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
   → 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.]
   → We should definitely address this

5. Some cyclicality is due to ill-designed economic policies
   → We should definitely address it

6. Some cyclicality is due to poorly understood phenomena [Agents irrationality, asset price bubbles]
   → 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 $\Delta$GDP & relevant inputs
      (ii) Link between $\Delta$GDP & 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

→ 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*