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What to Expect from Macroprudential Policies?

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The recent financial crisis stressed the prominent role of macro-prudential policies. This increased the importance of clarifying the actual scope for such policies, their link with the monetary policy and the possible useful tools. **Nicolas Véron**, Senior Fellow at Bruegel and Visiting Fellow at the Peterson Institute for International Economics, moderated the discussion.

William White, Chairman of the OECD Economic Development and Review Committe, opened the event. He highlighted the importance of avoid the distinction between macro-prudential/financial stability policies and monetary/price stability policies since both have impacts on credit, lending and spending patterns. Thus, financial stability has to be extended to include price stability. Indeed, the several linkages between the real and the financial sectors bring to a complex system characterized by a macro problem and the division between financial and monetary sphere has consequences in terms of cohesion in the overall policy.

First of all, a good identification of the problem is crucial for a good identification of the solution. In the context of the current financial crisis, the problem rose from the excessive credit growth. The problem does not rely on financial innovation; rather it is a monetary problem (in particular, the fiat monetary system) and this is confirmed by lessons from both economic history and the history of economic thoughts. This time the crisis started in the financial sector with the subprime bubble and it was the trigger of the mechanism. Half of the past crisis started in the real side, moving toward the financial side of the economy. What is crucial is that these crises were totally disconnected from the presence of inflation. It is the reason why it is wrong for ECB to focus only on price stability in a context that needs financial stability.

The research for the solution of the financial crisis opens up on "Lean (leaning against the upswing of the credit cycles) vs. Clean (cleaning up the afterwards the disaster)" debate: both the approaches must be used. Indeed, monetary as well as macro prudential instruments present shortcomings so the use of both instruments in a coordinated way is needed. The main implication is that there are several policies that are simultaneously required: monetary policies, banking regulations, banking supervisions, insurance supervisions and so on. Thus, the criteria for the choice of institutional framework rely on the imperatives "should, could, would": such new institution should see the need to act, should embody the power to act and should be willing to act. These criteria put central banks at the core.

The issue of making the framework operational raises some problems. As concerns the "should" problem, the basic framework of inflation targeting seems to be not enough. There are the needs of introducing a new analytical framework, of identifying where the risks come from, stressing the macro-imbalanced approach, of defining which instruments are available and of calibrating the available instruments.

The "could" problem is linked with the central banks' mandates. Indeed, the mandate of price stability is not enough. However, changing the mandate is difficult because of popular reluctance. Thus, the mandate must be extended to include a broader definition of price stability or stability over a longer horizon. In addition, macro-prudential power is up to different agencies and this carries out the related problem of ensuring the conformance of such powers.

The "would" problem is the most important point. There are several impediments in realty and the uncertainness comes from the "should" problem. In order to deal with it, tools such as transparency, accountability and clear mandate are needed and the definition of an explicit rule governing right decisions is crucial.

If at national levels something must be done even if it is not easy because of "could, should, would" problems, this issue appears to be even more complicated in an international dimension in which each national policy has externalities because of financial integration, with micro/macro implications. In conclusion, in current

situation crisis management and the definition of its tools have the priority; however, the issue of crisis prevention is taking more and more space in the policy debate.

After William White's presentation, **Carmelo Salleo**, Policy Adviser, European Systemic Risk Board, took the floor. He stressed that macroeconomic policies are based on the concept of general equilibrium that comes from a microeconomic vocabulary. There are two ways to look at the financial industry: from a partial equilibrium perspective, finance is seen as a single sector of the economy while, in terms of general equilibrium, its links with other sectors are taken into consideration. These two approaches have different consequences in terms of policy view. In particular, the PE view embodies the industrial policy debate about comparative/competitive advantage, the presence of national champions and the questionable "level playing field". The GE perspective allows seeing finance as an interconnected sector and requires a global view of the industry. This is aimed to identify positive externalities carried out by the financial industry and the part of the sector from which they arises; negative externalities and possible ways to eliminate them; market failures, their sources and of public intervention vs. other forms of private sector involvement. In particular, as concern market failures, it must be stressed that the main failure of the market is the human psychology, which takes different forms: time inconsistency due to misperception of short vs. long run; underestimation of risks because of no perception of rare events; Hubris rule. These arises the need to put incentives to generate pro-cyclicality, to take on excessive risk and to grow beyond manageable proportions. Thus, a macro-prudential approach to this situation could be answer to questions such as which part of the financial industry generate positive externalities and how to protect it; how to avoid negative externalities, if any, that spill over to the rest of the economy; how to address market failures, the role of governance and incentives and the balance between regulation and self-regulation.
The recent experience has shown two different behaviours in the US vs. Euro area: while the FED went beyond the scope of its mandate, the ECB intervened within the limits of it. The policy consequence is that Euro area banks cannot be regulated like American ones. European banks need to be more solid because they cannot be bailed out in one week (as it happened for the American ones) and they should have more capital in a regular basis. This carries out the need of a different business model for European banks that allows them to do business with higher capital requirements.
As concerns the limits of the macro-prudential policies, it must be stressed that the fundamental imbalance is of people's tendency of consuming more of what they produce and of financing this deficit with credit. This is the source of above mentioned credit growth.
Moreover, coordination of macroeconomic, fiscal, monetary policies is crucial. Macro-prudential policies need to have national dimensions because financial institutions are anchored in national realities. However, integrations of financial markets seem incompatible with the defence of national champions. The conclusion is that there is a dilemma dis-integration of markets or di-integration of national champions.
In this context, the ESRB is building a reputational framework in which central banks and supervisions can open to the dialogue. Once the reputation is established, ESRB will require effective power, in terms of effective implementation of its recommendations and of access to all the required data, in order to become a real European macro-prudential authority.

After the presentations, a discussion took place. First, about the systems risk, the speakers stressed the importance of understanding that the several and interconnected interactions characterizing the economies increase the real complexity and move away real world from the hypothetic normal distribution. Second, the need of having more data about the financial industry is impellent in a framework of new different approaches for economic financial analysis. Third, the subprime crisis turned out to be credit problem rather than a liquidity problem. This provides evidence that the ECB mandate is not the best way to conducting monetary

policy. Indeed, price stability is a recent phenomenon and central banks should set up financial stability aims and take them as primary objectives. Last, the discussion raised the issue of creating a new institution that must be powerful, independent and accountable. This must be a unitary institution and not simply a committee; in addition, power could be set by providing a money budget, with the chain effect of inducing its independence and its accountability in the long run. In conclusion, the shortcomings at international level lead to the conclusion that a global regulation cannot be further delayed.