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BoE-HKMA-IMF conference on monetary, financial and prudential policy interactions in the post-crisis world

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BoE-HKMA-IMF conference on monetary, financial and prudential policy interactions in the post-crisis world

The Bank of England (BoE), Hong Kong Monetary Authority (HKMA) and the International Monetary Fund (IMF) held the third joint conference on the interactions of monetary, financial and prudential policies in a post-crisis world at the IMF in Washington DC on 8 and 9 November 2017.(1) The conference once again provided a forum of exchange between senior policymakers and leading academics from around the world, focusing on issues emerging in the post-crisis environment, with a roundtable discussion on 9 November conducted under 'Chatham House Rules'. The main themes discussed were (i) implications of low interest rates for the business models and risks of financial institutions; (ii) the use of monetary and macroprudential policy tools to address financial stability risks; (iii) global co-ordination of monetary and prudential policies; and (iv) interconnectedness and procyclicality.

This report summarises the main issues discussed by participants during the two-day conference. Lessons from these discussions, and indeed those from the previous two conferences, include the need to look at the financial system as a whole, not least by gathering relevant data, the importance of understanding better the benefits and limitations of macroprudential policies and their interactions with regulatory and monetary policy, and the need for further global co-ordination on financial policies even if challenging.

Implications of low interest rates for the business models and risks of financial institutions

There was general agreement that persistent low interest rates can have different impacts on the financial sector over time. Most participants agreed that low rates were likely to benefit banks in the short term, but hurt them if they persisted for a long period. It was argued that if interest rates remained low for long, the early benefits of low interest rates on net interest rate margins might become outweighed by vulnerabilities related to profitability pressures in the longer run. This could force banks to rely on a search for yield and consequently increase credit risk. The subsequent uncertainty on asset fundamental values can in turn give rise to booms and busts through mispricing. Nevertheless, even in the short term, adverse effects on banks were conceivable. One participant presented work showing that there was a monetary policy rate — potentially above zero — below which monetary policy might be contractionary rather than stimulatory even in the short run. An important question arising from these discussions was whether the poor financial health of a bank would reduce its willingness to lend, as commonly supposed. Some suggested that 'gambling for resurrection' by banks could lead to the opposite conclusion.

Participants noted that life insurers could also be vulnerable to prolonged periods of low rates, especially those who offered 'variable annuities', essentially a mutual fund product plus a guaranteed return. As rates fell and guaranteed returns became harder to achieve, insurance companies might charge more for these products, take on more risks and sometimes withdraw from the market entirely. With the shares of insurance companies publicly traded, a sharp decline in share prices was not impossible, which might have negative effects elsewhere in the financial system.

Another consideration raised in this context was how the persistence of a low-for-long interest environment could encourage financial institutions to change their business models, only to find that when conditions subsequently return closer to normal, their business strategies would require further, perhaps disruptive, change. Moreover, the need to mitigate procyclicality in the financial system was not limited to the traditional banking sector, and participants emphasised the importance of the non-bank financial sector. Some participants were concerned that structural changes in the financial system — on the back of mostly bank-focused regulation since the crisis — gave rise to 'boundary drift'. As

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some financial institutions are subject to 'runs', safety nets are required to re-establish stability. But safety nets could create a moral hazard that called for further regulation, which in turn led to evasion. Then, according to some, the original problem might recreate itself elsewhere in a never-ending dynamic of widening safety nets, broader regulation and increased evasion/arbitrage. On the use of resolution to intervene and manage failed banks, it was argued that regimes focused on reducing moral hazard might be counterproductive in a systemic crisis, when only decisive interventions can stem contagion.

The use of monetary and macroprudential policy tools to address financial stability risks

Participants agreed that macroprudential policies had an important role to play in containing financial vulnerabilities. For example, household debt boom-bust cycles (often starting from what is viewed as moderate levels of debt) have historically been more disruptive than corporate debt cycles and these expansions have been mainly driven by changes in credit supply. The discussion further stressed the role of macroprudential policy and tighter capital regulation in managing that supply. Even if such policies did not reduce the amplitude of a financial upswing, they might well leave the financial system in healthier shape later if larger capital buffers had been built up. Some pointed out the difficulties in achieving macroprudential objectives if regulatory or supervisory coverage was incomplete, stressing intertemporal trade-offs and the potential for migration of risks across less regulated entities and markets.

A lively discussion took place on the roles of monetary versus macroprudential policies in containing stability risks. Some stressed that 'leaning against the wind' was inefficient because the costs from a weaker economy likely exceeded benefits of mitigating crises. Others asked whether the same argument might not apply to macroprudential policies, and some participants argued that although macroprudential policies were broadly seen as effective, their impact was subject to uncertainty, especially where they had not been used before. Others pointed out that the links to monetary and fiscal policies made it difficult to fully separate policies, and that the nature of macroprudential policies invited political economy interference. Pragmatism was therefore needed. Some expressed concern that it might not be straightforward to ease macroprudential policies in an economic bust as it might be a shock to confidence in the health of the financial system.

Governance of both monetary and macroprudential policies was also discussed. Some favoured a model where the central bank was in charge of both but through two separate committees with overlapping membership, such as at the Bank of England. It was noted that other arrangements were more common in practice, however, for example having finance ministries and supervisory authorities involved more directly. It was also noted that finance ministries should have a bigger influence in decision-making during downturns. This would help focus the mind of governments on issues having to do with debt 'resolution' (bankruptcies, loan defaults and bank recapitalisation) and the possible need to spend taxpayers' money.

Global co-ordination of monetary and prudential policies

Most participants saw a need for stronger international co-operation on monetary and prudential policies to 'internalise the externalities'. Speakers highlighted the growing degree of interconnectedness and spillovers from monetary and prudential policies. Although standard economic theory did not imply big gains from cross-country co-ordination while all countries maintain flexible exchange rates, reality differed from the textbook model.

There was agreement, though, that even if preferable, international co-ordination remained politically difficult. Given the general scepticism about the practicalities of co-operation, the fall-back lesson for many participants seemed to be the traditional one — keep your own house in order to avoid vulnerabilities to shocks. However, spillovers of own macroprudential policies to other countries were indeed in existence and evidence was presented to this effect. Co-ordination of macroprudential polices between a smaller and more tightly linked group of countries might be more feasible, however. More 'war games' simulating crisis responses in advanced economies could also be helpful.

In terms of domestic actions that could be taken, the case was made that macroprudential policies could help reduce spillovers from abroad and potentially restore monetary independence to a degree. Others noted a place for capital flow management policies in reducing capital inflows that otherwise might fuel a domestic credit boom. For example, the United States had a dominant role in the global financial system. And while US banks had access to the discount window, non-US entities held large US dollar-denominated liabilities and might face substantial funding risks should 2008-like liquidity strains re-emerge. Large foreign currency reserves in emerging markets helped mitigate these risks, but according to some also created the illusion of stability, inducing even more dollar borrowing. IMF resources and central bank currency swap lines might help. In a world still dependent on the US dollar, much rested on the United States adopting appropriate policies in times of crises, though, which some noted induced uncertainty. As a result, some argued that more reliance on capital flow management policies in the first place might prevent capital flows from becoming destabilising.

However, macroprudential policies could also provide a substitute for holding elevated levels of foreign currency reserves.

Forward-looking considerations

Participants agreed that going forward, further harmonisation and consistent regulation across different sectors should be promoted to avoid regulatory arbitrage. Ongoing legislative review should also take place to ensure the most effective tools are available to micro and macroprudential authorities.

In this context, the importance of finalising the Basel III regulatory framework for banks and a consistent implementation across countries was highlighted. And for the insurance sector in the European Union, the review of Solvency II regulation in 2021 was seen as an opportunity to provide consistency between micro and macroprudential policies. Participants expressed concern about the lack of data on international interconnectedness, particularly given the linkages between non-banks and banks, and the absence of backstops for liquidity and solvency problems.