

## **Symmetry: Should Macroprudential Authorities be required to stimulate credit and growth as well as to prevent crises? Some reflections for debate**

The present impasse in Europe as to how to get economies going again, and the populist and political hysteria about the austerity agenda, is encouraging debate as to the role that Macroprudential Authorities [MPAs] set up to undertake independent policy assessment might play in a pro-growth direction. In addition to their duties to prevent crises, should they also be given the task of trying to get economies to move again? I would anticipate that this debate will intensify.

The 'political' proposition is that if MPAs become competent at preventing asset bubbles and leverage build up, they might be thought to be competent in the opposite direction as well. I would argue - for debate - that whilst this sounds intellectually tempting, it would be dangerous for legislators to move in this direction.

### **What are MPAs trying to do?**

MPAs are being constituted as a response to filling a gap in policy that was shown to be missing when crisis hit in 2007-8. They are tasked with working on systemic risks to prevent crisis from occurring: this needs a forensic approach of identifying early warnings and taking mitigating actions.

Market based macroeconomic policy areas, including that of monetary policy, had not managed to lean or take preventive measures against increasing and mainly leverage-related systemic risks. What was needed was a determined 'sleuth', to intervene as needed, and with the thought processes of a detective developing an effective radar screen. The tasks and mindsets of fire prevention differ from those of the users of the buildings which the fire prevention is designed to protect!

### **Policy Conflicts**

There may of course be a necessary tension between policies to ensure safety of the financial system and those needed to get credit to flow [often used as shorthand in political minds for 'creating growth']. This policy conflict needs to be resolved: but my thesis is that it is better to encourage other authorities, backed by political will, to promote the growth agenda. What the MPAs *can* do in today's overleveraged post crisis world is to make sure that leverage levels in the economy gradually get to the level at which the necessary level of confidence is restored, to lend, invest and consume, which is a vital precondition for growth to resume. They can also act, as suggested below, in ways that have regard for other policy areas, including those relevant for growth. But I would worry about asking MPAs to be proactively engaged to deliver both objectives.

An exception might be in jurisdictions where the MPA and the Government are effectively one and the same [ie there is no 'independent' macroprudential policy assessment].

### **Some concerns**

If legislators do indeed insist that MPAs work symmetrically then I would be concerned about the following:

- **Confusion.** The public would be confused as to what the MPA was meant to be doing. This would undermine the legitimacy and credibility of a policy area which

needs plenty of both. Systemic or macroprudential policies require difficult judgements and result in unpopular decisions ['taking away the punchbowl']. And people enjoy parties: the public [and maybe some politicians] will want to go on partying at the time the punchbowl has to be removed.

- **Dual objectives.** Delegating authority to a body which has dual objectives raises real danger that neither of the objectives would be met: particularly where one of the objectives is unobservable. You can measure growth. You cannot measure ex ante the level of leverage at which a crisis will occur. And how do you make such a body accountable if you have such disparate objectives?
- **A new and difficult policy area.** Macroprudential or systemic policy is a new and evolving area of policy framework, and a very difficult one in two senses. Firstly there are difficult Governance issues which arise where you necessarily have several separate authorities engaged towards a common good [central bank, ministries of finance and supervisors]. But secondly there are many uncertainties as to how to 'do' macroprudential policy: issues such as what indicators matter, what data is relevant, what instruments will work, how they should be calibrated, and how they will be deployed. The area should be allowed the time to develop and mature before its policy objectives are widened so brutally.
- **Elusive growth.** Getting growth to happen is clearly a major challenge, and inevitably so at a time like today when levels of debt and leverage within economies are still too high to regain the confidence [and hence willingness to invest/consume] of private markets. Contemporaneous deleveraging and encouragement of growth are difficult bedfellows.

We know that for confidence to be restored deleveraging in a broad sense is still needed to some level lower than it is today. Attempts to spend your way indiscriminately out of trouble are likely to be upset by the actions of bond vigilantes - a real constraint for many jurisdictions, as in Europe today. [Perhaps may be less the case if you have a reserve asset currency like the dollar, or you can easily turn on the tap of infrastructure projects whose rate of return on capital can be judged].

But I would urge avoiding allowing this frustration to spill over into asking new and untested MPAs to take on the growth agenda - another policy area of equivalent difficulty - for which they cannot readily be designed. And even if it might be politically helpful to find a party to whom to delegate this responsibility, it would be very unwise to do so if this eroded the ability for the MPA to undertake the vital task of preventing the next crisis. Future generations will certainly not thank us.

- **Long term growth rate.** Attitudes towards what is the long-term sustainable rate of growth may need to change. Given the huge cost of crises and destruction of GNP, this seems likely to be lower than was earlier presumed. So although I am certainly not on the side of 'austerity or nothing' we have to be patient and certainly not look vainly for another party such as an MPA to find a 'magic solution'. Necessary deleveraging after such a long and ill judged party is a long-term and unpleasant process for those who seek growth! Statesmanship in getting the message across before becoming engulfed by populist movements is of course a key issue for today.

**Technical objections.** There are a number of more specific or technical objections to putting 'pro growth' on the agenda alongside 'stopping crises'

- **No reaction function.** There would be little possibility for the MPA to create a reaction function. In turn this would make the calibration judgements in relation to individual instruments even harder. Maybe it is rather ambitious to be speaking in these terms: but the stakes are high and it would be a pity to cut off this possibility. Unless agents are clear on the policy objective of the policymaker, how can they know how they are supposed to react?
- **Different skill and mind sets.** The skill sets and experience needed forensically to detect impending vulnerabilities on the radar screen are different from those associated with getting the economy to grow. How would you find and accommodate both within one decision making body? Although there are clear overlaps, those trying to achieve financial stability need a particular mindset that differs from policymakers involved with the cycles of the macroeconomy. I would include in large measure mindsets of those involved with monetary policy [indeed this is an argument for keeping MPAs separate from monetary policy authorities] but also other areas of policy with respect to the supply side as well as fiscal issues.
- **Instruments and accountability.** Using – and justifying - the sort of instruments available to MPAs to try to accelerate growth seems to me like pushing on the end of a string. Animal spirits no doubt need arousing: but there are so many determinants of growth that it will surely be hard to put an accountability process in place for the MPA to achieve it.

**So what can be done?** All this is far from suggesting that nothing can be done. Just as policies in respect of fire prevention need to accept that people need to be able to work in the buildings that they protect, so MPAs need to take account of the implications of systemic policies on other areas of policy like growth.

In some jurisdictions the mandates of policy areas such as monetary policy, and now macroprudential policy, are set by the political process. In turn these can be adjusted with some regularity. This suggests the following possibilities to resolve policy conflicts as ingredients in relation to the setting of mandates:

**Firstly there needs to be guidance as regards how safe should the system be.**

The safer the system, the more the measures in place to provide that safety may impact growth. So how safe should the system be? This requires thought as to the appetite for risk. Each jurisdiction needs to form a view on this. It may be a tough area to get one's mind round, but there is no such thing as an absolutely safe financial system [unless you ban credit and leverage which seems to call into question the very basics of our modern-day economies]. So, as a crude approach, do you require the system to be safe enough to withstand the shocks that might emerge in a 10 year period? Or do you want it to be safer with a 20 or even a 100

year return period? Depending on this determination guidelines can be given as part of the MPA's mandate. If the decision is to take a shorter return period, the MPA can take a slightly riskier approach than if longer.

I would suggest that risk appetite is a determination that should belong to the jurisdiction as a whole [and hence its political process] and not left to policymakers such as MPAs themselves. It may be difficult to articulate, but it's too important to be put in the too difficult box.

**But secondly to what specified other policy objectives should the MPA have regard?** The MPA's actions may indeed impinge on policy objectives in a number of policy areas whatever the level of risk appetite. So there is a legitimate question: for what areas of policy should the MPA have regard? This should be made clear in the MPA's mandate.

For example if the mandate requires the MPA to take account of the impact on growth, this could influence the choice of instruments in favour of those less likely to have an impact on it whilst still achieving the systemic objectives.

Equally the mandate could cover other social objectives, like home ownership, or welfare or competition. So for example in the area of home ownership instruments designed to increase the cost of intermediation in a sectoral sense might be used instead of LTV [which could have a greater impact on social priorities].

Overall the target of stability needs to have primacy. But I do not think it naïve to suggest that the route/choice of policy instruments chosen in many cases could take account of other objectives. Instruments of a conjunctural nature designed to raise the cost of intermediation so as to work against leverage build up may have a more direct impact on growth compared to instruments designed to strengthen the resilience of the system to withstand shocks.

In fire prevention you can either act to prevent the temperature from rising [ie no petrol allowed inside the building: akin to preventing the increase of leverage and credit bubbles] or you can make the building stronger and with thicker walls and doors or smaller windows to improve resilience [akin to better regulation and stronger banks]. A similar type of trade off may be achievable in the area of macroprudential policy.

To achieve success MPAs need time to develop. We shouldn't forget for what they were set up. And I hope we won't let them be hijacked as new enthusiasms and priorities emerge. Whatever these may be, systemic risks will surely be ever present. My thesis is that if future generations are going to feel that we have taken on board the implications of recent calamities we should certainly make sure we focus on this reality.

Andrew Large  
11/05/2012