

Challenges of Interactions between Macroprudential and other Policies

Report on a conference jointly organized by Narodowy Bank Polski and SUERF
Warsaw, 15 February 2019

Conference Report



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Ryszard Kokoszcyński, Member of the Board, Narodowy Bank Polski and Member of the Council of Management of SUERF, and **Jakob de Haan**, SUERF President and Head of Research at De Nederlandsche Bank began the conference with their welcome remarks. Their remarks introduced the comprehensive framework to study interactions between macroprudential policy and other policies that may have a substantial impact on the macroeconomic and financial stability. It is not only monetary policy, but also fiscal policy, financial policy, regulatory policies etc. These interactions are important for the proper calibration of policy instruments, the composition of policy mix, and for identifying possible leakages from macroprudential and other policies to foreign banks and non-bank financial institutions.

Stijn Claessens, Head of Financial Stability Policy and Deputy Head of the Monetary and Economic

Department, Bank for International Settlements, presented next his keynote speech **“Moving forward with macroprudential frameworks”**. This was a comprehensive review of challenges in conducting and assessment of effectiveness of the macroprudential policy (MaP). Among many issues he focused on nine important ones.

1. Financial system is important to economic growth and other goals, however changes in activity of the system seems procyclical and may be harmful to economy.
2. As MaPs are being used, empirical evidence is accumulating. Initially there were no case studies how macroprudential policy interacts with other policies and how effective may be. Empirical analyses show usefulness of changes of LTV and DTI in mitigating the systemic risk. However, the nature of

- interactions among MaP tools, with other policies is still an open question.
3. MaP and monetary policy (MoP) may need to be coordinated. When policies operate perfectly there are no major challenges. Both policies complement each other, e.g. phases of business and financial cycles overlap. However, this is an idealistic model. In practice, many questions arise: How much to adapt each policy to the other? How to inform each other? How to coordinate? What is governance? Where does MaP best reside?
 4. MaPs are used in a globalised world. According to recent empirical analyses MaPs are less effective in open economies, suggesting “evasion” or circumvention. Monetary policy and MaPs are also hard to coordinate internationally.
 5. Non-bank financing can be procyclical and may create tail risks. Consequently, it may have adverse real sector consequences. One of the most important challenges seems existence of dynamic and systemic view of risks and productivity of financial innovations.
 6. Data on systemic risks is still incomplete, and market discipline at the system level is limited. Construction of a reference systemic risk measures is still at work-in-progress stage.
 7. Financial structures affect growth and financial stability. As economy develops financing shifts away from banks towards markets.
 8. Communication and political economy, and
 9. Design of the overall system.

It seems that there is no general agreement who should be responsible for macroprudential measures. An optimal structure should be a compromise within trilemma of autonomy, transparency and accountability.

That was an unorthodox keynote speech as Stijn allowed for interruptions with questions and comments and he engaged very actively into this part of his session.

The title of the panel that followed Claessens’s speech was **“Policy Interactions: Different points of view”**. The panel was chaired by **Paweł Szałamacha**, Member of the Board, Narodowy Bank Polski. His introductory remarks noted that macroprudential policy is still a relatively new and developing policy field. Many countries constructed basic framework but strive to operationalize it further both in the area of systemic risks assessment and risk containment. Despite gaps in our knowledge concerning core operations of macroprudential policy, it is important to think now also about its interactions with other established economic policy fields. In this context, the most important are relations with microprudential supervision (due to overlap of the toolkits), monetary policy (e.g. with the risk-taking channel of monetary transmission mechanism), fiscal policy (e.g. taxes enhancing or limiting risky behaviour) and competition policies (e.g. in the context of systemically important financial institutions).

First step is to recognize how the policies interact – whether they are neutral or support other policies’ objectives. Second, what can we do about it? Is there a need to introduce some new elements in the reaction function of a given policy? Is there a need to coordinate policies?

Being at the central bank we are especially interested in the interactions of macroprudential policy with the monetary policy. Recent advances in macro-modelling offer a conceptual framework for thinking about these policies’ interactions. They can be analysed e.g. in theoretical (DSGE) models with borrower collateral constraints and a banking sector. We have a special DSGE session during this conference showing some recent advances of the DSGE-3D model as well as calibrations of the model in the case of Greece and Poland.

Henrik Braconier, Chief Economist, the Swedish Financial Services Authority (Finansinspektionen) began his intervention in this panel by identifying policies that may be influenced by MaP, i.e. microprudential policy, monetary policy, fiscal policy and structural policies. During his speech Braconier presented his own point of view about the nature of relationship between MaP and other

policies. He pointed out that spillovers on other public policy targets limits scope for delegation. Also, spillovers from other policy areas (further) limits possibility to monitor performance.

Michala Marcussen, Group Chief Economist, Société Générale and SUERF Vice President, focused her intervention on three major issues (valid mostly for the EMU): singleness, simplicity and collateral. In her opinion the euro area needs a single institutional entity responsible for macroprudential policy. Interactions of that policy with monetary policy should take into account that the euro area is not a homogeneous but rather a fragmented area – both perceived by price and quantity variables. Thus, macroprudential policy may be thought of as a policy compensating these potential deficiencies of a single monetary policy. Marcussen also stressed the importance of completing the Banking Union, in particular the European deposit insurance scheme. Her final point concerned the need for a proper supply of truly safe assets that could function as a collateral for repo transactions. The lack thereof may be a major obstacle in an effective functioning of market discipline for fiscal policy with dangerous spillovers for efficiency of – already costly – macroprudential measures.

Philipp Hartmann, Deputy Director, DG Research, European Central Bank defined each policy (MaP, Microprudential policy, Monetary policy, Fiscal policy and Social policy) and discussed their possible interactions. Macroprudential policy is not a special policy in this regard. There needs to be a carefully designed institutional setup for dealing with the composition relationship with microprudential policy. Relationship with monetary policy can be designed in two ways. Each policy should primarily pursue its own objective(s) or monetary policy needs to take side effects on financial stability into account, potentially even “leaning against the wind”.

The next session of the conference had as a theme “**Macroprudential policy and DSGE modelling**”.

Kalin Nikolov, Financial Research Division, European Central Bank, presented some recent developments in DSGE modelling for macroprudential policy. In the new setting of the

model the process of risk taking by banks seems to be a key amplification channel of borrowers risk. Shocks to non-diversifiable risk play an important role in generating extreme financial distress (numerous firms and banks defaults and large GDP drops) when banks are highly leveraged. Also, a proper assessment of the correlation of defaults (underlying nature of borrowers risk) is of first order importance when drawing conclusions on the optimal level of capital requirements.

Dimitris Papageorgiou, Economic Analysis and Research Department, Bank of Greece, presented the calibration of the DSGE-3D model to Greek economy. In this version a different transmission mechanism linking fiscal fragility to banking performance is incorporated. The amount of bail-in by depositors is then related to fiscal fragility. Also, capital requirements may vary optimally with the degree of deposit riskiness. In the model bank default (financial solvency risk) is conditioned on the sovereign solvency risk. As a result, the optimal level of capital requirements increases when fiscal fragility increases, and deposits become riskier. The increase in capital requirements in response to higher fiscal fragility ends up supporting a higher level of financial intermediation (in addition to lower direct default costs).

Dobromiř Serwa, Financial Stability Department, Narodowy Bank Polski and **Krzysztof Makarski**, Research Department, Narodowy Bank Polski, presented a calibration of the DSGE-3D model to the Polish economy. Reference DSGE-3D model was extended to incorporate monetary policy (Taylor rule) and price-wage adjustments (Calvo scheme). The model was applied to the case of a small open economy. Consequently, foreign economy block in the model was approximated using vector-autoregressive (VAR) model. Also, international transfers of goods and capital were included as well as foreign exchange rate. Model was calibrated to fit Poland and the euro area. Deposit insurance agency was financed by banks. Impulse response analyses show that MaP may to some extent stabilize credit and output. Its ability to stabilize credit and output varies with respect to the sources of shocks. Makarski and Serwa also discussed possible extensions of the model:

preventing contagion from crises abroad, scenarios with increased risk in banking sector, and shocks to Loan-to-Value ratio.

The third session of the conference included three presentations on **“Optimal Bank Capital – theory and practice”**. **Professor Javier Suarez**, CEMFI, Spain, presented the paper **“Bank capital in the short and in the long run”**. Several macro-banking papers analyse effects and socially optimal level of capital requirements from the long-run perspective. Other papers consider interaction between macroprudential policy and monetary policy with focus on stabilization. In this paper Suarez focuses on the transitional effects of capital reforms. As a result, in the long run rising capital requirements reduce excessive bank leverage, bank and firm defaults, and their social and fiscal costs. In the short run, rising capital requirements tighten credit supply to bank-dependent borrowers, reduce aggregate demand, and introduce deflationary pressure.

The next speaker, **Professor Moritz Schularick**, University of Bonn, presented the paper **“Bank capital and financial stability”**. Schularick posits two fundamental questions in his research agenda: What is the evidence that more capital makes systemic banking crises less likely? and What is the evidence that more capital makes crises less severe? Empirical analyses presented in

his presentation were conducted on the basis of a comprehensive new dataset covering the liability side of banks’ balance sheets for 17 advanced economies from 1870-2013. Schularick and his co-authors obtain very interesting but counterintuitive answers on these two questions that there is no evidence that, conditional with respect to the model and to the state of the economy, higher capital ratios reduce the likelihood of systemic banking crises. However, they make financial crises less costly.

The final presentation in this session, by **Skander van der Heuvel**, Deputy Associate Director, Federal Reserve Board was on **“The welfare effects of bank liquidity and capital requirements”**. Van der Heuvel stated in a very clear manner that the welfare costs should decide how stringent bank liquidity and capital requirements should be. He develops some extensions to a standard general equilibrium model that allows for a special role of banks as liquidity providers. Capital and liquidity regulations mitigate moral hazard on their part that is due to deposit insurance. These regulations bring also some costs as they reduce banks’ ability to create net liquidity and they can distort capital accumulation. Models of that kind when applied to data allow for quantification of both costs and benefits of capital requirement – van der Heuvel showed some results for the U. S.

Conference presentations are available at: