various macroprudential tools before and following the experience of the 1997 crisis (see table below). For example, central banks in the region have used countercyclical provisioning, loan-to-value (LTV) ratios and direct controls on lending to specific sectors to manage procyclicality in their financial systems. They are also addressing aggregate risk in the financial system through capital surcharges for systemically important financial institutions.

A well known example of the use of LTV regulation is Hong Kong in the 1990s, as, with a currency pegged to the US dollar, the Hong Kong Monetary Authority could not use interest rates to lean against buoyant real estate prices and the associated rapid growth of bank lending. Less well known but equally important is the experience of the Reserve Bank of India (RBI), which has also been active in introducing macroprudential tools. The RBI has introduced measures to restrain credit growth for housing and consumer finance, to reduce excessive speculation in equity and commodity markets, and to build up buffers through countercyclical provisioning.

Asian experience with macroprudential tools

Objective	Tools	Examples
Manage aggregate risk over time (ie procyclicality)	• Countercyclical capital buffers linked to credit growth	• China[1]
	• Countercyclical provisioning	• China, India
	• Loan-to-value (LTV) ratios	• China, Hong Kong SAR, Korea, Singapore
	• Direct controls on lending to specific sectors	• Korea, Malaysia, Philippines, Singapore
Manage aggregate risk at every point in time (ie systemic oversight)	• Capital surcharges for systemically important banks	• China, India, Philippines, Singapore
	• Liquidity requirements / funding	• India, Korea, Philippines, Singapore
	• Limits on currency mismatches	• India, Malaysia, Philippines
	• Loan-to-deposit requirements	• China, Korea

[1] Being considered.

Source: Committee on the Global Financial System.

These examples demonstrate that macroprudential tools can be effective in addressing vulnerabilities by enhancing the resilience of the financial system. It is still an open question, however, to what extent such instruments have been effective in restraining the growth of credit and asset prices. It will require more experience with these tools in order to calibrate them effectively to their specific purpose and the institutional setting where they are deployed. As I have mentioned several times already, we need to be realistic about what macroprudential tools can and cannot accomplish.

The message for supervisors is that the new tools and perspective need to be complemented with a much more active approach to supervision. They will need to adopt a "look-through" approach. They must look through legal and accounting structures (such as off-balance sheet entities and activities such as repo 105). And they must also look through the business cycle. This is hard to do, but I am confident that supervisors can meet this challenge.

Notes of caution and the practical challenges that lie ahead

Avoid overly ambitious expectations about the ability to manage the macroeconomic cycle

Macroprudential policy is being portrayed as a powerful tool to manage the macroeconomy and tame the financial cycle. While there are high hopes that this approach will be useful for addressing systemic risk, we need to be realistic about what it can accomplish. We need to avoid any overconfidence that these tools can be used to fine-tune the macroeconomic cycle. At best, they can relieve some of the pressure on traditional macroeconomic tools. More generally, policymakers need to accept that periodic, mild recessions or a marked slowdown in growth may be a necessary price for avoiding major recessions.

Moreover, the word macroprudential is becoming very popular, and we run the risk of using "macroprudential" as a catch-all term to cover all manner of policies. I think we should be careful. First, broad definitions unnecessarily widen the objective to be pursued by supervisors and lessen accountability. Second, we need to understand and communicate clearly the macroprudential objectives, impacts and responsibilities. Confusion about a policy may undermine its effectiveness.

2010 is an important year for the macroprudential approach

This is the year in which to quantify and finalise key elements of the regulatory reform, including the necessary calendar for implementation. The regulatory reform has many building blocks that need to be assessed jointly. One of the most fundamental improvements introduced by the Basel Committee in its reform package is the macroprudential focus to address both common exposures/interlinkages among financial institutions and the procyclical amplification of risks over time.

For this purpose, additional countercyclical buffers and capital requirements for large, connected and indispensable financial firms are under discussion. These should be set for firms along a continuum, not for a given list of institutions deemed systemic.

Particularly complex are the calibration and finalisation of these macroprudential components of the capital framework. For this reason, the calibration exercise this time is going to be more comprehensive: it will include a macroeconomic analysis of the benefits and costs of the regulatory reforms in a steady state environment and also of the implementation costs over the transition period to enable a phased-in process consistent with the recovery to be designed.

Additional complexity comes from the fact that additional proposals are under study. The IMF has been asked by the G20 leaders to prepare a report with options so that the financial sector could make a fair and substantial contribution to the burden of government interventions. From the financial stability point of view, the key is to recognise that taxes/levies and capital surcharges are complements, not substitutes. Capital requirements directly address the level of systemic risk by reducing the probability of failure of financial institutions. They affect risk-taking directly and unambiguously. If correctly calibrated, they also internalise the contribution of an institution (or a group of institutions) to systemic risk. Levies and taxes, on the other hand, are classic means of dealing with an externality and promote burden-sharing. More analysis is needed and, in any case, their calibration and implementation should take into account this complementarity and the cumulative impact that they will add to the core reform package.

Do not underestimate the practical challenges of putting in place a macroprudential overlay

Let me close by saying that putting in place this emerging framework for financial stability will be difficult. As we have seen, it requires new consensus and tools, but it also requires additional resources, better data, time, and international cooperation to enable us to take timely action. There are many details to be worked out, but a lot has already been achieved, and we need to move forward to avoid a recurrence of such a costly global financial crisis.

Thank you for your kind attention.

Annex

Global systemic framework

Macroeconomic policies

Monetary policy
- More symmetric
- Leaning against the wind
- Role of financial stability in setting monetary policy

Fiscal policy
- Automatic stabilisers
- Discretionary fiscal stimulus
- Bank rescue

Prudential policies

Macroprudential
- Procyclicality
- Forward-looking provisions
- Countercyclical capital charge
- Capital conservation
- Other: LTV
- Interconnectedness
- Systemic charge
- Cross-border resolution
- Market infrastructure

Microprudential
- Capital
- Capturing on- and off-balance sheet risks
- Trading book
- Securitisation
- Counterparty
- Better quality and transparency
- Leverage ratio
- Liquidity
- 30-day ratio
- Longer-term structural ratio

Supervision: proactive enforcement
- Perimeter of regulation
- Through the cycle / structures

Institutional framework

Institutional setup
- Distribution of responsibilities
- "Systemic regulator"
- Early warning exercise

International cooperation
- Keeping your house in order not enough
- G20
- Mutual assessment
- FSB
- Peer review
- BCBS
- Comprehensive impact assessment
- Peer reviews
- Other standard setters

Market discipline

Transparency; accounting; market integrity; consumer protection