Secure Financial Stability: Macroprudential Policy

By Steven J. Davis

Macroprudential policy aims to manage systemic risks to the financial system and to prevent those risks from damaging the economy. Looking across countries, macroprudential instruments include a wide variety of credit restrictions, liquidity provisions, and capital-related regulations. Examples include maximum loan-to-value ratios, limits on maturity mismatch, caps on foreign currency lending, and countercyclical capital requirements.

As discussed in my previous post, sound monetary policy is not enough to ensure financial stability. Prudential regulations that focus on the safety of individual financial institutions can help in this regard. But traditional forms of prudential regulation do not adequately guard against systemic risks and threats that arise from unregulated banking activities. In addition, when poorly designed or poorly implemented, banking regulations can become a source of financial instability rather than a prophylactic.

Broadly speaking, the hope for macroprudential policy is that it can supplement sound monetary policy and traditional prudential regulation in securing financial stability. Unlike monetary policy, a blunt tool that “gets in all the cracks” of the financial system, macroprudential policy can “target specific cracks” where financial vulnerabilities concentrate, to borrow a metaphor from Ravi Menon's recent speech at the Asian Monetary Policy Forum.
Menon, who is Managing Director of the Monetary Authority of Singapore, draws a sharp distinction between macroprudential policies applied “inside the house” and capital flow measures applied “at the gate.” He takes a dim view of the latter, characterizing them as highly distortionary and warranted, if at all, only to safeguard financial stability under extreme circumstances. Echoing the IMF, he remarks that, if used, capital flow measures should be “targeted, transparent, and generally temporary.” Consistent with these remarks, Singapore maintains open capital markets but has aggressively deployed macroprudential measures from time to time, especially in real estate markets.

Menon also stresses that no single macroprudential instrument is likely to exhibit a stable and reliable relationship to asset prices and financial stability. This reality pushes policymakers to deploy multiple macroprudential instruments over time, makes it harder to learn from experience, and generally complicates the task of conducting effective macroprudential policy. It also suggests that macroprudential policy is intrinsically less amenable to a rules-based approach than is traditional monetary policy. These observations highlight a few of the challenges associated with macroprudential policy.

Menon wraps up his assessment of macroprudential policy on a modest, cautiously optimistic note: “So far, the results [in Asia] have not been bad. [Policy actions] have largely tempered the credit cycle and the pace of asset price increases, while generally maintaining price and output stability.”

He also reminds us that the current global situation is highly unusual. After the dust settles and condition normalize, Menon anticipates that the conduct and
role of monetary policy will not look all that different from the period before the Global Financial Crisis. To be sure, central bankers will devote a more watchful eye to financial stability considerations, and they will carry and use a bigger macroprudential toolbox. These changes amount to important modifications in the practice of monetary policy and central banking, but not a major reinvention.

**Steven J. Davis** is *William H. Abbott Professor of International Business and Economics and deputy dean of the faculty at the University of Chicago Booth School of Business.*