Macroprudential policy: some global perspectives

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SUERF panel
These remarks represent my own views, and not necessarily those of IMF staff, IMF Management, or the IMF Executive Board

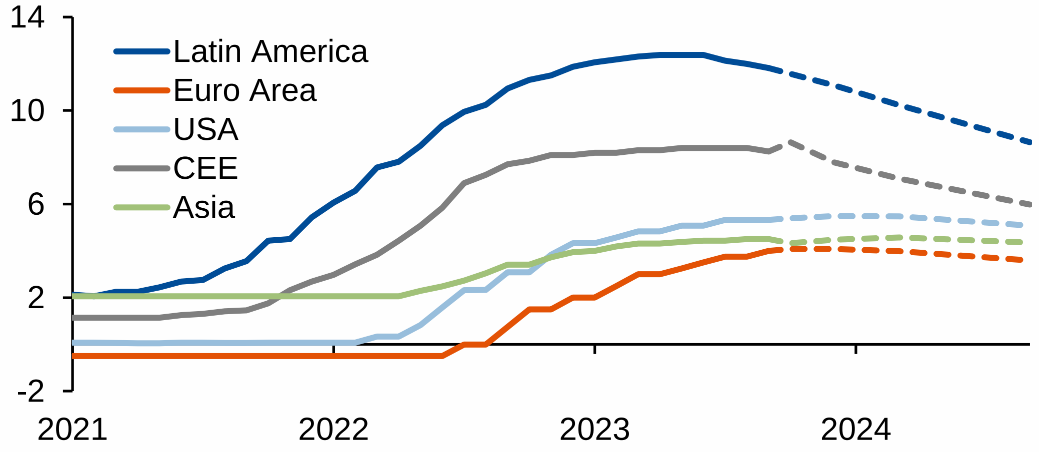
Short overview

- Resilience of global financial system post-pandemic suggests strong benefits of post-GFC macroprudential frameworks
- Complemented by substantial evidence that macroprudential tools are effective
- But some gaps in framework and key challenges ahead
  - I'll focus on upside inflation risks and interactions between monetary and macroprudential policy

Macroprudential policy has strengthened resilience

- **Pandemic and then inflation have been major stress test of post-GFC framework**
  - Sharpest monetary tightening by AEs in decades, and even faster in many EMs
  - Financial sector has generally performed well thus far, and financial conditions haven't tightened a lot in many economies (still, some bumps and could see more..)
  - Adverse spillovers to major EMs haven't materialized

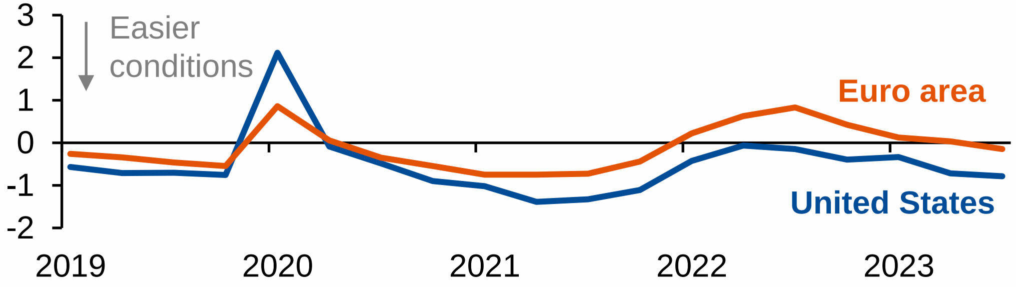
Policy Rate: Historical and Forecast
(Percent)



Sources: Bloomberg Finance L.P. and IMF staff calculations.
Note: Asia series is EM Asia excluding China.

Financial conditions haven't tightened a lot

Financial Conditions Indices
(Standard deviation)



Sources: Bloomberg Finance L.P., Haver Analytics, Federal Reserve, and IMF staff calculations.
Note: Financial conditions index expresses the price of risk. It incorporates various indicators, including home prices, but excludes balance sheet and credit growth. 2023 Q3 values are proxies.

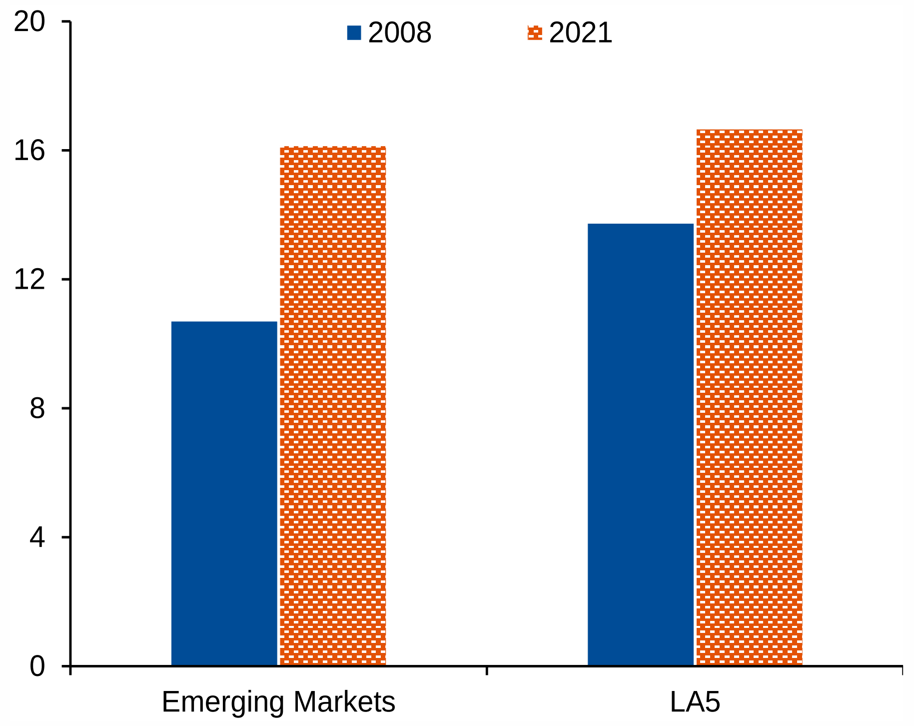
Tools and their effectiveness

Key components of macroprudential frameworks

- **Rigorous financial sector assessments by national authorities and through IMF FSAPs**
  - Liquidity and solvency stress-testing
  - Governance
- **Underpinned by deployment of key macroprudential tools**
  - Major strengthening of capital and liquidity buffers (including EMs)
  - Much more extensive use of borrower-based tools
  - Global use translates into positive spillovers

Rising capital buffers in EMs

EMs: Tier-1 capital
(Percent of risk-weighted assets)



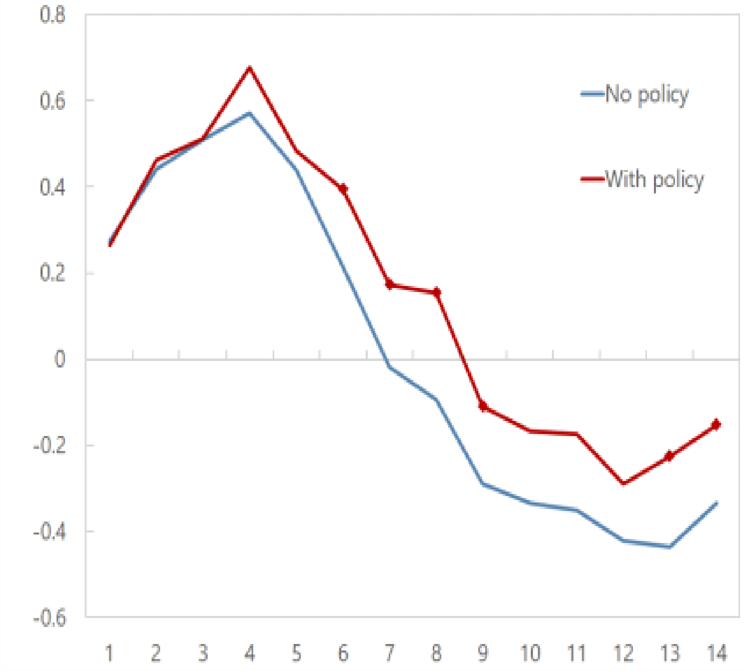
Source: IFS, WEO, IMF staff calculations.
Note: Aggregates are PPP GDP-weighted averages. Emerging markets = Hungary, India, Indonesia, Malaysia, Philippines, Poland, Romania, Thailand; LA5 = Brazil, Chile, Colombia, Mexico, Peru.

Substantial evidence that tools have been effective

- **High capital helps:**
  - Reduce pressure on banks to cut lending during downturn, lowering borrowing costs (BIS, 2022)
  - Lower downside risks to GDP when financial conditions tighten (Brandao et al, 2022)
  - Improves monetary transmission (Godl-Hanish, 2022, using only US data)
- **Costs of building buffers don’t appear large**

Macropru tools lower downside risks to GDP in medium-run from easier financial conditions

Detrended output and macroprudential policy



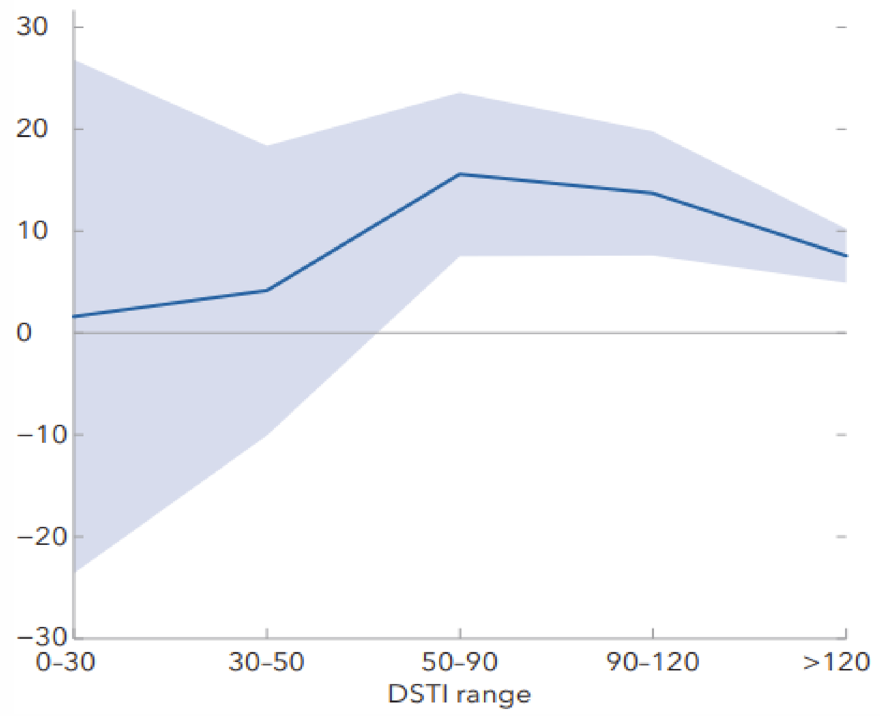
Source: IMF Working Paper, Nier and others (2020).
Note: Tail risk to GDP growth is measured by the 10th percentile of the future detrended GDP growth. A square marker means that the effect of policy is significantly different than zero at least at the 10 percent significance level.

Tools effective (2), but calibrate carefully

- **Borrower-based tools also effective:**
  - Have helped reduce vulnerabilities arising from high leverage
  - Targeted tools can significantly reduce default probabilities
- **Need careful calibration of tools**
  - Nonlinear effects – if too tight, little marginal effect in reducing risk but more likely to induce regulatory arbitrage

Mortgage defaults rise nonlinearly with debt service

(Percentage increase in probability of default for a 10 percentage points increase in DSTI)



Source: IMF Working Paper, Nier and others (2019).
Note: DSTI = debt service-to-income.

New challenges

Gaps and new challenges

- **Limited tools to address risks in nonbanks and corporates**
- **Greater risk of rapid bank runs**
- **More volatile global environment, with increased trade fragmentation and rising climate risks**
- **Must smooth transition to new digital payments systems**
- **Greater upside inflation risks (my focus here)**

Macroprudential policy in the low inflation post-GFC world

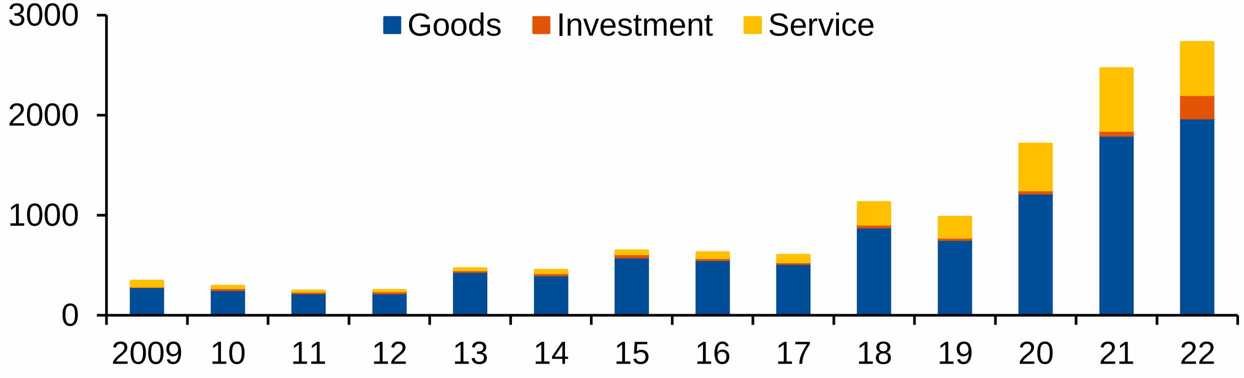
- Macroprudential policy in advanced economies has largely been forged in the low inflation post-GFC environment
  - Monetary policy focused on downside risks to inflation given limited policy space
  - “confluence” between objectives: central banks could lower rates to ease financial stresses, which also reduced risk that inflation would drift down

Now sizeable upside inflation risks: more volatile shocks and nonlinearity in the Phillips Curve

- Continued high inflation poses risks to financial stability, and upside inflation risks may persist well into the future
  - ▸ More volatile supply shocks due to trade fragmentation and climate transition
  - ▸ Phillips curve may be considerably more nonlinear than envisioned, so more risk of sharp policy tightenings

Trade restrictions have jumped sharply in recent years

Harmful Trade Restrictions Imposed
(Number of measures)



Sources: April 2023 World Economic Outlook, Caldara and Iacoviello (2022); and Global Trade Alert.
Note: In panel 2, data on harmful trade restrictions are as of February 1, 2023.

Financial stability risks from more persistent inflation

- More persistent inflation -- and need for tighter monetary policy -- could generate significant repricing of assets around the globe (Adrian, Natalucci, Wu 2023)
- Heightened strains for highly leveraged borrowers with substantial duration risk
  - Especially in interest-sensitive sectors such as real estate
  - Financial institutions may face even bigger valuation losses on “safe” assets
  - Rising unemployment would intensify credit risk
- Pressure from dollar appreciation on EMs with unhedged FX

Unwelcome tradeoffs: price vs. financial stability

- Central banks may face greater tension between price and financial stability objectives than under low inflation
  - Price stability may require interest rates to rise sharply in the face of financial market stress, and thus exacerbate rather than counter it
- With higher and more volatile inflation, more uncertainty about monetary transmission (may need sharp rate hikes)
- So aggressive policy tightening may risk a blowout in financial markets, while a softer approach risks allowing inflation to remain entrenched

Ex post tools can improve tradeoffs, but…

- Ex post tools/actions can help improve tradeoffs and may allow central bank to achieve price stability goals (“separation principle”)
  - CB lending to provide liquidity
  - Often needs to be coupled with forceful fiscal actions
- However, these tools may have shortcomings (*Adrian, Gopinath, Gourinchas 2023*):
  - CBs can address liquidity not solvency problems
  - Nonbanks may be out of reach of CBs
  - Often significant political economy challenges (“picking winners and losers”)
  - Fiscal space often limited, especially for EMs

Macroprudential measures can provide insurance and help monetary policy achieve price and financial stability

- Stronger capital buffers reduce the risk that monetary tightening causes significant financial market stress
  - Evidence suggest that better capitalized banks experience smaller rises in funding costs – also holds in aggregate
  - So desirable to build buffers (e.g., countercyclical capital buffers) that can be released should stresses materialize
- Stress tests can take better account of interest rate risks that come from need to respond to higher inflation
  - Can address through targeted tools and heightened supervision, and ideally reach nonbanks
- Greater financial resilience should make it easier for CBs to achieve objectives

Can’t simply lean on stronger macroprudential leg..

- Limiting financial stability risks shouldn’t rest entirely on macroprudential leg
  - May need to reconsider monetary policy actions that could easily lead to overheating (Gopinath, Jackson Hole, 2021)
  - Given huge post-pandemic rise in public debt, need to rebuild fiscal space to help address macro and financial stability risks