Monetary and Macroprudential Policy: Complements, not Substitutes

Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Today's program focuses on various aspects of reforms since the global financial crisis that aim to address the risks posed to financial and economic stability. Central banks have long recognized that financial stability considerations play a key role in achieving monetary policy objectives. Yet, there remains considerable debate about the role that monetary policy itself contributes to financial stability and what steps a central bank should take with its policy regime.

In my remarks today, I will review considerations on the interaction between financial stability and monetary policy, as well as the post-crisis enthusiasm for the use of macroprudential regulatory approaches in addition to supervision of individual banking firms. I will conclude with my own views on the role of monetary policy in assuring economic objectives are achieved in the context of financial stability.

The relationship between monetary policy and financial stability

Prior to the recent global financial crisis, a common view held that monetary policy should not lean against apparent financial market imbalances—except to the extent they affected the outlook for growth and inflation—but, instead, clean up after a bubble bursts. This line of thinking rested on three assumptions.

The first is that spotting asset price bubbles or financial imbalances in real-time is notoriously difficult—something that is just as true today as in the past. Knowing at what point and how aggressively to intervene using monetary policy also poses a number of practical challenges. A second assumption is that monetary policy can be effective at limiting the damage to the broader economy after the bursting of an asset-price bubble. The pre-crisis consensus viewed a collapse of asset prices as having the potential to inflict sustained damage to the broader economy, but also held that monetary policy could mitigate the fallout. A third

assumption supporting the pre-crisis consensus is what I will call "the separation principle," in which regulators concern themselves with oversight of the financial sector while monetary policymakers focus on macroeconomic objectives, such as inflation and, in some cases, employment. The goal of price stability was seen as largely complementary with that of financial stability, given a well-designed regulatory structure that monitored the risk exposures of the financial sector.

Given these assumptions, broader discussions on the role of central banks in fostering financial stability were rare. The bursting of the dot-com bubble of the 1990s, followed by the relatively mild recession in 2001 only reinforced these views. After many years of financial market stability in advanced economies, policymakers seemed to have reason to view monetary policy as appropriately focused on macroeconomic objectives—that is, until the onset of the global financial crisis that began in 2007.

The collapse of the housing market in the United States and the global economic events that followed have posed fundamental challenges to the thinking about the role of monetary policy in maintaining financial stability. And without doubt, financial instability inflicted damage that pulled many central banks far from their objectives for a prolonged period.

A macroprudential approach

Today, central banks are digesting a growing body of research on the appropriate roles of monetary and regulatory policy in fostering financial stability. The influence of this research on actual monetary policy decisions has been only modest, although financial stability concerns are becoming more frequently discussed in the context of monetary policy. For example, the Federal Reserve has adopted a Statement on Longer-Run Goals and Monetary Policy Strategy, which

conveys to the public the objectives of monetary policy. The statement says that "risks to the financial system" that threaten to impede attainment of the Committee's longer-run goals may warrant a monetary policy response. No adjustment to policy has yet been made due to risks from the financial sector.

However, some countries over the past few years have raised financial stability concerns to a level sufficient to warrant a policy response. In most cases, monetary policy was not altered. Instead, macroprudential tools were deployed to address overheating property markets or rising household indebtedness. Monetary policy has largely remained focused on inflation and employment, leaving financial stability to regulators and their macroprudential approaches; in other words, the separation principle remains largely intact.

In fact, the deployment of macroprudential tools may be perceived as further removing the need for monetary policy to be concerned with financial stability. For example, countercyclical capital policy can be used to reduce the banking sector's leverage and expand its loss-absorbing capacity during an expansion. Calibrating the appropriate timing and degree for using this tool, however, poses some practical challenges that are similar to those associated with monetary policy. The Federal Reserve plans to use a framework incorporating countercyclical capital adjustments, though details, such as when and by how much to release the buffer, will need to be more fully developed.

In addition to countercyclical capital, policymakers and regulators have embraced macroprudential approaches to liquidity requirements. These steps are designed to guard against excessive maturity transformation, which in the past has led to asset fire sales and large swings in asset valuations. With the new rules, banks must hold a minimum amount of highly liquid

assets under stressed conditions to ensure adequate funding and prevent fire sale losses and related externalities.

To evaluate whether the capital and liquidity positions of individual institutions aggregate to a stable banking system, stress-testing has been used. In the United States, stress-testing has long been a microprudential tool aimed at ensuring the safety and soundness of individual institutions and understanding, for example, a bank's interest rate risk exposure. Since the crisis, it has also become an important macroprudential tool that provides a horizontal view of systemically important firms and their vulnerabilities to a wide variety of shocks to economic and financial conditions. While stress-testing has proven to be a valuable tool, the results can be quite sensitive to a number of factors, such as model specifications and estimation periods. For these reasons, regulators should be cautious about taking too much reassurance from the tests.

Regulators also must remain focused on traditional microprudential, or firm-specific, supervision and regulation. Sound execution of macroprudential regulation depends on sound microprudential regulation. Ensuring that individual banking organizations are operating in a safe and sound manner is a prerequisite to their ability to withstand the economic and financial shocks that can lead to financial instability. In the United States, perhaps the most notable examples were the declines in residential and commercial mortgage underwriting standards that emerged in the years leading up to the crisis. For commercial real estate, in particular, growing concentrations led the banking agencies to issue supervisory guidance in 2006. However, highlighting such issues is of little value unless it is timely and accompanied by targeted actions to limit the risk exposure. From this standpoint, I see extremely strong complements between micro- and macroprudential regulation.

Financial stability and monetary policy interactions

Just as micro- and macroprudential policies play central roles in safeguarding financial stability, so does monetary policy. I often hear the view that macroprudential policy should be the "first line of defense" for maintaining financial stability. Unfortunately, this approach expects too much of tools for which our understanding is imperfect. In addition, a growing body of research shows monetary policy plays a key role in affecting risk appetite and risk premiums. Asking regulators to ensure risk-taking is not endangering financial stability places a large burden on our regulatory infrastructure, especially in an environment of highly accommodative monetary policy.

Indeed, central banks have used zero interest rates and large-scale asset purchases or quantitative easing as a type of monetary easing that would affect risk-taking, asset valuations and economic growth. While accommodative monetary policy can affect economic activity via this channel, it can also create financial market vulnerabilities, especially if sustained for a prolonged period. If financial imbalances in one sector turn out to have systemic consequences, then a reliance on the risk-taking channel of monetary policy to stimulate economic activity could prove more detrimental than beneficial over the longer run for achieving stable inflation and employment.

In particular, a monetary policy that fails to take into account building systemic or tail risks exposes the economy to potential large setbacks in the future. Investors fluctuate between being more or less concerned about these unlikely—but severe—economic outcomes. These concerns are often incorporated in risk premiums, which reflect investor concerns about the degree and likelihood of severe events. For example, a rise in risk premiums can indicate a recession may be on the horizon, even when macroeconomic data may be providing no such

signal. Alternatively, unusually low risk premiums, such as were experienced in 2003-2005, reflected investors who were underestimating the severity and likelihood of a downturn in the housing market.

Research points to the effect monetary policy has on several aspects of risk-taking. For example, after taking into account economic conditions, low policy rates are correlated with overall easier financial conditions, as we see banks increase the share of risky assets they hold, credit quality decline, risk premiums on syndicated loans fall, lending standards soften, and financial institutions move towards shorter-term funding and higher leverage.[1] Many of these factors manifest themselves in elevated asset valuations and rising credit growth. Once asset values or credit growth has risen to a level warranting concern, it is likely too late for monetary policy to smoothly unwind these imbalances without triggering a sharp reversal that ultimately inflicts damage on the real economy.

A focus on risk-taking and risk premiums in the context of monetary policy leads to two questions. The first is whether risk premiums are useful for predicting economic activity. Research from the Federal Reserve Bank of Kansas City suggests they are, but they offer more of a signal about the future when they are rising than when they are falling.[2] That is, rising risk premiums signal poor economic performance in the future, while declining risk premiums are not necessarily a good indicator of strong economic performance. Low risk premiums, however, may sow the seeds for future financial instability. The second question is whether monetary policy can affect risk premiums. This same line of research also suggests monetary policy does alter risk premiums. As policy eases, risk premiums have a tendency to decline, suggesting that

[1] See, for example, Rajan (2005); Jimenez et al (2012); Santos (2012); Maddaloni and Peydo (2011); Stein (2012, 2013); Adrian and Shin (2010); Adrian, Moench and Shin (2009). Adrian and Laing (2014) provide a comprehensive overview.

[2] See Cao, Doh and Molling, "Should Monetary Policy Look at Risk Premiums in Financial Markets?" forthcoming in the Federal Reserve Bank of Kansas City's *Economic Review*.

attempts to lower already low risk premiums will likely do little in terms of future economic activity but may foster conditions that pose risks to financial stability.

This line of thinking suggests to me that modestly tighter policy earlier in the business cycle expansion could moderate risk-taking and the potential for destabilizing financial imbalances to build. In reviewing financial stability reports for several countries prior to the global financial crisis, my staff found some countries effectively identified a number of risks that played important roles in the crisis but underestimated their severity.[3] Identifying "excess" risk-taking always carries challenges, particularly in finding the right benchmark with which to assess risk-taking. Still, a number of these reports highlighted risks, but late in the business cycle when there was little monetary policy could do except wait to clean up. In addition, using monetary policy to prick bubbles after they have developed, to slow elevated levels of credit growth, or to encourage firms to scale back on high levels of leverage are likely to end poorly.

The bottom line is that it is difficult to address stability concerns in particular sectors after they have developed. Instead, it may be appropriate to adjust policy to address suppressed risk premiums early in the expansion rather than late. Once valuation pressures emerge, or underwriting standards have been stretched, then it is often too late. As a result, interest rate policy used earlier in the cycle can foster a more stable financial landscape as a business cycle matures.

Revisiting the pre-crisis consensus

[3] Christensson, Spong, and Wilkenson, "Financial Stability Reports: How Useful During a Financial Crisis?" Federal Reserve Bank of Kansas City's *Economic Review*, 2010.

The lessons of the financial crisis are many and warrant careful assessment of assumptions that have guided the thinking about the proper relationship between monetary policy and financial stability. It remains true that we can't identify bubbles in real time, or at least don't know the proper time and manner to intervene to stem their rise. Following the collapse of a bubble, monetary policy can be judiciously used to limit the damage inflicted on the real economy. However, monetary policy runs the risk of remaining overly accommodative following a downturn, and lead to future instability. Importantly, policymakers should reassess the assumption that monetary policy and macroprudential regimes can be used independently. This "separation principle" remains widely accepted and continues to argue that macroprudential tools offer the "first line of defense" against risks to financial stability.

Our recent experience, combined with empirical evidence, suggests this view should be challenged. A comprehensive approach that views monetary and macroprudential policy as a complements, reinforced by sound microprudential underpinnings, is the best approach to achieve a stable financial system and the long-run objectives of central banks for sustainable economic growth.