

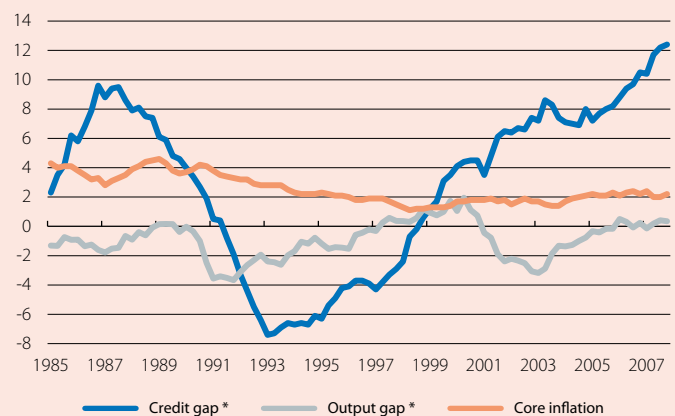
Economic policy against financial instability

In the 20th century, economic policy was affected by two big events: the Great Depression from 1929 to 1939 and stagflation¹ in the 1970s. The US saw its highest unemployment rates in the whole of the 20th century in both these episodes, over 25% in 1933, 20% in 1938 and 10.8% in 1982. Both events shook the theoretical pillars of economics and the role played by economic policy. Keynesianism appeared after the Great Depression, emphasising demand-oriented economic policies, while stagflation gave rise to a neoclassical revolution and a new consensus that gave monetary policy the responsibility of ensuring moderate, stable inflation. This consensus survived until the next big event, which occurred in 2007 with the outbreak of a global financial crisis and the Great Recession (2007-2009), resulting in the highest peak in unemployment since the 1980s. This article shows how financial instability is a key factor in understanding the changes in economic policy brought about by this last episode.

The macroeconomic consensus emerging in the 1980s gave economic policy the role of stabilising inflation and GDP growth. In fact, economists believed the financial sector tended naturally to self-stabilise, as far as financial stability was concerned economic policy limited itself to supervising the robustness of the main institutions. However, as can be seen in the chart, significant financial imbalances built up between 2002 and 2007, albeit latently behind stable inflation and economic growth figures. The fact that different financial subsectors also became increasingly interrelated also gave rise to sources of systemic risk which supervisory authorities were oblivious to since they lacked an overall view of the situation. For instance, subprime mortgages only accounted for 4% of the US mortgage market but triggered a crisis that affected a large part of the world's financial sector. Lastly, the severity of the Great Recession called the prevailing consensus into question, revealing that financial instability has significant repercussions on macroeconomic stability. In fact, as detailed in the article «Financial instability and the business cycle» in this Dossier, evidence is mounting regarding the links between financial instability and the state of the real economy throughout history. In the past few years, a new consensus has emerged in which financial stability is considered necessary to ensure macroeconomic stability. The question is which policies or instruments should be used.

Economic policy's first response has been to strengthen regulation and prudential policies. These can be both micro, focusing on the individual health of each institution, or macro, with an overall view of the system. Instruments have been designed to lessen sources of systemic risk, build up buffers during expansionary periods (providing greater leeway in recessions) and contain financial imbalances, such as debt that is excessive and/or based on volatile sources of funding, with the potential to cause instability. Microprudential policies have essentially been aimed at increasing capital and liquidity requirements and introducing new resolution mechanisms. Today's financial institutions must have more capital of higher quality. Stricter liquidity requirements have also been put in place to ensure institutions have enough good quality liquid assets to withstand the initial onslaught of a bank run. They must also have sufficient access to stable sources of funding that will not evaporate at times of stress.² Macprudential policies, on the other hand, have focused on designing instruments to prevent financial imbalances from emerging in the system as a whole. For instance, the introduction of capital requirements and leverage ratios that vary throughout the cycle. These act as a brake during times of expansion and force buffers to be built up, while restraining overheating and cushioning the effects of a recession. Regulations also allow authorities to set capital surcharges and other limits on lending to certain sectors, which can be tightened up as the business cycle progresses.

US: measures of macroeconomic and financial stability
(%)



Note: * Above-potential growth in credit and economic activity, respectively.

Source: CaixaBank Research, based on data from the Bank of International Settlements, US Congressional Budget Office and US Bureau of Economic Analysis.

1. Period of high inflation and low economic growth, in the US characterised by four recessions in just over a decade (1969-1970, 1973-1975, 1980 and 1981-1982).

2. The liquidity coverage ratio requires banks to keep enough high-quality liquid assets to withstand, in a stress scenario, possible net outflows of cash during a 30-day period.

On the whole, all these measures should help reduce the likelihood and severity of financial crises. Those banks with the best positions in terms of capital and liquidity, both in the US and the EU, experienced fewer bankruptcies during the last crisis. After the crisis they also contributed towards the macroeconomic recovery by granting more credit.³ However, evidence regarding the effectiveness of such measures is still limited as they are relatively recent. They also make the regulatory framework more complicated, give regulatory authorities discretionary powers and are subject to regulatory arbitrage problems. Because they restrict a sector's room to manoeuvre, they encourage companies to move their business outside the regulator's scope (so-called shadow banking).⁴ Given such weaknesses, several economists have suggested that monetary policy would be a good alternative since this is passed through the whole universe of financial assets, thereby preventing regulatory arbitrage.⁵ To this end, it has been proposed that central banks fix their benchmark interest rates with the explicit aim of ensuring financial stability (as well as achieving macroeconomic stability in terms of inflation and, in some cases, GDP growth).

Using monetary policy to ensure financial stability means paying less attention to price stability. This would therefore involve higher interest rates⁶ and, consequently, has drawbacks in terms of lower inflation and somewhat weaker economic growth. The advantage is that financial crises would be less likely and less severe.⁷ The IMF believes that monetary policy has little power to prevent financial imbalances. To be effective, it would require significantly greater interest rate movements than those required to stabilise inflation and economic activity.⁸ There is also a lot of uncertainty regarding these estimates because financial crises that are preceded by a bubble and end up in recessions do not occur very often. In a group of 17 developed economies, Jordà, Shularick and Taylor identify just 14 recessions preceded by a financial crisis and a real estate bubble since 1945.⁹ An additional difficulty for using monetary policy to ensure financial stability is that it can damage a central bank's credibility. The costs, in terms of below-optimum inflation and lower economic growth, are immediately evident but the benefits are difficult to measure because they occur in the future and involve something not happening. Monetary policy would impose a permanent obstacle when, in reality, not all financial crises entail the same macroeconomic cost (for example, the dot.com crisis in 2001 had few macroeconomic repercussions). Finally, one of the reasons why the pre-crisis macroeconomic consensus defended not using monetary policy to attack bubbles is that these are difficult to identify in advance. However, monetary policy needs to be implemented beforehand because its effects take time to filter down through the economy.

In conclusion, the new prudential policies provide a first line of defence which can be adjusted to the particular requirements of each situation. But, so far, they have not been used enough to confirm their effectiveness. Whether monetary policy might still have a complementary role to play, even though it is not the most precise instrument available, is still open to debate. In any case, financial instability and its links to macroeconomic stability are once again centre stage in economic policy.

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3. Haldane, A. G. (2017), «Rethinking financial stability», speech at the Peterson Institute for International Economics.

4. Institutions which carry out financial transactions outside the regulatory framework of traditional financial institutions, such as hedge funds and structured investment vehicles.

5. See, for instance, Juselius, M. *et al.* (2017), «Monetary Policy, the Financial Cycle, and Ultra-Low Interest Rates», International Journal of Central Banking.

6. Higher interest rates make debt more expensive and cool down growth in credit.

7. Svensson, E. O. (2017), «Cost-Benefit Analysis of Leaning against the Wind», NBER Working Paper, estimates that the costs are greater than the benefits. On the other hand, Gourio, F., Kashyap, A. and Sim, J. (2017), «The Tradeoffs in Leaning Against the Wind», NBER Working Paper, estimate that the benefits are greater than the costs.

8. IMF (2015), «Monetary Policy and Financial Stability», Staff Report. Along the same lines, see also Ajello, A. *et al.* (2016), «Financial Stability and Optimal Interest-Rate Policy», Federal Reserve Finance and Economics Discussion Series, and Svensson (2017).

9. Jordà, O., Shularick, M. and Taylor, A. (2015), «Leveraged Bubbles», Journal of Monetary Economics.