Is There Macroprudential Policy without International Cooperation?

Stephen G. Cecchetti
Brandeis University, CEPR, and NBER

Paul M. W. Tucker
Harvard University

Discussion

Fabio Ghironi
University of Washington, CEPR, and NBER

Asia Economic Policy Conference
Federal Reserve Bank of San Francisco
November 19, 2015

Summary

- Cecchetti and Tucker (CT) ask and answer three questions in the process of giving a resounding “no” answer to their title question:

1. Does global finance require a common prudential standard?
   - Yes, for all parts of the financial system, across countries.
     - Global finance makes financial stability a common resource subject to negative externalities.
     - A common standard is needed to avoid fragmentation and balkanization.
2. Does global finance require international cooperation in overseeing the system’s safety and soundness?
   - Yes, exposure to risk across sectors, institutions, borders requires cooperative, transparent information exchange.
3. Does global finance require coordination of dynamic policy adjustment?
   - Yes, to preserve the common resiliency standard under evolving conditions.

Means to an End and the Institutional Framework

- A common prudential standard, cooperation in oversight, and coordination of policy adjustments are all necessary means to an end:

  "the financial system as a whole should be 'sufficiently' resilient to ensure that the core services of payments, credit supply, and risk transfer and pooling can be sustained in the face of large shocks."

- The paper appears to suggest that the existing institutional framework is not sufficient to accomplish this goal.

- But why? And are questions 1-3 really new?

The Financial Stability Board

- In 2009, the G20 transformed the Financial Stability Forum into the Financial Stability Board (FSB) largely with the goal of accomplishing the "financial resiliency end."
- Given the objective of global financial stability, the view was that the FSB is needed precisely because of "integration" and "coordination":
  - The current global financial system is "integrated"
    - across countries, and not just across the advanced ones;
    - across sectors (banking, insurance, investment funds);
    - and across financial institutions and financial markets (institutions and market compete to intermediate between savers and borrowers).

The Financial Stability Board, Continued

- Given this pervasive integration, the FSB was precisely intended to provide “coordination” across member countries, standard-setting bodies, and other international financial institutions.

- In fact, the FSB was established with a broad mandate to:

1. identify and address financial system vulnerabilities;

2. coordinate the development and implementation of regulatory, supervisory, and other policies;

3. and promote reform through transparent peer review of implementation of global standards.

- The FSB crucially relies on peer pressure and transparency to foster compliance to common minimum global standards.

- Importantly, it has the “democratic pedigree” of G20 backing.

The Financial Stability Board, Continued

- Questions and ideas that shaped the creation and functioning of the FSB echo those in this paper.
- I would like CT to take on more explicitly the issue of institutional design:
  - What are the shortcomings of the FSB as focal point for success on questions 1-3 in the paper?
  - Can these shortcomings be addressed without creating a new institution?
  - How?

Cooperation vs. Coordination

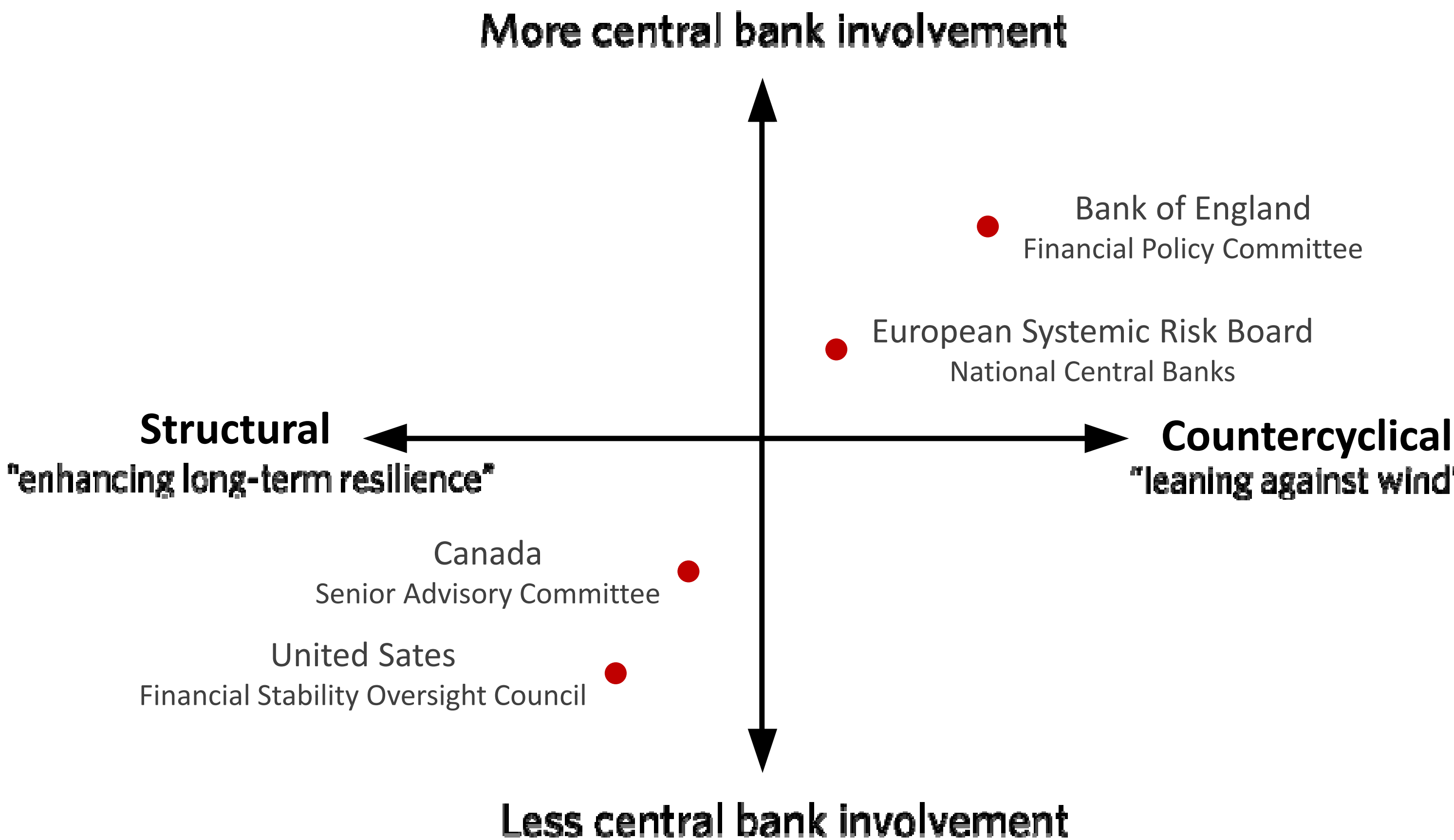
- I think the paper would benefit from defining some key concepts more explicitly.
- For instance, what exactly is the difference between cooperation and coordination?
- In the 1980s literature on policy interdependence—say, Horne and Masson (*IMF SP*, 88)—, cooperation was often used to refer to exchange of information; coordination referred to joint policymaking.
  - Coordination = authorities acting together in setting their instruments to optimize an average of the respective objective functions (Canzoneri and Henderson, MIT Press, 91).
- Canzoneri and Edison (Fed volume, 90) showed that, in the presence of multiple Nash equilibria, cooperation in the form of information exchange that would lead to settle on the best Nash equilibrium could generate most of the benefits of coordination.
- Cooperation as information exchange is clearly a theme in CT. But how should we think of coordination?
- Joint optimization of objective functions as standard in the 1980s literature on policy interdependence (and even in the most recent literature on dynamic, microfounded models of policy interactions) or, say, synchronization of policy actions?

Not Just Semantics

- We need to define clearly what players are involved and what we envision for their behavior (cooperation vs. coordination) because of the multiple dimensions the "global financial stability game" cuts across.
- For instance, countries (or jurisdictions) differ in the extent of central bank involvement in macroprudential policy—as well as in the objectives that macroprudential policy is pursuing.

Macroprudential frameworks vary across jurisdictions

Stylized representation of different macroprudential frameworks



Not Just Semantics, Continued

- There is growing consensus that monetary policy cannot ignore financial stability, and that macroprudential regulation can affect monetary policy by affecting the environment in which the latter operates (Kryvtsov, Molico, and Tomlin, Bank of Canada, 15).

- The conduct of monetary policy can affect the incentives for implementation of regulatory reform by affecting the environment in which these should be implemented.
  - Reforms may be perceived as more or less beneficial (or costly) at the time when they should be implemented depending on economic conditions that monetary policy can affect.
  - For an example of this argument in the context of the discussion on structural reforms of product and labor markets in the Euro Area, see ECB President Mario Draghi's speech in Sintra last May and Cacciatore, Fiori, and Ghironi (*JIE*, forthcoming).

- We can think of "lines of defense" against financial instability.

- Strategic interactions cut across lines, across policy institutions (when different institutions within a country are in charge of policies that affect each other's objectives and tradeoffs), and across borders.

“Lines of Defense” against financial instability

1. Own risk management by borrowers & lenders
2. Market discipline via disclosure
3. Microprudential regulation and supervision
4. Macroprudential policy
5. Monetary policy?

Not Just Semantics, Continued

- Who is supposed to cooperate in the form of information exchange and who is supposed to coordinate in the form of (possibly) joint setting of policy instruments?
- Well known result in game theory: Coordination limited to a subset of players can be counterproductive.
  - This is behind Rogoff's (*JIE*, 85) result that monetary policy coordination can be counterproductive:
    - It exacerbates time inconsistency in monetary policy if price/wage setters are not part of the coordinated arrangement.
- How do we deal with players "left out" (or who choose to remain out) of the "global resiliency coordination game" and their possible responses?
- Is this a dimension where the FSB is indeed still inadequate?

Capital Controls

- This is connected to the issue of capital controls.
- Capital controls can be looked at as an instrument of macroprudential policy.
  - See, for instance, the work by G. Benigno and coauthors, or Jeanne and Korinek—also a paper by Jeanne at the 2013 AEPC conference—, and others.
- But capital controls can also be an instrument that—by segmenting markets—alters the incentives for participation in the “all inclusive” cooperation/coordination that CT appear to have in mind.
- How should we think of the consequences of capital controls in the context of CT’s questions and answers?

Emerging Market Economies and Capital Controls

- Capital controls and their implications for global cooperation/coordination and resiliency must be kept in mind because the paper makes no distinction between advanced economies and emerging ones (EMEs).

- While a strong case can be made for having common financial regulatory standards across both sets of countries, EMEs generally have less developed financial sectors, thus their markets and institution are less able to manage risks.

- First-best solution would be to develop EMEs financial sectors.

- In absence of this, capital controls provide a different set of macroprudential policy tools that EMEs have been using—in recent years, with the "blessing" of the IMF.

- How do we ensure that use of capital controls does not imply that key players essentially "opt out" of the cooperation/coordination envisioned by CT?

The Global Financial Cycle

- This is also connected to the recent discussion of a global financial cycle and its implications for policy.
- Rey (KC Fed volume, 15) argues that a global financial cycle turns the traditional "impossible trinity" of Tommaso Padoa-Schioppa (renamed the "trilemma" since Obstfeld, Shambaugh, and Taylor in the early 2000s) into a "dilemma."
- Rey's hypothesis that flexible exchange rates in conjunction with a strong macro/financial policy framework may not be enough to shelter a small open economy from this global cycle is a concern for small open economies.
- She recommends that countries, especially those without developed financial markets, rely more heavily on macroprudential tools.
- Back to capital controls and their implications...

Dynamic or Responsive Macroprudential Policy?

- Macroprudential policy cannot be easily fine-tuned to be time-varying in an effort to be financially countercyclical.
- Resilience is built by mitigating two types of systemic risk: time series (procyclical behavior) and cross-sectional (interconnected and common exposures).
- Appropriate measures include increasing minimum buffers for capital and liquidity in financial institutions, controlling their leverage, increasing transparency, and addressing structural financial vulnerabilities (e.g., too-big-to-fail).
- Given these arguments, CT's use of "dynamic" macroprudential policy is a bit confusing, because it might imply time-varying and explicitly countercyclical.
- "Responsive" might be a better adjective because macroprudential policy should be able to respond quickly to emerging vulnerabilities.

Conclusion

- Very interesting, thought-provoking paper.
- I learned a lot by working on it.
- I hope these comments are helpful!