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## *Policy Forum: Macroeconomic Consequences of Macroprudential Policies*

# Macroprudential Policy in an Australian Context

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## 1. What Is Macroprudential Policy?

Macroprudential policy is a set of measures aimed at reducing systemic risk throughout the economy. The major goals of this policy approach are to build resilience against shocks, dampen the economic cycle and enhance the upturn following a negative economic shock. The need for such a policy response is built on the existence of externalities, a range of market failures and a range of policy failures.

There are many proposed tools in the policy arsenal of macroeconomic prudential policy. These include, amongst others: capital adequacy ratios (time-varying); contingent capital requirements; requirements for higher quality capital on balance sheets; explicit limits on credit growth; varying reserve requirements; caps on loan-to-valuation ratios; and dynamic provisioning.

## 2. Theoretical Framework

There is not an agreed theoretical framework on the optimal use of macroprudential policies. Indeed, this is not surprising since it is clear that the best approach to dealing with the problems that this type of policy is trying to address is in the realm of second-best policy. A market failure should be addressed by policies directly aimed at that market failure (see Hanson, Kashyap and Stein 2011). Poor macroeconomic policy that causes imbalances in the economy should be addressed by fixing that policy, rather than by bringing another second-best policy to the table. Rather than trying to develop a general theory of macroprudential policy, a more productive exercise is probably to use case studies where macroprudential policy has been tried in various countries at various times and understand the costs and benefits from actual examples (see Claessens 2014).

## 3. Key Issues

### *3.1 Market and Policy Failures*

The key issues that a policy-maker needs to address before embarking on macroprudential policy are: What is the market or policy failure?; What policy best addresses the identified problem?; Which policy-maker is responsible for the intervention? Is it the central bank, a micro-supervision agency or a special-purpose macro-supervision agency?; Is the macroprudential policy consistent with other macroeconomic policy goals or do the various goals contradict each other?

There are many types of externalities that might justify macroprudential policy. Most important are externalities that magnify booms and busts. There are also externalities caused by interconnectedness which accentuate shock propagation in an economy. An example is when a shock causes asset shrinkage, such as in a credit crunch or when there are asset fire sales that reduce asset prices generally, and therefore causes contraction across all balance sheets.

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### *3.2 Policy Interdependence*

Another issue that needs more focus is the issue of policy interdependence. For example, financial instability can result from policies across a range of areas. Microprudential policy that eases financial restrictions at the microeconomic level during a downturn might exacerbate the macroeconomic downturn. Fiscal policy, particularly tax incentives including incentive to leverage during an upswing in the economy, can exacerbate the cycle and financial instability. Inappropriate monetary policy where interest rates are cut to stimulate demand but instead push asset price bubble through a fragile economy can increase financial instability. There is also a serious issue with cross-border spillovers of policies. The current debate about the Fed raising US interest rates and changing financial conditions globally is an important aspect of policy interdependence. Is some use of macroprudential policy by the Reserve Bank the appropriate response to this external shock?

### *3.3 Targets and Instruments*

One of the most important issues concerns the long debate about which instruments should be aimed at which targets. In theory, monetary policy can be targeted at price or inflation stability and macroprudential policy targeted at financial stability. The real problem is that, in practice, macroprudential policy is used to offset macroeconomic policy failure, rather than target a real market failure. Repeatedly following this path can undermine the credibility of macroeconomic institutions, particularly central banks.

### *3.4 Cycle versus Trend Impacts*

The key issue in designing macroprudential policy is whether the policy intervention can actually achieve the goals it is intended to achieve. It is an important empirical question as to whether macroprudential policy, if successful in reducing the economic cycle, also reduces trend economic growth. The benefits of a smaller cycle can be dwarfed by the cost of a lower trend rate of growth. Different policy instruments will affect this tradeoff of costs and benefits differently.

The evidence from a range of studies is that macroprudential policy, depending on the instruments used, does impact across countries and across time (see Claessens 2014). Intervention, such as restrictions on loan-to-valuation ratio, debt-to-income limits, credit ceilings, reserve requirements and dynamic provisioning, appear to limit pro-cyclicality. Limits on loan-to-valuation ratio appear to limit output growth.

## 4. Conclusion

In the Australian context, the global shocks the economy faces are important in assessing the potential role of macroprudential policy. The main problem in many countries over the past decade and a half, including Australia, is that the structural pressures from the emergence of large emerging countries, such as China and India, into the global economy have been largely addressed with demand management responses, rather than by serious structural reform. When the commodity cycle turned down in recent years, the Reserve Bank of Australia (RBA) had to cut interest rates by more than desirable because the growing structural problems that always existed were not addressed during the boom. The situation the RBA faces in 2015 is not a first-best situation. Monetary policy is delegated with the task of doing most of the adjustment for a problem that is largely structural and requires a structural policy response. The consequence of lower interest rates, while temporarily supporting demand, has been to change asset prices (in share and real estate markets amongst others) and distort the allocation of capital in the Australian economy. Macroprudential policy is now seen as a possible way to rebalance the misalignment of targets and instruments. This moves toward a third-best world. Directly addressing the structural problems caused by a long wave of global change is by far the best way to respond—using policy that directly addresses structural adjustment. The role of monetary policy would then be to manage the

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cyclical implications of this structural policy adjustment.

The big questions that need to be answered by advocates of macroprudential policy are: Why does Australia need this policy now when it did not apparently need it in previous decades when the performance of the Australian economy was exceptional?; Will this type of policy more broadly worsen macroeconomic policy-making and make the policy mistakes bigger because policy-makers will rely on macroprudential interventions to clean up the mess from poorly designed macroeconomic policies more generally?

The real problem might be that policy-makers are taking on too many targets for policy (particularly monetary policy) and so there is a need to keep inventing instruments, however poorly suited they may be. When listing the suggested interventions usually contained in a macroprudential policy portfolio, the list looks somewhat familiar to those who were around the policy debates of the 1960s in Australia. It took many decades to remove these types of inefficient interventions in financial markets that for many decades had distorted the allocation of capital and retarded the potential growth rate of the Australian economy. While there may be a role for carefully designed policy aimed at macroeconomic stability, there are many other issues that this article raises that need to be carefully addressed.

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