The global financial cycle and macro-prudential policies

Daniel Dăianu is Professor of Economics at the National School of Political and Administrative Studies, Bucharest, and former Finance Minister of Romania, former MEP and a CASE fellow

Why macro-prudential policies?

The current financial crisis has highlighted financial stability as a paramount objective of economic policy. Macro-prudential measures (MPMs) as are contemplated and, in some instances, already implemented by European national authorities, aim at enhancing financial stability.

These measures range from loan to value caps for mortgage lending to banks' holding bigger capital buffers against various categories of loans. While there is a history of such measures practiced in emerging economies, they are, arguably, a novel (some would say a resuscitated) tool in many advanced economies, where a simplistic paradigm dominated macroeconomic and financial policies in recent decades. But the 'Great Recession' has changed the conceptual framework substantially.

The purpose of MPMs is, therefore, to diminish the dynamics that lead to boom and bust cycles while there is wide acknowledgment that price stability is not sufficient for achieving financial stability. This objective is all the more important at a time of still significant injections of liquidity in global financial markets which, against the backdrop of investors' intense search for yield, causes considerable over-valuation of financial assets.

In the US, Janet Yellen, the new chairman of the Fed has stressed that macro-prudential instruments, rather than monetary policy, are the means for dealing with macro-prudential, financial stability[1]. This view was also echoed by ECB officials; the ECB Vice President Vitor Constancio said that macro-prudential measures *"...are more compatible and effective to deal with imbalances in asset markets"*.[2]

Macro-prudential policies can have diverse effects in highly integrated financial markets and spillover effects, which do influence their effectiveness, need to be taken into account. In Europe, although there is market fragmentation under way under the impact of the deep financial crisis, the single market for financial services is not a chimera for it has a concrete meaning and content. Moreover, the need for MPMs in the euro area is to be seen against the backdrop of limited macroeconomic policy instruments in its member countries.

One could even argue that the need for MPMs in this area gives more salience to its incompleteness as a monetary union; that these measures are a substitute for capital controls, that they are a *sui generis* way of dealing with the 'trilemma' of open macroeconomics (how to reconcile a free flow of capital with exchange rate stability and independent monetary policy). In the European Union, spillover effects that derive from the implementation of macro-prudential measures (MPMs) can entail positive as well as negative effects.

Making judgments on MPMs is to be seen from the need in the EU to:

a. coordinate policies for the sake of achieving common goals;

b. have a collective policy stance wherever it is suitable, which is clearly the case in an economic area that aims at establishing a banking union which would go beyond the borders of the euro area;

c. consider the linkages between monetary policy and financial stability policy, however much one would entrust each of them with particular goals (fitting the Tinbergen assignment problem).

The nature and drivers of the financial cycle matter

Implementing MPMs has to be seen within a broad conceptual framework, which needs to pay attention to financial cycles. As Borio[3] observes, financial cycles cover much larger time frames than business cycles and are shaped by self-reinforcing interactions among perceptions of value and risk, which translate into booms followed by busts[4] can be seen as a precursor of this line of reasoning). This evolution is correlated with a big rise in debt (private) relative to income (GDP).

A key tenet of the Financial Cycle paradigm, as propounded by Borio and others is that financial liberalization enhances the amplitude of financial cycles. Another tenet is that a one-sided (focused exceedingly on inflation) monetary policy is inadequate since it does preclude the adoption of MPMs that could mitigate boom and bust dynamics, resource misallocation. Borio and Disyatat[5] talk about a 'policy drift' when there is maintenance of low interest rates for too long. Such a drift would accentuate over-borrowing and debt overhang.

Regarding the current circumstances in the world economy, one can detect a clash of views with regard to the policy effectiveness a central bank can obtain in combining its monetary stance with MPMs. While BIS experts seem to favour a monetary policy geared toward a sooner rather than later policy rate rise for the sake of weakening boom and bust dynamics in[6], the Fed and the ECB would rather maintain a relaxed MP stance.

In Europe, the threat of debt deflation is judged by not a few central bankers as quite menacing and asking for a continued relaxed monetary policy. And numbers fuel this apprehension for a headline inflation rate of just 0.4% last July is much below the ECB target at a time when correction of public and private debts is still a very protracted process.

While the assessment of the various tools central banks have at their disposal in order to deal with macro-prudential concerns is of great importance, another key issue pops up: the shape and nature of financial cycles, and, especially, of the 'global financial cycle'.

It is useful here to distinguish between an 'ordinary' and what could be named a 'policy-drifted financial cycle'. The former would be an unavoidable (endogenous) financial cycle, which is not biased by suboptimal policies considerably. Whereas a derailed, drifted cycle would be heavily influenced by drifted policies. In this context, the role played by major economies, as 'market-makers', is to be highlighted. Helene Rey speaks, in this context, about a 'dilemma' instead of the 'trilemma', in the sense that a global financial cycle, which is driven by the monetary policies of 'centre countries', sets the tone for the rest of the world irrespective of operating exchange rate regimes[7].

Whether a 'dilemma', rather than a 'trilemma', operates for policy-makers is less relevant for both views acknowledge that well targeted capital controls can play a useful role in broadening national policy space[8]. As spillover effects of MPMs adopted by EU member states are so much more important for the ECB, for the Union as a whole, the same logic can be applied to the global economy with regard to the policies of the central banks that provide reserve currencies. This is why what the Fed does is of enormous significance to the shaping of macro-prudential policies in Europe and elsewhere in the world.

Can MPMs be coordinated internationally?

A fundamental question, consequently, arises: what is the relationship between national macro-prudential policies and the financial cycle in the global economy, with the latter being so much under the impact of major central banks' policies? QE (quantitative easing) comes to one's mind in this regard, but not only. Policy coordination between the Fed and the ECB (ESRB) would be welcome under such circumstances. But how much is it feasible in view of the policy mandates central banks have, and which focus, primarily, on domestic economic conditions? Several related policy inferences can be made following the observations made above:

MPMs need to consider drivers of financial cycles, whether there are policy drifts that derail these cycles;

What drives the global financial cycle is critically important and, in this context, the role played by market-makers' policies; for what could appear a justified macro-prudential measure to a major central bank, may cause tremors in other markets;

There is, arguably, an optimal degree of financial liberalization, for emerging economies in particular (one reason being that they cannot borrow in their local currencies);

Targeted capital controls can play a useful role in underpinning financial stability in economies that can be ravaged by massive flow reversals. This observation should be examined in conjunction with the risks posed by growing inter-connectedness in financial markets and, correspondingly, by an erosion of robustness and resilience of economic systems;

There is need to think about and try to shape inter-connectedness (a suggestion made by Andrew Haldane and others)[9];

The reform of regulation and supervision of financial markets and the change of business models in the financial industry could bring about more robust and resilient organizations and economic systems;

Rediscovering the logic of the Bretton Woods arrangements would bolster the resilience of the international financial policy regime[10];

Designing proper regulatory and supervision frameworks of finance in the 'market-maker' (big) economies is essential for dealing with negative spillover effects of their policies.

"What is the relationship between national macro-prudential policies and the financial cycle in the global economy, with the latter being so much under the impact of major central banks' policies?"

How can the ECB coordinate its policies better with the FED and other major central banks, for the sake of mitigating boom and bust dynamics in the global economy, has to be given more clear answers. Is the Financial Stability Board an effective instrument to this end? What about G-20 in this regard? Can the IMF play a significant role in this respect? There is so much still to be figured out in order to make macro-prudential policies effective instruments. ■

1. Yellen, Janet, as quoted by Reuters in "Yellen drives wedge between monetary policy, financial bubbles", 7 July, 2014
2. Constancao, Vitor, as quoted by Wall Street Journal, "More ECB stimulus isn't likely soon? 28 July, 2014
3. Borio, Claudio, "The financial cycle and macroeconomics: what have we learned?", BIS Working Papers, no.395, December 2012
4. Minsky, Hyman, "Stabilizing an unstable economy." (first published 1986), New York, Mac Graw-Hill, 2008
5. Borio Claudio and Piti Disyatat, "Low interest rates and secular stagnation: is debt a missing link?", Voxeu, 25 June 2014
6. Caruana, Jaime, "Stepping out of the shadow of the crisis: three transitions for the world economy", Speech at the BIS' Annual General Meeting, Basel, 29 June 2014
7. Rey, Helene: "Dilemma not Trilemma: the global financial cycle and monetary policy independence", Voxeu, 31 August 2013
8. Klein, Michael and Jay C. Shambaugh: "Is there a dilemma with the trilemma", Voxeu, 27 Septeber, 2013
9. Haldane, Andrew and Robert May: "Systemic risk in banking ecosystems", 469, Nature, pp.351-355, 2011
10. Stiglitz, Joseph, "Risk and global economic architecture: why full financial integration may be undesirable", American Economic review, Papers and Proceedings, 100, May, 388-392, 2010