John Lipsky*

MACROPRUDENTIAL POLICY: WHAT IT IS AND HOW TO DO IT

Financial stability lies at the heart of the current global economic issues. This is a lesson we learned painfully in 2008, and we can see it playing out again today in Europe. In this complex interconnected world, it no longer makes sense to draw a clear defining line between the macroeconomy and the financial sector. One aspect of bolstering financial stability is especially worth taking a closer look at: the challenge of designing and implementing macroprudential policies.

What are the biggest intellectual challenges facing the IMF? Where is the most pressing need to conduct new research? The answer is immediate. Given the lessons of the last few years of crisis, the world needs a much clearer understanding of what are called 'macrofinancial linkages'. That is, how does the macroeconomy affect financial markets, and how do financial markets affect the macroeconomy? There is also a need to better understand how macroprudential policies work.

In this area, the IMF is already taking a leadership role. Olivier Blanchard, the Fund's Economic Cousellor, and the Director of our Research Department, together with his colleague Stijn Claessens, are working on analyzing and modeling macro-financial linkages.

Jose Viñals, the head of our Monetary and Capital Markets Department (MCM) and the principal representative at the Financial Stability Board, and his MCM colleagues have published a series of relevant documents on the topic of macroprudential policies on the website, www.imf.org. In April, a paper entitled,

---

* John Lipsky is the Special Advisor to the Managing Director, International Monetary Fund.

"Macroprudential Policy: An Organizing Framework", was published, followed by three companion papers: "Towards Effective Macroprudential Policy Frameworks – An Assessment of Stylized Institutional Models", "Macroprudential Policy Tools and Frameworks. Progress Report to G20", and finally "Macroprudential Policy: What Instruments and How to Use them? Lessons from Country Experiences" in August. In addition to these four papers, the September 2011 Global Financial Stability Report contains a chapter on macroprudential policy issues.

What is macroprudential policy? The goal of macroprudential policy is to limit the systemic risk. Macroprudential analysis looks at the intersection of the real economy and the financial sector, providing a birds-eye view of the entire system instead of focusing on individual instruments or individual institutions. Looking to the safety and soundness of individual institutions is important, but we must not miss the big picture–how everything comes together to affect the stability and resilience of the financial system in its totality.

The instruments of macroprudential policy are prudential and thus familiar in broad terms. But macroprudential analysis and policies are especially complex because they must deal explicitly with expected interactions between macroprudential policies on one hand, and monetary and fiscal policies on the other. Of course, this interaction makes it much harder to gauge the expected impact of macroprudential policy measures on the macroeconomy. It is obvious that these linkages have been understood imperfectly, which is one reason why the virulence of the 2007–2009 financial crisis was surprising.

What are the key elements of the Fund's work on macroprudential policies?

- ❖ Identifying and monitoring systemic financial risk, something that was not done well enough prior to the crisis;
- ❖ Specifying and calibrating the potential instruments of macroeconomic policy;
- ❖ Creating the instruments and governance arrangements that will be needed to guide macroeconomic policy.

First, identifying and monitoring systemic risks. In the account of senior Obama administration officials' discussions on how to deal with the unfolding crisis in the U.S. financial system during 2009, one can observe a striking thing: the role played by data gaps when policy makers were considering alternative actions. In many cases, data about exposures and interlinkages simply were not known, and policymakers ended up fumbling in the dark.

Obviously, having the right data is an essential starting point for understanding many systemic issues. These include aggregated indicators of imbalances in the macroeconomy, but also indicators from the balance sheets of various sectors, including data on leverage, the credit-to-GDP ratio, credit growth, and other potentially useful advance indicators of systemic imbalances. We also need to look at measures of market conditions such as spreads, measures of risk appetite,

and measures of market liquidity. A further element would be metrics of risk concentrations.

There is a need to think in terms of network models and the kind of analysis that underpins the designation of the G-SIFIs to understand the potential impact of risk concentrations. Equally essential is to move to macro-level stress testing, adding considerations of market dynamics and macro-financial feedbacks, as well as to pay attention to experience and to integrate the monitoring systems. That means it is necessary to think about how to take country-specific or contract-specific factors into account in assessing the implications of macro indicators for systemic stability and to incorporate the shadow banking system and the risks around it, a matter currently being addressed by the Financial Stability Board.

Doing all of this successfully means addressing data gaps. This includes such aspects as being able to analyze maturity and liquidity mismatches, being able to monitor and understand risk exposures, and being able to track CDS and OTC derivative markets. If these markets are not understood, there is no understanding of systemic stability issues.

Turning to the instruments of macroprudential policy, it is important to remember that the relevant instruments are not traditional economic policy tools, but prudential ones. These include instruments to limit excessive credit growth, such as time-varying capital requirements, dynamic provisioning, credit growth limits, reserve requirements, loan-to-value ratios, and deposit-to-income ratios. Instruments to deal with the amplification of systemic risk include limitations on maturity mismatches, limitations on foreign exchange lending and limitations on non-core funding.

Anticipating and dealing with the potential impact of failure lies at the very heart of the supervisor's mandate. This is consistent with the goals of the capital surcharges that are proposed for G-SIFIs. In addition, the IMF carried out a study for the June 2010 G20 Toronto Summit that examined alternative ways in which G20 countries' financial systems could bear the cost of their own resolution, rather than burdening the public purse. A broad systemic risk charge for this purpose was proposed. There were also proposals for a financial transaction tax (FTT). Typically, these proposals call for earmarking FTT receipts for specific, yet obviously mutually exclusive, purposes. In the report, it was noted that an FTT, while implementable, has some inherent technical weaknesses. These include possibly regressive incidence, which means that the burden of the tax ultimately may be borne by ordinary financial sector clients, the creation of unhelpful distortions, as activity is restructured in order to minimize the added tax burden, and relatively high administrative costs.

If authorities wish to levy a tax uniquely on the financial sector, the Fund study suggested a Financial Activities Tax (or FAT), which effectively compensates for the general exemption of the financial system from the value added taxation. At the same time, it is important that any effort to increase the financial system's

tax burden should be carefully integrated with the other financial reforms now under way. If not, there is a risk that there could be an outsized, and unwanted, withdrawal of credit at a time when the economy needs financial support to sustain growth.

The third issue to keep in mind in this context is the instrumentation of macroprudential policies. Experience suggests that such policies have been used in various combinations, in some cases by different authorities within the same country. The use of multiple instruments means effective communication between the relevant authorities is especially important. For example, credit limits have tended to be very specific, such as controls over mortgage lending. Moreover, this type of instrument has been applied in a judgmental, rather than rules-based, fashion. These aspects underscore the need for a clear overview regarding the design and implementation of these policies.

With the rising importance of macroprudential policies, policy coordination will become more important. For example, the Basel III agreement will institutionalize such policies on a broad scale. The agreement calls for the application of a maximum leverage ratio, the creation of a capital conservation buffer, and a countercyclical capital buffer. At the national level, new controls on SIFIs also imply that coordination between various regulatory and supervisory authorities will increase. That is also true globally, as indicated by the creation of a peer review council for G-SIFIs. In addition, securities market infrastructure is being developed to enhance systemic stability, such as the creation of central counterparties and other measures under consideration in IOSCO, but they will require successful communication and coordination to be successful.

Finally, there is the case of the governance of macroprudential policies. The relevant issues are varied and broad, including the mandate of the macroprudential authority, its powers, its available instruments, the form of its accountability, its transparency, the composition of decision-making, and its coordination with other authorities–including international coordination.

In this regard, two documents, incredibly revealing about the causes and results of the 2008 crisis, are worth mentioning. These are the Senior Supervisors Group October 2009 report entitled “Risk Management Lesson from Global Banking Crisis” and the follow-up report published in December, 2010. These reports examined the risk management processes in presumptive G-SIFIs. The conclusions were quite disturbing. They concluded that many major financial institutions did not have adequate processes in place to manage their risks.

There are at least two reasons why this conclusion is tremendously disturbing. First, it raises questions about corporate governance. Where were the boards of directors when they should have been evaluating senior management? Where were senior managers when they should have been evaluating their risk officers and

their practices? How could market discipline have failed so comprehensively, so that leading financial institutions were running risks they did not understand and could not manage? How can it be avoided in the future? The second question relates to the supervisors – if they could see the shortcomings after the fact, why could not they see them beforehand?

There is no simple answer to either of these questions. The answer cannot be just a better regulation, but has to involve also strengthened supervision, credible resolution mechanisms, and independent assessment of the application and effectiveness of regulations and supervision. The IMF papers mentioned earlier contain some preliminary conclusions regarding the application of macroprudential policies that has emerged from the experience to date:

- First, for macroprudential structures to be effective, central banks need to play a key role.
- Second, institutional fragmentation of the responsibility for macroprudential policies must be avoided. The more fragmented the authority, the more onerous the burden of coordination.
- Third, treasury participation is useful, but treasuries should not take the leading role, because of potential conflicts of interest.
- Fourth, systemic risk prevention and crisis management are different functions and should be supported by separate and different arrangements.
- Fifth, at least one institution must have access to all data. Someone must put it all together. It does not work if everybody has some of the data and nobody has all of the data.
- Sixth, the institutional mechanisms need to support action and not just understanding. In other words, the relevant question is not “What did you know, and when did you know it?”, but “When you knew it, what did you do about it?”
- Seventh, macroprudential authorities should be identified and should be accountable.
- Finally, macroprudential actions should not compromise the authority of other agencies and prevent their policies from being effective.

In conclusion, these are the challenges in creating effective macroprudential policies. The issues discussed above will be out there for some time to come, and they will be subject to intense debate. Nonetheless, real progress in enhancing systemic stability must be made. Success will require new thinking, new analysis, new organizations, and a comprehensive approach.