

Macroprudential policy during monetary tightening

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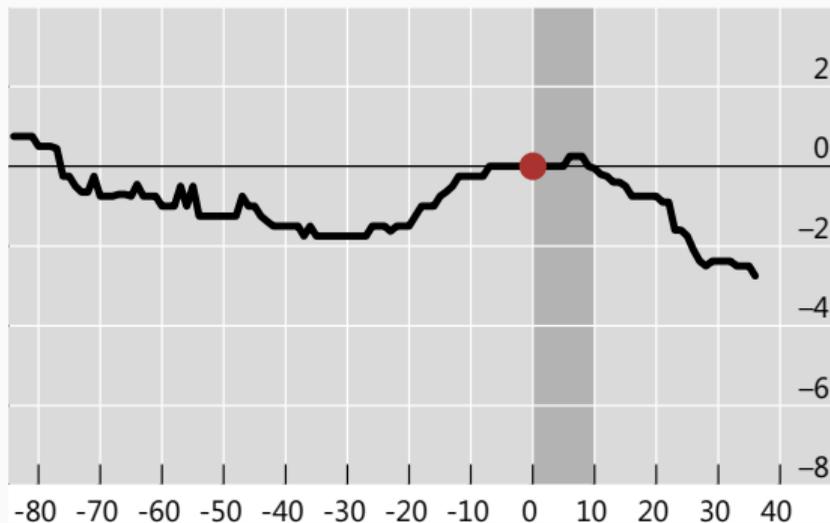
Presentation at the ECB workshop on macroprudential policies
Frankfurt-am-main, 16 October 2023

Motivation (1/2): Monetary policy as a cause of financial stress

“Swings in market sentiment, financial innovation, and regulatory failure are acknowledged sources of instability, but what about monetary policy? Can monetary policy create or amplify risks to the financial system? ...These questions are among the most difficult that central bankers face.”

— Ben Bernanke (2022), *21st Century Monetary Policy: The Federal Reserve from the Great Inflation to COVID-19*, page 367

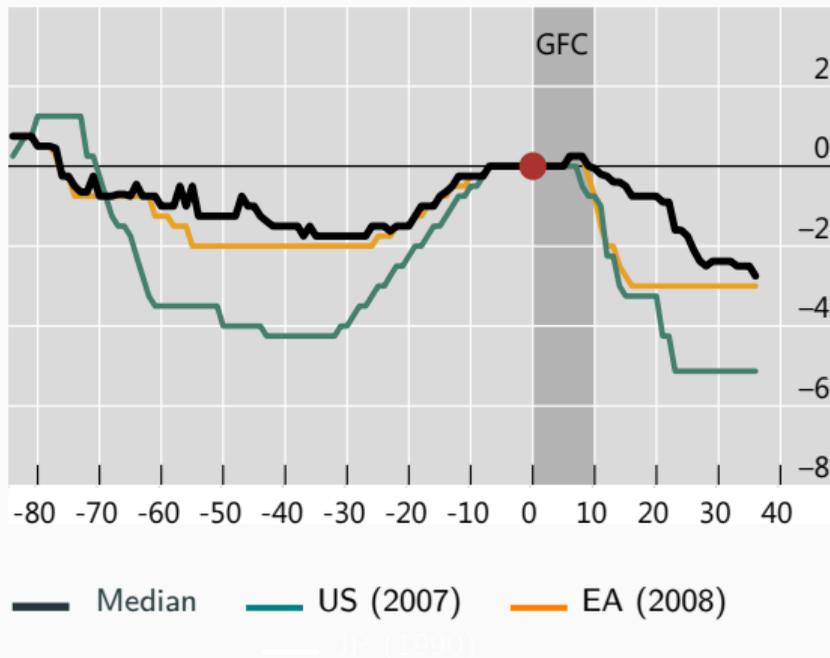
Motivation (2/2): “U-shaped” monetary tightening and financial stability



- “U-shaped” monetary policy rate dynamics – Jimenez et al (2023)
- Financial crises tend to be preceded by a rapid monetary tightening after low-for-long

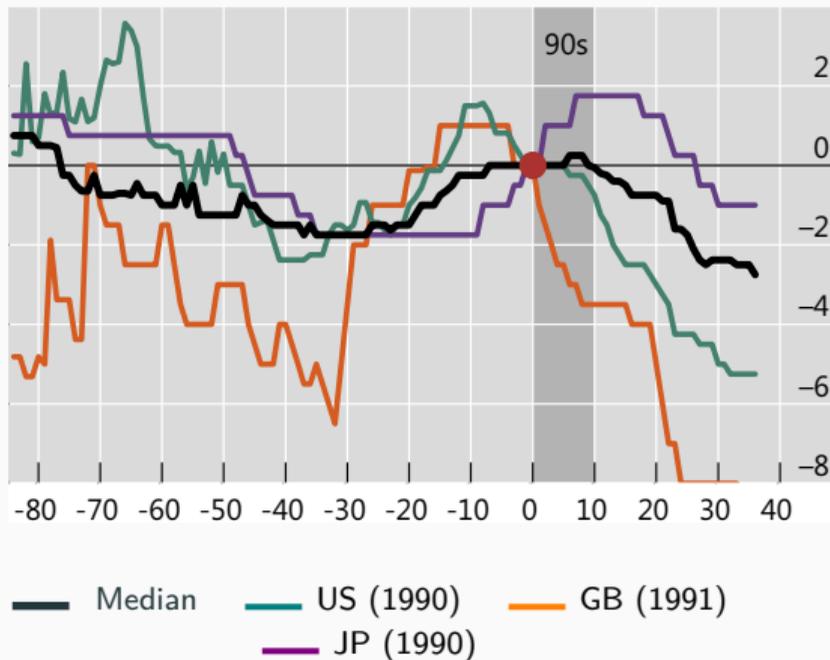
— Median — US (2007) — EA (2009)
— JP (1990)

Motivation (2/2): “U-shaped” monetary tightening and financial stability



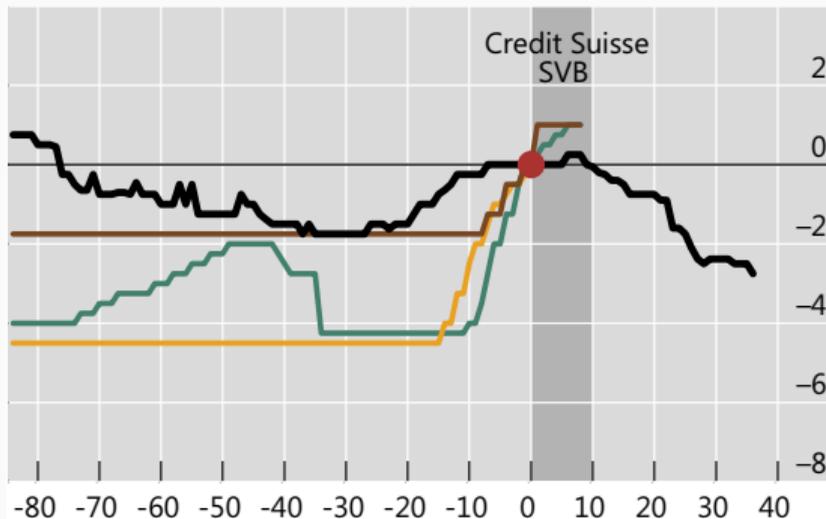
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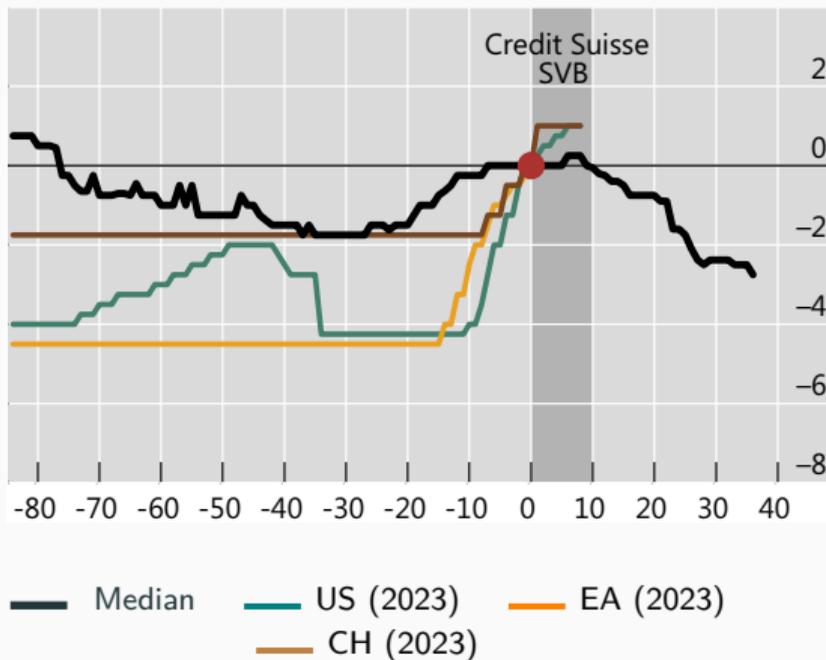
Motivation (2/2): “U-shaped” monetary tightening and financial stability



— Median — US (2023) — EA (2023)
— CH (2023)

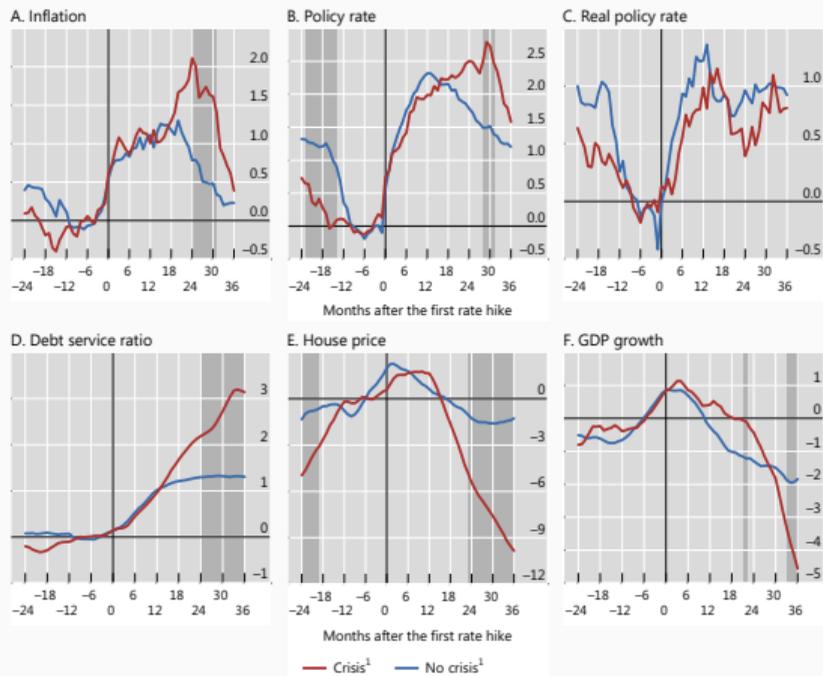
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- Risk to financial stability could constrain central banks’ fight against inflation (“financial dominance”)

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- Risk to financial stability could constrain central banks’ fight against inflation (“financial dominance”)
- Since the early 70s, 25% of monetary tightening episodes have ended with a crisis

Channels at work — An example



- Stronger and more persistent inflation (A) calls for more forceful and prolonged policy rate hikes (B-C)
 - The debt service ratio rises (D), putting pressures on borrowers and depressing property prices (E)
- The larger the initial stock of debt, the stronger the tightening of financial conditions
- These forces weigh on economic activity (F), which further increases risk of financial distress

Can (macro-)prudential policy increase central banks' room for manoeuvre?

- Yes:
 - Tighter (macro-)prudential requirements (e.g. CCyB) help to increase the resilience of the financial system in the face of rate hikes
 - They may allow central banks to hike rates more aggressively if needed to tame inflation
- No:
 - Tighter (macro-)prudential requirements could magnify the effects of the rate hikes and interfere with monetary policy stance
 - Their effects could kick with lags (i.e. too late) and amplify the downturn

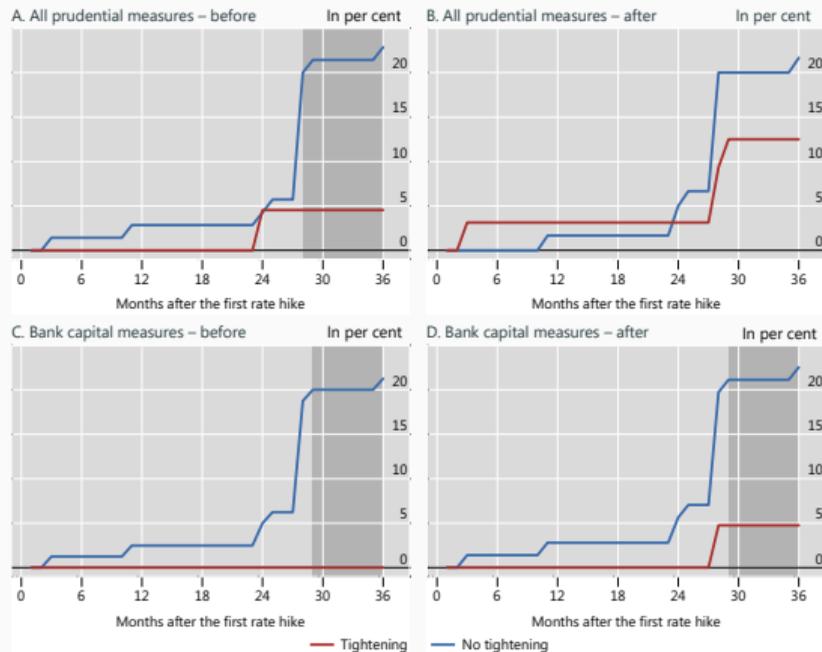
Some elements of answer — Roadmap

1. Past experience suggests that tightening (macro-)prudential policy increases monetary policy headroom
 - Higher capital requirements reduce the probability of a crisis down the road
2. Current experience seems to support such “pro-active” approach
 - Address specific risks early on to limit interference with monetary policy
 - Mix of *targeted* tools
 - Considering the fast pace of the ongoing and global monetary tightening, borrowers and the financial sector have overall been quite resilient so far (bar specific banks in US and CH)

Lessons from past monetary policy tightening episodes

- Boissay, Borio, Leonte, Shim: “*Prudential policy and financial dominance: exploring the link*”, BIS Quarterly Review, March 2023
- Analyse around 92 monetary policy tightening (MPT) episodes and (macro–)prudential policies in 21 AEs and 16 EMEs since 1990
- Test empirically whether (macro–)prudential tightening helps mitigate stress during MPT episodes

(Macro-)prudential tightening policy helps to mitigate financial stress



- Crisis frequency is 15pp lower after a net prudential tightening (iMaPP dummy 0/1)
- Bank capital measures seem effective
- The timing of prudential tightening does not seem to matter (two years before/after the first hike)

(Macro-)prudential tightening policy helps to mitigate financial stress

$$CRISIS_i = \alpha + \beta PRUD_TIGHT_i + \theta Z_i + \epsilon_i$$

- $CRISIS_i$: dummy equal to one if episode i is associated with a banking crisis
- $PRUD_TIGHT_i$: net number of prudential tightening measures in the two years before or after the first rate hike
- Z_i : control variables before the first rate hike: credit-to-GDP, level and change in inflation
- Interactions with initial condition (private credit/GDP, change in inflation)

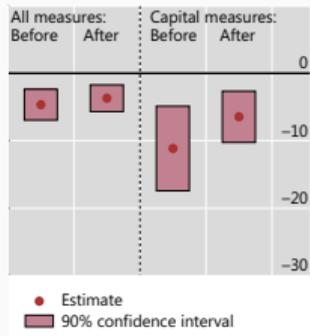
(Macro-)prudential tightening policy helps to mitigate financial stress

Prudential tightening reduces the likelihood of stress during monetary tightening

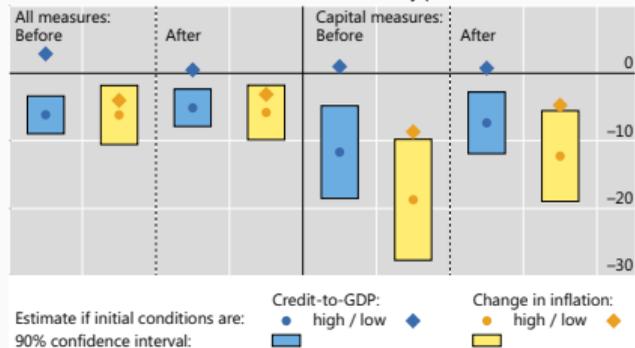
In percentage points

Graph 7

A. Unconditional effect



B. Effect conditional on initial debt and inflationary pressures



Sources: Baron et al (2021); Laeven and Valencia (2020); IMF iMaPP database (released in January 2021); BIS; authors' calculation.

- Prudential tightening helps to reduce the likelihood of distress (A)

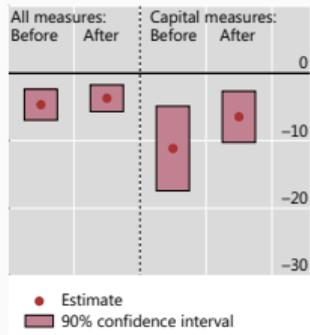
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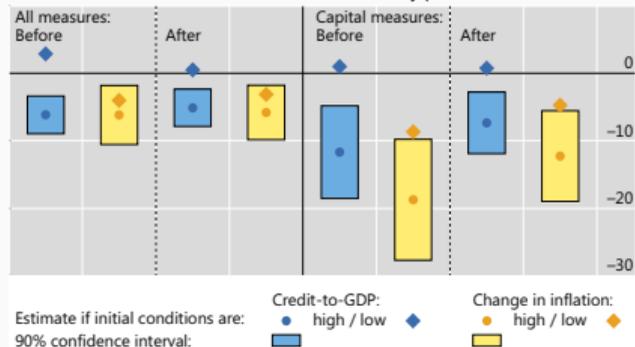
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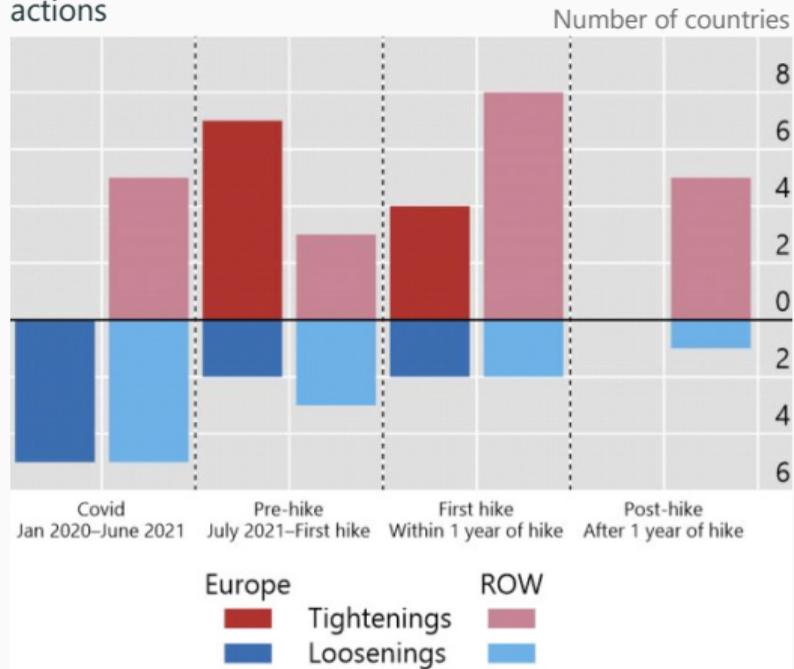
- Prudential tightening helps to reduce the likelihood of distress (A)
- Especially so if the monetary tightening takes place in the context of high debt levels or strong inflationary pressures (B)

(Macro–)prudential policy in the current monetary tightening episode

- Survey 18 central banks about (macro–)prudential policies in their jurisdictions between Jan. 2020 and Jul. 2023
 - AR, AU, BE, CA, CH, DE, FR, GB, HK, IN, IT, KR, MX, NL, SE, SG, TH, US
- We asked details on the policy interventions: tool, motivation, magnitude, implementation strategy
- Overall tightening of the (macro–)prudential stance
- A few principles seem to have guided (the design of) recent interventions

Four main motives for (macro-)prudential tightening

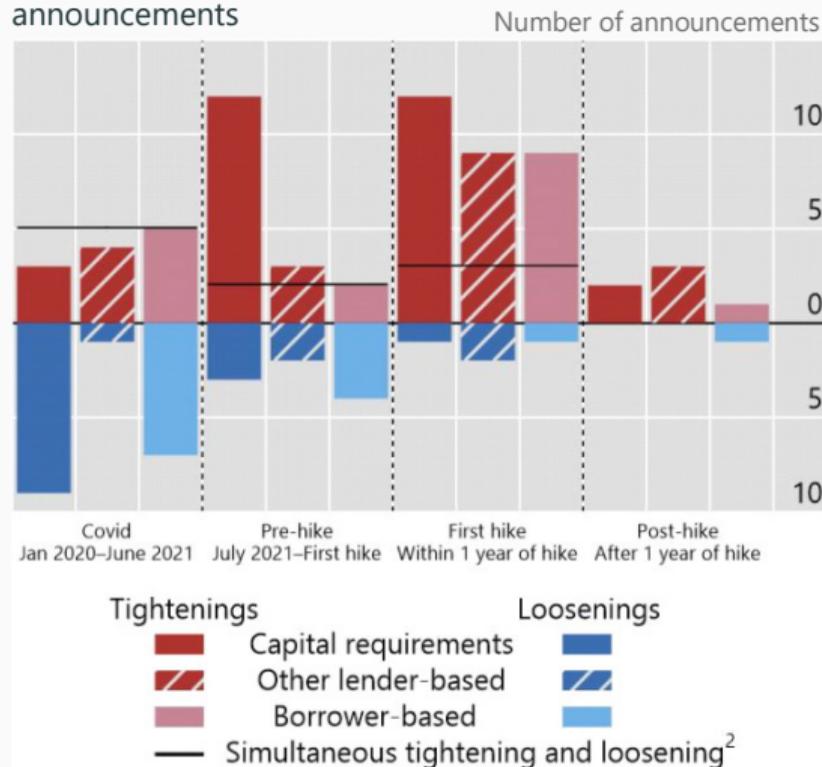
Number of countries that announced macroprudential actions



1. Roll back pandemic-related measures
2. Address imbalances that had built up further during the pandemic (housing markets)
3. Build up capital buffers that can be released in the event of an unexpected shock (e.g. positive cycle-neutral CCyB)
4. **Forestall the emergence of new risks arising from the rapid tightening of monetary policy**
 - Some (macro-)prudential loosening nonetheless

Mix of targeted tightening and loosening measures

Number and type of macroprudential policy announcements

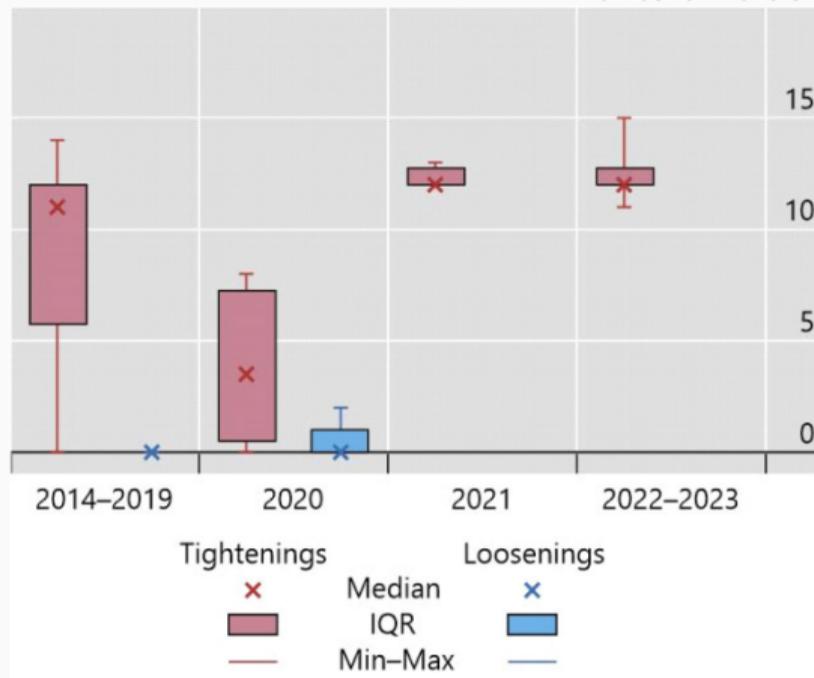


- Two main concerns:
 - Financial stress induced by monetary tightening
 - Binding (macro-)prudential requirements could themselves be a source of unintended stress
- Targeted measures can help address specific vulnerabilities without interfering with monetary policy
- Sometime requires to replace one requirement (loosening) by another (tightening)

Prudent prudential policy

CcyB phase-in period has lengthened

Number of months²



- Lengthen the phase-in period
- Lock in current levels of resilience (e.g. raise regulatory buffers knowing they will not immediately bind)
- Provide some flexibility on case-by-case basis
- Use supervisory guidance rather than “hard” requirements

(Macro-)prudential policy during monetary tightening

- Objective is not to manage aggregate demand
- No (explicit) coordination with monetary policy
- Take the potential effects of monetary tightening on financial stability into consideration
- Avoid pro-cyclical effects and interference with monetary policy
- Complement monetary policy (i.e. provide headroom for more rate hikes) rather than substitute for it (i.e. dispense central banks from hiking)
- Prudent policy: take targeted measures, do not affect overall stance, avoid potential cliff-effects, allow for long phase-in