"Macro-Prudential Regulations: Linkages with macro–economic policies for promoting financial stability"

Transcript of the comments by Stephany Griffith Jones, Financial Markets Director,Initiative for Policy Dialogue, former Professorial Fellow, IDS, Sussex University

Thank you very much Jose Antonio. I think Jose Antonio, you have been too modest in saying how earlier on you were actually thinking in terms of what is now called macro-prudential and counter-cyclical ; in fact, together with some people at the BIS like Claudio Borio, you were amongst the first people to think about counter-cyclical regulation and I personally benefitted by working with you on this issue from a long time ago.

Before I get into the more technical issues, I want to make a broader point, which is about the political economy, in the context of the difficulties of doing counter-cyclical regulation. There are difficult issues of incentives that you need to deal with. In times of boom, actors, whether they are regulators or academics, who say that "the credit expansion is too high and we have to tighten regulation" are always very unpopular. The politicians love booms as increases their popularity, markets and bankers love booms, as increases their profits, but even ordinary people, working class people or consumers also love them because they are doing very well, with increased employment and real wages; to go against the current and say this a party and is too much fun, and we have to take away the punch bowl, is politically very difficult. I think one of the most interesting discussions in terms of macro-prudential regulation is whether one should do it through ex-ante rules or through discretion. I will talk a little bit more about that, and about the bias, which I think, should be in favour of rules precisely to avoid over-enthusiasm in booms, although it is difficult to deal with the problems of uncertainty. But I think rules will help.

Of course in the bust, and post-crisis, for a very long time we have the opposite difficulty, which is how you revive credit after banks have perceived how high the risks are, and when everybody is overleveraged; that is a really big challenge which Sir John referred to. We have seen this difficulty of reviving bank credit since 2007, particularly in Europe and also in the US, and as we have seen before in the emerging economies, during and after the numerous crises in the last two decades.

Furthermore, there is then this catch 22 situation because if it is difficult to impose counter-cyclical regulation in the boom, as all is apparently going so well, and arguments of "this time is different" are very loud; furthermore, you do not really want to do it in the bust because you are trying to encourage lending, and the banks tell you that excessive regulation will further discourage lending. So when do you do it? In that sense, I think it is correct that there are rules that are now being brought in even though they may be implemented later. I think this is a very difficult thing to handle, but I believe clear minimum counter-cyclical rules to be key.

In this audience perhaps one does not have to emphasise so much how important the boom bust cycle is, but I would like to quote Avinash Persaud, who stressed that this is perhaps the main market failure of financial markets. Of course, the analysis of this comes from the Keynes – Minsky tradition, and from the fact that finance, to defend bankers a little bit, deals with the future, that cannot be forecast, the future is dominated by uncertainty and therefore opinions matter a lot. There is the important insight from Keynes, illustrated by the concept of beauty contest, that market actors are looking much more at each other than they are at the true fundamentals of companies or countries. Of course, the insights on asymmetries of information, provided by Joseph Stiglitz in his pioneering research, make it a bigger problem; contagion and herding are the mechanisms through which this works, both on the upside and downside .

So what are the tools that can be used for macro-prudential? I actually found extremely helpful an IMF paper from the middle of 2003, Key Aspects of Macro-Prudential Policy, http://www.imf.org/external/np/pp/eng/2013/061013b.pdf , which set out very nicely the issues and particularly evaluates the tools; it builds also on the work of the Financial Stability Board, The paper includes the issue of how much you do across the board versus how much you do sectorally. As Jose Antonio mentioned, India is one of the pioneers in regulating the boom in property markets. To my surprise the UK has not yet used for example loan to value ratios, even though the property market is today booming in certain parts of the United Kingdom, particularly London. So I think this is one of the cases where I think some emerging economies have actually done very well in implementing counter-cyclical regulation. The mechanisms of loan to value ratios or loan to income ratios are actually quite simple and have been used effectively by Hong Kong and others. These ratios can be used or tightened when there is an expansion of credit in a particular sector or/and when property prices are increasing.

As this nice IMF paper points, if you want to have good counter-cyclical regulations, you have to look at what are the products and the extent of the innovation. I think that the choice of tools has to be adapted to the kind of financial sector that you have. What a shadow banking means in the US with sophisticated hedge funds and Special Purpose Vehicles is different from the shadow banking in India, or in China, or even more in a low income country in Africa. So if you want to have to have comprehensive counter-cyclical regulation, you have to structure it which in ways that are adjusted to your own situation.

I think it is good, as this IMF paper points out, to have a range of tools in place, because none of the tools work well on their own; Sir John just showed us how bank leverage was going up before the crisis and this was disguised by the increase of capital adequacy related to risk weighting. It is good to have different tools in place in a timely way, because when the boom is already happening it may be too late to get the system going. The tools include capital adequacy based on risk weighted assets, but also the simpler measure of leverage, as well as provisions, to deal with solvency; furthermore, you need liquidity regulations, as well as the sectorial tools mentioned before.

It is again interesting that the IMF paper I referred to before calculates that if the counter-cyclical capital requirements were of the magnitude that they are now, it could have reduced the bank losses in Ireland by 25% and by 100% in the case of Spain. So if Spain had then the much tighter capital requirement of the kind that are going to be imposed now, they might have avoided the banking crisis completely, which I think is very encouraging. Of course I think Spain should have had sectorial requirements for property lending. It is also interesting that a large number of countries now are using sectoral requirements like loan to value and debt to income ratios. Over half of the countries that were surveyed by the IMF actually had loan to value requirements. So I think that is another encouraging sign.

I think after the North Atlantic crisis we also have rediscovered liquidity risk. I think one of the big problems of regulation previously was that liquidity tools such as reserve requirements or any other tools were practically forgotten; in the UK and in the US less than 1% of assets were in liquid assets, which was of course very risky. So anything that would have gone wrong, and of course a lot went wrong, would create a crisis. One of the interesting things about these liquidity regulatory tools is that if you force smaller dependency on wholesale markets which by nature can dry up very quickly, you will also be slowing down the growth of credit because you will force banks and other actors to lend based more on expansion of deposits, and expansion of deposits will be slower than the wholesale markets. So that in itself greater reliance on these liquidity tools will actually help smooth the cycle of lending,which is of course the idea.

Now I want to return to this issue of rules versus discretion, which the Turner report looked at very carefully and set out the issues. I think you do need to have rules because you have to avoid the whole issue of "this time it is different" as Reinhart and Rogoff have very clearly pointed out. Every time when there is a boom, an excessive boom, people will tell you- politicians, regulators – that this time is different, and bankers will tell you that we have got better models. And usually of course it is not different, and therefore if you have fairly simple rules, then there is a natural restriction to this excessive boom. It is true that of course reality changes, and in particular in financial markets as Joseph is explaining, there is a lot of innovation. I think a way of getting around this dichotomy is to have some minimum clear counter-cyclical rules through capital, leverage or provisions, -across the board or at the sectoral level-, but if there is lot of financial innovation or if there is a lot of credit expansion and evidence of property or other asset bubbles, you can tighten the rule. Unless there is a very good reason, you cannot loosen the counter-cyclical rule because the experience is that once you start loosening, then things start going wrong. The idea is an asymmetric approach; counter-cyclical rules cannot be loosened, but can be tightened if circumstances justify

The third point, which is very important, is the whole issue of comprehensiveness because if you tighten regulations on the banks, you will have the growth of a shadow banking system. Therefore there is the idea which we have been writing about with Jane D'Arista, and which is now become very mainstream; you should have equivalent regulation for whatever institution that creates credit if they are funded by deposits or even if they are not funded by deposits. Indeed, the whole idea of systemic risk has changed. This sounds very nice conceptually but it is difficult to implement. What is the equivalent regulation for a hedge fund as compared to a bank, to make sure that there is not an excessive expansion of credit? I think that is a very important and difficult challenge across the world, because we now hear, that for example in China there is a very rapidly growing shadow banking system which the authorities are having some trouble controlling.

And of course a final point in relation to this is that you need extremely good supervision so that the regulators and supervisors actually know what innovation is going on. I worked for example once in a major international private bank, and nobody knew how much lending was being done in the 70s to the private corporate sector in Latin America. There was no good data, and because there was no good data, even if regulators would have been more willing to tighten, they could not do it. So I think the quality of data, the quality of information needs to be improved. This has to be done also through very rigorous onsite supervision.

And my last point is about how you coordinate macro-prudential internationally because if you are a relatively small economy, let us say a small African, Latin American or Asian country and you do very good counter-cyclical regulation domestically, but foreign banks come into your market and undermine this, or even more indirectly, if the countries that you trade with or you have financial links, -say the United States or China- do not do good macro-prudential regulation, then you have this major externality that the crisis could happen there and it could spillover to your country.

Therefore I think it is in the interest, particularly of relatively smaller economies, to make sure that large economies are well regulated. This is again a big challenge, how do you persuade those like the United States to have good macro-prudential policies, to avoid these very negative spill-over effects.

Thank you very much.