Second session: The use of macroprudential tools

Macroprudential tools, monetary policy, and the cycle

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Prior considerations

- Not all procyclicality deserves the same treatment
- The treatment depends on the source of cyclicality:

1. Some cyclicality is **not undesirable**

2. Some cyclicality is due to **mechanisms** that
   - Are in hands of private agents to improve (e.g. via contracting)
   - Can be improved via infrastructure (e.g. central counterparties)

3. Some cyclicality is due to **external effects**

   $\longrightarrow$ Can be dealt with by *correcting the externality*

4. Some cyclicality is due or amplified by **institutions and regulation**

   [Accounting & accounting-based rules, capital requirements, etc.]

   $\longrightarrow$ We should definitely *address* this

5. Some cyclicality is due to **ill-designed economic policies**

   $\longrightarrow$ We should definitely *address* it

6. Some cyclicality is due to **poorly understood phenomena**

   [Agents irrationality, asset price bubbles]

   $\longrightarrow$ We should *learn more and explore* channels to tackle with it

It is tempting to think of a large fraction of the "above trend" credit as "excessive", but there are fundamental reasons why credit is *and* should remain *cyclical*

Specific developments

1. **Monetary policy**

   Expand scope of monetary policy to deal with price stability in a broader sense

   [Expanding horizon of reference or definition of target price index]

2. **Loan to value limits**

   Introduce LTV limits at reasonable levels (70-80%?) and experiment with them

   [Similarly, minimal haircuts in asset funding?]

3. **Capital requirements**

Definitely, correct the procyclicality of capital requirements

- Dominant trend
  - Full implementation of *through-the-cycle* input estimates
  - Some version of the Spanish pre-provisioning system

- My view:

  Relying on through-the-cycle estimates is a mistake:

  (a) Makes internal models harder to verify

  (b) Expands the scope of supervisory discretion

  (c) Kills the statistical interpretation of *required capital*

  (d) Not clear that available data can deliver reliable through-the-cycle estimates

- My advice:

  Adjustment factor based on simple macro aggregate (GDP, credit?)

  – Richer alternatives may have virtues

  – But also many pitfalls in terms of simplicity, predictability, flexibility and manipulability

  – Go for a smooth factor based on, e.g., lags of GDP growth

    * Tailored to specificities of credit categories & jurisdictions.

    * For cross-border loans, use composite index based on borrowers' location

    * With elasticities to GDP growth calibrated according to:

      (i) Link between ΔGDP & relevant inputs
      (ii) Link between ΔGDP & credit growth
      (iii) Targeted "countercyclicality"

- At this stage,
  - Start with the modest target of neutralizing regulation-induced procyclicality
  - Leave further adjustments to the discretion of macroprudential authorities

    $\rightarrow$ Automatic stabilizer + Explicit, transparent tool for discretionary fine-tuning

4. **New requirements**

   Liquidity and stable-funding requirements may need an approach similar to that proposed for capital requirements

   [Or their suspension during systemic crises]

5. **Systemic risk charge**

A systemic risk charge should "price" any *residual* (not otherwise priced) contribution to systemic risk

- Possibly based on *composite measure* of the marginal contribution of each intermediary

- I would make it
  - An explicit charge (i.e. a *tax* with fiscal implications)
  - As much rules-based as possible
  - Open to discretionary fine-tuning

It is necessary to signal that there are explicit tools that operate as automatic stabilizers *and can be* fine-tuned *by the new macroprudential authorities*