Macroprudential Regulation: Optimizing a Currency Area

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Colloquium in Honor of Lucas D. Papademos

Based on "Report: Monitoring the ECB"
with C. Goodhart, P-O. Gourinchas and R. Repullo

Two Challenges

1. Financial Stability
   - Build up of risk
     during bubble phase
   - Materializes in crisis

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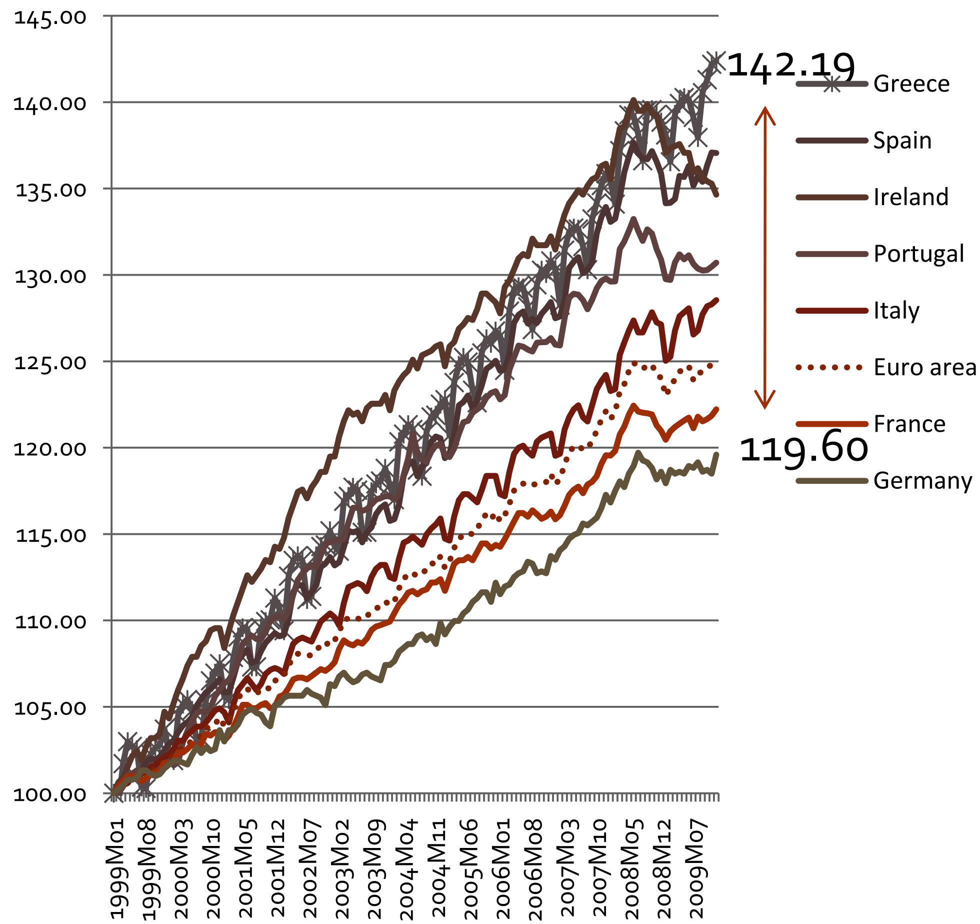
2. Price Stability Dispersion



Overview

1. Redefine second pillar = financial stability pillar
   - Lean against credit bubbles
   - Redefine monetary and credit aggregates
2. Make currency area optimal
   - More than one instrument -- regional

Current Rationale of Second Pillar

- Monetary analysis
  - Focus on money aggregates/supply
  - Long-run/medium term view
    - Note: strictly speaking introduces a second objective
      - Short-term (Pillar 1)
      - Medium/long-term (Pillar 2)

      How to weigh them?
  - Cross checking

- Quantity theory of money

$$M_t V_t = P_t X_t$$

- Prediction (after high money growth):

→ High inflation in the very long run

New Rationale for Second Pillar

- Financial stability
  - Lean against (credit) bubbles
    - High credit growth (partially reflected in M3)
- Prediction (after high credit growth):
  - Financial crisis impairs monetary transmission mechanism
  - Crisis binds hands
    - one is driven by events and hence not in control
  - High de-/inflation volatility
    - Deflationary pressure
    - Inflation due to monetization after bailouts

Note difference to Quantity theory!

Arguments for "Benign Neglect Policy"

1. Difficult to identify bubble
   - Any policy is a decision under uncertainty
   - Risk management approach
2. Lean versus clean
   - Symmetric treatment
   - Asset bubble vs. credit bubble
3. Interest rate is not most effective tool to prick bubbles
   - Effective when combined with "open mouth policy"
     - in early phase +
     - when term spreads are thin and bubble driven by yield curve carry trade
4. Too crude – not surgical
   - Bubbles affect large part of economy
   - Use in conjunction with other instruments
5. Pricking bubble led to disastrous outcomes (US 1928, Japan 1989)

Financial versus Monetary Stability

- When is there a trade-off?
  - Times of "great moderation":
    - Inflation is (seems to be) contained
    - Credit and asset price expansion – "credit bubble"
    - *Build-up of risk*, which will only materialize later
    - After burst,
      - deflationary pressure
      - monetary transmission mechanism can be impaired
      - bailouts + government deficits (potentially leading to long-run inflation?)
  - Should interest rate be increased
    - Price stability (inflation targeting) No
    - Financial stability Yes
- New rationale → modified monetary aggregates

Quantitative Aggregates

- Credit aggregates
  - Credit (growth) aggregates
  - Credit lines
    - Excessive draws on credit lines are signs of upcoming troubles
    - Newly extended credit lines
  - Shortening of maturity structure
  - Repo growth

  + asset bubbles + "bubble anecdotes"

  Soundness of balance sheets
  - Features
    - Maturity structure
    - Counterparties (levered banks vs. households)
- Money aggregates (related)
  - Portfolio shifts to shorter maturity, safer assets

The Second Challenges

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   - Build up of risk during bubble phase
   - Materializes in crisis
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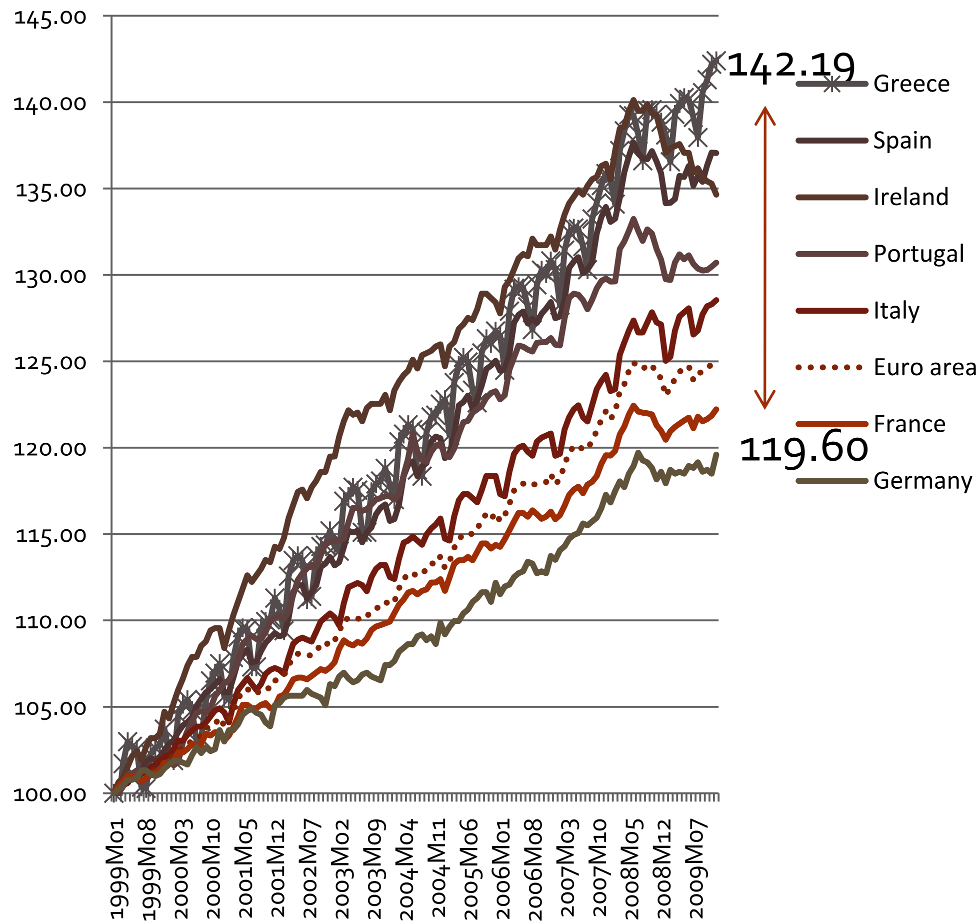


Optimal Currency Area - reconsidered

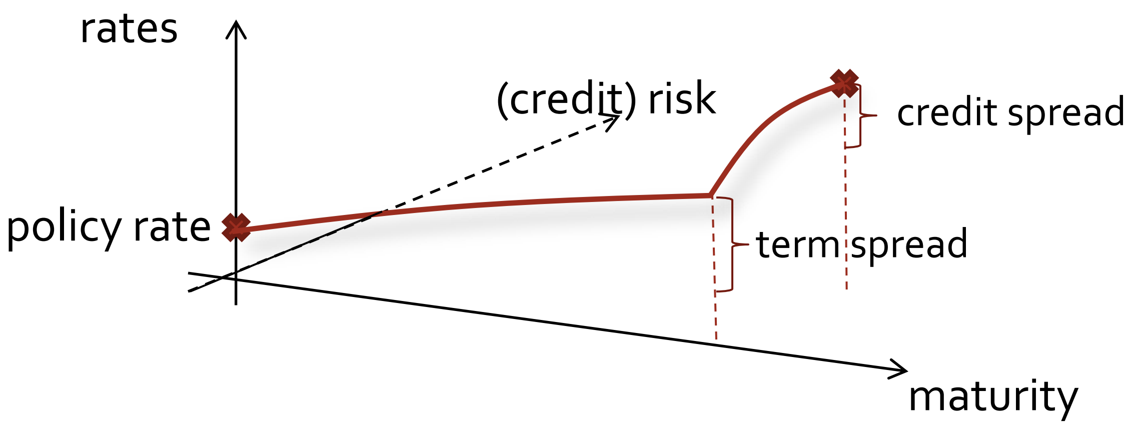
- Currency union
  - Loss of instrument: same interest rate in whole area (+ "loss of a valve", since exchange rate is fixed)

- Traditional view: optimal currency area if
  - No large asymmetry in shocks
  - Fiscal integration
  - Labor mobility

- Hence, Euro area is not an optimal currency area
- How can the ECB *make* it an optimal currency area?
  (transfer union is politically not feasible)

The Insight

- Same short-term interest rate
  … but what counts for economy is ‘risky long-term rate’



  - Affected by haircut policy + macroprudential regulation

The Idea

- Use regional …
  - Collateral policy (haircuts)
    - E.g. haircuts for mortgages in country X (with housing boom) are higher
  - Haircut/margin regulation (analog to US-Regulation T)
  - (Purchase regional assets)
  - Macroprudential regulation (through ESRB)

as an active policy instrument

  - Too lean against regional bubbles/imbalances

⇒ Justifies larger currency area, but needs clear governance structure

  - Details to be worked out in Brunnermeier-Gourinchas (2010) “Monetary Policy is a Non-Optimal Currency Area”

How Can ECB-ESRC Affect Macroprudential Regulation?

- Adjust Maastricht criteria
  - Ireland satisfied the Maastricht criteria, but …
  - private debt is subject to "bailout risk" for government
- Define 'expected' public debt
  - Public debt + Prob(bailout) * bank debt
  - Prob(bailout) = f(quality of bank regulation)
- Advantage: ESRB gets some teeth control, how member states conduct bank regulation

Conclusion

1. Financial Stability = second pillar
   - Modify monetary/credit aggregates
2. Optimize currency area
   - Using haircuts/macroprudential regulation as active policy instruments (to distort)