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G20 and Macroprudential Policy

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At the upcoming G20 meetings the issue what can be done to avoid a repetition of the current deep financial crisis will again be debated. Much attention and criticism will be directed to central banks. That is unavoidable: central banks must never again permit the development of financial imbalances that are large enough to lead to the collapse of major parts of the financial system when they unwind. In the future, policy makers must "lean against the wind" and tighten financial conditions if they perceive that imbalances are forming, even if there is little hard data to rely on. And they must be mindful that the costs of acting too late can dwarf those of acting too early.

But monetary policy is not the best tool to use for this purpose. Interest rates have simply too blunt effects to deal with financial imbalances, which are typically localised in particular market segments, institutions or, in the euro area, countries. To slow down the growth of such imbalances, interest rates would have to be raised by implausibly large amounts which would depress economic activity overall and would hurt other segments of the economy. Furthermore, within the euro area it is not desirable to use monetary policy to deal with financial imbalances that only affect some countries. While tighter monetary policy might have been useful to limit housing bubbles in Spain or Ireland, it would have made for an even weaker housing market in Germany.

Of course, this is well-known to policy makers and precisely the reason why so much time and effort is being spent on developing macroprudential tools – non-interest rate tools – that can be used to constrain financial activity and prevent bubbles from forming. This important process has just started and much work remains to be done. To give it additional impetus, the G20 must focus squarely on it.

What would a new macroprudential regime look like? It will have six important characteristics.

First, the new regime must be international in scope. This is why the G20's attention is crucial. One common unintended consequence of regulation is that financial activity simply shifts to financial centres with a more liberal regime, as evidenced most famously by Regulation Q in the US that led to the establishment of the euro dollar market in London in the 1960s. Of course, one could argue that if risky financial activities move abroad, they are somebody else's problem. But in the modern day, financial markets are closely integrated across the world and a crisis in one country can spread globally in little time. Thus, regulation must be international. In turn, this implies that international agreement must be reached and that differences, such as those regarding hedge funds, must be overcome.

Second, it must have a broad coverage and include all institutions that are highly leveraged or engaged in maturity transformation. One important factor that led to the adoption of the low-regulation regime that created the conditions for the crisis was that during the tightly controlled regime of the 1970s firms avoided regulation by shifting financial activities to the unregulated sector. To prevent this from happening again, the new regime must not focus solely on deposit-taking institutions but cover as many financial institutions as possible.

Third, macroprudential policy must be transparent and predictable. To limit the procyclicality of the financial system, the macroprudential policy instruments will be varied over time. In financial booms and busts policy makers will thus rely on those instruments that they feel will most effectively deal with the precise imbalances diagnosed. To avoid that such policy changes trigger unexpected and therefore potentially harmful swings in asset prices, policy must be predictable. That requires transparency about the reasons for policy changes and the authorities' assessment of financial conditions.

Fourth, there is no single instrument that can be relied upon to ensure financial stability, and the macroprudential regime must make use of a whole range of available tools, even though some have shortcomings. Thus, pro-cyclical capital requirements, leverage ratios, loan-to-value ratios and other tools all have a role to play. A pragmatic approach must be taken.

Fifth, macroprudential policy must be conducted together with monetary policy. While macroprudential policy, in contrast to interest rate policy, can be focussed on the market segment that raises financial stability concerns, such as real estate lending or lending to hedge funds, both affect the economy in broadly similar ways, and it is therefore important that they are co-ordinated carefully.

Sixth, the task of setting macroprudential policy must be determined jointly by representatives from the central bank and all government agencies with responsibility in this area. International cooperation is also essential and attention from the G20 is therefore desirable. Given the close links between monetary and macroprudential policy and the fact that the crisis has shown that the cooperation between central banks and other authorities responsible for financial stability has not always functioned as well as hoped for, it is crucial that the authority for setting macroprudential policy at the national level is vested in one body. At the international level, these bodies must maintain close contacts.

Constructing a well-functioning macroprudential regime with a global dimension is no small task. The leadership of the G20 is therefore essential.