

# The Limits of Macroprudential Policy

*Hardly a magic cure for the credit cycle.*

BY WILLIAM R. WHITE

**T**he global economic crisis that began in 2008 had its roots in excessive and imprudent credit creation and the associated rise in debt levels. Similar “boom-bust” cycles have been seen throughout history, although with increasing frequency and magnitude in recent years. The same history teaches us that problems can emerge in the financial sector and spread to the real economy, but that problems in the real sector can also feed through to weaken the financial sector. The central policy conclusion to draw from this is that, while stability in the financial sector and price stability are both desirable, they are not sufficient to ensure macroeconomic stability. That is unfortunate in that policymakers have been focusing narrowly on those objectives in recent years.

This insufficiency is being recognized in the form of growing concerns about global economic prospects. In particular, the almost total reliance on monetary policy to stimulate aggregate demand in recent years has encouraged a further, sharp rise in global debt ratios. As well, there has been a decline in the quality of that debt, especially with respect to corporations. Given pressure on profits in many jurisdictions, the global financial system also remains vulnerable in spite of many improvements to financial regulation.

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To the limited extent that policymakers have recognized the dangers posed by the credit cycle, they seem to have taken comfort in the possible use of “macroprudential” regulatory policies to improve both crisis prevention and crisis management. Such comfort also implies that other, potentially more painful but more effective solutions, need not be envisaged. Again, this is unfortunate since macroprudential policies not only

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have inherent shortcomings, but are being increasingly applied in ways that are totally inconsistent with how their use was originally envisaged. Indeed, they might now actually be raising the expected costs of future macroeconomic instability rather than reducing them.

#### **A BROADER FRAMEWORK**

We are all familiar with traditional microprudential policies (such as those of Basel I and Basel II) directed to improving the health of individual financial institutions. Such policies are essentially static in nature. Macroprudential policies were originally envisaged as financial regulatory policies directed to improving the health of the economic system in general and the financial system in particular. These policies have both a cross-section (static) dimension and a time-varying (dynamic) component. The former emphasizes the systemic threat posed by individual institutions that are “too big/complex” to be allowed to fail, as well as the threats posed by interdependencies within the system. The latter recognizes that risks ebb and flow over the cycle and focuses on identifying the buildup of such systemic risks and introducing policies to offset them.

There are also trade-offs within the realm of macroprudential policies. To the extent policymakers feel confident in their capacity to conduct time-varying macroprudential policies, they can in principle ease back on the more static requirements. However, as will be discussed below, such confidence is hardly warranted. Moreover, the effectiveness of the static macroprudential policies already in place still leaves a lot to be

desired. While progress has been made on the issue of resolving financial firms designated as systemically important, there are few if any commentators who are confident that the failure of such a firm would not still have significant and costly side effects. As for interdependencies, there has been a marked reluctance to address this directly through legislation. In the end, arguments made by lobbyists in favor of “efficiency” all too frequently seem to outweigh those for “stability.”

It is important to note that the time-varying component of macroprudential policies, as originally conceived at the Bank for International Settlements, was nested in a broader “macrofinancial” framework. This consisted of using both monetary policy and macroprudential policies to lean against credit developments thought likely to result in a “boom-bust” cycle. Early leaning would reduce the probability of a bust, as well as the associated costs should it happen nevertheless. The suggested joint use of monetary and macroprudential instruments was a response to the belief that each separate instrument had limitations. To restrain a credit bubble using monetary policy alone might result in destructively high interest rates. As for macroprudential tightening, it invited evasion and avoidance, likely pushing credit growth into less regulated areas of the financial system.

The more technical question of how, in principle, these instruments might be best ordered and combined was never addressed in depth. In practice, it turned out there was no appetite for the use of either of them in the advanced market economies. Consistent with the Greenspan doctrine that it was easier to “clean” up after the bust than to “lean” against the boom, the stance of monetary policy continued to be driven almost entirely by the behavior of inflation relative to announced targets. As for the use of macroprudential instruments, some early enthusiasm for using them to reduce the likelihood of a “boom-bust” credit cycle was soon replaced by a much narrower objective: to ensure that the financial system would continue to provide essential

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services in the aftermath of a crisis. To some degree, this reflected the practical observation that a significant degree of macroprudential tightening in both Spain and Hong Kong had not prevented a significant economic bust, but it had left the banks healthier than otherwise. As with monetary policy, the focus of macroprudential policy turned away from sustainability to resilience.

#### **MACROPRUDENTIAL POLICY IN THE “BOOM”**

Even given the choice of this narrower objective, macroprudential policies would still be expected to tighten during periods of rapid credit expansion. However, this raises two inherently difficult questions. First, how does one assess the need to act? Second, how does one determine precisely what to do in response that will best ensure financial resilience?

Concerning the first issue, if the objective is to ensure the provision of essential financial services *in extremis*, then there must be agreement as to what those services are and what level of services is adequate. In effect, we need a target to justify policy action to achieve that target. Since all tightening measures will have some cost in terms of economic growth forgone, we also need some estimates of those costs to ensure they are not greater than the benefits tightening provides. Pertinent to all these evaluations will be the assessment of the adequacy of insolvency regimes for financial institutions, since this will have a big influence on spillover effects from single bankruptcies.

As if this were not difficult enough, we need to be able to identify when systemic risks in the financial sector are growing. The crucial problem here is that we have

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no agreed model indicating how financial crises unfold. Indeed, it may be impossible to construct such models since financial systems are highly complex and also highly adaptive. In such systems, multiple equilibria and highly non-linear outcomes are possible and likely.

At the moment, there seem to be two schools of thought about possible indicators of growing systemic stress. The BIS has tended to focus more on highly aggregated data: for example, credit growth and leverage relative to trends, and elevated prices of financial

assets and property. Another school, supported by the International Monetary Fund and more recently the G-20, has focused on highly disaggregated data (risk maps) revealing more about nodes of pressure and possible points of rupture. The first approach relies on

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broad historical patterns (the school of what is the same) while the latter focuses more on recent changes to financial structure that might be dangerous (the school of what is different). While this second approach is more data- and resource-intensive, there are some historical grounds for believing that broader problems in financial markets are often triggered by developments in specific markets that have recently been subject to significant structural change.

Once the need to act has been determined, deciding precisely what to do is also difficult. The list of potential macroprudential instruments that might be tightened is long: caps on loan-to-income and debt ratios, balance sheet restrictions (including loan growth), and counter-cyclical debt and reserve ratios for lenders, among others. One problem is that many macroprudential instruments are actually microprudential instruments being used for a different purpose. This raises the question of the availability of the instrument to the macroprudential authority, as well as possible offsetting responses by other regulatory agencies pursuing their own purposes. This is a further complication to the fact that the market itself will adapt to any regulatory changes.

The use of any individual instrument must be assessed on the basis of its effect on economic growth, on contributing to the resilience of the financial system, and on its distributional effects. The effect of mortgage caps on the ability of poorer citizens to buy a house has proven a particularly contentious issue. Proceeding beyond individual instruments to the possibility of different packages of instruments is a further complication.

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While empirical work is ongoing, policymakers to date remain far from sure about what trade-offs are available to them.

Finally, there are broader questions about “how” as opposed to “what.” Should policy rely on changing incentives or on outright prohibition of certain actions? There are precedents for both in microprudential regulation. Should policy changes be based on rules or discretion? Tightening based on discretion simply might not happen, but rules cannot be optimal when objective circumstances change. Should policy changes be incremental in the face of uncertain responses, or are large changes required to change mindsets about what is acceptable? On all of these issues, reasonable people can differ.

#### **MACROPRUDENTIAL POLICY IN THE “BUST”**

Using macroprudential policy in the aftermath of a “bust” is no less complicated. A traditional view might be that both monetary policy and macroprudential policy should be eased to stimulate aggregate demand. Indeed, given that “busts” tend to be more abrupt and violent than “booms,” perhaps policy itself should also be more asymmetrical. However, once the focus of macroprudential policy shifts to the resilience of the financial system, another worry arises. A significant easing of macroprudential instruments might be interpreted by the market as a sign of regulatory forbearance in the face of severe underlying difficulties. This might undermine confidence rather than reinforce it. The only way to square this circle is to have a sufficiently tight setting of such instruments before the crisis so as to provide some regulatory room for manoeuvre. Evidently, this was not done prior to the crisis that began in 2008. Macroprudential instruments received little if any attention and microprudential instruments were generally being eased as part of an ongoing global trend to financial deregulation.

Regardless of what might have been done in the wake of the 2008 crisis, one fact is reasonably clear. Countries that have altered their setting of macroprudential instruments have generally tightened them. Far from the original BIS suggestion that monetary and macroprudential measures should support each other, these policies are now working at cross purposes. Similar to the restrictive stance of both microprudential and fiscal policies in recent years, tighter macroprudential policies have contributed to the perception that ultra-easy monetary policy must continue as “the only game in town.”

This is unfortunate, since the stimulative properties of monetary policy seem increasingly ineffective against the “headwinds” of debt encouraged by those same monetary policies. Worse, the unintended and dangerous side effects of those monetary policies are becoming increasingly apparent. Rising debt levels not only strangle aggregate demand but raise the probability of destructive bankruptcies. Growing wealth inequality fosters political discontent. Resource misallocations and zombie banks, lending to zombie companies, have

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reduced productivity growth. Low intermediation margins and the search for yield have raised the risks of financial instability.

#### **GOING FORWARD**

Policymakers face significant challenges going forward. How can the global economy be extricated from the exposed position in which it currently finds itself? The risks of a major downturn are now quite elevated, potentially with serious political consequences. How must the structure of the system be altered, and the policy response to emerging problems changed, to avoid similar problems building up in the future? These are serious problems demanding serious answers. To suggest that there is no cause for worry, since the deft use of macroprudential policies will keep all problems under close control, is both delusional and dangerous. ◆