Session 2:

NEW MACROPRUDENTIAL AND MICROPRUDENTIAL SAFETY NETS

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THE NEED FOR MACROPRUDENTIAL SUPERVISION

1. INTRODUCTION

The need for macroprudential supervision is being currently discussed in many countries. However, macroeconomic (or macroprudential) supervision, sometimes called systemic supervision, has not been a hot topic recently in Poland. Most probably because the awareness of the crisis in this country is generally very low, simply because there was no bank crisis but mere asset freeze. The extended access to repo operations and a fistful of foreign exchange swaps were enough to satisfy the demand for additional liquidity in Polish banks.

However, those experiences were not typical. In general, the global banking crisis accentuated the importance of financial stability role of central banks that started to be apparent as early as in the late nineties. Central banks limited their activity in this field mostly to preparing Financial Stability Reports and some moral suasion. The current crisis has proved that this approach was insufficient. What became apparent during the crisis was that inefficiencies of the financial sector may have really grave and real effects. The crisis also illustrated – what is equally important and not frequently realized – that large imbalances and vulnerabilities may develop in the real economy even if the financial sector looks stable and is relatively stable as was the case for example in Spain. Thus, now the need to extend the framework of macroprudential policy is obvious.

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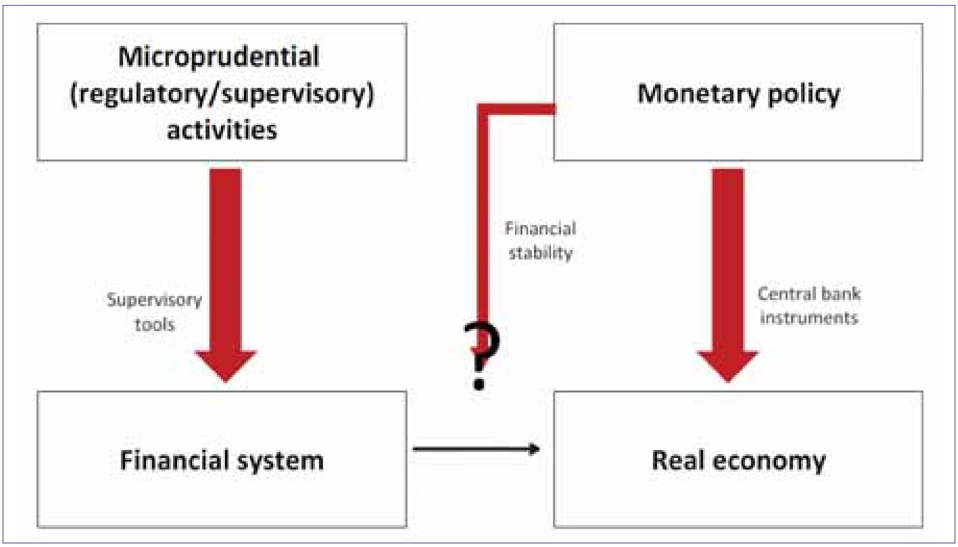
2. OUTLINE OF TWO MODELS

Before the crisis, monetary policy and banking supervision were effectively separated. Central banks were responsible for price stability. Supervisory authorities were responsible for the solvency of individual, especially systemically important, banks. Macroprudential policy was regarded as potentially important but with no dedicated tools (with the exception of moral suasion) it was toothless. Now this has changed in the sense that central banks treat the financial stability mandate much more seriously and macroprudential policy is treated as a legitimate, second target of the central banks. However, if central banks are responsible for macroprudential policy, they should be equipped with proper and effective tools.

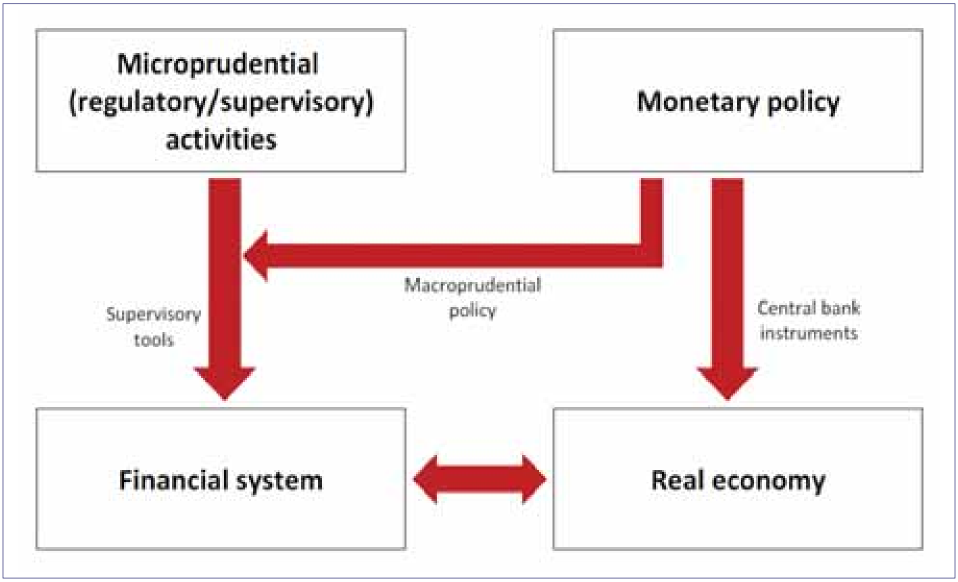
Chart 1. Microprudential supervision and monetary policy segmented model



Source: Author's slide no 3 of the presentation at the Conference session.

One of the crucial issues is having a clear understanding of what are the tasks of macroprudential policy. How should the financial stability and the tasks of the macroprudential policy be defined? In the literature there are quite many definitions of financial stability. They stress a number of factors. Firstly, the financial system is providing efficiently financial intermediation and risk management services to the non-financial sector. This is the main issue. The second is the low probability of a systemic crisis, however the word "systemic" usually refers to the financial system. Financial stability is also defined as a situation where financial institutions have high enough capital to absorb their potential losses.

Chart 2. Microprudential supervision and monetary policy correlated model



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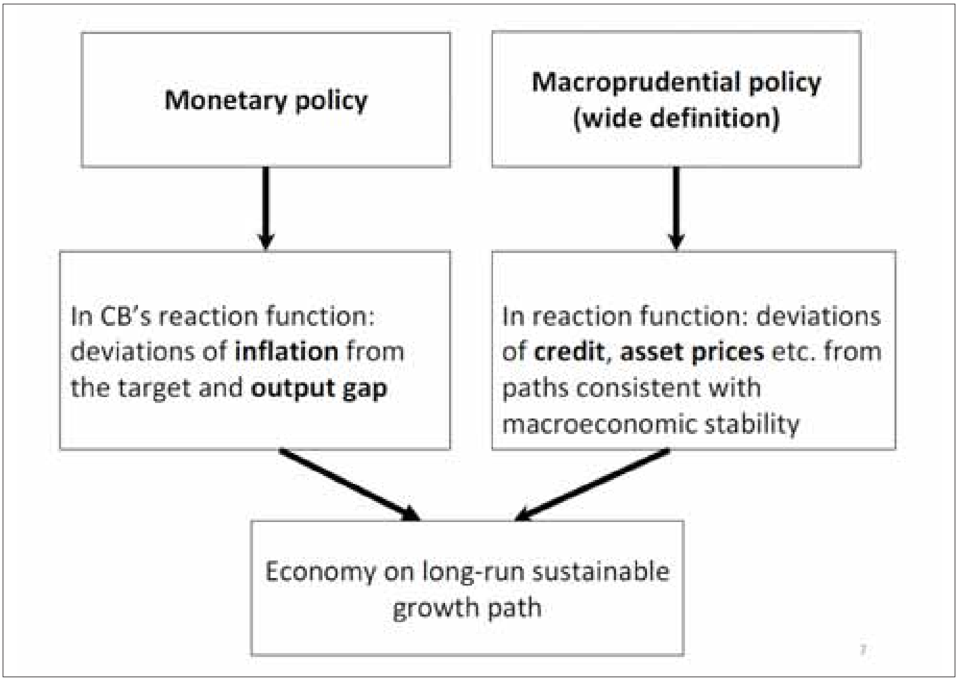
3. THE ROLE AND THE MAIN OBJECTIVE OF FINANCIAL STABILITY POLICIES

What is the role of financial stability? What is the main objective of financial stability policies? Let us assume that such objective is to prepare the financial system for low probability but high impact events. Such an approach is still dominating in the literature, but it is a narrow definition of macroprudential policy tasks. There is definitely a need for a wider definition of macroprudential policy task. As was highlighted by Charles Goodhart and Olivier Blanchard, macroprudential policy should be an additional weapon of a central bank for stabilizing the economy. Thus the task for macroeconomic policy should be stabilizing the output gap, i.e. fluctuation of GDP around the potential output. In this broader definition, macroprudential policy would be more effective also in stabilizing the financial sector, because implementation of such approach would lead to a more active and forward looking use of macroprudential instruments.

The monetary policy can be described as a central bank reaction function, which includes deviations of inflation from the target and changes in the output gap. This is the operational objective of the central bank. In the macroprudential policy realm the reaction function includes also deviations of credit, asset prices

Chart 3. Functions of monetary policy and macroprudential policy in sustainable growth:



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and other relevant variables from paths consistent with macroeconomic stability. Together, the monetary policy and the macroprudential policy should make the economy remain on the long-run sustainable growth path.

Why should this wider definition of macroprudential policy tasks be used? Are the current central bank instruments not efficient enough? The recent crisis illustrated that they are not. The reasons are the growing role of the financial sector, lower sensitivity to monetary policy instruments in boom times, and also some special cases like with countries being in the ERM II. Such countries may have a problem how to reconcile the low inflation with keeping exchange rates within a certain band. Additional challenge for policy makers is how to react to asset price booms that do not result in apparent financial system instability.

Let us imagine the cases when macroprudential policy action would be a necessary (or at least beneficial) macroeconomic tool even if there was no outright threat to the financial stability. Spain is a useful example. In the core of the financial sector – the banking sector — macropolicies have preserved the basic stability of the Spanish financial sector. Of course, it is the special case of

Spanish 'caixas'. What is important is that the core banks in Spain are healthy and strong. The microprudential instruments used for macroprudential purposes were effective in preserving the strength of the Spanish banking sector. However, from the macroeconomic point of view, it proved to be insufficient. Spain got into a severe economic crisis resulting from the long-term unsustainable lending boom, followed by a bust. This is a striking example that the narrower definition of macroprudential policy task is not sufficient.

Focus the attention on Poland, what are the lessons from the unfortunate Spanish experiences for this country? The fact that Spain and Poland are very similar in a sense that both were, or are at a certain stage of their development "a catching-up" country cannot be escaped from. Spain probably cannot be called "a catching-up" country anymore. Poland certainly can. It is going through the similar road of economic development as Spain went through in the 1980s and the 1990s.

4. THE NEED FOR MACROECONOMIC PERSPECTIVE IN MACOPRUDENTIAL POLICY

The next important issue is why the macroeconomic perspective is needed in the macroprudential policy. The narrow understanding of the macroprudential policy stresses vulnerabilities (risk exposures) and the loss absorption capacity of the financial sector. However, there might be unintended macroeconomic consequences of actions targeted at reducing risk exposures. We can reduce risks within the financial sector, but those risks will reappear somewhere else. They will reappear in the real sector. Here are two rough examples.

Let us first consider an example of a catching-up economy: one of the possibilities is that such an economy suffers from a shortage of savings. This is a textbook case. It is not necessarily the case all over the global economy, but certainly it is typical for Central Europe. The shortage of domestic savings is supplemented with foreign capital inflows. Therefore, the banks, especially if the general situation is conducive to it, resort to foreign financing. They bring in foreign currency capital and they lend it out. This phenomenon is often described and explained using demand-side view, namely that borrowers, households and corporates, especially the smaller companies, are tempted to borrow in foreign currencies because of the interest rate differential. That is true, but let us look at this from the other point of view: that the banks have a market for loans. They want to expand those markets. Thus, they bring in foreign capital and they lend it out. From the risk management perspective, as far as market risk factors are concerned, the easiest option for a bank is to lend in foreign currencies. The result is pushing over the risk to unhedged borrowers. This way the banks avoid the risk accumulation and the currency mismatch within the bank at the cost of the real sector (credit risk is not considered here, but the recent experience shows that banks tend to put less emphasis on credit risk management during boom periods). Which comes first: is the supply side or the demand side more important? Clearly, if one wants to avoid risk within the financial institution, one has to unload those risks into the real sector.

The next example is related to the maturity transformation. Again, a look at that matter from the perspective of a situation where a financial institution is necessary. Long-term mortgages are lent, so they need to be balanced out with long-term liabilities. But in the balance sheet there are short-term deposits of the non-financial sector. This is more a potential than what is really happening, a tendency of the banks, especially as a consequence of the crisis, to try to go away with the maturity mismatch and resort to some longer term liabilities. Where to find them? For instance in the investment funds which would provide such long-term instruments. However, then the banks would not be interested in taking short-term deposits anymore. They would make short-term deposits less attractive and push the depositors to invest in other instruments, more risky, like mutual funds. Again, the result would be a sub-optimal structure of assets on the part of non-financial sector agents. If the maturity mismatch is to be eliminated within financial institutions, something needs to be done to unload this kind of risk to someone else. And this “someone else” is the real sector. Therefore, thinking of macroprudential supervision only in terms of financial sector instability, may be too narrow a meaning. It may be insufficient to notice imbalances developing beyond the financial sector, in the real sector, even if they originate in the financial sector.

5. CONCLUSION

The summary is basically a plea to understand the macroprudential stability function, macroprudential supervision in its broader sense. It makes sense to consider macroprudential supervision in terms of stabilizing the output gap, identifying and stabilizing macroimbalances that may develop not only within the financial sector but also outside of it.