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# CENTRAL BANKING AFTER THE GREAT RECESSION

18 January 2016, 10.30-15.00

Bruegel, Rue de la Charité 33, 1210 Brussels

**On-the-record invite-only event:** This event was for selected invitees only, but the discussion was on-the-record. The event was livestreamed and a video recording has been uploaded to the Bruegel website.

## Session 1 - Macroprudential policy and its relationship with monetary policy: the complex European framework.

- **Ignazio Angeloni**, Member of the Supervisory Board, ECB, and Fellow-at-Large, Bruegel
- **Claudia Buch**, Vice-President, Bundesbank
- **Cecilia Skingsley**, Deputy Governor and Member of the Executive Board, Sveriges Riksbank
- Chair: **Dirk Schoenmaker**, Senior Fellow, Bruegel

**Dirk Schoenmaker**

What is meant by macroprudential policy? How important is macroprudential policy and what is the interplay between macroprudential policy and monetary policy? Growth in the euro area stands at 1-1.5 percent, inflation at 0-0.5 percent and nominal interest rates are at zero. As such, one could ask what the ECB is doing.

Two important questions emerge in terms of strengthening the resilience of the financial sector:

1. Should we aim to tame the financial cycle?
2. To which extent do we need ECB for consistency and which instruments does the ECB have?

**Ignazio Angeloni**

Macroprudential policy is complex and not fully resolved. There are two types of complexities: institutional complexity and analytical/inherent complexity.

*Inherent complexity* is the difficulty for macroprudential policy of finding a place between microprudential supervision (making banks safer, including those of systemic importance) and monetary policy (defending price stability). This is exacerbated by the difficulty of distinguishing between micro- and macroprudential supervision in terms of goals and instruments. There is currently a three-level paradigm, with microprudential supervision, a wider macro picture considering systemic risks, and a separate monetary policy. Angeloni proposes an alternative, where micro- and macroprudential supervision and policies are treated together, while monetary policy retains its distinct status.

There is a risk that macroprudential policy could be diverted and used for other purposes. For example, credit policies were used to correct monetary policy stance in the 1970s and 1980s, but this turned out to be unsuccessful.

*Institutional complexity* entails a lack of coordination. At the moment, national authorities implement supervision and the ECB can only top up. The ESRB is a powerful source of analysis and it issues recommendations, but it does not carry out operational decisions. The Supervisory Board and the Governing Council have the right to initiate and together, as a macroprudential forum, they are fairly powerful - but there is no policy action.

Financial stability in the euro area is complex, especially in a low interest rate environment. The latter encourages risk-taking behavior and affects various sectors, such as the insurance sector. Most importantly, it slowly weakens the banking sector through low profitability. The main burden for microprudential supervision of the banking sector will stem from weak banks. These are at risk from still high levels of non-performing loans (a heritage of the crisis) and the general fragility from low profitability and its consequences.

**Claudia Buch**
Macroprudential policymaking takes place in an environment with a high degree of uncertainty. What do we need to focus on? Do we need modifications to the instruments that are already in place? What kind of data is needed? Why should we wait?

On the one hand, inaction bias is inherent in all discussions; on the other hand, hasty actions carry great risk. Ms Buch states that central banks need clear evaluation, which would lead to clear actions by narrowing down the rate of uncertainty. Germany is on a good track in term of implementation of macroprudential policy, but behind monetary policy, since the former is a new field and we lack experience.

The following steps are vital in implementing macroprudential policies:

1. The availability of good data is vital to indicate whether policies are reaching their goals.
2. You must define the target and then make policies. However, it is more difficult to define macroprudential targets as opposed to monetary policy targets, where the target is inflation.
3. Identify intermediate objectives.
4. Ex-ante evaluation of how policy instruments are related to the objectives needs to be more concrete.
5. Ex-post evaluation using collected data. For example, Germany is trying to implement macroprudential supervision in the housing market. Even though the volume of housing credit is not going up, there is a fear of a housing bubble. If there is a housing bubble the Bundesbank would not have either the appropriate instruments or the legal background to respond. There is no sufficient data and information on debt-to-income ratio of households. Therefore, researchers are assembling micro-level data on the cross-border work of international banking.

On the European level we need:

1. A macroprudential policy cycle, with good data and a clear legal framework.
2. A coordination mechanism for peer reviews and sharing best practice. Such methods can be very useful for international action.

**Cecilia Skingsley**

How is macroprudential policy organised and governed in Sweden? The Financial Supervisory Authority (FSA) was established in 2013. There is also a Financial Stability Council, which meets biannually, but has no power, not even the power to give recommendations. It is chaired by the Cabinet Minister for Financial Markets. The National Bank's role is limited in policymaking when compared with EU institutions. The loan-to-value (LTV) ceiling is 85 percent and the counter cyclical capital buffer is 1.5 percent.

How are macroprudential and monetary policies reconciled in Sweden? One difficult question was the formulation of the FSA mandate. What legal tools should the FSA have? How effective is the Swedish policy framework? The FSA's mandate is limited, unless there is an evident threat to financial stability. FSA withdrew compulsory amortisation and further macroprudential tools were put on hold for more than a year. Monetary policy should not lean against the wind. If the Riksbank had worried less about household debt, interest rates would have been lowered faster as a response to the crisis.

Lessons from the crisis for Sweden:

1. It is difficult to use policy rates to lean against the wind, since even though short-term benefits are useful, long-term benefits are uncertain.
2. The Riksbank worried too much about household debt and housing prices, while it should always focus on inflation and act from there.

**Q&A**

*There is a lack of clear legislation, there is self-regulation and some coordination. Do we need a stronger legal basis? Do we need a European approach?*

- On the supply side we have the counter cyclical capital buffer, though with a coefficient of 0 because we started from a cyclical weakness. On the demand side, we have LTV, which is a European instrument.
- We need a stronger national mandate and strong linkages between countries at the European level. LTV and amortisation requires hard work to introduce, once introduced they are hard to get back or move around. The SSM can in principle act to introduce a counter cyclical capital buffer on the European level, but more analysis is needed in terms of the transmission channel.

*The ECB has two pillars: monetary pillar and the rest. What is the place for macroprudential policy in the development of monetary aggregates, which are driven by credit? In what direction should we think about the conceptual framework when discussing the role of euro area macroprudential policy?*

- Sweden has two pillars, however the monetary indicators have not been useful for long. The Riksbank's role is to fight inflation, which is influenced by credit growth. But we are not FSA.

- There are many reasons to discuss national instruments, since the costs of a financial crisis are national. We need hard instruments and a clear goal of what we are trying to achieve.

*There is a great value in thinking about macroprudential policy and we need a framework for thinking about it beyond the instruments.*

- The question about the state of mind is very important, but complex. There is a need to educate the existing authorities.

*New fields are developing, such as the developments in the equity markets and capital markets. How can macroprudential policy be used in this “new world”. How big should its scope and ambitions be?*

- Macroprudential policy is aimed at bank resilience and credit cycles. We learned from the crisis that when households get it wrong things get worse. I don’t see desperate need for macroprudential policy for other forms of financing.

*Do you see a problem in terms of the statutory complexity? Central banks require a legal basis to enforce macroprudential policies, but according to the Maastricht Treaty, central banks can only work with private tools and cannot impose behaviour. Is there a problem in giving the central bank these tools? There are no legal appeals against an interest rate increase.*

- It was also the case for credit controls, where it required two sets of lawyers.
- It could be designed in a way in which the central bank makes a decision and passes through a council comprised of democratically elected representatives.

*What is the interplay between structural vs. cyclical macroprudential policies? Structural proved to be more important with time and not so much fine-tuning. Sovereign exposure is also an issue.*

- We do not want misaligned incentives, but we need to make sure that a small shock does not affect the aggregate. In this sense macroprudential policy is already structural.

*Session 1 notes by Uuriintuya Batsaikhan, Research Assistant*

## Session 2: After the crisis, the evolving role of central banks

- **Markus Brunnermeier**, Professor, Princeton University
- **Charles Goodhart**, Professor Emeritus, London School of Economics
- Discussant: **Andrzej Rzońca,** Member of the Monetary Policy Committee, National Bank of Poland
- Chair: **Gregory Claeys**, Research fellow, Bruegel

**Grégory Claeys** introduced the second session by reminding everyone of the historic evolution of central banks from institutions first established to essentially finance wars (Bank of England), then to ensure financial stability (Federal Reserve), and finally to be the central institution for macro management in terms of price stability. However, we have recently witnessed three major changes: the renewed pre-eminence of the financial stability mandate not ensured by price stability alone, the use of new tools like QE, and a long period of below-target inflation which has led people to question central banks' ability to manage inflation. The three main questions guiding the session were the central bank's institutional design, its tool kit, and whether there should be a new paradigm in central banking.

**Charles Goodhart** started off by asking why central banks are now having such a hard time in lifting inflation rates and what went wrong. He showed that the relationship between base money and broader monetary aggregates broke down, i.e. the traditional idea of the money multiplier does not hold, and banks found themselves in a liquidity trap. Commercial banks did not use the additional money to buy bonds or issue loans as these entailed interest and credit risk, or required further capital. As for loans, there was also simply a lack of demand.

He then asked whether we could have avoided such a situation, arguing that the increase of capital requirements during the crisis could have been handled better. Since raising capital requirements in practice simply leads to a decrease in assets, he argues that instead banks should have been recapitalised with public money under certain conditions, e.g. forcing banks to retain dividends until the money is paid back.

Looking ahead, Goodhart discussed various strategies and their problems. Helicopter money, the combination of easy fiscal and monetary policy, has a number of problems. If it is one off, he suspects the money to just go into savings. At the same time, an open-ended commitment implies risks. Another strategy would be to penalise currency usage. He discusses various ways of organising this. One could abolish currency altogether, or discourage the use of currency via introducing an exchange rate between currency and deposit money. Both would require massive regime changes. Easier would be charging commercial banks for withdrawing currency from the central bank.

Goodhart looked at developments in the relationship between treasuries and central banks. While in stable periods this relationship became clearly established with operational independence in the last epoch (1980-2008), transition periods witnessed a confused and uncertain relationship. He argues that we have again returned to such a confused period. QE implies interest rate risks for the central bank. As now it holds long-term government bonds at low yields on the asset side of its balance sheet and bank reserves on its liability side, it could face potential losses once interest rates increase again. Credit easing exposes

central banks to political and economic risks since under credit easing the central bank also buys assets with credit risk. Since taxpayers ultimately bear the risk, the question is whether the central bank can decide alone which risks to take? Finally, he raises the question of what the balance between macroprudential and fiscal policy is, since the former renders central banks more involved with specific asset markets such as housing.

**Markus Brunnermeier** discussed a host of other questions regarding the future role of central banks and the changing operational environment. He talked about the shift from level to risk perspective. With no clear-cut separation between borrowers and savers, banks function as risk mitigators diversifying risky claims. When banks shrink their balance sheets and there is less mitigation, risks are once again with households. These in turn do not invest in risky projects but safe assets, i.e. money, which leads to deflationary pressures.

Another topic was about moving from the representative agent analysis to focusing on bottlenecks in particular markets. Those can be in the financial, the household, or the corporate sector. The choice of instruments by the central bank should depend on which one is identified as the bottleneck. The reasons for favouring a targeted approach is to take into account redistributive effects. Monetary transmission works differently across sectors (and regions) and monetary policy can imply asymmetric treatment of large firms vs. SMEs, with the latter being at a disadvantage.

Brunnermeier also addressed the independence of central banks by exposing the “game of chicken” between the fiscal authority and the central bank. While the former is forced to adjust budget deficits under monetary dominance, its (strategic) inability to control long-run expenditure may limit the monetary authority to raise interest rates under fiscal dominance. Practically, there is a dynamic game with no clear dominance. Brunnermeier adds another dimension of financial sector dominance with banks’ (strategic) inability to absorb losses leading to a second game of chicken between the fiscal authority’s recapitalisation and the redistributive monetary policy by the central bank.

Brunnermeier furthermore raises the question of whether the central bank’s balance sheet should remain large. He relates this question to which entity should be favoured for maturity transformation of risk-free government debt. He concludes that the private sector is not good at it, leaving it to the central bank.

Finally, he talks about the interaction between monetary and macroprudential policy. While monetary policy, which he labels as a kind of insurance scheme, impacts both risk taking and risk premia, macroprudential policy is able to control risk taking separately from risk premia. Therefore macro-prudential policy is essential because otherwise the insurance role of central bank and the redistributive effects of its policies could lead to moral hazard and excessive risk taking. Macroprudential policy can also be fine-tuned to the regional level and thus may complement the common monetary policy.

**Andrzej Rzońca** commented on the two presentations. He labels both as representing the majority view in favour of unconventional monetary policy. In his comments he questions that. He argues that it has had several negative effects, such as delays in restructurings that in turn resulted in uncertainty as to when the actual restructuring will happen. He argues that

the recovery period was prolonged, because the economy could not shed its non-viable firms, credit growth was blocked, and necessary new market entries did not occur. Furthermore, unconventional monetary policy can lead to higher fiscal debt as governments are less incentivised to carry out reforms.

**Charles Goodhart** and **Markus Brunnermeier** in their rebuttal were sceptical about the idea that liquidation is a good way of restructuring. It makes the downturn worse and Brunnermeier was bringing to mind again that the idea of QE is to switch off amplification effects, i.e. too much restructuring.

In the Q&A session the idea of central bank interference in the inflation derivative market was discussed as a way to reach the inflation target by providing an insurance to firms against too low inflation and allowing to offer wage increase compatible with the target of the central bank.  Last, the question of whether macroprudential policy should be organised nationally only or not was discussed. The bottom line was that it should be fine-tuned at the regional level but coordinated on the European level as banking is cross-border and also to avoid potential risks of cross-border arbitrage.

*Session 2 notes by Bennet Berger, Research Assistant*