

Political challenges of the macroprudential agenda

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Central banks frequently lead the macroprudential policy implementation. The hope is that their credibility in conquering inflation might rub off on macroprudential policy. This column argues the opposite. The fuzziness of the macroprudential agenda and the interplay of political pressures may undermine monetary policy.

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A key factor in conquering inflation in the 1980s was the doctrine of central-bank independence. Similarly, the success of the macroprudential agenda also has come to depend on an independent central bank with a credible commitment to implement politically unpopular measures. Indeed, one recent IMF study finds that timely macroprudential-policy implementation requires involvement of the central bank (Lim et al. 2013).

Yet it is unlikely that the inflation-fighting success can be replicated in the macroprudential domain. Even worse, the reputation of central banks is at risk, not the least because of the link between macroprudential policy and monetary policy. Some central banks seem to see interest rates as yet another macroprudential tool, and we might even come to see macroprudential tools as an alternative to interest rates for executing monetary policy. For instance, while the Bank of England's forward guidance (2013) linking interest rates to unemployment would cease to hold if it increased systemic risk, the Bank has insisted it could avoid interest-rate rises by using macroprudential tools.

However, the main problem is the lack of credibility. As the weakest link, this may explain the rather cool market reception to recent forward guidance. By being in charge of macroprudential agenda, the central banks have taken on significant reputational risk, which ultimately may undermine their ability to efficiently execute monetary policy.

Macroprudential ambiguity

Since 2007, central banks have been increasingly tasked with developing and deploying macroprudential policy tools aimed at limiting the buildup and consequences of systemic financial risk.

This means that the relevant authority, more often than not the central bank, has to monitor the economy and develop a toolkit for dealing with any threats. In practice, there are significant technical challenges, above and beyond those faced by the central bank a generation ago.

In fighting inflation, the central bank has one explicit tool at its disposal – interest rates – as well as an unambiguous and easily measured objective – inflation. There is no equivalence in macroprudential policy. Instead, the policymaker has at her disposal a wide-ranging collection of often conflicting tools and an even more baffling set of measures designed to capture systemic risk, financial instability, or the object of interest in the macroprudential agenda. This macroprudential ambiguity makes it difficult to build the necessary political consensus for employing the macroprudential toolkit.

Shaping the agenda

The implementation of macroprudential policy, especially in times of crisis, inevitably involves a wide array of institutional actors, including the fiscal authority, as witnessed by the composition of the Financial Stability Oversight Council in the US and the Financial Policy Committee in the UK.

Such institutional designs increase both the politicisation and access for divergent viewpoints, which permits any critic to utilise macroprudential ambiguity to point out that a different tool or different measure is more appropriate. The direct involvement of the fiscal authority gives critics even more leverage. The more avenues that divergent interests have for influencing policymakers, and especially when access is via the political process, the more scope there is to inhibit policy implementation and engage in rent-seeking.

Peculiarities of the macroprudential political bias

Politicisation of macroprudential policy leads to countervailing pressures. Regulators may be biased either towards non-intervention, because they would be subject to political pressure against tightening during a boom, or towards intervention, because they would face less criticism for puncturing a non-bubble than for failing to spot a real one. This is a common problem in financial regulation, and has become a significant contribution to procyclicality.

It is often politically difficult to take measures that reduce short-term economic growth in the interests of fending off a bust that many think will not happen. For instance, in Norway, members of parliament threatened to strip the power to implement loan-to-value ratios from the regulator when it recently proposed lowering them.

On the other hand, especially after a crisis, regulators may lean toward premature intervention because they fear being criticised for failing to spot a bubble. A recent example comes from Iceland, determined to prevent any future crisis at all costs, but in doing so limiting investment and economic growth (Danielsson 2013). A recent cross-national IMF (2012) study also finds a bias towards tightening.

Regional differences

Thus far, the interplay of these political pressures has shown significant regional differences. The general focus of the macroprudential agenda in the West has been on countercyclical and conservation capital buffers. Asian countries, on the other hand, have taken the lead in developing and deploying more aggressive macroprudential tools, for example some that lean against asset-price movements.

Since 2010 Chinese regulators, have lowered the loan-to-value ceiling to 70% for first-time buyers, with even lower limits applied in cities with “excessively fast” price appreciation. Similar measures have been rolled out in Hong Kong, India, Indonesia, South Korea, Malaysia, Singapore, and Thailand (Lim et al. 2013).

Some of these differences may reflect what political scientists see as different “varieties of capitalism” (Hall and Soskice 2001). Historically, Asian economic models are more conducive to regulatory intervention in the credit allocation process than those in North America and Europe where, with a partial exception of Canada and some Scandinavian countries, policymakers seem less comfortable deploying the full arsenal of the macroprudential toolkit. These varieties of capitalism may make the commitment to implement certain types of macroprudential policy more credible in some economies than in others.

Conclusion

The macroprudential agenda is hard to disagree with.

- How can one object to measures that prevent the build-up of imbalances that will cause significant economic harm.

No wonder then that the macroprudential agenda enjoys significant political support, memories of the crisis are fresh and policies have not yet been implemented.

- Yet macroprudential policy will have to be implemented and receive political support in a positive economic and financial environment, where the memories of the last crisis have faded whilst the short-term benefits of the bubble are highly visible.

Political support then is likely to be much weaker than it is now.

- As a practical matter, the macroprudential agenda seems set up for failure in many countries.

The technical uncertainties and institutional designs give sufficient room for significant political objections to gain traction. Since any implementation is likely to run into strong political objections, anything that gives credence to those objections is problematic.

Having the central banks take the lead in implementing macroprudential policy might seem sensible. After all, their credibility in conquering inflation might rub on macroprudential policy. We fear the opposite, that the fuzziness of the macroprudential and the interplay of political pressures undermine monetary policy.

- The success of the macroprudential agenda depends both on maintaining political consensus as well as the existence of a robust, unambiguous toolkit.

Central bankers have fine-tuned the art of economic communication to steer inflation expectations.

- They must now become better political communicators, and sharpen up their macroprudential toolkit, to maintain consensus for managing systemic risk.

If central banks fail in either task, all the sound and fury in the macroprudential domain could signify nothing, risking both financial and price instability.

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