Thinking ahead for Europe

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Session 3: Macroprudential policy in recovering economies

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During recovery fundamental dilemma:

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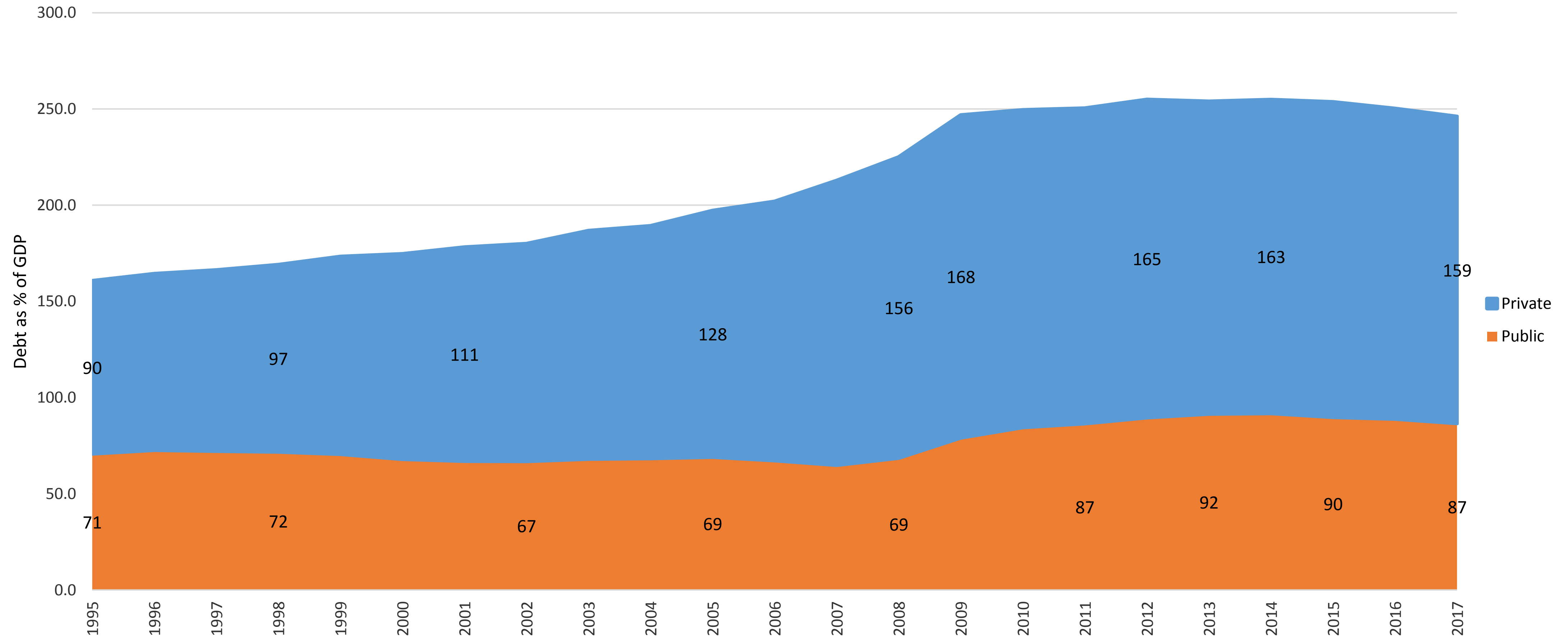
- Recovery taken here to mean the current situation:
- Output gap still positive, but closing, monetary policy very expansionary, asset prices, especially housing increasing, macro-prudential concerns start.
- Need to coordinate monetary and macro-prudential policies.
- Dilemma:
- Crisis caused (?) by high (excessive) leverage.
- During recovery: would like to get leverage down, but at the same time demand still weak, so do not want to be too tough.

Frozen conflict (euro area)



Source: Ameco

An aside on fiscal policy

- Fiscal policy faces a similar conflict:
- Should fiscal policy be tight during recovery (as long as it is incomplete) – or aim at reduction of debt level?

- Stability Pact and Fiscal Compact can be understood as macro-prudential for governments, the debt reduction rule is equivalent to an LTV for governments.

Recovery with increasing asset prices: conflict of interest

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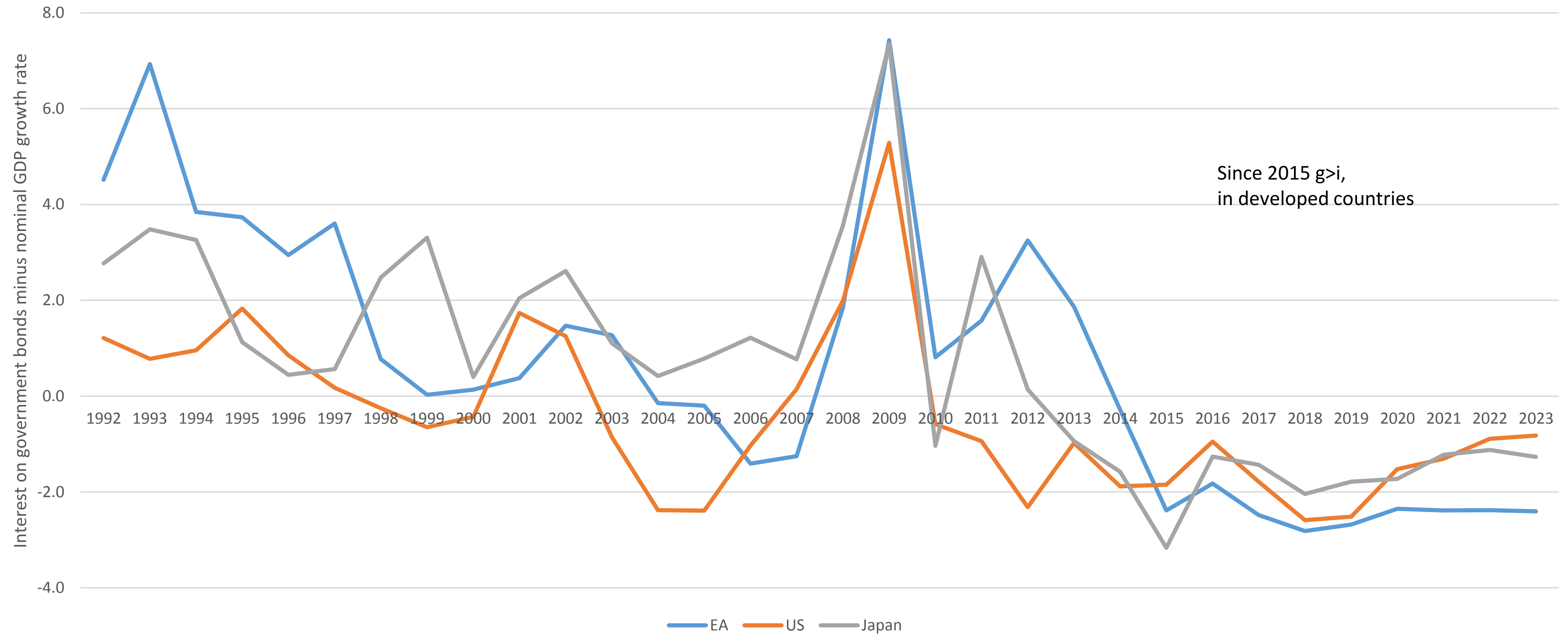
- One foot on the accelerator (negative rates, QE), the other on the brake (Macro-prudential, e.g. increasing LTVs(?))
- Monetary Policy: get spending up, even if financed by debt (CB can influence mainly (risk free) interest rates).
- Macro-prudential: prevent agents from taking on too much debt (of which they already have accumulated a lot).
- Independent instruments? Schularick (2018) finds LTV tightening by 10 points equivalent to 25 bps monetary tightening – but only for emerging markets.
- (In booming economies macro-prudential and monetary policy more likely to work in same direction.)

Financing conditions remain (and can be expected to remain) very favorable



Source: IMF (WEO) and AMECO

Stability breeds instability(?)

- With $i<g$ even non profitable projects can be financed and no debtor seems insolvent (any debt/GDP ratio will go to zero over time).
- This is what macro-prudential policy should avoid?
- But we do not observe more leverage (so far in EA).
- (Evidence on increased risk taking more anecdotal and qualitative.)

What is the purpose of LTVs?

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1. Make it more difficult to buy existing houses, little impact on construction activity.
2. LTV (Loan To Value) is misnomer: loan to appraisal value (LTAV).
3. Lower LTV means (at given house prices) would be (credit constrained) buyers need to save more before they can buy => consumption down.
4. Low LTV means only ‘high net worth’ agents can access credit. But they are the ones which need it less.
5. Lower interest rates reduce the income of ‘high net worth’ agents
6. => Tight (low) LTVs make monetary policy less effective.

Specific issues for euro area

- In euro area macro-prudential national but monetary policy single.
- National macro-prudential policy allows reaction to real estate bubbles (which are typically national/regional).
- At present danger of over-heating real estate markets mainly in ‘low debt’ countries, e.g. Germany.
- Tighter LTVs in Germany imply low interest rate policy of ECB on German economy is reduced.
- Back to dilemma: Low interest rates have impact mainly in ‘high debt’ countries => intra-area disequilibria will not be reduced.

Conclusion

- In a recovering economy conflict between desire to bring leverage down and keep recovery going (stocks versus flows).
- Similar for fiscal, monetary and macro-prudential.
- Macro-prudential useful to address pockets of financial excesses, but reduce impact of monetary policy and slow down re-distribution of leverage.
- Better to tighten first monetary (and only later macro-prudential policies)?