DEUTSCHE BUNDESBANK
EUROSYSTEM

# How crises have changed the tasks and practice of central banks: Macroprudential policies

**Professor Claudia M. Buch**

**Conference “Turning points in history”**
Deutsche Bundesbank
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# Policy perceptions have changed in response to the crisis.

- **Allocation of policy tasks before the crisis:**
  - Monetary policy should ensure price stability.
  - Banking supervision should ensure the stability of individual banks.

- **But safeguarding the stability of individual banks may be insufficient to protect the stability of the financial system.**
  - The crisis triggered quite persistent declines in real output.
  - Governments intervened on a massive scale to support the banks.
  - Debt levels remain at an elevated level.

➢ **Macroprudential policy has emerged as a new policy field.**

➢ **The need to adjust monetary policy strategies has been discussed.**

1. What are the goals and instruments of monetary policy and macroprudential policies?
2. How new are macroprudential policies?
3. What are the implications for central banks?

1. What are the goals and instruments of
monetary policy and macroprudential policies?

# The goals and instruments of monetary policy are quite well-defined.

- **The ECB's Governing Council has announced a quantitative definition of price stability:**
  - Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%.
- **The Governing Council has also clarified that, in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term.**
  - „**Taylor rule**“: simple description of monetary policy decisions

$$i_t = \pi_t + r_t^* + \phi_\pi(\pi_t - \pi_t^*) + \phi_y(y_t - y_t^*)$$

→ **Price stability has been maintained throughout the crisis.**

# The goals and instruments of macroprudential policy are less well defined.

- **ECB's definition of financial stability:**
  - Financial stability can be defined as a condition in which the financial system – intermediaries, markets and market infrastructures – can withstand shocks **without major disruption in financial intermediation** and in the **effective allocation of savings** to productive investment.

- **Systemic risks arises if the failure of individual institutions affects the stability of the overall system:**
  - **Domino effects**: A bank's customers run into difficulties due to the bank's failure and their direct contractual relationships with it.
  - **Information effects**: Even without contractual relationships, one bank's failure, can trigger a run on other banks (e.g. fire sale externality).

# Comparing monetary and macroprudential policy

| | Monetary policy | Macroprudential policy |
|---|---|---|
| **Objective** | Price stability<br>(inflation below but close to 2%) | Safeguarding the stability of the financial system |
| **Addressees** | Banks as counterparties for monetary policy transactions | Banks and other financial intermediaries<br>Fiscal authorities<br>Central banks |
| **Instruments** | Interest rates<br>(Open market operations,<br>standing facilities,<br>reserve requirements) | Monitoring of macroeconomic indicators<br>Capital surcharges<br>Lending restrictions etc |
| **Institutions** | European System of Central Banks | European Systemic Risk Board (ESRB)<br>Financial Stability Committee (FSC)<br>German Financial Stability Committee (*Ausschuss für Finanzstabilität*, AFS) |

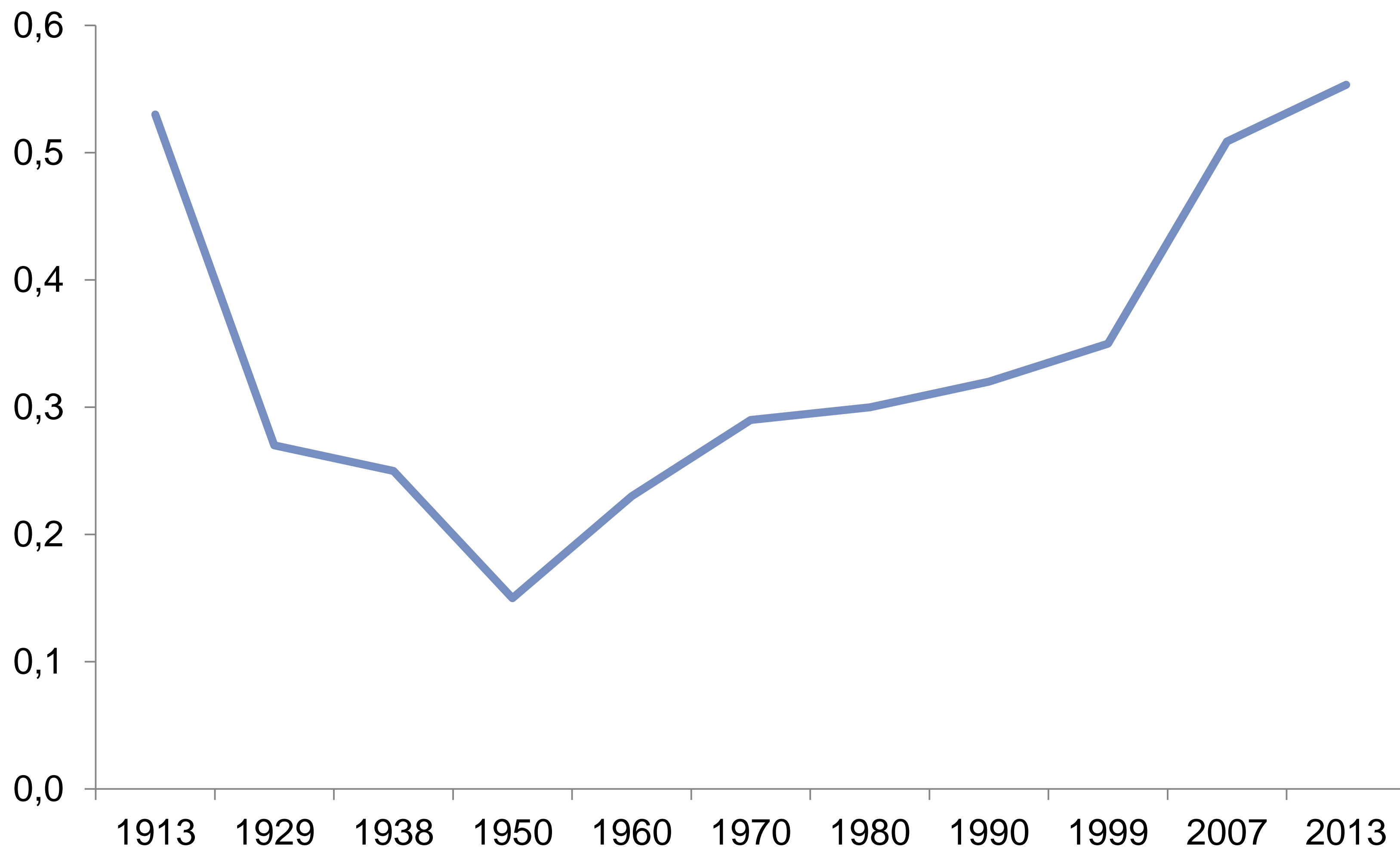
# There are several feedback channels between monetary policy and financial stability.

- **Feedback from monetary policy to financial stability:**
  - **Credit channel**: Lower interest rates increase asset prices and stimulate credit supply.
  - **Risk-taking channel:** Credit supply particularly to high risk creditors is amplified in phases of low interest rates.

- **Feedback from financial stability to monetary policy:**
  - Banks have incentives to coordinate their behavior and to increase their exposure to macroeconomic risks.
  - **Bubbles** on financial markets can affect price stability.
  - Distressed financial institutions affect the transmission of monetary policy.

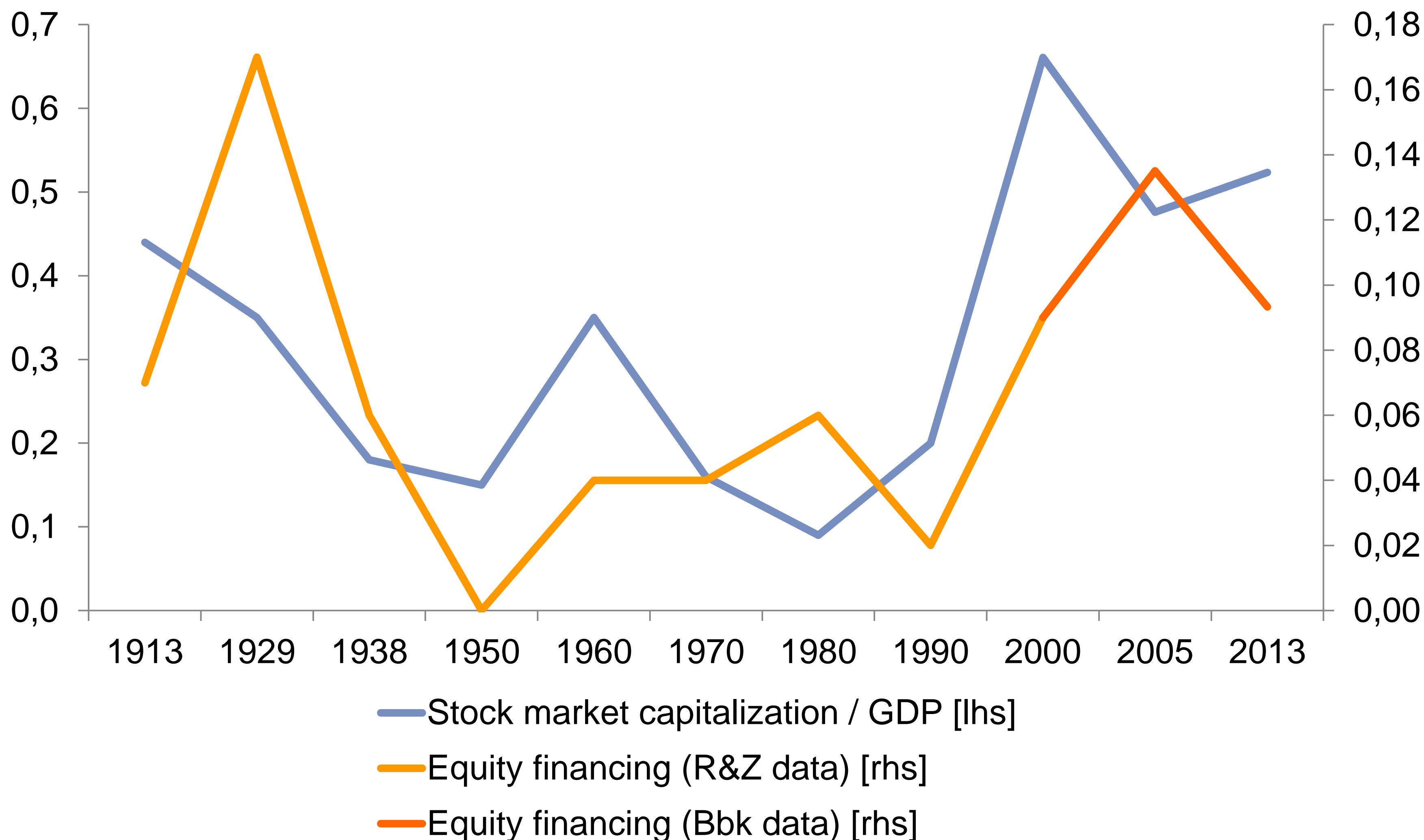
# 2. How new are macroprudential policies?

# Deposits in German banks (% of GDP)




Source: Rajan and Zingales (2003), Deutsche Bundesbank

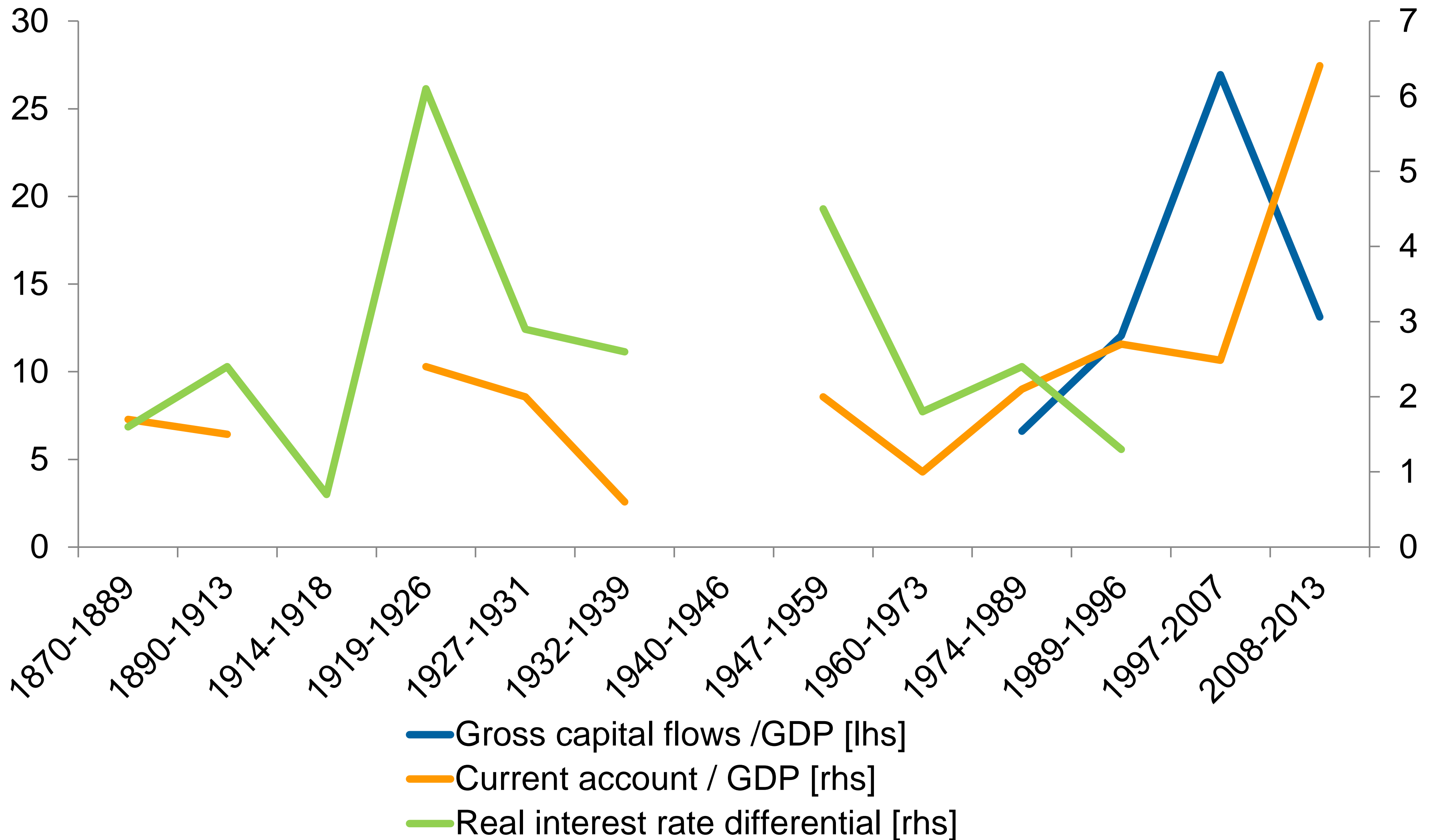
# Stock market capitalization in Germany and external equity capital






Source: Rajan and Zingales (2003), Deutsche Bundesbank

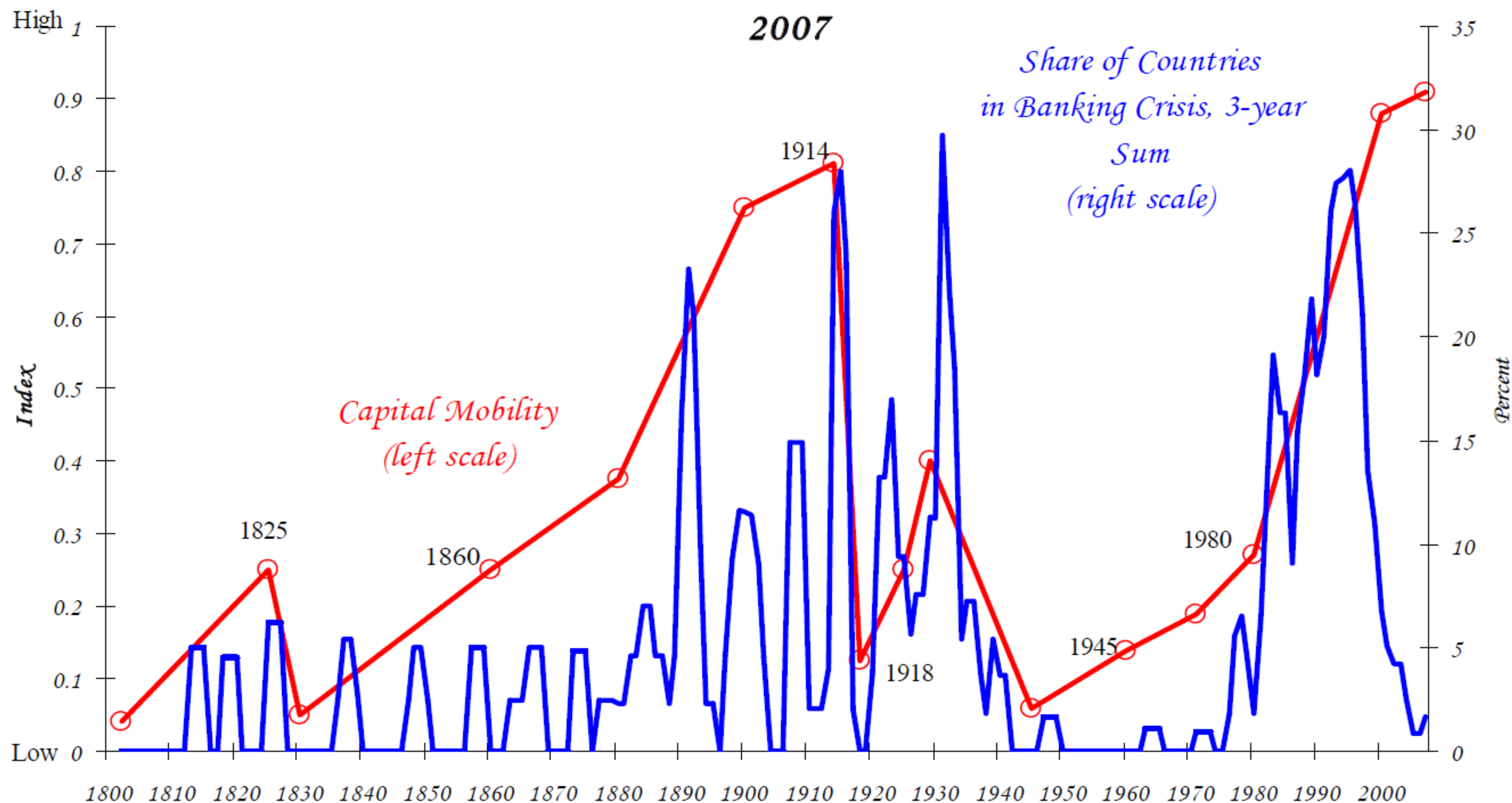
# Integration of German capital markets into international capital flows






Source: Obstfeld and Taylor (1997), Broner et al (2013), Deutsche Bundesbank

# Historically, banking crises were often preceded by phases of increased capital mobility.






Source: Reinhard and Rogoff (2008)

# Policy responses to financial crises share similarities with macroprudential policies discussed today.

- **Brunnermeier and Schnabel (2015) examine bubbles on financial markets and the economic policy response in the past 400 years.**

- **Bubbles have been triggered by ...**
  - ... expansionary monetary policies
  - ... credit booms and capital inflows
  - ... innovations in financial markets and deregulation.
- **Financial crises and policy responses in Germany:**
  - **1872-73 "*Gründerkrise*"**: "*Banknotensperrgesetz*" to limit creation of liquidity
  - **1927 stock market crisis**: Bank holidays, credit supply restrictions, capital controls

➢ **Costs of financial crisis have been higher the longer interventions were delayed and the higher the share of debt finance.**

# 3. What are the implications for central banks?

# New macroprudential institutions in Europe

| | European Systemic Risk Board (ESRB) | Financial Stability Committee of the ECB | German Financial Stability Committee (AFS) |
|---|---|---|---|
| **Year** | 2010 | 2011 | 2013 |
| **Region** | EU | Euro area | Germany |
| **Markets** | Banks<br>Insurance sector<br>Market infrastructures | Banks | Banks<br>Insurance sector<br>Market infrastructures |
| **Instruments** | Warnings and recommendations national and European institutions | Tightening of national instruments | Warnings and recommendations to national public institutions |
| **Role of the Bundesbank** | Voting member | Voting member | 3 members each from Bundesbank, Federal Ministry of Finance, BaFin<br>Provides analysis<br>Veto power |

# Selected goals and instruments of macroprudential policy

| Goal | Instrument |
|---|---|
| Limiting size effects | Higher capital surcharges for large, systemically-relevant institutions |
| Limiting procyclicality | Variation of capital buffers over the cycle (countercyclical capital buffer CCB) |
| Limiting risks of mortgage lending | Loan-to-value ratios, amortization requirements, debt-service-to-income ratios, ... |

The ESRB lists over 100 macroprudential measures that have been implemented in the EU, about ¼ on a reciprocal basis.

# New financial stability mandate of the Bundesbank

- **January 2013: New law to strengthen financial stability in Germany**
  - Strengthen cooperation between Bundesbank, Ministry of Finance, and BaFin
  - Link micro- and macroprudential supervision
  - Establish Financial Stability Committee (AFS)

- **Implementation of the financial stability mandate:**
  - New business area „Financial Stability“ (established in 2009)
  - Contributions to (international) policy groups (ESRB, FSB, FSC ...)
  - Annual Financial Stability Review (since 2004)

- **Warnings and recommendations**
  - **June 2015**: Recommendation issued by the AFS on new macroprudential instruments for the real estate sector

# Summing up:
# What are the implications for central banks?

- **Macroprudential policy addresses risks to financial stability arising from ...**
  - Incentives for risk taking
  - Insufficient buffers against risks
  - Misalignment of asset prices

- **Surveillance and regulation of systemic risks has improved:**
  - New institutions and policy instruments
  - New legal frameworks and mandates for Central Banks

- **Monetary policy and macroprudential policy are closely related.**
  - A fundamental change in the monetary policy strategy is not required.
  - **But:** Interactions between policies need to be taken into consideration.

➢ **The next steps:**
  - Evaluate policies
  - Analyze feedback channels between monetary policy and financial stability
  - Improve data availability and data use

# Further reading

- **Deutsche Bundesbank, Monthly Report March 2015, The importance of macroprudential policy for monetary policy, Frankfurt a.M.**

- **Deutsche Bundesbank, Financial Stability Review 2014, Frankfurt a.M.**

- **Research Data and Service Center:**
  **http://www.bundesbank.de/Navigation/EN/Bundesbank/Research/RDSC/rdsc.html**

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# Backup

# Main messages of the Bundesbank‘s financial stability report 2014

1. **Low interest rates may lead to increased risk-taking.**
2. **The capitalization of German banks has improved, but profitability remains weak.**
3. **Mortgage lending is not highly pro-cyclical, but structural vulnerabilities exist.**
4. **The Banking Union helps to better identify risks and facilitate private-sector risk sharing.**
5. **The preferential regulatory treatment afforded to sovereign exposures needs to be abolished over the medium term.**

# Macroprudential policy-making takes place under a high degree of uncertainty.

- **Macroprudential policy is a new field, and most macroprudential instruments are largely untested.**
  - What are appropriate objectives and (intermediate) policy targets?
  - What level of granularity is needed for the surveillance of financial stability?
  - Which theoretical models guide policymaking?

- **This uncertainty entails risks …**
  - … of an inaction bias and the quest for "more data" and "more analysis".
  - … of (ab)using macroprudential policies for other policy purposes.

➢ **A clear strategy for (ex-post) policy evaluation is needed.**

# Three views on how monetary policy should address financial stability concerns (Smets 2014)

- **"A modified Jackson Hole consensus"**
  - Monetary policy focuses on price stability.
  - Monetary policy cannot contain financial instability.
  - Macroprudential policy takes care of financial stability.
- **"Leaning Against the Wind vindicated"** (Borio et al.)
  - Monetary policy primarily focuses on price stability.
  - Monetary policy systematically considers implications for the financial cycle.
  - Financial stability is addressed by macroprudential policy.
- **"Financial stability is price stability"** (Brunnermeier et al.)
  - Price and financial stability are closely interlinked.
  - Monetary policy explicitly considers financial stability risks.