

The Role of Monetary Policy and macro-prudential Tools for financial Stability in the Euro area

Daniel Detzer works as Advisor on Financial Market Policies and is PhD candidate at the Carl von Ossietzky University Oldenburg

Jan-Martin Frie is Economic Policy Analyst at the European Political Strategy Centre (EPSC), the in-house think tank of the European Commission

Proponents of macroprudential regulation as a tool to maintain financial stability have been vocal for a long time but the concept has been given serious attention only after the great financial crisis (GFC). One stream of this discussion, aims to revisit the role of central banks' in preserving financial stability. More narrowly, a long-standing discussion of how central banks should react to asset price booms or bubbles had gained new traction shifting the tides for those in favour of using interest rates to "lean against the wind (LATW)". In the following we will shortly review the discussion around the role for central banks in financial stability and using the interest rate as a tool to this end in particular. We approach this question with a focus on the Euro area. Here we develop a compelling case against using the interest rate to react to asset price inflations. We then shortly outline some more effective and efficient instruments. For those more suitable instruments we will draw up some thoughts of whether the responsibility of their use should be placed with the European Central Bank, another EU-level institution or whether the centre of gravity should remain at the national level.

The theoretical debate

There has been a long-standing discussion on how a central bank should react towards asset price bubbles. The different positions in this discussion include on the one hand, different varieties of what Jean Claude Trichet called the "orthodox view". This school of thought argues that there should be "no special role for asset prices"¹ or in another version that the Consumer Price Index used to define the central banks objective² should be explicitly extended to include asset prices. It is argued within this view that asset prices can be seen as a proxy of future consumption prices and as such the central bank should be concerned with them, since she should ensure not only stable prices for output today, but also for future output. In both views financial stability is of no special concern for the central bank and the focus remains on the maintenance of stable prices for consumption goods.

On the other hand, others advocate for a role of the central bank in preserving financial stability. An extreme, but today less supported position of this view is that central banks should attempt to prick bubbles. This means with a decisive move in interest rates the central bank forces the most extreme positions to liquidate and so helps to deflate a bubble. A more moderate version of this view is the so

¹ The most extreme supporters of this camp advocate that price stability suffices to ensure financial stability. While most see this position as having been rejected empirically, a more moderate version proposes that asset prices should only be considered in so far that they concern consumer price inflation through their "regular mechanisms" (such as wealth effects).

² Currently, the ECBs primary target is to maintain price stability. Secondary, and only if price stability is not conflicted by this, she is supposed to support the general economic policy in the EU. In addition she is supposed to "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" (Article 127 AEUV). For the Fed, the Congress established the statutory objectives for monetary policy--maximum employment, stable prices, and moderate long-term interest rates--in the Federal Reserve Act.

called “leaning against the wind” position, which argues that interest rates should cautiously be increased beyond what inflation predictions would warrant when a potentially detrimental asset price boom is detected (Trichet 2005).

Before the GFC, the prevailing opinion in academic circles and the larger central banks of the world was the former of those views, according to which central banks should largely ignore asset price booms and only clean up afterwards.³ Arguments in favour of this view are:

- It is impossible to detect asset price bubbles or to distinguish them from rational shifts in expectations (some authors even doubt that from a theoretical point of view the existence of bubbles)
- Intervention would risk making matters worse
- Central banks are better placed to clean up the damage afterwards

Other prominent figures, for example from the Bank for International Settlements, advocated for a long time the potential benefits of leaning against-the-wind policies and more generally stressed the importance of the stability of the financial system for central banks to effectively pursue their monetary policy (Borio and White 2004, Caruana 2016).⁴ Recent research, but in particular the experience of the GFC have questioned much of the conventional wisdom and have strengthened the case of those arguing in favour of the leaning against the wind view.

- Research has shown that with a couple of indicators such as debt levels and asset prices the build-up of imbalances and the occurrence of a bust and financial crisis can be predicted with a relatively low margin of error⁵
- The bursting of asset price bubbles, in particular in the wake of the GFC, have demonstrated the enormous and lasting costs
- Finally, the argument that central banks alone could, through accommodative monetary policy, stabilize the economy and limit the damage after the burst has been put into question by the GFC, when conventional monetary policy was unable to get the crisis under control and despite extraordinary measures many countries slipped into deflation. Finally, only substantial government intervention was able to stabilize the financial sector.

We largely agree with the arguments of the second view, that advances in supervisory practice make the detection of asset price misalignments significantly more reliable and that their bursting can impair the financial system with potentially high costs for the economy as a whole. Therefore we would agree that such misalignments should be addressed by appropriate instruments but we have serious doubts that the short-term interest rate is the right instrument to do so. In the following we will outline our concerns and argue that in particular in the Euro area there are good reasons against its use.

³ For different proponents of this view see e.g. Bernanke and Gertler (1999) or Kohn (2006).

⁴ In fact, the ECB explained that the absence of financial stability impairs the transmission channel of standard monetary policy instruments and requires the resort to non-standard monetary policy measures. As such, financial stability became a *de facto* objective of the ECB.

⁵ For example, Borio and Lowe (2002) use credit-to-income and asset price indicators and show that deviations from trend would have predicted a financial crisis correctly 55 per cent of the time, while giving a false signal in only 3 per cent of the cases; see also Gerdesmeier et al. (2012) and the literature review they provide.

Why the short-term interest rate is not the right instrument to avoid the built up of asset price bubbles

Firstly, the effect of changes in the interest rate on financial stability is not well researched. The Bundesbank for example argues that monetary policy and risk taking by private actors is connected through the so-called risk-taking channel⁶. However, at the same time she argues that an increase in the interest rate may actually weaken financial stability if debt levels are high already and LATW increases debt service burdens. Also, she argues that there may be second order effects which may lead some actors to actually increase risk taking. These theoretical arguments for ambiguous effects of monetary policy on financial stability are supported by empirical research by Blot et al (2015), which does not find a stable relation between financial and price stability. This draws into doubt the suitability of the interest rate as an appropriate instrument to address asset price bubbles.

Secondly, it has to be doubted that a reasonable increase could flatten an asset price boom by much. An interest rates increased by 2-3 percentage points (which would a substantial increase given today's low rates) will most likely not be able to substantially dent a bubble when expected returns are in a range of 10 to 20 per cent⁷. Surely, a central bank can always increase interest rates much higher but that may come at the cost of damaging the economy and causing a crisis in the financial sector itself.⁸

In addition to these general reasons opposing the use of the interest rate to support financial stability, the specific setting of the Euro area adds some additional arguments rooted in practical and political economy considerations.

Why the Euro area is special

Firstly, asset price booms are often spatially limited. House price bubbles are often only relevant at a regional level, stock price booms mostly national. Before the outbreak of the crisis, we have seen real estate booms in Ireland, Spain and to a certain degree in the Baltic states. Would that have been reason enough to increase the interest rate, even though other EMU members already suffered from a too high real rate? Currently, the situation is reversed. In Germany in certain areas real estate prices are booming, while much of the rest of the Euro area is still recovering from the crisis. Confronted with such differing situations in the Euro area, how should the ECB react? It would have to weigh the sacrifice of some output of the Euro area against the potential taming of a bubble occurring in one or only a few countries. This problem is aggravated by the fact there is little private and public risk-sharing in the Euro area. If for example a real estate bubble affects some of the states

⁶ It is supposed to work through three transmission mechanisms: lowering of interest rates leads to higher assets prices and a changed risk perception and tolerance; actors such as life insurance companies may have promised fixed nominal rates of return to their clients, so that a lower interest rate may force them to increase the risk in their portfolios to be able to provide those returns; moral hazard due to the expectation of aggressive monetary policy in case of a crisis.

⁷ For example, based on the UBS Gallup survey, Adam et al. (forthcoming) report real annual return expectations of stock market investors of 13 per cent during the tech boom in the US. Case and Shiller (2003) survey the expectations of house price appreciations in 1988 and 2003 and mean responses reached 10 – 15 per cent price increases for a one year horizon, but similar figures even for the annual change of housing prices over the next ten years.

⁸ See for example Greenspan (2002), who argues that in the stock market rallies of 1989, 1994 and 1999/2000 moderate rate rises have not been able to interrupt these bull markets.

of the USA, it could be argued that the costs of a bust are shared by all states to some degree via federal unemployment schemes, tax systems and cross border exposures of private actors. Therefore, it can be better justified to use a blunt instrument like the interest rate (in the absence of better suited instruments) which does affect all other member states equally, since they also would share into the costs of a bubble. Consequently, the low degree of risk sharing does not allow to make a similar case for the Euro area.

Secondly, while the primary objective of the ECB is keeping inflation at its target level according to its statute it has also a responsibility to support growth and employment in the Euro area. Before the crisis, some have criticised that she has in the past been overly zealous regarding inflation at the cost of output and as a result employment losses being higher than necessary. Giving the ECB explicitly the additional task of safeguarding financial stability would mean in practice according to the Bundesbank “a monetary policy stance that tends to be stricter in upswings, even in the absence of inflationary pressure, and is aggressively eased during a marked downturn, but a less persistent expansionary policy stance following a period of economic downturn”.

Finally, giving a mandate for financial stability to the ECB would have further political drawbacks. As we will outline below, there is a range of promising instruments proposed in academic and professional discussions or already in place in some member states. Mandating the central bank now to use the interest rate to ensure financial stability would strengthen voices against the creation of further workable instruments even further, since they could point at this already existing instrument and responsibility at the central bank, knowing it most likely would not be used.

So what's the way forward?

As outlined, the interest rate is not a particularly well-suited instrument to address accumulating financial imbalances. Academics from different areas as well as practitioners in financial markets, regulation and supervision have proposed a range of well targeted instruments which seem promising to achieve the envisioned goals at lower cost. At the core of for instance borrower-based-instruments is the idea to limit the ability to borrow too much from the demand side. For real estate markets loan-to-value and debt-to-income ratios seem promising measures. Prior to the GFC these instruments were used primarily outside of the EU so that the more recent introduction of such measures in the EU will need to be closely monitored and evaluated. First assessments from for instance the Central Bank of Ireland, which has introduced caps on loan-to-value and loan-to-income ratios in early 2015, are encouraging (Donnery 2017).

For a general credit boom countercyclical capital requirements or loan loss provisions are potential targeted instruments on the supply side. Finally, so called asset based reserve requirements could be a highly flexible instrument. Research suggests that borrower based instruments such as loan to value and debt to income ratios as well as supply-side measures such as limits on leverage and dynamic provisioning are particularly effective in slowing credit growth and house prices (Cerutti et al. 2015). However, the design of the specific instruments needs to be informed for instance by the micro-structure of the local housing market and the overall position in the financial cycle.

However, these instruments face strong opposition from various vested interests. As a result, by today, only few countries have made a wide range of instruments available.⁹ A telling example is Germany. Following a recommendation of the financial stability committee the ministry of finance proposed a law giving the supervisors a flexible tool box to address real estate bubbles. In parliament however, heavy lobbying has reduced the originally envisaged tool box to only two instruments, which in addition have been blunted by wide ranging exceptions.¹⁰

Here, the European level could play a more prominent role than it does today. In fact, the EU is currently revising the macro-prudential framework. The current framework, which is focused on banking and made up of five pieces legislation¹¹, has evolved gradually over the past years. As a result of this evolving character, the tools available under EU legislation overlap in parts, creating inconsistencies in the way the instruments are activated and feature complex processes in how they are coordinated. The review hence intends to clarify responsibilities and ensure instruments are used more effectively. *The key aim is to ensure the right balance between national flexibility, and community control is achieved. This may involve streamlining the toolset of instruments, changing the activation procedures for these instruments, enhancing the role of the ESRB as a macro-prudential hub, and clarifying the SSM's role in the framework.*¹²

We support to strengthen and expand the mandate of the ESRB in coordinating macro prudential policy in the EU, as part of a network of responsible national competent authorities. While in theory we see merits to entrust the EU level with the full set of macro-prudential tools¹³, we are cautious that the European authority that would apply macro-prudential might be used as a scapegoat by national politicians, who understand the need to act but face domestic opposition to such a move. Giving the European level the full responsibility to ensure financial stability and reining in national bubbles will put it in an even more precarious situation. Should it not use its powers and a bubble bursts it will be criticised as ineffective on these grounds. If it uses its instruments however and successfully prevent bubbles it will be criticised to have acted without reason. In both cases anti-EU sentiments will be furthered. The mounting criticism of politicians against the ECB monetary policy, which prevented the Euro area from falling apart, provides a telling example of what to expect when it will increase national loan to value ratios in a real estate boom. Eventually, as already mentioned above, because fiscal costs of a crisis must be borne nationally the final decisions of applying macro prudential tools should stay with national authorities. Those in turn should be given the right incentives and independence to be able to take the necessary measures. A publicly visible comply or explain approach could be envisaged. Potentially, here incentives could be strengthened by limiting access to EU support and funds if a national authority ignored a warning and so failed to prevent a crisis.

The current framework should be underpinned by legislation that ensures that the national and the EU level has full access to all information relevant to understand fully the current state of financial

⁹ For an overview of the current macroprudential instruments available in a range of countries see Claessen (2014).

¹⁰ The draft law can be found as Bundestagsdrucksache No. 18/10935 at <http://dipbt.bundestag.de/dip21/btd/18/109/1810935.pdf>.

¹¹ Two [European Systemic Risk Board](#) (ESRB) Regulations, the [Capital Requirements Directive IV](#) (CRD IV), the [Capital Requirements Regulation](#) (CRR) and the [Single Supervisory Mechanism](#) (SSM) Regulation.

¹² http://ec.europa.eu/finance/consultations/2016/macprudential-framework/index_en.htm

¹³ We recall that regulatory forbearance of national competent authorities was one of the main reasons why supervision in banking was transferred to the European level. The risk is that this could be that such behaviour could be replicated with respect to the intervention on the grounds of macro-prudential considerations.

stability and ensure that the full tool box is available to the competent national authority. Some instruments would benefit from better data available to supervisors and regulators. The establishment of credit registers, such as the Central Credit Register of the Irish Central Bank and AnaCredit, the ECB's analytical credit datasets, can go a long way to improve the situation and should be set up and interlinked at all levels throughout the EU.

Finally, macro prudential policy coordination at EU level should include all relevant actors that contribute to financial (in)stability also beyond banking.

So to sum up

- The experience of the GFC and advancement in the methodology to detect asset bubbles suggest that macro-prudential policy should be pursued more actively.
- Contrary to some voices, the short term interest rate is not an adequate instrument to meet the build-up of asset price bubbles.
- A comprehensive toolbox of borrower-based and financial-institutions based instruments seems more promising.
- Given that costs are born at the national level and that these instruments need to be informed by local knowledge, we believe that the instruments are best placed with a system of national supervisors, where the ESRB should play a central role.
- It will be crucial that the European as well as the national level have all the data they need in order to monitor market developments.
- Some harmonisation of available macro-prudential tools would be important and should also include relevant actors other than banks.

References

Adam, K., J. Beutel and A. Marcet (forthcoming): Stock Price Booms and Expected Capital Gains, *American Economic Review*, forthcoming.

Bernanke, B. and M. Gertler (1999): Monetary Policy and Asset Price Volatility. In: *Economic Review Federal Reserve Bank of Kansas City*, 84(4), 17–52, <http://www.nyu.edu/econ/user/gertlerm/kansasfed.pdf>

Blot, C., J. Creel, P. Hubert, F. Labondance and F. Saraceno (2015): Assessing the link between price and financial stability. In: *Journal of Financial Stability*, 16(1), 71–88.

Borio, C., and Lowe, P.W. (2002): Asset prices, financial and monetary stability: exploring the nexus. BIS Working Paper No. 114, Bank for International Settlements, <https://www.bis.org/publ/work114.pdf>

Borio, C. and W. White (2004): Whither monetary and financial stability? The implications of evolving policy regimes. BIS Working Paper No. 147, Bank for International Settlements, <https://www.bis.org/publ/work147.pdf>

Caruana, J. (2016): Monetary policy for financial stability. Keynote speech at "52nd SEACEN Governors' Conference" Naypyidaw, Myanmar, 26 November 2016, <https://www.bis.org/speeches/sp161130a.pdf>

Case, K.E., und R.J. Shiller (2003): Is there a bubble in the housing market? Brookings papers on economic activity No. 2, 299–342, https://www.brookings.edu/wp-content/uploads/2003/06/2003b_bpea_caseshiller.pdf

Cerutti, E., S. Claessens and L. Laeven (2015): The use and effectiveness of macroprudential policies: new evidence. IMF Working Paper No. 15/61, International Monetary Fund, <https://www.imf.org/external/pubs/ft/wp/2015/wp1561.pdf>

Claessen, S. (2014): An Overview of Macroprudential Policy Tools. IMF Working Paper No. 14/214, International Monetary Fund, <https://www.imf.org/external/pubs/ft/wp/2014/wp14214.pdf>

Deutsche Bundesbank (2015): Die Bedeutung der makroprudenziellen Politik für die Geldpolitik. Bundesbank Monatsbericht März 2015, Deutsche Bundesbank, https://www.bundesbank.de/Redaktion/DE/Downloads/Veroeffentlichungen/Monatsberichte/2015/2015_03_monatsbericht.pdf?__blob=publicationFile

Donnery, S. (2017): Communication, calibration and coordination - challenges implementing macroprudential policy in the euro area. Speech at the second ECB Macroprudential Policy and Research Conference, Frankfurt am Main, 12 May 2017, <https://www.bis.org/review/r170516e.htm>

Gerdesmeier, D., H.-E. Reimers and B. Roffia (2011): Early warning indicators for asset price booms. In: *Review of Economics and Finance*, 3, 1–20.

Greenspan, A (2002): Economic volatility. Speech delivered at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming August 30, 2002, <https://www.federalreserve.gov/boarddocs/speeches/2002/20020830/>

Kohn, D. (2006): Monetary Policy and Asset Prices. Speech delivered At "Monetary Policy: A Journey from Theory to Practice," at European Central Bank Colloquium held in honor of Otmar Issing, Frankfurt, Germany, <https://www.federalreserve.gov/newsevents/speech/kohn20060316a.htm>