OPINION

AVERTING FINANCIAL CRISIS

By Jeffrey Chwieroth and Jon Danielsson

HOW ARE CENTRAL BANKS CREATING AN EFFECTIVE MONETARY POLICY?

IN THE WAKE OF the global financial crisis, the world's central banks have been given the task of developing and deploying tools to limit the build-up of systemic risk and its potentially disastrous consequences of financial instability and economic distress. The hope is that the credibility acquired from conquering inflation in the 1980s and 1990s will rub off on the new agenda of 'macroprudential policy' – looking at the soundness of the financial system as a whole (as opposed to microprudential regulation, looking at the safety of individual financial institutions). We fear the opposite: that the fuzziness of the macroprudential agenda and the interplay of political pressures may undermine the reputation of central banks and threaten the effectiveness of monetary policy.

In fighting inflation, central banks have one explicit tool – interest rates. And an unambiguous and easily measured objective – inflation. There are no equivalents in macroprudential policy. Instead, policymakers have a collection of often conflicting tools and an even more baffling set of measures designed to capture systemic risk and financial instability. This makes it hard to build the political consensus for employing the macroprudential toolkit. The implementation of the policy inevitably involves a wide array of institutions, including the fiscal authority. This increases both the politicisation and access for divergent viewpoints, which permits any critic to use macroprudential ambiguity to argue that a different measure or different tool is more appropriate. The direct involvement of the fiscal authority gives critics even more leverage. The more avenues that divergent interests have for influencing policymakers, the more scope there is to inhibit policy implementation.

WHAT'S AT RISK?

The politicisation of macroprudential policy leads to countervailing pressures. Financial regulators may be biased towards non-intervention because they would face political pressure against tightening during a boom. It is often politically difficult to take measures that reduce short-term economic growth in the interests of fending off a bust that many think will not happen. This is a common problem in financial regulation, creating 'pro-cyclicality' – when the behaviour of market participants and policy authorities amplifies the volatility of the financial system. Regulators may also lean to premature intervention because they fear being criticised for failing to spot a bubble. But the desire to prevent future crises at all costs could put constraints on investment and the capacity for growth.

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The macroprudential agenda is hard to disagree with: who can object to measures that prevent the build-up of imbalances that will cause significant economic harm? No wonder the macroprudential agenda currently enjoys much political support, especially as memories of the crisis are fresh and policies have only been implemented sparingly. But at some point in the future, this policy will have to be implemented more widely and receive political support in a more positive environment, where memories of the last crisis have faded and people are enjoying the short-term benefits of the bubble. Then this support is likely to be weaker than now.

As a practical matter, the macroprudential agenda seems set up for failure in many countries. The technical uncertainties and institutional designs give sufficient room for significant political objections to gain traction. Since any implementation is likely to run into strong political objections, anything that gives credence to those objections is problematic.

Having the central banks take the lead in implementing such a policy might seem sensible. But the success of the agenda depends on maintaining political consensus as well as the existence of a robust toolkit. Central bankers have fine-tuned the art of economic communication to steer inflation expectations. They must now become better political communicators, with sharp tools, to maintain consensus for managing systemic risk. If they fail, all the fury around the macroprudential agenda could signify nothing, risking both financial and price instability. ■

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