BANK OF ENGLAND

Speech

The interactions of macroprudential and monetary policies: a view from the Bank of England's Financial Policy Committee

Speech given by

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The background to my talk today is the development, in response to the financial crisis, of macroprudential approaches to policy, as a new way to try and address risks to financial stability. Before the crisis, the Bank of England monitored and assessed financial stability risks and produced Financial Stability Reports to discuss them, but neither the Bank nor the regulators had clear authority over tools to deal with these systemic risks. Many failings led to the financial crisis – both in the private and public sectors. But one of them was the absence of an entity with both the responsibility and the authority to do something about systemic risks – risks that transcend the interest and incentives of private participants in the markets and the regulators charged with overseeing individual institutions. Now there is such a body in the UK – the Financial Policy Committee (FPC) – and I have been privileged to be a part of this effort to fill the gap, to protect the resilience of the financial system.

Of course the FPC does not operate in a policy vacuum. We work closely with the microprudential authorities to quantify macroprudential risks we have identified and we utilize mostly tools from the microprudential handbook to address those risks. And what we do to build and preserve financial stability will interact in important ways with the actions of the Monetary Policy Committee (MPC) to meet its inflation and macroeconomic objectives. And it is this latter set of interactions I want to reflect on in this talk today. I do so from the perspective of an external member on the FPC, although one who has a spent a lot of my career also involved in monetary policy.

From the start it has been clear that monetary and macroprudential policy actions interact and the two committees' actions will be of interest to each other. The FPC and the MPC have overlapping membership to help each body understand and take account of the actions of the other. The importance of that interaction has also been recognized formally in the respective remits from the Chancellor, which specify for the FPC that in order to enhance coordination "the Financial Policy Committee should note in the records of its meetings, its policy statements and its Financial Stability Reports how it has had regard to the policy-settings and forecasts of the Monetary Policy Committee."[1] The MPC has a parallel requirement. And the importance of this interaction and coordination is also seen in their actions to date: in particular the inclusion of the financial stability knockout in the MPC's forward guidance on interest rates, and the decision to give responsibility for assessing that knock-out to the FPC.

In the rest of my remarks I plan to explore some of these interactions, with an emphasis on the macroprudential perspective, and on the particular challenges of interaction in the current economic situation in the UK.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207473/remit_fpc_290413.pdf

The two policy frameworks in the UK

The monetary policy framework in the UK is similar to that in many advanced economies, and is one we have become familiar with over a number of decades now globally. Since 1997 the UK has operated monetary policy with an inflation-targeting MPC inside the central bank, but including membership from outside the Bank hierarchy. The MPC has considerable independence from short-run political pressures to use its tools – Bank Rate, asset purchases, and guidance about future Bank rate decisions – to meet the objectives set by the Government within the framework established by Parliament. Its primary objective, of course, is price stability – the 2 percent inflation target. Achieving that target entails considerable attention to economic activity and its implications for the rate of growth and degree of slack in the economy.

In many respects that basic model was adopted for macroprudential policy. The FPC is a committee within the Bank that has external members. Parliament has set its basic objectives and the Chancellor provides a more specific annual remit for the Committee. As I'll discuss later, our objective is not to iron out all cycles of asset prices or credit. But it is to ensure as best we can that the basic functions of the financial system - for payments, for intermediating between savers and borrowers, for managing risk– work even under very adverse circumstances and that the amplification of cycles by the financial system is damped.

Still, it is a new framework. It has an objective that cannot be defined numerically, but instead requires the macroprudential authority in the UK, the FPC, to identify risks to financial stability that could arise in different ways: for example, from excessive leverage, dangerous exposure to runs, mispricing of risks, or concentrated or poorly understood distribution of risks in the financial system. And the FPC will act to mitigate these risks using a broad set of tools.

Many of these are forms of old tools – capital standards, liquidity requirements, supervisory oversight - that have been, and still are, used as part of microprudential regulation. But now we propose also to deploy them in a new way – by varying them over the cycle or changing them in response to specific risks; by considering the system as a whole; by setting standards so that market participants internalize, that is take into account, the wider costs or externalities, of financial instability; and by paying special attention to protecting against tail risk, like runs and fire sales that threaten to disrupt intermediation and to feedback on economic activity.

Both the MPC and FPC also share a secondary goal of supporting the policies of the government, including for growth and employment. More fundamentally they share an overriding objective of sustained and sustainable growth of the UK economy. Experience has taught us that both price stability and financial stability are prerequisites for achieving this underlying goal.

The potential for policy spillovers

Most of the time, the actions of one committee in pursuit of its objectives will be complementary to meeting the objectives of the other committee. Boom conditions in financial markets often threaten a pickup in inflation, calling for both types of policies to be tightened; and as we have seen, downturns in the economy can be exacerbated by a tightening of credit availability that macroprudential policy may also be able to lean against as monetary policy eases. More generally, high and variable inflation would be a detriment to financial stability, since it would tend to induce a series of unanticipated shocks to both borrowers and lenders and it could induce added leverage as interest rates lagged inflation expectations. A resilient financial system is necessary for maintaining economic and price stability and moderating the cycle, keeping output near potential – a necessity revealed by the crisis.

But the actions of each policy body can affect the primary objective of the other in complex ways.

We have seen in the past decade or more the ways in which the monetary policy cycle can contribute to the financial cycle, and how this can feed back to the economic cycle. Relatively low short-term interest rates, which may be needed to achieve an inflation target and raise output and employment toward their sustainable potentials, can lead to financial risks building up. Intermediaries, banks and nonbanks can be encouraged to increase the extent of maturity transformation they engage in – borrowing short to lend long. Profits boosted by carry trade type activities can encourage added leverage and risk taking. Increases in collateral values, from declining interest rates, ease borrowing constraints and encourage leverage in both intermediaries and in households and businesses. And low long-term interest rates, whether or not a result of monetary policy, can encourage over-investment, as we saw in the US housing market. Pressures to achieve return objectives in this type of environment can result in inadequate compensation for credit or duration risk. Subsequent increases in policy interest rates needed to assure price stability can cause these risks to materialize in ways that have a much greater impact on the financial system and economy than expected or required for keeping inflation at target.

More generally, the success of monetary policy in damping inflation and business cycles in the years before the crisis arguably led to complacency and financial stability problems. As Governor King reminded us so many times,[2] the NICE (non-inflationary consistently expansionary) economy could not persist forever, but the longer it did, the less financial market participants – and their regulators – prepared for its inevitable demise. When the downturn came, the lack of preparation, including the build-up of leverage and the greater reliance on short-term wholesale funding to finance long-term assets meant that the financial sector was greatly exposed to unexpected developments and its problems made the economic cycle much worse.

[2] King (2003), (2013) http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech454.pdf

If monetary policy were the only available macroeconomic tool, then the MPC could be called upon to take into account the potential costs of a future financial crisis materializing. That might constrain the extent to which it eases policy to achieve its primary objective for inflation, or require it to tighten before it might otherwise do so constraining growth relative to the economy's potential. And it might also constrain its willingness to tighten if it were concerned that higher rates could precipitate financial instability and trigger a downturn instead of the "soft landing" it was seeking.

An important benefit from macroprudential policy will be to limit the constraint that financial risks may place on monetary policy. Increasing capital and liquidity buffers – especially in good times – will mean the MPC need not be as concerned about the effects of its policies – both tightening and easing – on financial stability. A more resilient financial sector will be better able to deal with unanticipated changes in interest rates. And increasing capital and liquidity buffers in the upswing may damp inherent procyclicality that could arise otherwise. By limiting the increases in leverage and maturity transformation that can follow in a low-rate environment, the FPC can reduce the odds that lenders will lose access to market funding and that adverse feedback loops between the real economy and financial sector will be triggered. And identifying and dealing with risk in interconnections in the system makes unexpected transmission effects less likely.

An advantage of using macroprudential policy to manage these risks is that the policies can be targeted at the specific sector that might be threatening financial stability. That could be with recommendations to the microprudential authorities to tighten oversight of particular kinds of lending or market activities, or increases in sectoral capital requirements. In contrast, tightening monetary policy to deal with threats to financial stability would have broader effects, including on spending and borrowing that do not pose threats to stability and yield societal benefits.

But we also need to recognize that macroprudential policies, by influencing financial conditions under a variety of circumstances, can have broader effects on how the monetary authorities pursue their objectives. The higher capital and liquidity requirements and other margins of safety being brought in by the new regulatory framework both in the UK and internationally will make financial intermediation more expensive than it had been. The externalities of financial instability will be internalized to a greater extent in the price of leverage and maturity transformation in order to limit both of them, and that will affect what the public earns on its saving and what it pays for its credit, with effects on saving and spending.

It is likely that much of the expense will be incurred in the transition to new higher standards. There are a number of reasons for that from the potential short-term costs of substituting equity for debt that might be passed on to depositors and borrowers and lead to a re-channeling of credit flows, to constraints on lending as liquidity requirements were implemented, to an increase in bank funding costs as perceptions of implicit public support for SIFIs are reassessed. The phasing in of new regulations is an attempt to reduce transition costs and have them occur more when the economy is on stronger footing.

But a weak banking sector cannot and will not support lending to households and businesses — as we have seen in recent years.   And if we do this right, the result will be a considerably more robust and resilient financial sector, one that creditworthy households and businesses can count on for finance, one that is much less vulnerable to unanticipated developments, and therefore one less likely to amplify business cycles and in particular, one in which a repeat of something like the past few years had become much, much smaller.

For its part, monetary policy will need to adapt to a different configuration of financial conditions not only in the transition but even after we return to a stronger economy and financial sector. Both the cyclical and steady state behavior of financial conditions are likely to be different as macroprudential policies are put into place.

I do not see this as a problem most of the time. The two policies generally will be acting in synch with one another – leaning against both boom and bust. Each will be employing tools better targeted to its main objective – the policy rate for business cycle management when many types of activities are likely to be rising and falling together, and macroprudential tools to address vulnerabilities in the financial sector. Moreover, successful macroprudential policy should keep monetary policy from encountering the difficulties of having its main policy instrument – Bank Rate – effectively pinned at the zero lower bound.

Monetary policy will be able to adapt to evolving macroprudential policy, much as it has to evolving fiscal policy, varying the policy interest rate to achieve the desired inflation outcome. I expect that it will be monetary policy that should do more adapting – or be the 'second mover' – because macroprudential policy is likely to be adjusted less frequently, and with long lags in its effects. Still, we on the FPC will benefit from knowing how the MPC is viewing the economic situation and how policy may evolve, so we can be alert to potential financial stability spillovers. Good communication and understanding between the committees will be required.

Monetary and Macroprudential policies in current circumstances – special challenges for the FPC

Although each type of policy will readily adapt to the other under most circumstances in the future, the situation of the past few years has posed special challenges. The financial crisis, and the subsequent correction of a number of imbalances in the financial sector and the real economy that had built up in the years leading to the crisis, have left both the UK economy and the UK financial sector in a weakened condition. As a consequence, policy makers have faced constraints as they responded with policies aimed at restoring higher levels of economic activity, employment, and growth while simultaneously building the resilience of the financial sector so it can better support the real economy and reduce its vulnerability to future shocks.

For monetary policy, the constraint has been a very weak recovery from a very deep recession, reflecting a variety of restraining forces, including cautious lending behavior by weakened lenders. That, in turn, has meant that supporting the economic recovery has required a prolonged period of very low interest rates, promises to keep them low until recovery is better assured, and sizeable asset purchases, with potential implications for financial stability.

The FPC, in implementing its macroprudential polies has faced the necessity of strengthening financial markets by requiring the rebuilding capital buffers in banks and tightening a variety of regulation. In some cases, those types of actions could have the potential for raising costs that are passed on to savers and borrowers, potentially challenging efforts to restore demand.

The starting points for the economy and financial system, therefore, imply that the interactions of monetary and macroprudential policies are more difficult and sensitive than they are likely to be under more normal circumstances after both the economy and the financial sector have been strengthened.

For its part, the FPC has been attempting to minimize any potential real economy spillovers from rebuilding resilience. When the interim FPC recommended to the microprudential authorities that banks meet higher capital standards and that the calculation of capital take a more conservative approach to potential losses, we also specified that the capital plans to meet these requirements not involve reducing lending to the UK real economy. The banks should rebuild capital by increasing the numerator of their capital ratios – not by reducing the denominator of risk-weighted assets, where those assets are related to their core mission of lending to creditworthy UK businesses and households. Retaining earnings by limiting compensation, dividends and share buybacks, and raising new capital have been acceptable methods of increasing capital ratios, as has been reducing exposures to noncore businesses.

When we considered liquidity buffers, we took account of the fact that access to central bank liquidity has been enhanced as a backstop for banks and that banks themselves have raised their holdings of liquid assets to very high levels. So we recommended to the PRA that the new liquid asset requirements be phased in gradually – with requirements initially set at 80 percent of their ultimate level. Relative to the full requirement, that frees up considerable balance sheet room for lending now, when it is most needed.

The MPC, for its part, has recognized the possibility that its policies could lead to the build-up of vulnerabilities in the financial system and it has included a financial stability knock-out in its forward guidance linking Bank Rate (and asset sales) to the rate of unemployment.[3] And it has given responsibility to the FPC for forming a judgment on when the knock-out has been breached: that is to judge when the stance of monetary policy poses a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives. In the event of the FPC declaring the FS knockout breached, the guidance linking Bank Rate and asset purchases to unemployment would

[3] http://www.bankofengland.co.uk/publications/Documents/inflationreport/2013/ir13augforwardguidance.pdf

cease to hold, but the actions of the MPC in response would not be automatic – they would also depend on its assessment of the appropriate setting of monetary policy required to fulfill its remit to deliver price stability.

This is a judgment that the FPC intends to consider at its quarterly meetings, and we've already begun. As we carry on monitoring these risks in future quarters, important factors to monitor will be the impact that the stance of monetary policy is having on pricing of risks, in particular signs that risk is becoming mispriced, on the growth of credit, on potentially unsustainable increases in the prices of assets, on increases in leverage both within the financial sector and in the real economy and on greater maturity mismatch. Each time we will pass on our assessment to the MPC, first privately, so that they can consider it alongside the other developments in the economy at the time, with our view becoming public after the MPC has met.

As you are already aware, our first discussion of this in September led to a judgment that there was no breach of the knock-out. Even if we start to perceive increasing risks from the stance of monetary policy we have our own macroprudential tools that we would turn to first. These range from recommendations to the PRA and FCA to be sure institutions are exercising special caution in their exposures to particular sectors or in particular ways that appear to be threatening their resilience to raising countercyclical or sectoral capital buffers ourselves. Only if those tools are unable to contain the risks would we activate the knock-out – it is a last resort. And one that you should be able to see coming, if needed, as we take actions and consider publicly their effectiveness and discuss the FPC's collective view of the risks in our Financial Stability Reports and the Records of our meetings.

Among the sectors we will be watching carefully is housing and the associated quality of mortgages. That market is being boosted not only by near zero monetary policy rates, but also by the Bank's 'Funding for Lending Scheme' and the Government's 'Help-to-Buy: mortgage guarantee' – which provides lenders with an HMT guarantee – for a fee – on the losses on the high LTV slice of individual mortgage loans.

The Treasury has also given the FPC a similar role for keeping a watch-out on financial stability risks that can arise from Help-to-Buy. The FPC will be asked annually to review the pricing of the fees in the scheme and after 3 years, when the scheme is set to expire, the Chancellor of the day will seek the FPC's view on the impact of the scheme on financial stability risks before renewing the scheme.

Recently there has been evidence of some pick-up in mortgage approvals and house prices. As a Committee, the FPC said in September that we would be vigilant to whether increases in house prices and lending activity could give rise to vulnerabilities in the financial system. One particular danger sign would be evidence of a bubble dynamic in prices – that is, increases in prices in anticipation of future increases.

One reason that the FPC knows vigilance is needed is that housing cycles have been important in a number of past UK credit cycles. The FPC will take action as needed to ensure that the financial sector remains resilient to developments in the housing market – that credit standards do not become too lax in the mortgage market and that lenders are adequately capitalized to manage losses that might arise. And between our powers of recommendation to the micro-regulators – the PRA and FCA – and our powers to direct some capital requirements, we have the tools to do that.

In deploying our tools, the objective of the FPC, as the macroprudential authority, would not necessarily be to micro-manage housing or other asset and credit cycles. Instead it primarily would be about stopping these cycles from being amplified by financial markets and generating costly fallout for the wider economy. Financial cycles, imbalances and asset bubbles will persist. It is human nature to become overly optimistic and pessimistic, to go through cycles of greed and fear. Herding behavior in markets reinforces this tendency.

A key consideration is likely to be the extent to which the asset price cycle is reliant on credit- not all are. The dot-com boom in the equity markets of the second half of the 1990s is a good example of this. To be sure, transactions occurred in financial markets, but credit did not play a major role. This bubble distorted resource allocation for a time and its ending resulted in a recession in the US as wealth declined, but given that credit played a very limited role, it's not clear that macroprudential policies would have been effective at addressing the bubble as it built and cushioning the economic weakness that followed its bursting.

Where credit is involved, however, we can aim to have lower peaks and higher floors on financial cycles; in my view, just how much changing macroprudential policies can damp many asset price and credit cycles is an open question and will depend in part on the nature and phase of the cycle. But there should be no ambiguity and no question about our ability to build more resilience in the financial system. We may not be able to make better drivers but we can make cars and roads safer to reduce damage when accidents happen – to the cars and passengers in them and to innocent bystanders.

Advantages of the MPC and FPC structure to address the policy interactions

The watchdog roles that the FPC have been asked to take on – just a few months into its existence as a statutory body – provide a clear signal of the value in having an independent group of experts with special expertise and an explicit primary objective for preserving financial stability.

Having a separate body tasked with setting macroprudential policy has other advantages too. A body with distinct primary objective for financial stability can help ensure clarity of purpose and help build credibility for acting to achieve that aim.

The set-up of separate bodies operating macroprudential and monetary policy tools is also consistent with the idea of matching tools to the objectives that that they are best suited to achieving. I have argued that monetary policy is a blunt tool for addressing financial stability risks that can stem from asset cycles, and macroprudential policy may be an inefficient tool to try and manage economic and credit cycles too closely.

But having both policies operated by committees housed at the Bank of England, with overlapping membership and the ability to benefit from each other's distinct expertise, is just as important a feature of the institutional set-up. It will help to manage and make more transparent the complicated interactions between monetary and macroprudential policy, ensuring an ongoing dialogue and deep understanding of each other's policy problems in real time.