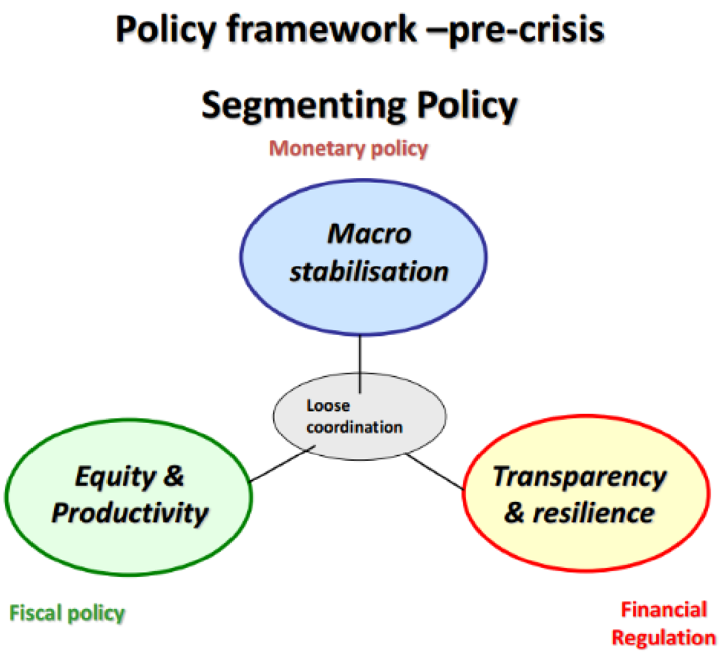
"Macro-Prudential Regulations: Linkages with macro–economic policies for promoting financial stability"

<u>Transcript of the comments by Sir John Gieve, Former Deputy Governor, *Bank of England*</u>

Well good morning and thank you Jose Antonio. I am blushing a bit to be addressing such a distinguished audience. You know so much more about economic policy making than I do. I guess I was invited because I was at the Bank of England with the terrible title of "the Deputy Governor for Financial Stability" during the Atlantic crisis; so you are getting here the reflections of a repentant sinner. I am going to take a broad view about the place of macro-prudential in economic policy making because it seems to me that in the West, the North Atlantic, we have not fully faced up to some of the implications of the crisis we faced, and that we are in danger therefore through our writings, recommendations possibly also the IMF of giving some slightly misleading messages.

So I am going to talk briefly about the policy framework before the crisis, what we learnt over the last 6 years, where macro-prudential fits into the apparatus, and then something about coordination and the role of central banks. I have called the talk "From monetary to macroeconomic policy" because when I arrived at the Bank of England in 2006 I was very struck by a change in terminology. When I was learning economics 30 years ago, I did macro and I did micro, and macro was quite a complicated business, it had fiscal policy, debt management, of course monetary policy, house purchase controls and various regulatory devices. When I arrived in BOE and started going to the IMF, BIS, I found that no one talked about macroeconomic policy, they talked about monetary policy, and that seemed to me to reflect a seductive simplification which had become the orthodoxy at any rate in the West. I have tried to capture this in this first diagram about how we looked at policy at that time. The key point was that as far as stabilizing the economy was concerned, the view was that it should be left to independent central banks targeting inflation and if they did that and conditioned inflation expectations adequately, then of course the economy would not be perfectly stable, but there would as much stability as desirable, so that's the top of this diagram in the blue field.

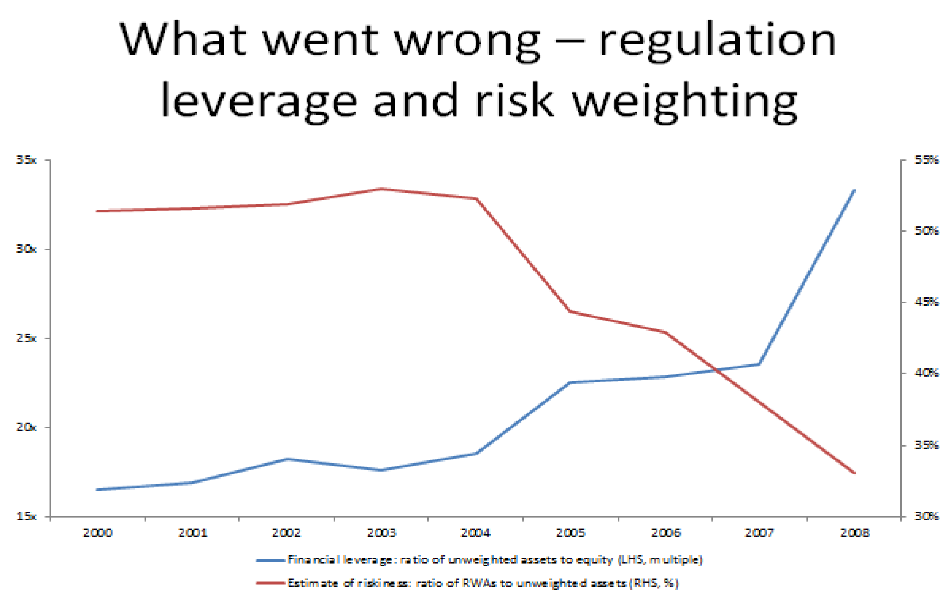


Fiscal policy which, when I was growing up, was seen as a core part of macro policy, was considered for various theoretical and practical reasons to be out of the game. In effect it should be put on autopilot and one should concentrate on the micro aspects of fiscal policy, the incentives it set for productivity, the measures it took to bring about equity, and so far as there was a growth agenda, that was about expanding growth, that was about the supply side including these incentive measures. And then you had financial regulation which was separate again and had a limited remit to mitigate known market failures, asymmetries of information, consumer protection, insurance failures, and the rule there was that the regulators only intervene where failure is demonstrable and they were confident they could fix it.

Now, you recognize that in the UK we actually split our institutions to reflect this tripartite arrangement with the Bank of England doing monetary policy, the FSA doing financial regulation and the Treasury doing fiscal policy. And that was true in a number of countries: in Japan, in Australia, in Canada; indeed it still is true in Australia and Canada. But even in the countries which didn't split their institutions in that way, like the US, this thinking informed the way they did policy, and there was far less cross fertilization if you like between the monetary people for example in the Federal Reserve and the regulatory people than you might have envisaged. There was a bit of coordination and we did contingency planning exercises for example for pandemics and what it would happen if there were war or operational failures. But to a large extent the consensus was that we should segment the policy objectives and tools. Central banks should have one set of instruments, interest rates, (we never thought of QE at that point), and address one target, inflation, for which they could be held accountable

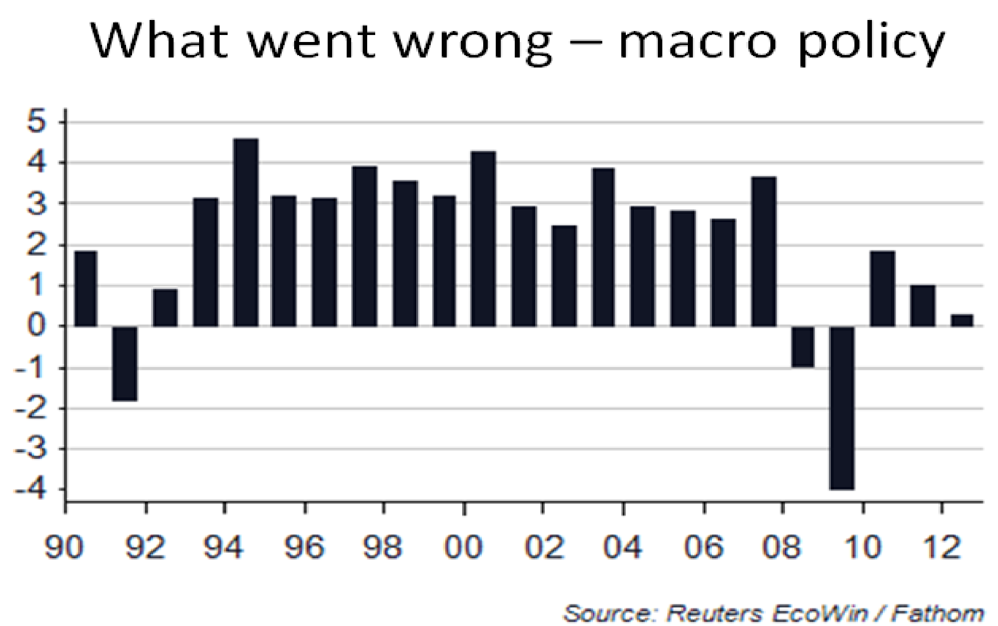
And this approach seemed to work. We thought we had cracked it. In 2006 there was a strong consensus among policy makers and a large chunk of professional economists that we knew how to run a modern market economy. Not only did this work in practice, but most important, it was blessed by theory. There was a theory to back this up which was that the only way of getting hold of inflation was to take out politicians with their muddled motives out of decision taking and to appoint professional economists whose professional reputation was on the line, and therefore who could be trusted to concentrate on their main target.

What went wrong? One obvious thing that went wrong was regulation of the financial sector. This second graph, I think captures it quite well.



The blue line shows what happened to gross leverage, that is total assets/equity of the UK banks, and as you can see it rose steadily from 15 times up to 35 times. The red line shows the regulatory risk weighting of those assets. You will see that it went down from 50 per cent to approaching 30 per cent. In other words we saw that leverage was increasing but we convinced ourselves that it was safe. That was a shared misperception, it was an intellectual error shared between regulators, banks, credit agencies and most commentators. I remember going to visit all the banks in New York in 2006, and saying “the markets are a bit fragile, what do you think?” and they all said “I am very worried about it (indeed a bit more worried than everyone else), but we are very cautious unlike everyone else and John, our risk management is so much better now than it used to be that we can handle it”. And what they meant was that they had hedged their positions through the various complicated credit derivatives and markets which had developed. And they believed it, and we, while having worries, went along with that too. And of course what we found in the crisis was that that these hedges didn’t hedge the system even if they hedged individuals and if you ended up with the mono-line insurers and AIG writing a lot of badly conceived policies underneath it all, the whole thing could collapse and it duly did; moreover the complexity of the markets made opaque the true credit standing of the individual banks which exacerbated panic when it started. So that was one thing that went wrong.

I think that was very obvious straightway. In the UK, for example, Adair come to the FSA and published an excellent report which exposed it all. We quickly reached a consensus that we needed to have a wholesale review of regulations. We have done that and while we have not changed very much our underlying approach but we have required more of everything; more capital, more liquidity, more transparency and more supervision. We have really upped the regulatory requirements on banks and other financial institutions.



But something else also went wrong and this was macroeconomic policy. This is a graph, which shows the growth rate in the UK and you will see this remarkable period of stability, stable growth IfI did the inflation figures; they would show exactly the same. In other words, we went through a period of great stability but of course it ended in disaster with this very deep recession from which, certainly in Europe, we have not recovered, and in the US only sluggishly recovered. And as Joe said earlier, this was not because of a black swan event, a meteor did not hit the world, it was not something exogenous which disturbed a perfectly working system. The crash was the result of endogenous forces working during this period of stability and the progressive build-up of imbalances between and within countries. As it turned out, inflation has been reasonably contained; if you look at the G7, the inflation rate has never gone outside the range 1.5 – 2.5% in 20 years. But it has turned out that stabilizing inflation did not stabilize the macro economy. It follows that the view that inflation targeting and segmentation of monetary policy could achieve stabilization was wrong monetary policy was part of the problem; it allowed and to some degree underpinned the destabilisation of credit and asset markets.

This lesson has not been widely accepted particularly among central banks. You will see that Ben Bernanke and Charlie Bean among others have published interesting articles arguing that broadly monetary policy was fine and it was only regulation that went wrong. I think it slightly beggars belief that we had a massive credit boom, and that the general price of credit was not part of the problem. Nonetheless it is not accepted widely accepted, and that is why, in my view, some of the lessons drawn from the crisis by the North Atlantic commentators are slightly misleading.

One of the conclusions, we reached on regulatory side was that we needed to have a new set of macro-prudential instruments and that is now a common conclusion. But partly because we have not accepted explicitly that there is anything wrong on the monetary side, we have grouped together under macro-prudential policy two quite different things. One is about looking at the financial system as a system, as a network and not just at the individual components and therefore trying to strengthen the nodes as my ex colleague Andy Haldane would say. For example you take the most important institutions; you make them the safest institutions by requiring higher capital for them compared to the smaller institutions (which are the reverse of what used to happen). You do various things on infrastructure, you have resolution plans, and you separate and limit what sorts of business different institutions can do. In all these ways, we are trying to make the system more resilient to shocks and in that way protect the banks against the real world doing something which destabilises the financial system

But the second policy grouped under the “macro prudential” label is about managing this credit cycle and this is different point, this is protecting the economy from the banks This involves the use of regulatory measures like loan to value limits, dynamic provisioning, and changing margins or haircuts to manage the growth of credit to avoid credit bubbles and crashes.

In the West we have put those two together, but it seems to me that it is important to look at them separately because what we are now talking about, going back to my three fold distinction, is a world where there are a lot of overlaps between the work of the central bank, the regulators, and the finance ministry (because, of course, fiscal policy too has made a major resurgence as part of the stabilization job).

A lot of what is macro policy is about managing the overlaps and tensions. I think if you look at the actions of central banks, even as they have emphasized that they are still targeting inflation, they have been doing nothing of the sort. They have been trying to revive growth. In action you will see the Bank of England, the Federal Reserve, even the ECB, implicitly running a more complex macro policy in which they still want to keep inflation low but they want also to put growth back on a sustainable path and to prevent credit bubbles which will disturb that. So they have a number of objectives and they have a number of instruments to achieve them. They still have rates of interest, now there is QE too, but there is also fiscal policy on the deficit and tax which can affect incentives and finally there are counter-cyclical prudential measures. The point to make is that there are obvious trade-offs and tensions between the objectives and the instruments, not just in theory but here and now t. If you take the UK and Europe, for example, for the last five years, we have had two brakes and one accelerator. We have had a brake on fiscal policy with austerity, we have had a brake on macro-prudential as we force up the capital requirements and the liquidity requirements on banks and we have been trying to offset that by having an amazingly expansionist monetary policy.

At a different level, of course there has also been a tension between the systemic resilience objective which says let’s build up all the buffers on systemic risk and the credit revival, the growth agenda which says well don’t do it now because if you do that then you will squeeze credit, and that credit squeeze has been a huge part of the story of the continuing recession in Europe. Moreover you will see in the UK, the focus of policy is less on interest rates or even on QE but it is on subsidized lending schemes which are partly fiscal and partly monetary to try and promote credit revival and therefore growth. We recently had an agreement that the Bank of England will widen its discount window and that will allow the Bank of England, now as regulator, to reduce the liquidity requirements on banks which will allow them to advance more credit, IN short we now have a mix of overlapping measures – some monetary, some fiscal, some regulatory and we need to look at them together.

That is my final message for emerging economies that are getting advice from leading international agencies. Because I think you have long lived in this complex world in which you use regulatory as well as monetary measures to manage the economy. The point here that I want to make is that there was a moment in 2006 when Central Banks could believe they were truly independent. They had one instrument and one target and the instrument was sufficient to deliver the target. They didn't need anyone's help; all that they needed was for politicians and banks to leave them alone. That segmented approach to policy didn't work. We are now dealing with a world in which you have got a variety of policy instruments, a variety of goals, you need to coordinate them and you need to do so against a background of chronic uncertainties, where yesterday's economic models have been proven largely flawed.

It may still make sense to put most of the policy instruments, regulatory as well as monetary, in the Central Bank but responsibility for the overall impact of the system including the central banks will inevitably rest with government. It is notable that every government in the west which was in power at the time of crisis (, apart from Angela Merkel's), has lost power, whereas central bankers on the whole have remained in position or have retired garlanded with praise. The buck has stopped with governments. Inevitably that will lead to a more assertive stewardship if you like by government of the overall policy stance including the policies of the central banks.

In short we are seeing a return to complexity in macroeconomic management, a return to collaboration. Yes, a strong central bank is vital in order to bring professional knowledge not just of economics but of finance into policy making but it needs to work with government and the simple seductive segmentation of policy responsibilities must be avoided.

Thank you.