BANK OF ENGLAND

Speech

Cooperation and coordination across policy domains

Speech given by
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I greatly appreciate the opportunity to return to the BIS and participate in this conference on "Supervisory Policy Implementation". The theme of this meeting is the current macrofinancial environment and its implications for supervision across sectors. I'm going to come from a slightly different angle of coordination across policy domains. And, while I will address the implications of the current environment at the end of my talk, I will concentrate more on the general issues of cooperation across monetary policy, macroprudential, and microprudential policies; how we deal with those challenges in the United Kingdom, where I sit on the Financial Policy Committee—the macroprudential authority; and what general lessons might be drawn from experience in the UK.

Policy interactions and the case for coordination and cooperation

Monetary, macroprudential and microprudential policies share a common underlying objective—to enhance public welfare by fostering sustained economic expansion at the economy's potential, damping financial and economic cycles. But they contribute to overall stability by focusing on different risks to sustained expansion, and use different tools to meet their objectives.

Monetary policy of course focuses on price and economic stability at the business cycle frequency and uses actual and expected changes in a short-term policy interest rate and, recently, asset purchases to meet its goals. The primary objective of microprudential policy is the safety and soundness of individual banks and other financial institutions as the foundation for overall financial and economic stability. It sets standards for, and supervises compliance with, capital, liquidity and risk management so financial institutions can meet the needs of their customers and of the economy. Macroprudential policy is focused directly on financial stability—trying to assure the ability of the financial system to deliver essential services at reasonable prices in support of economic growth under a variety of circumstances, including after a severe stress. It does so mostly by putting a macroprudential finish on microprudential tools to take account of externalities of financial instability and damp inherent procyclicality of the financial system. Macropru is focused on the financial cycle, which may be longer than the economic cycle that has the attention of the monetary policy makers, and it must consider system-wide amplification loops, which may be missed by microprudential regulators looking on an institution-by-institution basis.

Because each policy works at least in part by affecting the cost and availability of credit, how each is carried out can affect the primary objectives of the other policies—and therein lies the opportunity for cooperation and coordination to improve overall outcomes.

The interactions between monetary policy and financial stability have been discussed extensively, especially after the global financial crisis. Low interest rates and easily available credit can encourage borrowing and risk-taking through greater leverage by households, businesses and financial intermediaries. Leverage leaves borrowers more vulnerable to unexpected increases in interest rates, reductions in credit availability, and declines in income and it leaves intermediaries vulnerable to loan defaults and asset price declines.

The actions of borrowers and of intermediaries when problems threaten can amplify the immediate effects of credit or income shocks. In the extreme, the provision of financial services is severely disrupted with very serious adverse effects on the economy, as we saw so vividly in the crisis a decade ago.

When low short-term interest rates are accompanied by upward sloping yield curves, intermediaries are incented to borrow short and lend long. This leaves them vulnerable to runs if high leverage raises questions about their ability to repay. And in low rate environments savers and intermediaries trying to meet unrealistic nominal interest rate targets may settle for inadequate compensation for extra risk they are taking. This will compress risk spreads and raise asset prices beyond sustainable levels justified by fundamentals.

Of course, macro- and micro-prudential authorities have been well aware of these risks in recent years and of the lessons of the crisis. And as a result, steps have been taken to build resilience in the financial system. Capital requirements on banks have been raised; liquidity requirements imposed; and the adequacy of these requirements has been tested under severely adverse scenarios. The actions to bolster resilience have tended to raise the cost of credit and tightened availability, often for more risky borrowers. This corrects for the inadequate resilience and too-easy availability before the crisis and lays the foundation for greater and more consistent lending from healthier banks in the future. But the higher cost of credit will also affect aggregate demand and, possibly, aggregate supply through its effect on capital spending. The balance of demand and supply is critical to the monetary policy authorities pursuing their inflation target.

Much of the time macropru and monetary policies are likely to be pulling in the same direction. Exuberant economies and greater risk-taking often go together, calling for tighter monetary and macropru polices. Equally, recessionary conditions and inflation undershoots will tend to be accompanied by a pullback in credit availability that justifies easing in monetary and macropru policies.

But depending on the source of the financial or economic disturbance and the circumstances more generally this may not always be the case. There will be situations, including over the past few years, in which the two types of policies are pulling on credit conditions in opposite directions. A key message I would like to underline this afternoon, is that this possibility is a <u>positive feature</u>, not a <u>bug</u> in the system.

Macroprudential and monetary policies are trying to accomplish two different, albeit closely intertwined, objectives—financial stability and price stability. As the famous Tinbergen rule tells us, with two goals, it's always helpful, indeed often necessary, to have at least two instruments. Macropru tools are designed to be most effective at building resilience to allow the financial system to deliver services to real economy borrowers and savers. Monetary policy tools have a long history of use in countering business cycles and delivering on inflation targets. To enhance the odds on achieving both goals simultaneously each policy should do what it does best.

When the policies are pulling in different directions, the optimal outcome of achieving both price and financial stability requires that each is able to offset any adverse consequences of the other on its particular objective. For example, when macropru is restricting credit availability, but inflation below its goal, monetary policy must be able to ease enough to achieve its target; when interest rates are low, macropru must have the tools and scope to protect financial stability.

Under these favourable circumstances, formal coordination and cooperation becomes less essential to promote public welfare. But even then, the implementation of one set of polices can affect the outcome of the other. Therefore, understanding and communication will help in achieving society’s goals in the most effective manner. Each set of policymakers will be able to do its job better--will be able to anticipate and prepare for changing conditions-- if they understand the considerations likely to be influencing the other policy.

Coordination and cooperation become more helpful, the closer each policy is to constraints that inhibit its ability to offset the effects of the other policy. For example, if monetary policy is at or near the effective lower bound and relying on unconventional policy measures, macroprudential authorities may need to phase in higher requirements taking more time to achieve the appropriate level of resilience. Or, they may need to target their actions as narrowly as possible on the threat to financial stability to minimize their effects on aggregate demand.

To be sure, with monetary policy at its effective lower bound, risks might be skewed toward adverse economic outcomes, reinforcing the need to build resilience. And narrowly focused macropru policies might affect sectors, like real estate, that are especially important to the transmission of monetary policy. Therefore, phasing and focus are likely to be helpful approaches. But they need to be implemented carefully with a full cost-benefit analysis, and ongoing monitoring.

Analogously, in the future the macroprudential authorities may find themselves constrained in containing systemic risks because they are arising outside the regulatory perimeter. So monetary policy may need to adapt by taking longer to raise inflation to target than it otherwise would--for example, by running higher interest rates than dictated solely by the inflation objective.

Our discussion so far has been about the interactions between macroprudential and monetary policy, but those between macro and micro-prudential are also important. As noted, macroprudential regulation usually involves putting a “macroprudential finish “ on microprudential regulation. This takes account of the systemic risks, externalities, interconnections and procyclicality of the actions of individual institutions, even when they are “safe and sound”. So close cooperation is critical to the success of macroprudential regulation. Cooperation will be enhanced when the microprudential regulators share the objective of preserving financial stability.

One test of this cooperation will come in a recession. As risks materialize and loan defaults rise, macroprudential authorities will want to release capital buffers to maintain lending but microprudential regulators will see elevated risks to safety and soundness. It will be critical to successful cooperation to build adequate macroprudential buffers in good times so that safety and soundness is not threatened by a reduction in capital or liquidity requirements.

Coordination and cooperation across policy domains in the UK

In the UK we have had considerable experience in coordinating and cooperating across policy domains over the past six years, illustrating the possibilities and challenges of policy coordination.

Institutionally the UK is well set up to consider and implement policy coordination. Responsibilities for monetary policy (MPC), macroprudential policy (FPC), microprudential policy (PRC), and market conduct are vested in four separate bodies, each with its own primary mandate and personnel. The policy committees for three of those—monetary, micro and macro are inside the Bank of England; the fourth authority is in the Financial Conduct Authority (FCA), which is outside the Bank, but its CEO sits on the FPC. The three Bank committees each have external members with expertise in the appropriate area, but they also have internal Bank of England members with considerable overlap among the committees.

A potential disadvantage of this set up is the risk of dominance by one perspective—group think. A key role of the external members of these committees, like myself, is to be sure that all sides of an issue and all reasonable policy responses are considered. And we take this responsibility very seriously.

Having three of the committees within the Bank along with the overlapping personnel naturally leads to considerable sharing of information and analysis. On the FPC we receive briefings and background material from staff working with other committees. And of course, their members let us know about policy considerations relevant to us.

In the Chancellor’s remit letters to the FPC and MPC he has emphasized that we should look for opportunities for cooperation and coordination consistent with the primary objective of each committee. And in fact cooperation and coordination across the MPC, FPC, and PRC has been a prominent feature of policymaking at the Bank.

For example, in 2012-2013 the FPC was trying to ensure that the resilience of the banking system was being rebuilt after the crisis while the MPC was trying to stimulate lending and spending with policy rates near the effective lower bound. We, the FPC, used a stress-test like exercise to identify the sterling amount of capital the banks required. Our recommendation to the microprudential authorities following this test emphasized that increased capital requirements were to be met by building capital not by reducing lending at a time when the MPC was trying to encourage lending.

In 2013 the MPC announced forward guidance that interest rates were likely to remain low until certain benchmarks for the economy or inflation were reached. But it recognized that expectations of low interest rates for a long period could cause risks to financial stability to build. So it gave the FPC a “knock out” of the interest rate guidance. If the FPC, saw low interest rates creating financial stability issues we could not address with our macroprudential tools, we would notify the MPC and it would reconsider its policy guidance. Importantly the knock out meant that the FPC had to explicitly consider at each quarterly meeting whether such risks were being created and send our assessment to the MPC. This assessment would be published after the relevant MPC meeting.

A third interesting example of MPC and FPC coordination occurred after the UK voted to leave the European Union. The MPC responded to the possible adverse economic effects of the vote by easing a variety of policy tools. These included asset purchases and incentives to borrow from the Bank of England and lend to private borrowers, both of which would add to the balances of the commercial banks at the Bank of England. To ensure that FPC capital requirements would not discourage use of these facilities or undermine the effectiveness of the policies, we exempted deposits at the central bank from the exposure measure of the leverage ratio. At the same time, we said we would adjust the ratio so that this action did not result in a reduction in overall leverage requirements.

The FPC has also coordinated closely with the microprudential regulators. We work in close partnership with the PRC on the calibration of the stress tests and interpretation of the results. And we have asked them on many occasions to gather added information on particular activities that could pose a risk to financial stability. For example information about commercial real estate lending helped us judge whether action on our part to preserve resilience was warranted.

After the Brexit referendum in June 2016, the FPC decreased the countercyclical capital buffer (CCyB) from the 0.5 per cent we had imposed in March. The PRC worked closely with us to ensure that the capital buffer was indeed released—not offset by an increase elsewhere—and that the released capital was available to support lending, not paid out as dividends or share buybacks.

Lessons from the UK experience.

So, as you can tell, coordination and cooperation across policy domains has been a prominent feature of policy implementation in the UK over the past six or so years. It is too early to judge the success of this new regime. The ultimate effects of policies can take a long time to be felt, and new stresses will arise to test the system. Still, it does seem a promising start. All the authorities appear to have made progress toward their individual primary objectives, even if, at times it looked like push-me pull-you. To repeat, the potential for policies moving in different directions on credit costs and availability has been a positive attribute, not a bug of the system. So what lessons can we draw from this experience?

First, it has required very close communication and shared understanding among the various committees and authorities. This entails a willingness to be flexible about actions and recognize spillovers. Obviously this has been greatly helped by having different policy authorities inside the Bank of England with overlapping membership.

This organizational structure is highly unusual, perhaps unique to the United Kingdom. A key attribute that can be replicated in other structures however, is the important role of the central bank in micro and macroprudential regulation. The central bank brings a perspective and expertise on markets and the economy that generally is not duplicated elsewhere in the government. And the participation of the central bank is required when cooperation and coordination stretches across monetary policy.

Second, it's very helpful for the macroprudential authorities to have a variety of tools to address systemic risks. The greater the variety, the more likely that macropru can be targeted on the source of systemic risk, and can do so fairly narrowly to reduce the spillover to the economy and the conduct of monetary policy.

In my view, it is particularly important for the macropru authority to have tools to address real estate cycles, given the prominence of such cycles—both commercial and residential—in episodes of financial instability. In the UK, the FPC can impose sectoral capitals requirements on real estate lending if we see risks building on bank balance sheets. In addition, we have used powers to set loan-to-income standards as well as minimum standards for testing borrower affordability. The more macroprudential policy can effectively address systemic risks, the less pressure on monetary policy to do so by steering away from, or taking longer to get to, the inflation target. Moreover, the stronger and more resilient the financial sector, the less likely will be a crisis that forces monetary policy to the effective lower bound and the more reliable and predictable should be the transmission of monetary policy through the financial system to the economy. Strong, active macroprudential policies facilitate strong active monetary policies focused on price and economic stability.

Third, cooperation between the macroprudential and microprudential policies will be enhanced if buffers are built up in good times. Those buffers need to be high enough to be released without endangering the safety and soundness objectives of the microprudential authorities. Our intention on the FPC is to have a CCyB in the region of one per cent when risks are in a '*standard range'*— meaning neither elevated in exuberant times or depressed after risks have materialized say after a crisis. We will set the CCyB after getting information from the stress tests, which, as I noted are conducted jointly with the microprudential regulator.

Coordination and cooperation across policies in the current conjuncture.

I'm going to address my remarks about coordination and cooperation in the current conjuncture to the global situation, not to the particular challenges facing the UK.

Globally, we appear to be drawing closer to the end of a difficult period in which both regulatory and monetary policies were coping with the fallout from the global financial crisis. Regulatory policy needed to focus on building resilience in the financial system. And monetary policy in many jurisdictions has had to target extraordinarily low interest rates for some time, and also to employ various measures of unconventional policy to stimulate growth and hit inflation targets.

Those tasks aren't fully accomplished. We need to implement and fine tune the post-crisis regulatory reforms. And in many places monetary policy interest rates remains extremely accommodative. Yet, one can see some light at the end of these post-crisis tunnels. The basic framework for a much strengthened financial system is in place. And many economies seem to be on a much firmer growth trajectory with inflation expected to rise to targeted levels.

As we've discussed, in the post-crisis environment smart, focused and coordinated policies had the potential to yield considerable dividends by achieving multiple targets at the same time. As we transition toward a more normal and sustainable posture for regulatory and monetary policies some of the tensions that called for policy coordination in recent years will abate.

But thinking about and preparing for coordination and cooperation across policy domains will remain essential to promoting public welfare. Different authorities will be better able to accomplish their objectives if they understand the other policies and communicate clearly.

Moreover, even if all goes as hoped, the transition is likely to last a while and the constraints and limitations of each policy will not be far away. Monetary policy can contribute to financial stability by acting as gradually and as predictably as allowed by the evolving economic circumstances.

Macro and microprudential policies need to be alert to and anticipate financial stability risks that might arise as rates rise and central bank portfolios stabilize and then decline. Stress tests of banks will be an essential tool for spotting risks and building resilience. Particularly as interest rates rise along the yield curve. The curve itself may even twist in unexpected ways, revealing vulnerabilities in asset prices and portfolio choices. But a resilient financial system will enable monetary policy to continue to unwind the unconventional policies previously put in place.

New and unanticipated shocks are inevitable in the transition, and also in the next, new steady state. For at least some of these, cooperation across policy domains will help to realize the full benefits of having multiple tools for multiple objectives—the positive feature of the system.

Today, I've tried to lay out the case for coordination under certain circumstances and illustrate how coordination and communication across domains has been implemented in the UK. I hope that has been helpful as you think about your own jurisdictions.