Seven don’ts and one hope: The nexus between prudential and monetary policies

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Introduction

- **Objective**
  - Explore selectively nexus between prudential (PP) and monetary policy (MP)

- **7 observations in the form of “don’ts”**
  - Not... deadly sins or commandments! Far from it
  - Simply suggestions intended to spur discussion

- **Overarching theme**
  - How best to tame the financial cycle (FC)
  - FC = Self-reinforcing interaction between risk perceptions/tolerance and financing constraints
    - Historically the major source of systemic risk/costly banking crises (G 1)
    - Major manifestation of the “procyclicality” of the financial system

- **If had to choose a single “don’t“?**
  - Don’t think that taming the FC is easy! But there is hope!...
  - ... and we should try hard
Graph 1: The financial cycle is longer than the business cycle (the US example)

The financial cycle as measured by frequency-based (bandpass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices. The business cycle as measured by a frequency-based (bandpass) filter capturing fluctuations in real GDP over a period from 1 to 8 years.

1 The financial cycle as measured by frequency-based (bandpass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices. 2 The business cycle as measured by a frequency-based (bandpass) filter capturing fluctuations in real GDP over a period from 1 to 8 years.

1. Don’t oversimplify the micro/macro prudential distinction

- **Common view**
  - Right to use the term “macroprudential” policy (MaP) & to contrast it with “microprudential” policy (MiP)
- **At the BIS, we have yielded to this temptation, but have always stressed**
  - “MaP” was a philosophy/orientation of PP, not a separate policy
    - Two coexisting souls
    - same tools (capital, liquidity, etc), but different perspective:
      - focus on system as a whole (MaP) vs individual institutions (MiP)
  - Our concern: dominance of a “MiP” perspective; rebalancing needed
- **These nuances have been lost in translation, with two unfortunate outcomes**
  - Excessive institutional frictions and complexity
  - Overly rigid classification of instruments
    - eg, power of supervisory guidance as MaP tool underestimated
- **Bottom line**
  - Some of this maybe the necessary price to pay to change the culture
  - But achieving a more common culture should be the priority
    - pave way for simpler structures, fewer tensions and more effective frameworks
2. Don’t underestimate the role of capital as the basis for lending

- Common view:
  - Higher regulatory capital is quite costly for lending and the economy
- This concern is greatly overdone
  - 1. Capital is a buffer: allows banks to take losses while continuing to function...
  - ...& flip side: capital is the foundation for all lending
    - Point stressed by my colleague, Hyun Shin
  - 2. Concern is not borne out by experience: empirical work indicates that
    - Banks have adjusted easily to higher requirements
    - Higher capital reduces other funding costs and can support lending (G 2)
  - 3. BCBS macroeconomic impact studies have deliberately understated the net benefits of higher capital
    - Despite very conservative assumptions about the costs...
    - ....have found considerable scope for increases
    - Including for the leverage ratio (latest QR study)
- Bottom line
  - We should be less timid when asking for higher regulatory capital
Graph 2: Capital lowers funding costs and boosts lending

Cost of non-equity funding  Non-equity funding  Lending

1 The panels represent scatter plots between the average level of leverage for a group of 105 international banks and selected bank-specific indicators: average cost of funding, average growth rate of non-equity financing; average annual growth rate of lending; */**/*** denotes significance at the 10/5/1% level.

Source: Based on Gambacorta and Shin (2015).
3. Don’t set overly ambitious goals for MaP during busts

• Common view:
  ▪ Goal of MaP during busts: boost credit growth at all costs

• But this is the wrong goal; better one is
  ▪ To prevent unnecessary constraints on the supply of lending
  ▪ Why?
    - Boom-bust leaves in its wake too much debt (debt overhang)
      • Needs to be digested; credit demand is necessarily weak
    - Digestion (deleveraging) is necessary for self-sustaining recovery
    - Growing evidence
      • Post-bust recoveries are credit-less recoveries
      • Economy rebounds more strongly if deleveraging takes place (G 3)

• Bottom line:
  ▪ Make sure buffers are sufficiently high to start with
    - So that markets do not become the binding factor in the bust (at least for long)
  ▪ Think harder of ways to maximise buffer resources in the bust
    - More active use of restrictions on dividend payments?
Graph 3: Deleveraging strengthens the subsequent recovery

Standard recessions

\[ y = 5.13x + \ldots \]
\[ R^2 = 0.01 \]

Financial crisis recessions

\[ y = -7.35***x + \ldots \]
\[ R^2 = 0.19 \]

*/**/*** denotes significance at the 10/5/1% level.

4. Don’t regard the length of the FC as a reason to forget MP

- **Common view**
  - The FC is much longer than the business cycle, so MP should leave it to MaP
    - “separation principle”

- **Unconvincing**
  - If we truly care about taming the FC, imprudent to leave it to MaP measures
    - Even where used vigorously, MaP has not prevented emergence of usual signs of financial imbalances
      - eg, EMEs (T 1)
  - As a means to rein in financial booms MaP tools operate much like MP
    - Restrain credit expansion, asset price increases and risk-taking
    - Tension in pressing on accelerator and brake at the same time
      - ie, loosen MP and seek to offset impact on financial instability with MaP

- **Bottom line**
  - Best to think of MaP and MP as complementary tools
  - Need to adjust MP frameworks accordingly
Table 1: Early warning indicators of banking distress – risks ahead

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<tr>
<th></th>
<th>Credit-to-GDP gap</th>
<th>Property price gap</th>
<th>Debt service ratio</th>
<th>Debt service ratio if interest rates rise by 250 bp</th>
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<td>-10.9</td>
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</table>

Legend

- Credit/GDP gap > 10
- Property gap > 10
- DSR > 6
- DSR > 6
- Credit/GDP gap ≤ 10
- Property gap ≤ 10
- 2 ≤ Credit/GDP gap ≤ 10
- 4 ≤ DSR ≤ 6
- 4 ≤ DSR ≤ 6

1 2015Q3 figures, except for property prices gap: for China 2015Q2, for Netherlands, Switzerland, Korea and Norway 2015Q4; Credit-to-GDP gap: for Greece 2015Q2.

Sources: National data; BIS; BIS calculations.
5. Don’t overlook the impact of the FC on productivity growth

- Common view
  - The FC is largely a demand story
    - causes huge output costs by depressing aggregate demand
- But there is an important and neglected supply-side story (G 4)
  - Recent BIS research reaches 3 findings (21 economies, last 40 years)
    - 1. Financial booms tend to undermine productivity growth as they occur (G 3)...
    - 2. ... mainly through shift of factors of production (labour) to lower productivity growth sectors
      - Eg, shift into bloated construction sector
    - 3. The impact of the misallocations that occur during the boom is much larger if a crisis follows
      - Synthetic 5-year boom & 5-post crisis years: cumulative impact is some 4 pp
- Bottom line
  - Constraining financial booms has benefits even if bust and crisis do not follow
  - Even more critical to repair banks and balance sheets post-crisis
    - To shift resources & allow MP to get more traction
  - MP is so ineffective also because it can do little to offset resource misallocations
Graph 4: Financial booms sap productivity by misallocating resources

Annual cost during a typical boom ... ... and over a five-year window post-crisis

Estimates calculated over the period 1969–2013 for 21 advanced economies. Resource misallocation = annual impact on productivity growth of labour shifts into less productive sectors during a 5-year credit boom and over the period shown. Other = annual impact in the absence of reallocations during the boom.

6. Don’t think of a financial stability-oriented MP simply as “leaning-against-the-wind”

- **Common view**
  - MP should behave *as usual* unless clear signs of financial imbalances emerge, at which point it begins to lean ("selective attention")

- **This view is dangerously narrow: it fails to consider**
  - The limitations of MP in dealing with the bust
  - The risk of doing too little too late
    - Simply precipitating the problems MP is designed to prevent...
      - ...or at least perceived to do so!
    - & inducing an easing bias over time that can lead to a “debt trap”
      - Debt levels rise and policy runs out of ammunition (debt trap)

- **Bottom line**
  - Need a new (systematic) policy strategy: less asymmetric over the whole FC
    - Leaning more deliberately against the boom
    - Easing less aggressively and, above all, less persistently during the bust
  - Key: not to deviate too much and for too long from “financial equilibrium”
    - Work under way at BIS to make this notion more precise
  - Risk: overburdening MaP
7. Don’t presume that even MP and PP combined can tame the FC

- Common view
  - Even if MaP is not enough, combining it with MP should be so

- While possible, it would be imprudent to presume so
  - FC is a complex phenomenon involving demand and supply aspects
  - There are serious political economy obstacles to deploying the instruments
    - Inaction bias
  - The FC can wreak havoc with public finances....
    - Flattering effect of booms (G 5)
    - Devastating effect of busts (G 6)
  - ....even as fiscal space is critical to deal with the bust
    - To support balance sheet repair and the financial system

- Bottom line
  - A holistic approach is the most prudent and effective response
  - Mix of PP, MP, fiscal and structural policies
Graph 5: Overestimating cyclically-adjusted fiscal strength in booms
(real-time estimates)

Graph 6: Government deficits and debt surge post-crisis

Government net lending

Government debt

Median, percentiles including partial data and forecasts.

1 2007: the United Kingdom, the United States. 2008: Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden, Switzerland.

Sources: Borio et al (2016).
Conclusion

● Seven don’ts...
  ▪ Don’t oversimplify the micro/macro prudential distinction
  ▪ Don’t underestimate the role of capital as the basis for lending
  ▪ Don’t set overly ambitious goals for MaP during busts
  ▪ Don’t regard the length of the FC as a reason to forget MP
  ▪ Don’t overlook the impact of the FC on productivity growth
  ▪ Don’t think of a financial stability-oriented MP simply as “leaning-against-the-wind”
  ▪ Don’t presume that even MP and PP combined can tame the FC

● ....and one hope
  ▪ Edging closer to taming the FC
Selected recent references (BIS and Basel-based committees)

- Borio, C and P Disyatat (2014): *Low interest rates and secular stagnation: Is debt a missing link?*, *Vox EU*, 25 June