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The macroprudential governance framework and its implications for the effectiveness of macroprudential policies

Keynote address by Jan Smets, Governor of the National Bank of Belgium, at the ECBN 3rd Policy Research Conference on "Evaluating the effectiveness of macroprudential policies"
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Ladies and gentlemen, it is a great pleasure for me to address the 3rd Policy Conference of the European Central Bank Network on the topic of "Evaluating the effectiveness of macroprudential policies". No doubt, having effective macroprudential policies in place is going to be a major factor in mitigating financial stability risks. On the macro front, it is the so-called first line of defence against new instances of financial instability. And we have learned the hard way that risk mitigation is of crucial importance; just cleaning up after a credit bubble has burst is no longer an option.

Indeed, ten years after the start of the crisis we are still coping with its consequences. It is only in the course of 2015 that euro area GDP has regained its pre-crisis level. Evidently, output losses relative to pre-crisis trends are even bigger. Permanent income has dropped dramatically and spending has been cut. That has led to a huge increase in unemployment. Public debt levels have been driven up, not only by the direct costs of financial sector repair but also because of the fiscal implications of the fall-out on the real economy. At the worst point in the crisis, the euro area faced a genuine sovereign debt crisis, which in turn further threatened the stability of the financial sector. Distressed banks tightened their credit conditions and were hampered in their capacity to transmit the monetary impulses of the ECB to the real economy, while the depth and length of the economic slump caused further deterioration in the quality of banks' balance sheets, as non-performing exposures increased. The ECB had to respond with unprecedented measures, first to avoid a financial system meltdown and restore the monetary transmission mechanism, and later on, increasingly to provide sufficient monetary policy accommodation to counter the deflationary forces in the economy, as policy rates had approached their effective lower bound.

In the meantime, it is fair to say that we see progress on many fronts. The economic recovery is firming. Inflation appears to have bottomed out and deflation has now become a fairly remote risk. Yet, last week's Governing Council meeting decided that the continuation of the very accommodative monetary policy stance is still warranted in order to achieve a sustained adjustment of inflation towards 2 %. There is also progress on other fronts. Private and public debt levels have started to come down. But they are still high in some countries, and public debt sustainability continues to be an issue for several euro area member states. With the enhancement of prudential regulation at global level and the creation of the banking union in the euro area, a lot of progress has been made in the supervision of banks, but more needs to be done as both the concept of the banking union and the process of banks' balance sheet repair are still incomplete. So, while things have definitely improved and the euro area is nowadays again seen as a region of stability, one cannot overestimate the impact the crisis has had on the euro area economy and on the living standards of its citizens. And despite the improvement, the euro area has not yet fully recovered and still faces significant challenges.

The domain in which progress has been most impressive is precisely the one we discuss today and tomorrow, that of macroprudential policy. To put it frankly, a brand new policy domain has been created in just a few years. As a matter of fact, the crisis was not just a reminder that financial stability – and not only price stability – matters for a smooth functioning of the economy, but also indicated that it has an important macroprudential dimension, besides the existing microprudential aspect. While the latter is crucially important for the health of individual financial institutions, on its own it fails to fully internalise the systemic risk component, which goes beyond individual institutions and finds its origin in either the interconnectedness of financial intermediaries or in the procyclical patterns in the financial system, and in its interactions with the macro economy. Today, as recommended by the de Larosière report, we have, in the European Systemic Risk Board (ESRB), a European institution addressing this type of risk, and macroprudential authorities are now fully operational in each and every country of the European Union.

That in turn has boosted research in this field, and this conference is a good illustration of the importance that macroprudential policy research has nowadays acquired, both in academia and in the central bank community. Indeed, the time has come where we no longer have to merely concentrate on establishing this new policy domain. We are already in a position where we can start evaluating the effectiveness of macroprudential policies, which are increasingly being implemented. This is a process of learning by doing, and I am sure the learning, including from the work that will be presented at this conference, will lay the foundations for a virtuous circle of improvements in the conduct of macroprudential policies. Let me stress in this respect the importance of the European Central Bank Network conferences, as they focus on research with immediate policy relevance based on macroprudential policy experiences in euro area countries, and as such complement work done in the ESRB context.

Assessing the effectiveness of macroprudential policy is not only important within the contours of this new policy domain, but also has important implications for the allocation of financial stability responsibilities between macroprudential policy and monetary policy. With effective macroprudential policy in charge of financial stability, monetary policy can focus on price stability - with all its positive spillovers for financial stability - and we come closer to the ideal Tinbergen world, where an independent policy instrument is available for each policy objective. Of course, in reality matters are more complex as both policies work, at least to some extent, via the same transmission channels. One important aspect is that monetary policy may prove too blunt an instrument to address financial stability risks, which often manifest themselves in specific markets or segments of the financial system. In such instances, granular macroprudential policy is more appropriate given its potential for closer targeting. That argument is even stronger in the case of the euro area, which is still a heterogeneous and incomplete monetary union, as financial imbalances often tend to manifest themselves in specific national markets. Compared to monetary policy which is only available at area-wide level, macroprudential policy can activate an important country-specific component, and that is precisely one of the reasons why national macroprudential authorities have been set up.

One could dwell on a vast set of issues regarding the interactions between monetary and macroprudential policy. But instead, I will concentrate in the remainder of my talk on the respective governance frameworks and, more specifically, on what the monetary policy framework with independent central banks teaches us for the conduct and the effectiveness of macroprudential policy. In other words, would it be wise to grant the same degree of independence to the macroprudential authority? And what would that imply for accountability?

Let me go through the arguments, starting from the concept of independence in the monetary policy domain, and then see to what extent this concept and the underlying principles can be extrapolated to the macroprudential governance framework.

Central bank independence has not always existed as we know it today. On the contrary, over time the relationship between sovereign States and their agent issuing money has changed considerably. It was only after the great inflation of the 1960s and 1970s that a consensus emerged in which monetary policy conducted by independent central banks is considered best practice. Both theoretical insights and actual policy-making led to this consensus. On the theoretical side, there was emphasis on the time inconsistency problem leading to the inflation bias. Monetary policymakers with too short a policy horizon are tempted to push the economy beyond its natural level in order to reap the short-term gains, while in the longer run that merely generates higher inflation. An independent central bank is better equipped to withstand the temptation to overheat the economy, and that eventually leads to a better social outcome. Moreover, the actual conduct of monetary policy during that era provided evidence supporting this view. Indeed, during these turbulent years the Bundesbank – at that time by far the most independent central bank – was much more successful in weathering the storm of monetary instability. Today there are legal provisions granting independence to central banks – and in the EU such independence is hard wired in the Treaty - , but what really forms the solid basis for central bank independence is the societal consensus that this is indeed best practice.

That is a first important qualification. Let me add a few more, before I move on to what all this could imply for the macroprudential policy framework. First of all, the central bank independence I described is a concept of constrained independence, not absolute independence. Indeed, central banks are independent to the extent that their action contributes to achieving the objectives assigned to them. In other words, central banks are only operationally independent and only within the clear boundaries of their mandate. For the ECB, for instance, it is the mandate given by the Treaty which stipulates that price stability is the primary objective, and its independence is to be seen as a means to achieve this objective. Second, in democratic societies independence has to go hand in hand with accountability. Indeed, the independent central bank has to explain its actions – both ex ante and ex post - and clarify how they fit into the mandate and contribute to achieving the objective. And obviously, accountability is facilitated by having a clear and verifiable objective. The fact that many central banks have adopted quantified inflation objectives is instrumental in this respect, while it also provides agents with a clear nominal anchor for their expectations. And, finally, central bank independence also rests very much on the presumption that monetary policy predominantly acts via macro or aggregate transmission channels and does not have first order distributional effects. This is not to say that monetary policy has no distributional effects at all. On the contrary, we all know that increasing or decreasing policy rates affects creditors and debtors in opposite directions, but the dominant view is – or perhaps I should say was – that these effects are secondary and are not crucial for monetary policy’s transmission, which acts mainly via aggregate channels.

And, yes, views on this can change over time. In the last few years, we have seen that independent central banks have come under increased scrutiny worldwide, and that some of their actions are increasingly debated, if not openly criticised. That has, of course, to do with the immense amount of - often extraordinary - measures that central banks had to take during the crisis. That feeds the idea that central banks have too much discretion – in other words are too independent – as often the link between the actions and the final objective has become less clear. Moreover, the distributional implications of some of the non-standard measures did get a lot of attention, be it for their direct effects on the distribution of private wealth or for the possible fiscal implications of the increased risk on central banks' balance sheets. In sum, central bank independence proved to be a valuable asset during the crisis, and at the same time it became clear this asset is delicate and fragile. Therefore, central banks are well advised to exert their independence with caution.

What does all this mean for the macroprudential governance framework? Well, there are similarities, but also differences.

For a start, macroprudential policy also faces a sort of time inconsistency problem, in very much the same way as monetary policy. Indeed, the benefits of macroprudential actions are not very visible and often materialise only in the longer term, while such actions tend to entail immediate costs which are easier to observe and often are politically sensitive. This can lead to a so-called inaction bias. Granting macroprudential power to operationally independent authorities in the context of a clearly stipulated macroprudential mandate would be very instrumental in curbing the inaction bias. That is indeed what the ESRB recommends to EU member states: to have operationally independent macroprudential authorities. Up to this point, there is a of lot similarity with the monetary policy case.

However, things get more complex when we focus on some of the other underpinnings of independence. The first one is the accountability issue. No doubt, the macroprudential authority also has to explain and justify its actions. And just as in the case of monetary policy, it has an interest in doing so which goes beyond the mere accountability issue. By explaining its actions, it informs agents about the reaction function of the macroprudential authority, and they will adapt their behaviour accordingly. In other words, an expectation channel is activated and that will enhance the effectiveness of macroprudential policy. And indeed, we see that macroprudential authorities make great efforts to explain their actions. Yet, there are two significant differences compared with the monetary policy case. The first is that, while in the monetary policy domain more transparency, in principle, unambiguously adds to policy effectiveness, this is not always the case in the financial stability domain. Being fully transparent on the health – or weakness – of financial intermediaries, for instance, may indeed prove counterproductive. Second, the financial stability objective of macroprudential policy is quite vague as it is difficult to define it neatly, let alone quantify it in a verifiable manner. Linking macroprudential policy actions with the final objective therefore becomes more complex. Structuring communication around intermediate targets – such as credit growth or credit gaps – for which we know from research that they have leading indicator properties for financial crises can mitigate this problem considerably, but cannot solve it completely.

Finally, the distributional dimension is more pronounced in the case of macroprudential policy. This brings us to what I would like to call a macroprudential policy paradox. As I said before, in the pursuit of financial stability we have a preference for macroprudential policy over monetary policy because of its more granular and targeted nature. But precisely this targeted aspect increases the distributional dimension, and as the short-term costs of a macroprudential measure are more concentrated, they also become easier to identify. As a result, the inaction bias tends to become more of an issue, while delegation to an independent authority – the logical solution to combat the inaction bias - tends to lose legitimacy. However, when confronted with this paradox, let's not forget that the distributional dimension does not only apply to macroprudential actions. Inaction also has its distributional implications. Indeed, the repercussions of instances of financial instability are not equally distributed either, and the weaker groups in society often tend to suffer more. We have seen that too, in the crisis. In this context, the debate has often focused on household credit for house purchase. A macroprudential tightening in this market tends to have a more pronounced impact for less wealthy households and is more detrimental to their access to home ownership. That is often felt as unfair and contrary to policies which promote home ownership as part of social policy. While inclusiveness - and access to housing is certainly an important element of it – is essential for our societies and our economies to thrive, we have also learned from the US experience that allowing households to become excessively indebted eventually does more harm than good for social cohesion. Tolerance for excessive indebtedness is no substitute for genuine social policies.

Before concluding, I would like to briefly discuss the possible alternatives in case the inaction bias proves to be a hard constraint, which I don't think it will. One possibility is that the ECB uses its macroprudential powers, as it can indeed top up certain national measures. While it is appropriate to have this option as a backstop, it is far preferable that national macroprudential authorities themselves succeed in implementing the appropriate macroprudential measures in their jurisdiction. Having to have recourse to ECB decisions not only reduces ownership, but also shifts the independence/accountability debate to a higher level, not least because it would force the ECB to take country-specific measures. Finally, in a worst-case scenario – but one which in my view is highly unlikely - where macroprudential policy fails to act as the first line of defence, monetary policy will have to bear a larger share of the financial stability responsibility. But that would clearly be less efficient, lead to more policy trade-offs, and seriously complicate the independence-accountability nexus in the monetary policy domain.

These are certainly important but complex matters, and a delicate balance has to be found between forces which push in different directions. It is definitely too soon to come to a final verdict on this issue of the optimal macroprudential governance framework, as here too we are still in the process of learning by doing. However, as I said earlier, I am confident that the learning will eventually improve the doing.

I thank you for your attention and wish you all a very pleasant stay at this highly relevant conference.