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Is there a Future for Macro-Prudential Policy (MPP)?

- The financial system is interconnected and behaves pro-cyclically, and credit and asset prices tend to reinforce each other. To counter the effects and systemic financial risks that arise from these characteristics, conventional macroeconomic and micro-prudential policies may be insufficient. This will not change in the foreseeable future, so the use of prudential tools to limit systemic risks will remain part of the toolkit of public policy.

- To provide a more precise answer to the question posed in the title of this note: there isn't only a future for the MPPs, but many futures.

- The reason for this answer is that MPPs are specific to the circumstances and goals of each country. This specificity is related to several factors. In this talk I will deal with three of them: (i) The diversity of institutional arrangements, (ii) the diversity of states of development and 'visions' of the financial system, and (iii) the diversity in the size and complexity of economies.

Diversity of institutional arrangements

- Institutional arrangements differ between countries, and MPPs are only part of the broader framework of policies to promote financial stability. The decision-making process for MPPs includes identifying the existence of systemic risk, selecting specific prudential tools, and implementing policies. This process depends in part on whether financial regulation and supervision are concentrated in one institution or spread among various state agencies.

- Therefore, the future MPP framework depends on the state and evolution of institutional arrangements. In particular, there is no consensus on the convenience of concentrating these policies into one single agency, such as the central bank.

- Both centralized and decentralized schemes have advantages and disadvantages in terms of resolving policy tradeoffs, improving the decision-making process, aspects of political economy, flexibility in the institutional coverage of MPPs and others. Even if one of the schemes were deemed better, the necessary changes resulting from this decision would probably require legal or constitutional reforms with political economy risks specific to each country.

- The alternative of concentrating large discretionary powers in a state agency is attractive if we consider the benefits of increased agility in the decision-making process, as well as the facility to expand the perimeter of regulation according to market conditions. This scheme probably works best in countries characterized by strong and efficient institutions, as well as a functioning system of checks and balances.

- However, in countries where state institutions are weak and subject to strong political or sectorial pressures, this arrangement can be dangerous. If the entity that concentrates power is the central bank, it could even compromise the quality of monetary policy. In these cases, it is preferable to have a scheme that includes: a level of dispersion of power between agencies responsible for financial stability; the independence of the most relevant bodies, such as the central bank and the financial regulator; the prevalence of the rule-based MPPs; and the creation of a coordinating body for MPPs that defines the responsibilities and how to act in each of the institutions that are part of the network of financial stability.

- The independence of the financial supervisor and central bank from political and sectorial interests is particularly important in the formulation of MPPs. Since it is impossible to base an entire MPP framework on rules, ample room for flexibility and discretion is always necessary, especially in a field as dynamic as the financial sector. However, discretion is best exercised from autonomous entities. Long horizons, clear objectives and less sensitivity to political and sectorial lobbying allow these agencies to make unpopular decisions in the short term in a timely manner but generate benefits in longer time horizons, thereby moderating the so-called "Inaction Bias".

- The implications of institutional differences go beyond establishing the MPP framework. The type of policies available depends on the specificities of each country's institutional structure. For example, in certain economies fiscal policy is flexible enough to quickly adjust certain tax rates in response to the behavior of financial flows. In others, such flexibility is unthinkable, given the existing legislative procedures.

- Similarly, different legal frameworks and different states of institutional development determine variations in the available information to generate an MPP response. For example, the breath of information in credit bureaus, offices or tax administration registries may allow for more precise monitoring of private sector leverage, asset prices and the allocation of new credit. This enables finer MPP responses in terms of time and measures, as well as less frequent errors.

- In summary, the future will continue to see many frameworks and uses of MPPs, depending on the state and progress of countries' institutions.

<u>Diversity in stages of development and "visions" of the financial system</u>

- Differences in the level of financial deepening and sophistication of economies are important for MPPs in two key aspects:

    - The need and effectiveness of the MPP
    - Triggers and response times of an MPP

- Differences in the degree of financial development determine the response of the economy to exogenous shocks, both internal and external. Large and complex economies with sophisticated and deep financial systems may have a greater capacity to absorb such shocks without generating large volatilities in macroeconomic and financial aggregates. Thus, in these economies MPPs will be less necessary to face these shocks, and will also be less effective because of more possibilities for evasion. Consequently, the use of macro-prudential instruments will be less frequent in these countries and they will probably be aimed at reducing the risks associated with the pro-cyclical nature of the financial system, as well as countering the "natural" strengthening between asset prices and credit.

- The degree of financial development also determines which prudential tools should be used. For example, reserve requirements are more useful policy instruments in financial systems based on depository entities. Consequently, as the financial system develops it may require an expansion of the regulatory perimeter and level of sophistication of regulation. For example, in Colombia and other countries it is necessary to advance the understanding, regulation and supervision of financial conglomerates and non-bank intermediaries.

- In economies with simple financial systems, easily observable movements of simple variables can be triggers of an MPP response. For example, in a financial system consisting of banks mainly funded with non-institutional deposits, banking credit growth may be a sufficient indicator of the leverage of firms and households and, therefore, of systemic risks. The MPP response to this indicator will most likely be directed to contain it.

- The case is different for more complex financial systems, in which bank asset growth does not necessarily coincide with private sector liabilities, or in which the characteristics of active and passive instruments used by intermediaries are critical to determining systemic risk. In this case, an MPP response involves reactions to different variables with different measures affecting different agents.

- This implies a more selective and shorter use of MPPs in complex financial systems. This differs from what happens in economies with simple financial systems, where the effectiveness of MPP measures may persist for longer, as there are no tools or vehicles that facilitate their evasion.

- At a more general level, a diversity of uses and frameworks of MPPs is expected in the future, as countries resolve the dilemma between stability and financial deepening in differing manners.

- Given the cost of a delayed reaction to a situation of high risk ("type I error"), some countries will choose to consistently counter suspected excesses; in doing so they will introduce disintermediation or efficiency costs in cases of sustainable financial progress (?) ("type II error"). Other countries will privilege financial innovation, especially if the financial system and capital markets are leading sectors in the economy.

- This difference is evident in the regulatory approaches of several countries. In Colombia, for example, financial intermediaries can only develop products and activities expressly permitted by the regulator. In other countries, intermediaries can develop anything that regulation does not prohibit. The effects of this differential approach on the pace of financial innovation and the generation of systemic risks are clear.

Diversity in size and complexity of economies

- MPPs are at an intermediate point between monetary policy, with its objectives of price stability and smoothing of the economic cycle, and micro-prudential policies, which aim to manage individual or idiosyncratic financial risks. Therefore, we can expect MPPs to interact and create synergies or conflicts with monetary policy. In particular, differences in the size and complexity of economies affect the interaction of monetary policy with MPPs and, therefore, will remain a determinant of the diversity of uses and frameworks of MPPs in the future.

- In small open economies, external shocks (such as higher revenues from exports or large capital inflows) can simultaneously generate strong leverage expansions among residents, currency and term mismatches, and an appreciation of the exchange rate that leads to inflation below the target. Under these conditions the response should be to ease monetary policy to stabilize inflation, which can exacerbate the risks of financial instability. Therefore, MPPs will have to be used frequently.

- In contrast, in more complex economies where non-tradable sectors are more important and the production structures more sophisticated, the same shock can generate inflationary pressures through increases in aggregate spending. In this case, the response of monetary policy contributes to mitigate the risks of financial instability and an MPP helps to contain inflationary pressures. Consequently, the application of MPPs may be less frequent because monetary policy is sufficient.

- The economic structures of countries change slowly in relation to financial and economic cycles. Hence, differences in economic structure will remain a key determinant of the diversity in the frequency, instruments and effects of MPPs among countries.

Conclusion

- The diversity of institutional arrangements, states of development and “visions” of the financial system, as well as in the size and complexity of economies are crucial for the employment and the validity of MPPs. I believe that these conditions will determine the circumstances under which countries may use MPPs in the future.