Monetary Policy, Macroprudential Policy, and Financial Stability

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Background (i)

“While easier financial conditions have supported economic growth and helped contain downside risks to the outlook in the near term, they have also encouraged more financial risk-taking and a further buildup of financial vulnerabilities, putting medium-term growth at risk.”

“With very low real interest rates and with low inflation, this also means very low nominal interest rates, so one would expect increasing risk-seeking by investors. As such, one would expect greater reliance on Ponzi finance and increased financial instability.”

Larry Summers (2014)
Background (iii)

“An environment of low interest rates following a period of high rates is particularly problematic, for not only does the incentive of some participants to ‘search for yield’ go up, but also asset prices are given the initial impetus, which can lead to an upward spiral, creating the conditions for a sharp and messy realignment.”

Raghu Rajan (2005)
Some questions

• Why do we have “lower for longer” interest rates?
  → Secular stagnation or monetary policy (or both)?

• What is the link between interest rates and financial stability?
  → What are the transmission channels?

• Can macroprudential policies help maintain financial stability?
  → Are there negative side-effects?

• Should central banks be responsible for financial stability?
  → Are there relevant political economy concerns?
Question 1

Secular stagnation or monetary policy?
An early Fed view

“Over the past decade a combination of diverse forces has created a significant increase in the global supply of saving, a global saving glut, which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today.”

Ben Bernanke (2005)
Secular stagnation or monetary policy? (i)

• Important to clarify what do we mean by “interest rates”
  → Nominal or real?

• Short-term nominal interest rates set by central banks (CBs)
  → But they respond to inflation and output developments

• What is driving these developments?
  → Real factors (domestic and international)
  → Fiscal policy, etc.
Secular stagnation or monetary policy? (ii)

• Why do we have “lower for longer” interest rates?
  → My tentative assessment: Bernanke was probably right

• But much more research is needed
  → CBs react to real developments
  → CBs actions (and communication) have real consequences
  → Need to improve our understanding of feedback effects
Question 2

Link between rates and financial stability
Interest rates and financial stability (i)

• “Easier financial conditions encourage financial risk-taking”
  → What are the channels?

  “Lower yields have compelled insurance companies, pension funds, and other institutional investors with nominal return targets to invest in riskier and less liquid securities.”

Interest rates and financial stability (ii)

• Is it all about investors with nominal return targets?
  → Essentially the argument in Rajan (2005)
  → No additional arguments in Summers (2014)

• What about the rest of the financial system?
  → Alternative transmission channels
Martinez-Miera and Repullo (2017)

• Model of competitive banks financing entrepreneurs
  → Default risk depends on bank monitoring
  → Incentives to monitor depend on spreads
  → Spreads depend on the level of interest rates

• Risk-taking channel
  Lower rates → Lower spreads → Lower monitoring
  → Higher risk-taking
Interest rates and credit spreads

• Simple setup without bank monitoring
  → Risk-neutral lenders with funding cost $R_0$ (the safe rate)
  → Investment projects
    Unit loan → Return = \begin{cases} R , \text{ with prob. } 1 - p \\ 0 , \text{ with prob. } p \end{cases}
  → Zero profit condition
    \[(1 - p)R = R_0\]
  → Spreads are increasing in safe rate
    \[R - R_0 = \frac{R_0}{1 - p} - R_0 = \frac{p}{1 - p}R_0\]
Interest rates and financial stability (iii)

• What is the link between interest rates and financial stability?
  → Channel based on investors with nominal return targets
  → Alternative channel based on banks’ monitoring incentives

• But much more research is needed
  → Why nominal return targets?
  → Is monitoring approach supported by evidence?
  → Are there alternative channels?
Question 3

Role of macroprudential policies
Role of macroprudential policies (i)

• When interest rates are low (for whatever reason)
  → and this leads to higher risk-taking (for whatever reason)
  → Can macroprudential policies help?

  “Policymakers should lean against the buildup of vulnerabilities by deploying and developing macroprudential tools.”

Role of macroprudential policies (ii)

• Many possible tools
  → Countercyclical capital buffer
  → Borrower-based measures, etc.

• What are the channels whereby they reduce risk-taking?
  → Which ones are more effective?
  → Are there negative side-effects?
Martinez-Miera and Repullo (2019)

• Same setup as in Martinez-Miera and Repullo (2017)
  → Adding bank capital (and capital requirements)

• Higher capital requirements
  → Shift investment from risky to safe firms
  → Lower return of debt and higher return of equity
  → Lower leverage (by regulation) and risk-taking by banks
Role of macroprudential policies (iii)

• Can macroprudential policies help to lean against risk-taking?
  → In Martinez-Miera and Repullo (2019) they can help
  → More powerful than monetary policy

• But much more research is needed
  → Understand working of other macroprudential tools
  → Understand possible side-effects
  → Especially, risk of shifting intermediation to shadow banks
Question 4

Role of central banks
Role of central banks

- Should central banks be responsible for financial stability?
  - Decide on the deployment of macroprudential tools?
  - Arguments both in favor and against
Arguments in favor (i)

• Solving time-consistency problem (as in monetary policy)
  → “Take away the punch bowl just as the party gets going”

• Solving coordination problem with monetary policy
  → Cooperation should be welfare improving
Arguments in favor (ii)

• Central banks have the required human capital
  → Macroprudential policy is challenging
  → Financial stability objective cannot be readily measured
  → Unlike in the case of monetary policy
  → Where you can measure inflation, output, etc.
  → Macroprudential policy requires qualified economists
  → They are mainly found in central banks
Arguments against

- Distributional consequences of macroprudential tools
  → Possibly greater than those of monetary policy tools
- Central banks may end up accumulating too much power

  “We need to think through afresh the degrees of freedom central banks should be granted and, in particular, how far they should be able to venture into what has traditionally been regarded as the preserve of fiscal authorities.”

  Paul Tucker (2018)
Concluding remarks
Concluding remarks

• Why do we have “lower for longer” interest rates?
  → Real factors are key

• What is the link between interest rates and financial stability?
  → Effects through banking system are important

• Can macroprudential policies help maintain financial stability?
  → Yes, but we are far from understanding the channels

• Should central banks be responsible for financial stability?
  → Yes, but there are relevant political economy concerns
Happy 25th Anniversary!
References


