BANK FOR INTERNATIONAL SETTLEMENTS

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

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Introduction

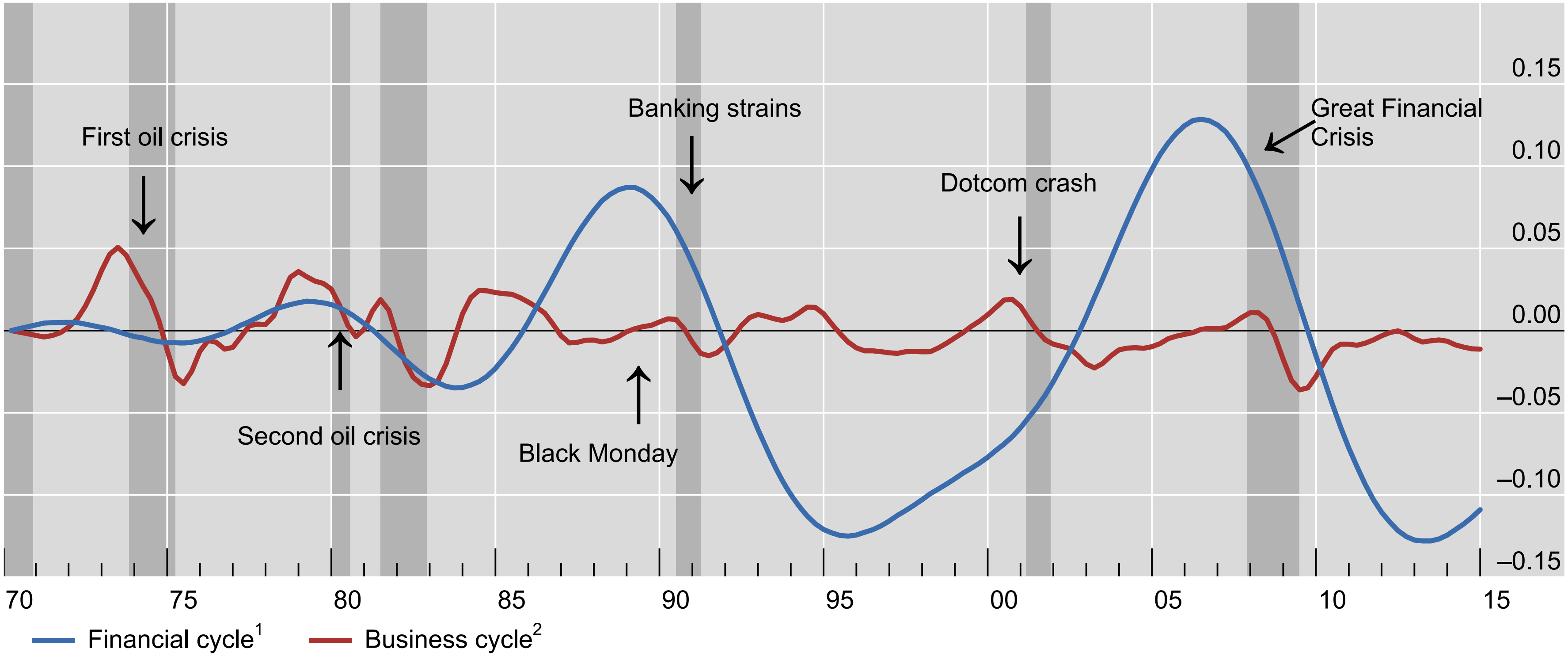
- Objective
  - Explore selectively nexus between prudential (PP) and monetary policy (MP)

- 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)



[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.

Source: from Drehmann et al (2012), updated.

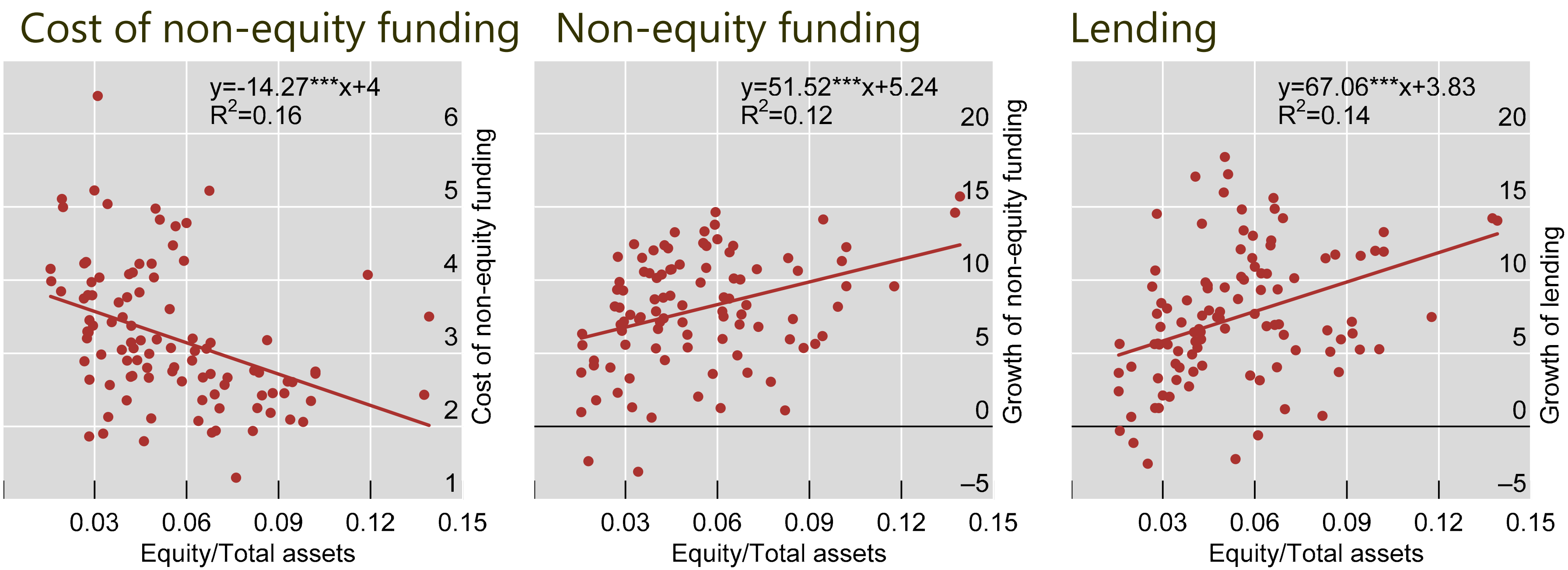
1. Don't oversimplify the micro/macro prudential distinction

- 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, <u>not</u> 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[1]



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.

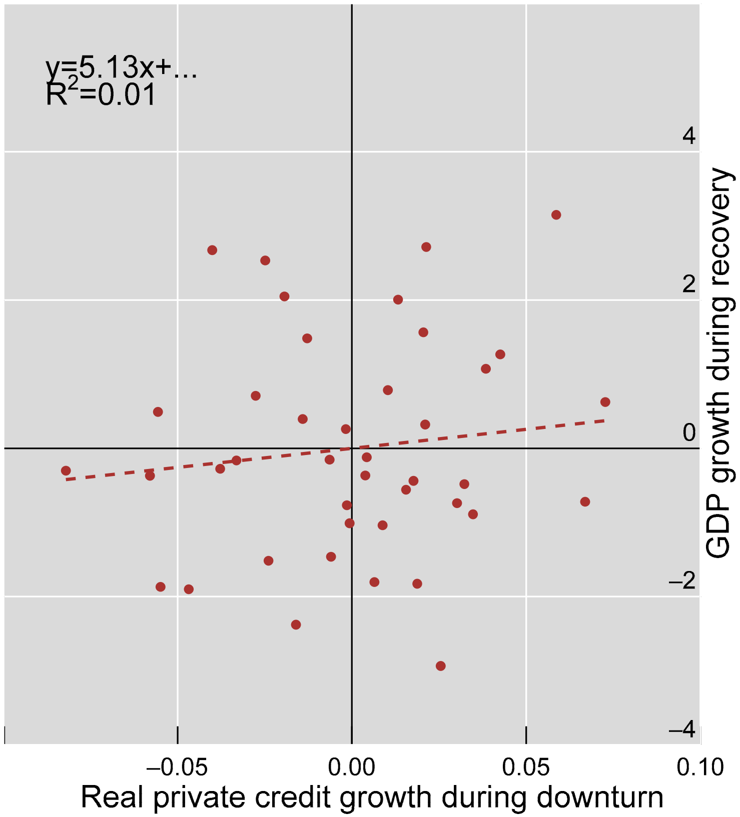
Source: Based on Gambacorta and Shin (2015).

3. Don't set overly ambitious goals for MaP during busts

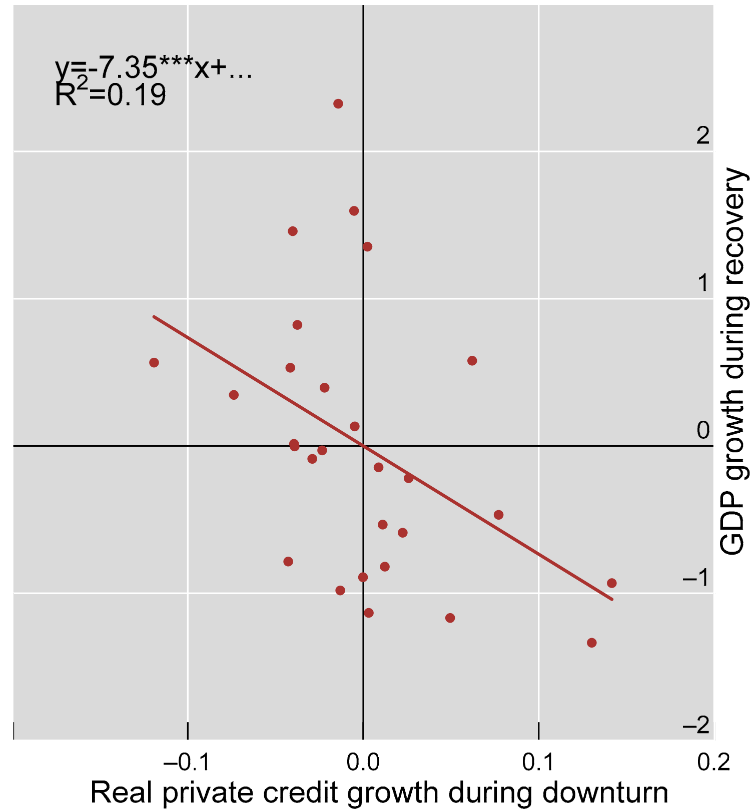
- Common view:
  - Goal of MaP during busts: boost credit growth at all costs
- But this is the wrong goal; better one is
  - To prevent unnecessary constraints on the supply of lending
  - Why?
    - Boom-bust leaves in its wake too much debt (debt overhang)
      - Needs to be digested; credit demand 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



Financial crisis recessions



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

Source: Based on Bech et al (2012).

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

	Credit-to-GDP gap	Property price gap	Debt service ratio	Debt service ratio if interest rates rise by 250 bp
Asia	16.4	10.6	2.0	4.3
Australia	4.9	5.1	0.9	4.7
Brazil	9.9	–13.9	6.6	8.4
Canada	12.3	4.9	2.3	6.3
China	27.7	–5.8	5.4	8.7
Central and Eastern Europe	–11.2	6.6	0.5	2.0
France	1.5	–10.9	1.0	4.0
Germany	–5.8	10.3	–1.6	0.2
Greece	–9.3	4.1		
India	–3.4		1.7	2.9
Italy	–10.8	–16.2	0.6	2.8
Japan	4.4	13.6	–1.9	0.9
Korea	3.9	6.4	0.0	3.6
Mexico	7.3	4.2	0.5	1.2
Netherlands	–18.4	–15.3	1.0	5.8
Nordic countries	0.5	2.6	1.1	5.1
Portugal	–36.0	9.7	–0.9	2.5
South Africa	–1.4	–7.4	–0.7	0.6
Spain	–44.2	–21.7	–2.5	0.4
Switzerland	7.2	9.9	0.0	3.2
Turkey	15.6		5.5	7.1
United Kingdom	–30.1	0.3	–2.2	0.6
United States	–10.9	2.0	–1.9	0.7
Legend	*Credit/GDP gap>10*	*Property gap>10*	*DSR>6*	*DSR>6*
	2≤Credit/GDP gap≤10		*4≤DSR≤6*	*4≤DSR≤6*

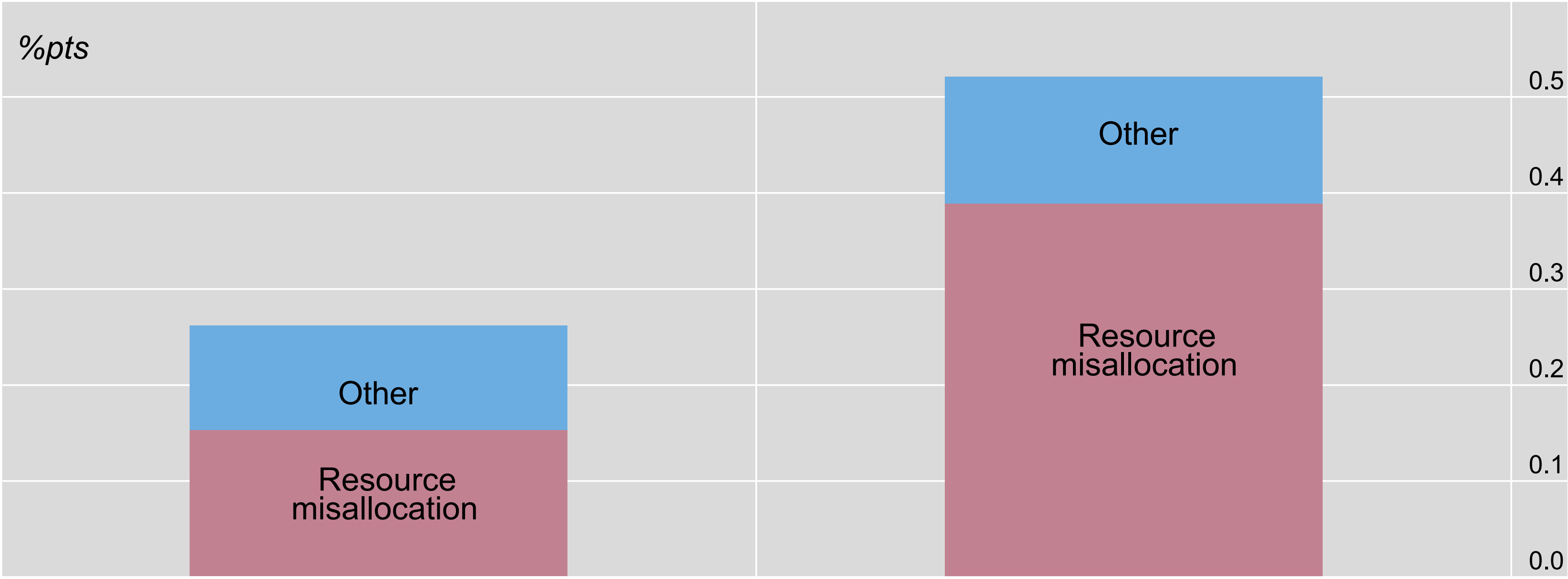
[1] 2015Q3 figures, except for property prices gap: for China 2015Q2, for Netherlands, Switzerland, Korea and Norway 2015Q4; Credit-to-GDP gap: for Greece 2015Q2.
Sources: National data; BIS; BIS calculations.

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 <u>during the boom</u> 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 <u>even if</u> 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.

Source: Borio et al (2015).

6. Don't think of a financial stability-oriented MP simply as "leaning-against-the-wind"

- Common view
  - MP should behave <u>as usual</u> 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

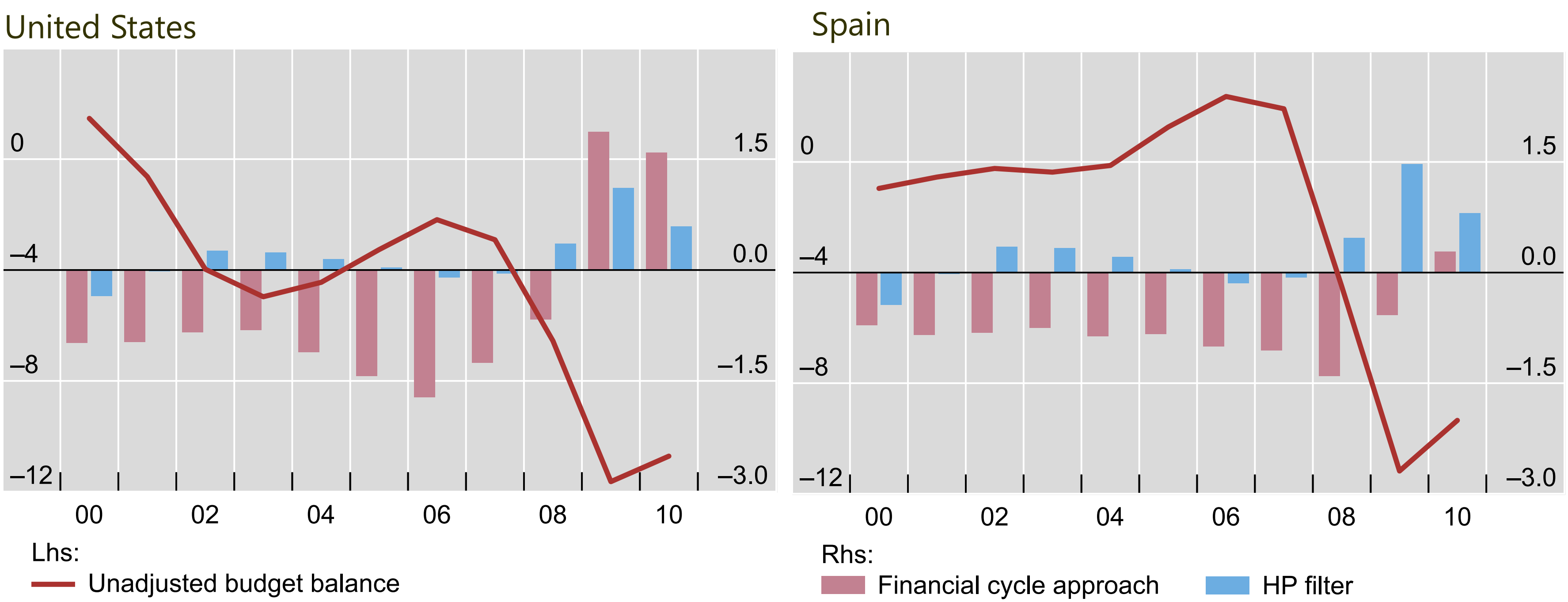
- Common view
  - Even if MaP is not enough, combining it with MP should be so

- 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

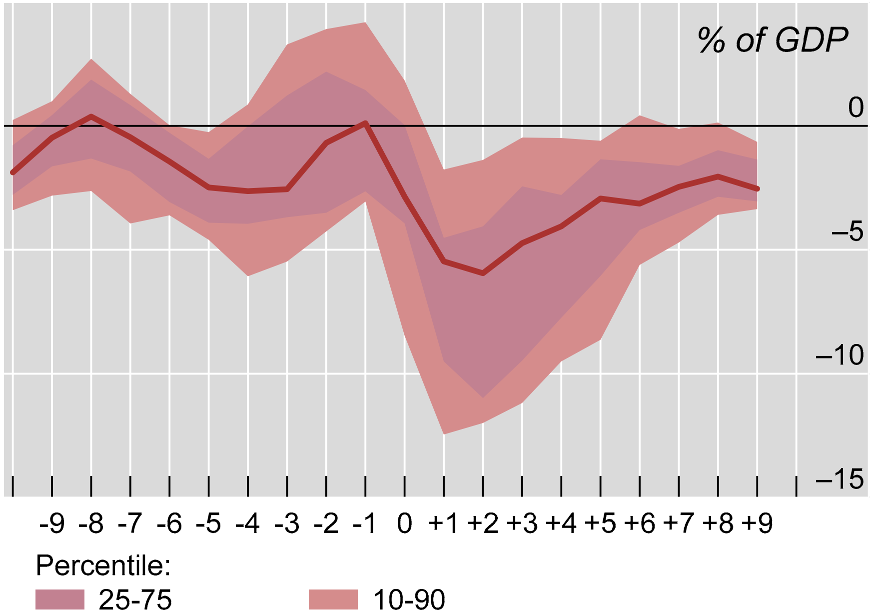
(real-time estimates)



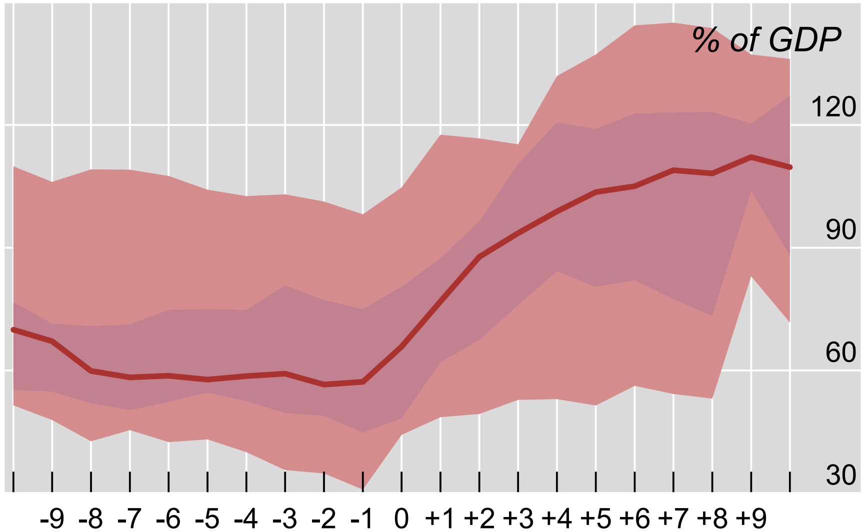
Source: Borio et al (2013).

Graph 6: Government deficits and debt surge post-crises

Government net lending[1]



Government debt[1]



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

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