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Can prudential policies shield EU countries from foreign monetary policy spillovers?*

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Can prudential policies help to reduce the macro-financial spillover effects of foreign monetary policy for all EU countries? Using local projection methods, I show that EU countries with tighter prudential policies face significantly smaller, and less negative spillovers to bank credit and house prices from US, UK and EA monetary policy tightening shocks. Measures of a macroprudential policy nature such as capital buffers, lending standards restrictions and limits to credit growth appear to be particularly effective at mitigating the spillover effects of US monetary policy, while measures of a microprudential nature as minimum capital requirements, risk weights and limits on large exposures prove effective in mitigating spillovers effects of UK monetary policy. Results indicate that domestic prudential policies can dampen EU countries' exposure to foreign monetary policy and may be a useful tool in the face of spillovers coming from centre countries and within the EU.

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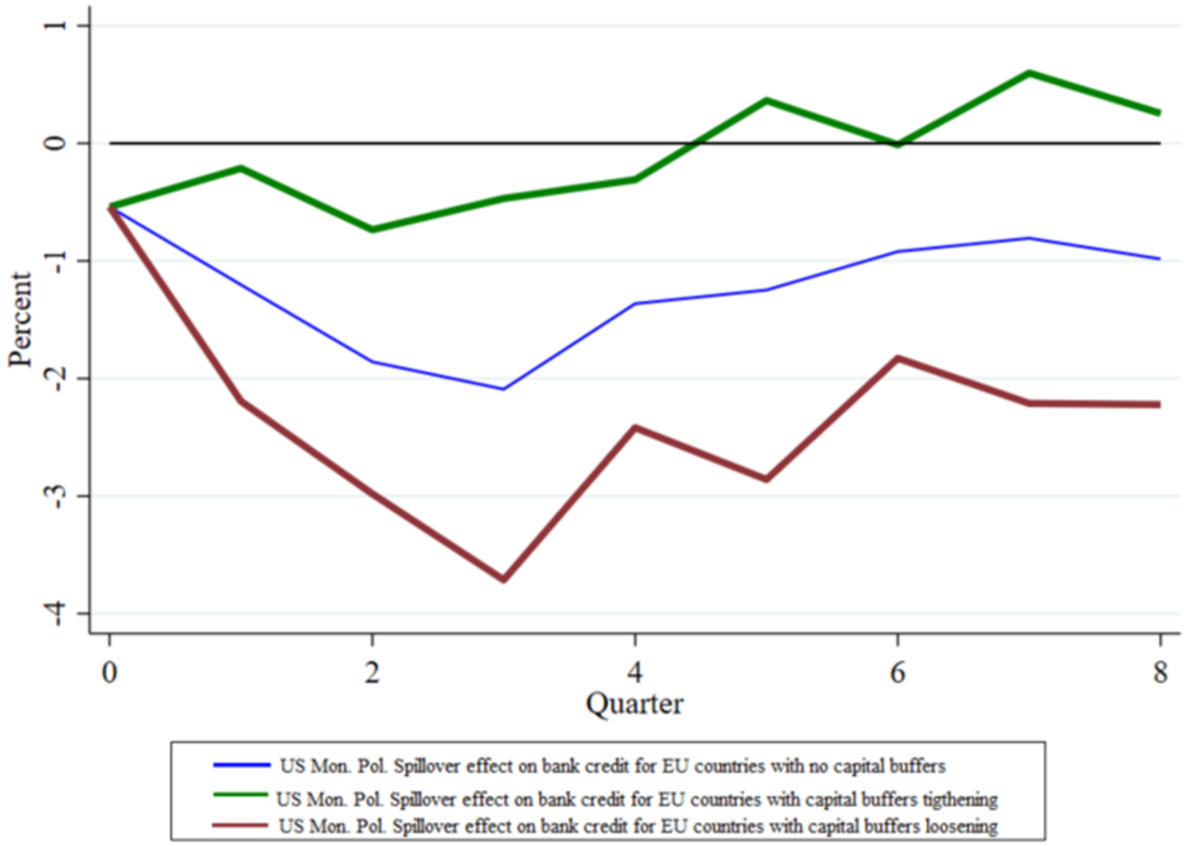
1. In the face of spillovers: prudential policies in EU countries

The influence of US on the global financial cycle ensures that US monetary policy is a timeless concern amongst policymakers around the world, as well as in EU countries. The tight links that the UK has to the EU market - notwithstanding Brexit - may also raise concerns about the influence of UK monetary policy on the remaining members of the EU. In EU countries, which are one of the most active countries world-wide at enacting prudential measures, I show that in the face spillovers, (macro)prudential policies in EU countries can help to offset foreign monetary policy spillovers, helping to resolve policymakers' 'dilemma'. I use data from the MaPPED database which cover a wide range of (macro)prudential policy actions in 28 EU countries from 2000 to 2018, spanning measures such as capital buffers, lending standard restrictions, limits of credit growth and volume, risk weights, minimum capital requirements, limits on large exposures and concentration. Together with measures of unexpected US, UK and Euro Area monetary policy shocks, I estimate the interaction between foreign monetary policy and EU (macro)prudential policies in a panel local projections setup. I examine how domestic indicators of financial stability nature such as bank lending and house prices in EU respond to various foreign monetary policy shocks, and particularly I show which domestic (macro)prudential policies can prove effective at offsetting some of the monetary policy spillovers.

2. Prudential policies: effective at reducing monetary policy spillover effects

The main result from the analysis is that an EU country with tighter prudential policies faces significantly smaller reductions in bank credit and house prices following a monetary policy tightening shock from the US and the UK, and to some extent from EA. A +1pp exogenous tightening of US monetary policy leads to a 2pp fall in bank credit and a 2.5pp fall in house prices on average, after around 15 months, in EU countries with no prudential policy actions in place. Further, a +1pp tightening of UK monetary policy leads to a 3.7pp fall in house prices and a 1pp drop in bank credit for EU countries. Results show that an EU country with an additional (one standard deviation) macroprudential policy tightening action - such as capital buffers (Figure 1) - faces a substantially smaller spillover in the face of US monetary policy, with an offsetting effect of up to 1.9pp for bank credit and 1.3pp for house prices respectively. Measures such as risk weights and limits on large exposures, have a similar offsetting effect of up to 1.5pp and respective up to 2.4 for house prices in EU countries that are facing UK monetary policy spillovers. These findings indicate that even an additional prudential policy tightening can significantly reduce or offset the monetary policy spillover.

Figure 1: US monetary policy spillover effects on EU countries bank credit – with and without prudential measures



Note: The blue line shows the estimated spillover from a +1pp US monetary policy tightening shock to an EU country with no prudential policy. The green line shows the comparable spillover estimate for an EU country with a +1 - additional tightening of a macroprudential policy action – capital buffers. The red line shows the effect of the spillover for an EU country with a -1 - loosening of a macroprudential policy action – capital buffers.

3. Policy implication

This implies that national prudential policies can help to insulate EU countries against spillovers of monetary policy coming from centre countries (such as the US or the UK), especially given the current environment where central banks tighten their monetary policy to curb rising inflation. The findings have important implications, suggesting that macroprudential policies (such as capital buffers and lending standards restrictions) can effectively reduce the spillover effects of US monetary policy shocks, while microprudential policies (such as risk weights, minimum capital requirements, limits on large exposures) are effective at reducing spillover effects from within the EU market, namely from the UK and EA monetary policy shocks. These findings could help policymakers to maintain monetary policy autonomy in the face of spillovers and the global financial cycle, and better decide which measure to activate to safeguard their respective economies.

About the author

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