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EXECUTIVE SUMMARY

1.

governance levels, macro-prudential policies should not be overstrained, and it should rather be complemented by fiscal and structural policies.

- The governance structure in the euro area might strike the right balance between macro- / micro- prudential at both European and national level. What is crucial is that the ECB will be able to retain both micro-prudential responsibilities (i.e. balance sheet assessment, through the Single Supervisory Mechanism), and, in coordination with the European Systemic Risk Board, direct macro-prudential competences to "guide" the policy stance of individual national authorities (through the Capital Requirements Regulation and Directive). The ECB/ Single Supervisory Mechanism should therefore be able to internalise any tensions between macro- vs. micro-prudential policies and establish a well-defined hierarchy between them.

- Some of the new ECB competences are likely to result into a conflict of interest / institutional bias especially when the ECB acts in its liquidity provision role (i.e. lender of last resorts for banks). Hence communication between different parties and a clear mandate, prioritising objectives, should be ensured in order to reduce the intersection of responsibilities, and align preferences at the same time.

- Here, coordination with national macro-prudential authorities will be essential. National macro-prudential authorities should internalise any tensions between monetary and macro-prudential policies.

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3. THE INTERFACE BETWEEN MONETARY AND MACRO-PRUDENTIAL POLICY

3.1. How do they interact?

There is a general consensus that price stability and financial stability are complementary over the long run. However, over the short-/ medium-term, the two objectives can clash. As an example, during quantitative easing (QE) programs, macro-prudential instruments designed to contain financial market leverage can run counter to monetary policy measures. While expansive monetary measures, such as quantitative or credit easing, aim to increase borrowing and spending in the economy, macro-prudential policy aimed at [illegible] by banks. These two objectives are clearly conflicting. Therefore aligning the two policies is important. But, aligning them too much can also be dangerous as it might lead to [illegible] dominance of policies, or [illegible]

macro-prudential policy tools.[11] Under this perspective, monetary policy can contribute to the build-up of financial imbalances. This is the case as the monetary policy stance impacts on risk appetite of financial intermediaries, which, in turn, affects the health and stability of the financial sector, hence, the outlook for price stability.

The ideal set-up would be that of having a countercyclical monetary policy, which is stricter during upswings, even in the absence of inflationary pressures, and is aggressively eased in the short term during marked contractions. Even if, in the short run, the monetary policy stance was to cause the target variables (i.e. inflation) to differ from their desired values, this would be justified by the possibility of avoiding future (larger) deviations, such as the likelihood of a crisis. In saying so, however, one should also recognize the limitations that monetary policy faces, in particular with respect to eliminating the debt overhang that is typical of a financial downturn.

Therefore, the extended perspective stresses the risk of overloading monetary policy by attaching targets under (financial) crises times that are not reasonable to achieve. Hence, rather than using monetary policy as a crisis combat tool, the latter should be used preventively in order to avoid an overloading later on. The preventive nature of monetary policy is regarded as necessary in order to protect credibility regarding its price stability objective. The monetary policy is regarded as effective in at least containing ex ante risks to financial stability, even if this objective can be attained only in conjunction with a solid macro-prudential policy.[12]

The Bank of International Settlements (BIS) largely endorses this perspective. The current institutional set-up of the FED pursues this logic. In addition, there are signs that the ECB is slowly moving in this direction.

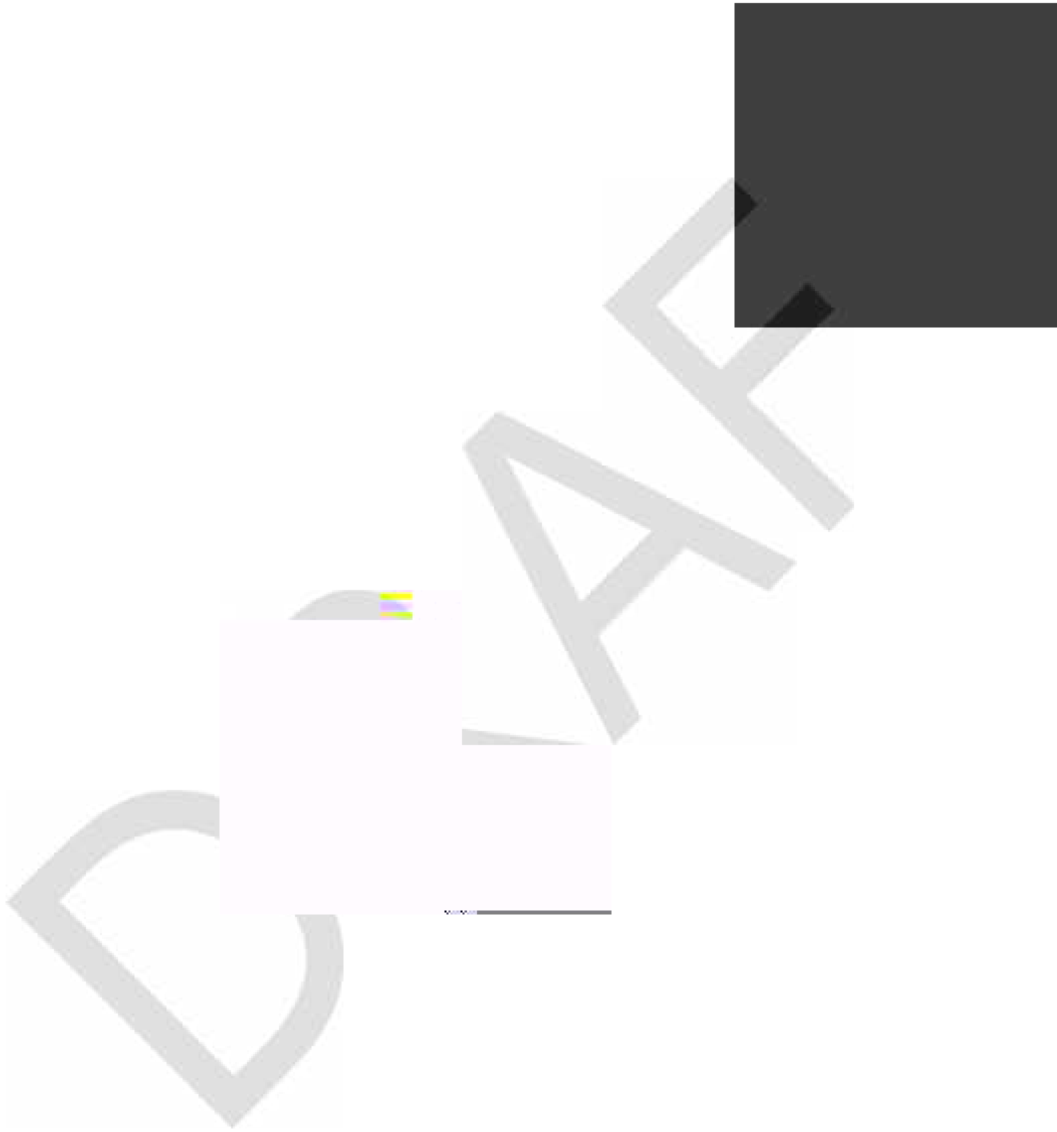
Integrated perspective

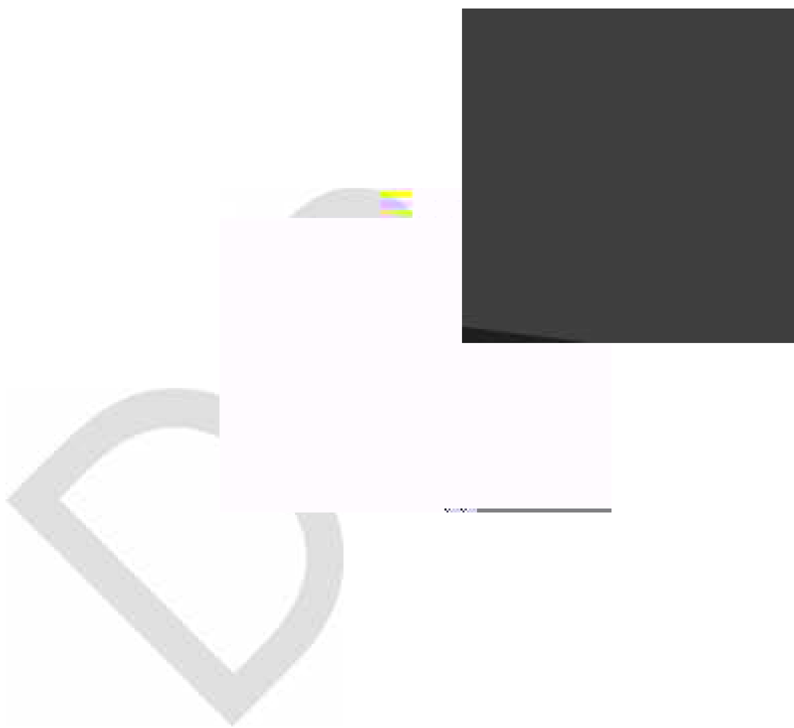
The proponents of this perspective argue that even the extended perspective calls for an excessively strict, and inappropriate, separation of the two policy areas, i.e. price and financial stability. The underlying assumption is that it is very difficult to separate price stability from financial stability, as well as it is hard to split the instruments and transmission mechanism of monetary policy from that of macro-prudential policy. As a result, it is highly ineffective for the monetary policy to solely focus on price stability. For instance, securities purchase programs, one of the unconventional policy measures adopted recently by the ECB, does not only have direct intended monetary policy effects, but also, through recapitalization of ailing financial intermediaries, impact on financial stability, which in turn feeds back directly into price stability.[13] In a similar way, macro-prudential tools that affect quantity of lending (a financial stability objective) impacts on money creation and, thus, on price stability.

Hence, this view advocates using simultaneously monetary policy (standard and non-standard) and macro-prudential instruments in order to ensure financial stability and price stability at the same time. Therefore a strict separation of tools by target areas is, according to them, counterproductive. Instead both policy areas should cooperate closely. Moreover, financial market events should always be part of monetary policy considerations.

In cases where a crisis outbreaks – despite the joint efforts an integrated perspective would call for – a "bottleneck approach" should be taken. The sectors that suffer the most from a debt overhang, and whose balance sheets were hit the hardest, should be primarily supported. Without such policy efforts, the contraction in some sectors could easily result in a broader liquidity spiral and fire sales of assets, which in turn could lead to self-reinforcing deflationary spirals and sudden stops.[14] This view is in line with the actions taken by the

[11] See Borio (2014), Feroli et al. (2014), Goodhart (2014), Stein (2014), and Woodford (2012), amongst others, for a discussion on the limitations of macro-prudential tools, and the difficulty of conceptualizing financial stability.
[12] Bundesbank (2015).
[13] See Stein (2013) for a discussion of this feed-back loop.
[14] See Mendoza (2010) for the theoretical foundations of this mechanism, and Buiter and Sibert (2008) for a discussion on the need for a 'market-maker of last resort' in such cases.





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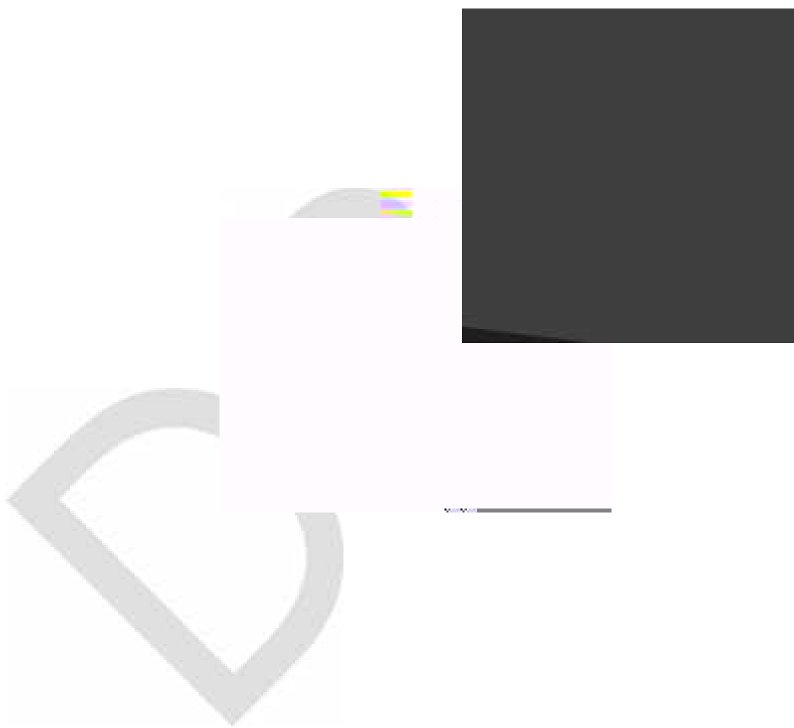
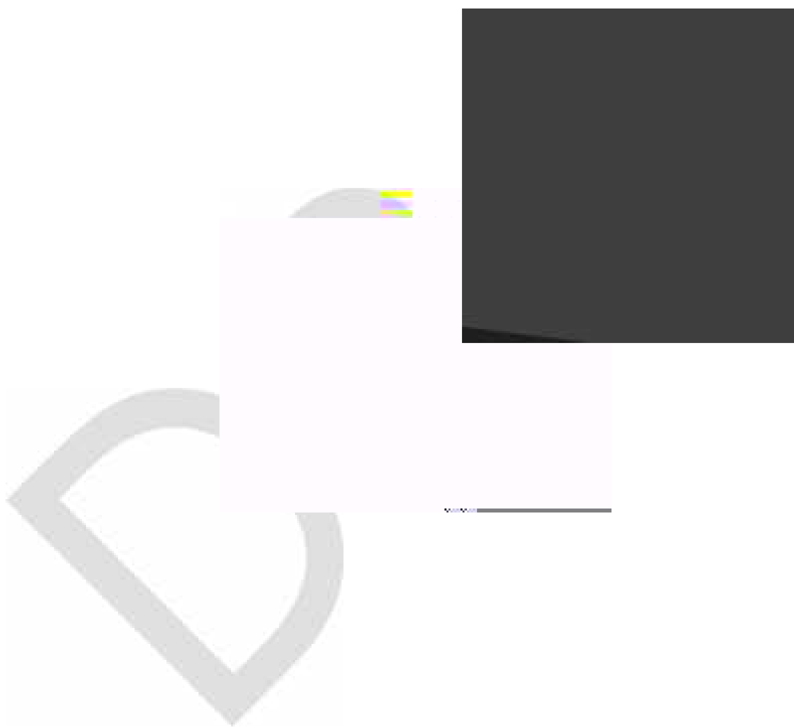
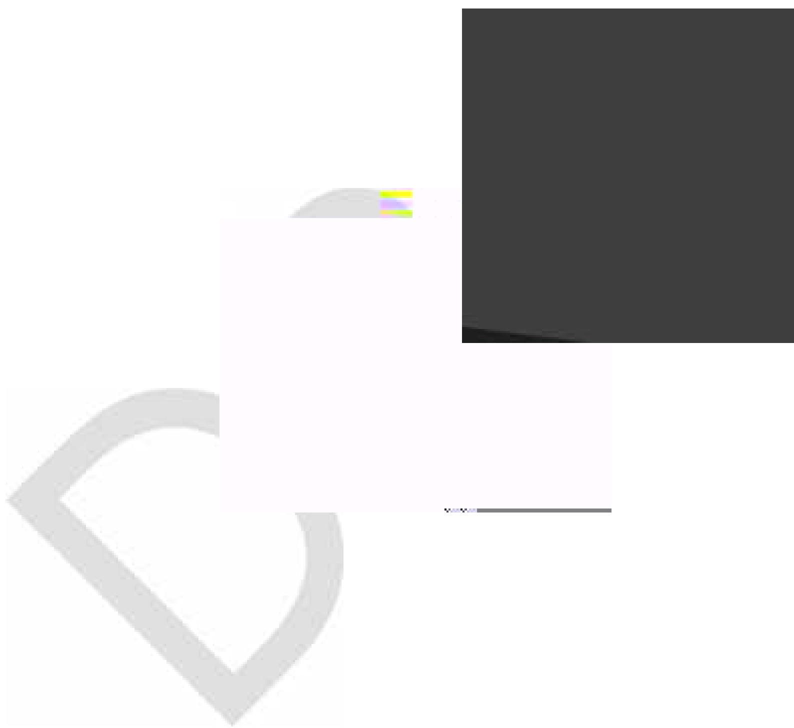
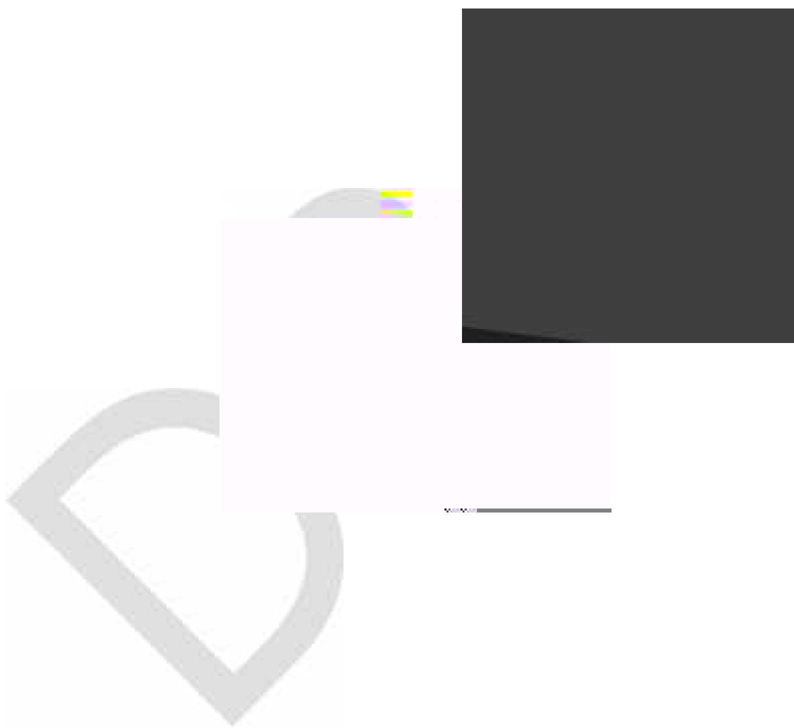








5. WHEN IS INCLUDING MACRO-PRUDENTIAL POLICY BENEFICIAL? EVIDENCE FROM THE LITERATURE

The specific literature on this issue is at its infancy. A common thread among recent studies on interactions seems to be that macro-prudential and monetary policies are, in many instances, complementary and support each other. However, there is also a potential for trade-offs, or even conflicts of interest between them. While the exact type of trade-offs will depend on the specific model assumptions, there are some general lessons to be learned based on the (selected) literature review below.[24]

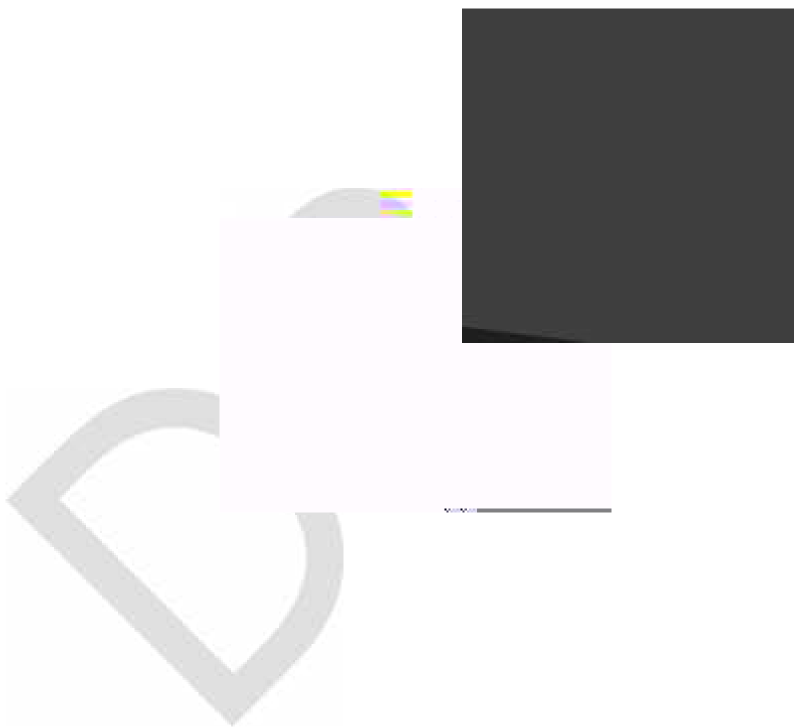
Angelini et al. (2014) find that in 'normal times', when the economic cycle is driven by supply shocks, macro-prudential policy yields negligible benefits relative to a 'monetary policy-only' scenario, even if the two authorities cooperate. Furthermore, if both policies are finally implemented, the economy is better off when the two cooperate, as that will prevent any conflict of interest in aims. Yet, the benefits of macro-prudential policy become more sizeable when economic fluctuations are driven by financial or property market shocks that in turn affect the supply of loans. Once again the benefits increase when the two authorities cooperate closely.

In the same vein, Quint and Rabanal (2013) show that introducing macro-prudential policies is largely welfare improving, but that there are also winners and losers from including these instruments. Under property price or risk shocks, these measures reduce the volatility of real variables by offsetting the propagation effects triggered by these shocks. However, when technology (or supply) shocks hit the economy, macro-prudential policies have the opposite effect and magnify the countercyclical behavior of the lending-deposit spread. This imposes larger fluctuations in consumption, housing investment, and hours worked for borrowers. Hence, in such circumstances, introducing macro-prudential policy would increase the welfare of savers, but reduce that of borrowers.

Similar considerations apply for an aggregate demand shock. A monetary policy response alone is optimal if it durably stabilizes output AND inflation. When stabilizing inflation comes at the cost of lower output, and when lending imposes a systemic risk externality, there is some scope for using macro-prudential policy alongside monetary policy so as to limit systemic risk stemming from the expansion in leverage.

Gelain and Ilbas (2014), on the other hand, show that the successfulness of a monetary-macro prudential policy mix depends on how responsive macro-prudential policy is to changes in the business cycle (or output). There are considerable gains from coordination if the macro-prudential regulator has a similar response to the business cycle as the monetary policy, i.e. it has been assigned a sufficiently high weight on output gap stabilization. If, on the other hand, the main focus of the macro-prudential mandate is on credit growth, then this can reach better outcomes in the absence of coordination, even if the central bank does worse. This trade-off in coordination gains is equally present in a situation characterized by high real and financial volatility, such as experienced during the recent financial turmoil, and their results are robust to numerous definitions of financial stability.

Taking a different stance, Claessens et al (2013) argues that while interactions can enhance or reduce the effectiveness of each policy in achieving its objectives, there is no great need for coordination in most cases. However, there are exceptions, in particular when monetary and macro-prudential policies are constrained. An example of such constraint is a monetary union where individual countries do not have authority over monetary policy. In such cases, the burden on the other policy (in this case macro-prudential) increases and additional distortions can give rise to coordination issues. In such a (second best) scenario



6. CONCLUSIONS

The European Union has pursued a number of initiatives to create a safer and sounder financial sector for the single market. In parallel, bold unconventional monetary policies have been implemented in order to combat low inflation, foster risk taking and, ultimately, reinvigorate growth.

But monetary and macro-prudential policies interact with each other and thus may enhance or diminish the effectiveness of the other. Monetary policy affects financial stability by shaping, for instance, leverage and borrowing. Equally, macro-prudential policies constrain borrowing, which in turn have side-effects on output and prices, and therefore on monetary policy. When both monetary and macro-prudential functions are housed within the central bank, coordination is improved, but safeguards are needed to counter the risks from dual objectives.

Against this background, this paper outlined the theoretical and empirical underpinnings of macro-prudential policy, and discussed the way it interacts with monetary policy. We identified advantages as well as risks from cooperating in the two policy areas, and provided suggestions in terms of institutional design on how to contain those risks. Against this backdrop, we evaluate the recent European practice.

We conclude that the governance structure in the euro area might strike the right balance between macro- / micro- prudential at both European and national level. What is crucial is that the ECB will be able to retain both micro-prudential responsibilities (i.e. balance sheet assessment, through the Single Supervisory Mechanism), and, in coordination with the

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