

Second session: The use of macroprudential tools
Macroprudential tools, monetary policy, and the cycle

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Prior considerations

- Not all procyclicality deserves the same treatment
- The treatment depends on the source of cyclicity:

1. Some cyclicity is **not undesirable**

2. Some cyclicity is due to **mechanisms** that

- Are in hands of private agents to improve (e.g. via contracting)
- Can be improved via infrastructure (e.g. central counterparties)

3. Some cyclicity is due to **external effects**

→ Can be dealt with by *correcting the externality*

4. Some cyclicalality is due or amplified by **institutions and regulation**

[Accounting & accounting-based rules, capital requirements, etc.]

→ We should definitely *address* this

5. Some cyclicalality is due to **ill-designed economic policies**

→ We should definitely *address* it

6. Some cyclicalality is due to **poorly understood phenomena**

[Agents irrationality, asset price bubbles]

→ We should *learn more and explore* channels to tackle with it

It is tempting to think of a large fraction of the “above trend” credit as “excessive”, but there are fundamental reasons why credit is and should remain cyclical

Specific developments

1. Monetary policy

Expand scope of monetary policy to deal with price stability in a broader sense

[Expanding horizon of reference or definition of target price index]

2. Loan to value limits

Introduce LTV limits at reasonable levels (70-80%?) and experiment with them

[Similarly, minimal haircuts in asset funding?]

3. Capital requirements

Definitely, correct the procyclicality of capital requirements

- Dominant trend
 - Full implementation of *through-the-cycle* input estimates
 - Some version of the Spanish pre-provisioning system

- My view:

Relying on through-the-cycle estimates is a mistake:

- (a) Makes internal models harder to verify
- (b) Expands the scope of supervisory discretion
- (c) Kills the statistical interpretation of *required capital*
- (d) Not clear that available data can deliver reliable through-the-cycle estimates

- My advice:

Adjustment factor based on simple macro aggregate (GDP, credit?)

- Richer alternatives may have virtues
- But also many pitfalls in terms of simplicity, predictability, flexibility and manipulability
- Go for a smooth factor based on, e.g., lags of GDP growth
 - * Tailored to specificities of credit categories & jurisdictions.
 - * For cross-border loans, use composite index based on borrowers' location
 - * With elasticities to GDP growth calibrated according to:
 - (i) Link between ΔGDP & relevant inputs
 - (ii) Link between ΔGDP & credit growth
 - (iii) Targeted “countercyclicality”

- At this stage,
 - Start with the modest target of neutralizing regulation-induced procyclicality
 - Leave further adjustments to the discretion of macroprudential authorities
 - Automatic stabilizer + Explicit, transparent tool for discretionary fine-tuning

4. New requirements

Liquidity and stable-funding requirements may need an approach similar to that proposed for capital requirements

[Or their suspension during systemic crises]

5. Systemic risk charge

A systemic risk charge should “price” any *residual* (not otherwise priced) contribution to systemic risk

- Possibly based on *composite measure* of the marginal contribution of each intermediary
- I would make it
 - An explicit charge (i.e. a *tax* with fiscal implications)
 - As much rules-based as possible
 - Open to discretionary fine-tuning

It is necessary to signal that there are explicit tools that operate as automatic stabilizers and can be fine-tuned by the new macroprudential authorities