

Discussion of “Applying an Inflation Targeting Lens to Macroprudential Policy ‘Institutions’”

Charles Bean
London School of Economics

Macroprudential policy has been very much the flavor of the month ever since the 2007–8 global financial crisis, as central banks seek to reconcile their mandate to maintain monetary (price) stability with the objective of maintaining systemic financial stability. Before the crisis, these were seen as largely complementary goals. But, with hindsight, we can see there may be occasions when they are in conflict.

Since Tinbergen, we have known that achieving n objectives requires n (independent) instruments. Monetary policy alone cannot guarantee both monetary and financial stability. We need another instrument, effective at mitigating the risks to financial stability. Macroprudential policy is supposed to provide that additional instrument, leaving monetary policy free to maintain price stability. Unlike monetary policy, however, policymakers have little experience in the application of macroprudential policy tools, and even less in designing an appropriate institutional framework within which to operate them.

In their interesting and novel paper, Güneş Kamber, Özer Karagedikli, and Christie Smith view the issue of institution design through the lens of what they identify as the four key attributes of inflation targeting, namely objective(s), independence, transparency, and accountability.

This certainly provides a useful organizing framework, but the first thing to note is that these attributes themselves derive from what we might think of as just two *meta-objectives*: policy effectiveness and political legitimacy. Not surprisingly, the small—but rapidly growing—economic literature on macroprudential policy focuses on policy effectiveness. It has much less to say about political legitimacy, though I think this is where some of the trickiest issues emerge.

Let me begin, though, by recalling how the authors' four key attributes play a role in achieving price stability. First, expectations of future interest rates, inflation, and output play a central role in determining the level of activity and prices today. And having a clear objective for inflation (and for subsidiary concerns, such as output and employment) together with transparency on how the central bank intends to go about achieving its objective(s) helps to shape those expectations of the future.

The delegation of the instruments of monetary policy to an independent agency is potentially helpful because it can eliminate (or at least mitigate) the time-inconsistency problem and reduce the scope for policy being misdirected for short-term political ends. It is not, however, a *necessary* feature of inflation targeting. For instance, the UK government first adopted an inflation target in 1992 after sterling's ignominious exit from the EU Exchange Rate Mechanism, but the Bank of England was not given full operational responsibility for monetary policy until 1997. Between 1992 and 1997, the Chancellor of the Exchequer still made the decisions on interest rates, but he did so in a regular and open process in which the Bank of England was an equal partner, thus providing a brake on any tendency to misuse policy.

If policy is delegated to the central bank, however, democratic legitimacy necessitates public accountability in return. And effective accountability is enhanced by having a clear objective against which the central bank's performance can be evaluated, as well as transparency over the rationale for its decisions. Trust *can* replace active accountability—for instance, the Bundesbank in the era before monetary union—but it somehow needs to be earned first.

In light of these comments, let me turn to macroprudential policy, starting with the objective. The first thing to be said is that the financial stability objective is intrinsically different from that of price stability. We can easily define an aggregate measure of prices and can observe, more or less continuously, whether price stability according to that measure is achieved, and at what cost to output and employment. In assessing policy, the material issue is then whether the central bank has used its "constrained discretion" effectively and appropriately. To be sure, judgment is necessary, but the room for debate is reasonably well circumscribed.

Maintaining financial stability is completely different, since it hangs on *avoiding* something—financial *instability*, resulting in a significant impairment to the process of financial intermediation—rather than achieving something. And the mere absence of financial instability does not indicate that everything is well. A prime example here is the buildup of risk ahead of the global financial crisis.

Moreover, we presently lack reliable and agreed indicators of the risks to financial stability. Certainly leverage ratios, bank capital ratios, and risk spreads are sensible things to look at. But leverage ratios do not take into account the riskiness of different assets. Bank capital ratios avoid that problem, but at the cost of introducing another problem in the form of risk weights that are open to manipulation. And spreads often provide a misleadingly comforting picture just before a financial crisis breaks, blowing out only in the subsequent bust.

Now it might be tempting to think that, with research, we might be able to develop reliable statistical indicators of the probability of a financial stability event. I think this is fool's gold. The threats to financial stability tend to shift both form and location over time. Risks can be disguised—for instance, by shifting them off balance sheets, as happened in the run-up to 2007–8. And it is easy for people to think that they are smarter than their predecessors and to believe that “this time is different.” All of this means that we should not expect to be able to quantify the likelihood of a financial stability event with precision—the present is just not enough like the past to regard it as a draw from a stable statistical distribution. The problem is more akin to dealing with Knightian uncertainty.

The bottom line from all this is that it is far more difficult to track progress and for people to agree whether actions taken to mitigate financial stability risks were prudent and justified or just a case of tilting at windmills. That in turn makes effective accountability much harder to achieve than in the monetary policy sphere.

That does not mean all is lost. But rather than prioritizing the fine-tuning of the credit cycle, we are better off focusing first on improving systemic resilience: in other words, protecting the banks from the financial cycle. This means ensuring that banks (and other financial institutions) have sufficient loss-absorbing capacity,

together with enough debt that can be bailed in; that resolution regimes are fit for purpose; and that the more essential parts of the financial system are suitably ring-fenced. And indeed such issues have rightly been at the top of the G20/Financial Stability Board/Basel Committee on Banking Supervision (BCBS) agenda in the aftermath of the crisis.

Macroprudential policies to address time-varying risks such as a buildup of credit—protecting the economy from the banks, in other words—then becomes more of a supplementary weapon: it is potentially useful, but we should not expect too much. The authors dangle the carrot that eventually such policies might be set according to some simple state-contingent rule, but I think this is really pretty unlikely. Macroprudential state-contingent rules are certainly feasible—for instance, the BCBS “buffer guide” links the counter-cyclical bank capital buffer to the behavior of the credit-GDP ratio—but are unlikely to have satisfactory operating properties for the reasons already discussed. I think the application of discretion is simply unavoidable in this area.

Let me now turn to the question of whether macroprudential policy is best delegated to an independent agency (which may or may not be the central bank). Even more than with monetary policy, a long time horizon is needed to take financial stability considerations on board. By itself, that provides a strong argument for delegation to a technocratic body charged with taking such a long view. But the distributional consequences, particularly of interventions such as caps on loan-to-income or loan-to-value ratios, are more obvious and concentrated than is the case with monetary policy. You can be sure that when such constraints are applied during the upswing of the credit cycle, there will be no end of pushback from lenders, people denied mortgages, and politicians—all of whom will be claiming that the macroprudential authority is curbing borrowing needlessly. So democratic legitimacy for delegation first requires establishing a broad constituency for financial stability akin to that which now exists for price stability. Despite the financial crisis, I am not sure that constituency is properly established yet.

If macroprudential policy is to be delegated, to whom should it go? The obvious choices are either the banking supervisor or the central bank (sometimes, of course, they are the same). The case for the latter is that it already adopts a macroeconomic perspective

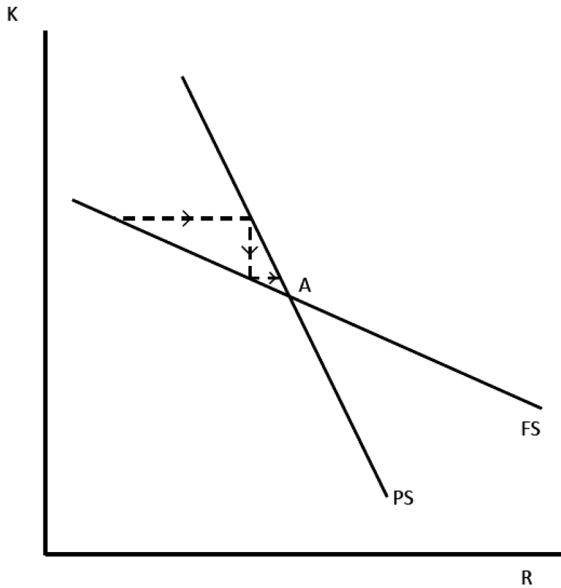
and also has day-to-day dealings with the banking system. But if banking supervision is not in-house, then it is absolutely essential that central bank and bank supervisor work closely together. Certainly, it is my perception that the Financial Policy Committee, the body charged with operating macroprudential policy in the United Kingdom, has worked more effectively since supervision came back to the Bank of England in 2013.

Should macroprudential policy just be delegated to whatever body already determines monetary policy? This might seem the natural choice, which also internalizes any coordination issues if they are set by separate bodies. However, this ignores the fact that special expertise is useful for both monetary policy (macroeconomics, monetary economics, etc.) and macroprudential policy (finance, knowledge of banking, etc.) and separate committees allow such specializations to be represented.

Of course, if there are two committees, some overlap in membership is probably desirable, as is the case in the new arrangements in the United Kingdom. But does one need to go further and establish formal mechanisms to ensure coordination? I believe the answer to this is no, at least in principle.

Without going through the details, the way I think about the issue is captured in figure 1. Suppose we have two objectives: price stability and financial stability. We also have two instruments: a monetary policy instrument, R ; and a macroprudential instrument, K . Raising either R or K reduces aggregate demand and reduces the risk of financial instability. A good macroprudential instrument is one that has a big effect on the risk of financial instability without damaging aggregate demand too much (i.e., it is well targeted). The pairs of R and K consistent with achieving price stability thus lie on a downward-sloping locus (PS in the figure). And the pairs of R and K consistent with a given risk of financial instability will also lie on a downward-sloping locus (FS in the figure). However, if the macroprudential instrument has a comparative advantage in maintaining financial stability, then FS will be flatter than PS. In that case, provided the monetary and macroprudential policy committees share the same *overall* objective (i.e., welfare function), the principal can just assign price stability to the former and financial stability to the latter and leave them to get on with it: the economy will converge to a Nash equilibrium where the two stability loci intersect. That

Figure 1. Assigning Monetary and Macroprudential Policies



said, it seems to me quite natural that the two committees should talk to each other. And, indeed, at the Bank of England, not only do the Monetary Policy Committee and Financial Policy Committee have several members in common, but they have also met together on several occasions.

Having introduced this apparatus, it is also useful for illustrating the point that sometimes monetary and macroprudential policy settings may appear to be in conflict. Figure 2 illustrates a case when they are not: “irrational exuberance” associated with excessive optimism about future prospects. In such a case, both borrowing and aggregate demand are likely to rise, shifting both PS and FS out. As drawn, it is appropriate to raise both R and K.

In contrast, figure 3 shows what happens in the face of a beneficial supply shock. In this case, the increase in supply shifts the PS locus inwards (policy needs to loosen to boost aggregate demand to match supply) but it may also be prone to set in motion a speculative credit boom, shifting the FS locus out. Now we need a loosening in monetary policy (R falls) accompanied by a tightening in

Figure 2. Irrational Exuberance

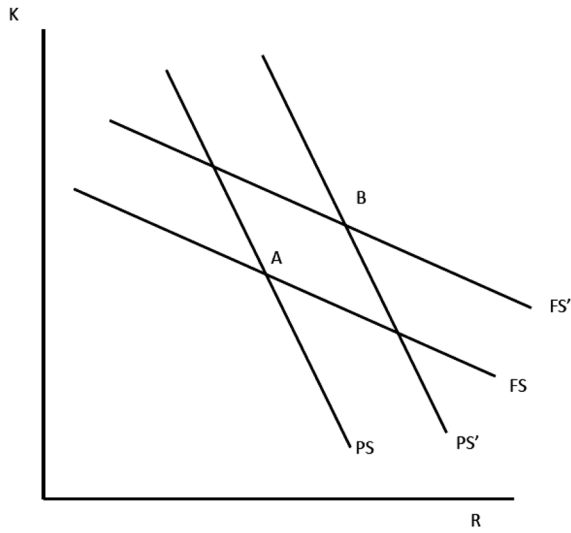
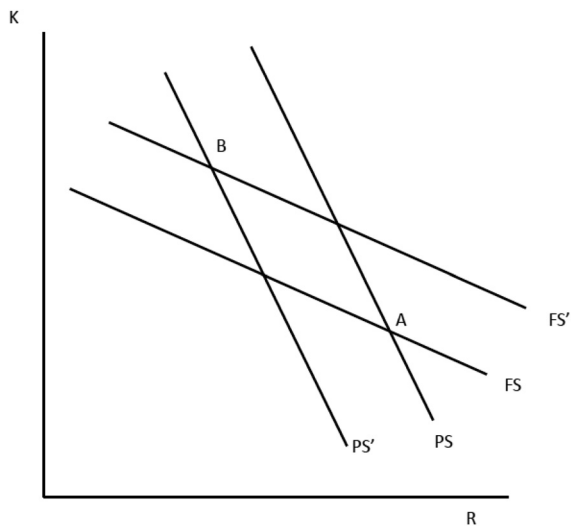


Figure 3. Beneficial Supply Shock



macroprudential policy (K rises). It is therefore perfectly reasonable for the instruments to move in opposite directions.¹

Let me turn next to transparency. Transparency certainly improves the effectiveness of monetary policy. Can the same be said for macroprudential policy? I think the answer is less clear. Certainly, warnings promulgated through Financial Stability Reports and other communications may change behavior in a beneficial direction—though the warnings contained in the Bank of England's Financial Stability Reports in 2005–6 regarding the underpricing of risk and the problems that could arise from off-balance-sheet vehicles seem to have had negligible effect! And advance warning that, for instance, the macroprudential authorities were contemplating raising the countercyclical capital buffer could both encourage banks to raise capital in advance and discourage them from lending so much now. However, such transparency also gives financial institutions more time to work out ways to arbitrage possible future interventions designed to curb their behavior.

Of course, transparency is not just about increasing policy effectiveness. It is also potentially helpful for improving accountability. Here I think one must acknowledge that finance is a technical and jargon-ridden world that parliamentarians and the public can struggle to understand. Transparency in the macroprudential authorities' communications can also be most helpful in building the constituency for financial stability.

Finally, what about accountability itself? Holding a macroprudential authority accountable is intrinsically harder than holding a monetary policy authority accountable because of the fuzziness of the macroprudential objective and the difficulty of knowing whether policy interventions were justified or were just tilting at windmills. Specialist knowledge is needed, and parliamentarians really need expert support if they are to do an effective job. Alternatively, the oversight function normally carried out by parliamentarians can also be delegated to a group of independent experts, though this runs the risk of creating a world where one lot of experts/technocrats criticize another lot of experts/technocrats. It is not clear why the view of one group should be regarded as preferable to that of the other.

¹This is a direct analogue of a rebalancing in the composition of aggregate achieved through a combination of fiscal tightening and monetary loosening.