Robust Policymaking in an Uncertain, Multi-Objective World

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The views expressed in this presentation are my own and do not necessarily reflect the views of the Federal Reserve Bank of New York of the Federal Reserve System.

Road Map

1. Overview of a “generic” policy framework
2. Comparison of current macroeconomic, macroprudential and microprudential frameworks
3. Consideration of role for “unconventional” monetary policy tools

What are monetary policymakers, regulators, supervisors, and conduct agencies trying to do?

- Transform a set of authorities into outcomes consistent with the achievement of their objectives

What capabilities does the official sector need to effectively transform authorities into objectives?

- **Measure the world:** Identify concrete observable metrics for policy objectives, and identify gaps between objectives and the environment
- **Interpret the world:** Determine when and what type of intervention in the environment is needed to promote objectives
- **Influence the world:** Intervene in environment to address gaps between measured conditions/behaviors and objectives
- **Learn and adapt:** Continuously update the effects and efficacy of interventions to remain effective in promoting objectives over time

Two general observations on the current state of policymaking for central banks and close cousins

- (1) Tendency to “silo” the pursuit of macroeconomic and macroprudential, and microprudential objectives (Bank of England currently trying to push against this), including:
    - Monitoring
    - Analysis
    - Decision-making
    - Deployment of tools

Implication:

- *Tends to mask the presence of short-term conflicts/tradeoffs across objectives that can hinder ability to achieve goal of sustainable growth over time*

Two observations on the current state of policymaking

- (2) Macroprudential policy frameworks (the set of basic capabilities) are underdeveloped relative to frameworks for macroeconomic and microprudential objectives
  - [See table on next slide]

(Informal and Subjective) Assessment of Current Policymaking "Capabilities" by Type of Objective

Type of capability: ↓ / Type of objectives: →	Macroeconomic	Microprudential	Macroprudential
I. Measuring the world: Understanding how the economic and financial environment is evolving relative to objectives			
Identifying concrete, observable metrics/targets for objectives	Very high	Medium	Low
Measuring, monitoring and analyzing developments in real time	High	Medium	Low
Identifying gaps btw actual conditions and objectives on timely basis	High	Low	Very low
II. Interpreting the world: Determining when and what intervention in the environment is needed to promote objectives			
Establishing common thresholds for what constitutes a "material" gap	High	Low	Very low
Determining in real time whether thresholds have been breached	High	Low	Very low
III. Influencing the world: Intervening in environment to address gaps between measured conditions and objectives			
Developing reliable and effective tools for intervening in environment	High	Medium	Very low
Determining which tool(s) can most effectively address a given gap	High	Low	Very low
Promptly executing on a decision to deploy a tool to address a gap	Very high	Low	Very low
Maintaining an intervention (i.e. desired policy stance) as necessary	High	Medium	Very low
IV. Learning and adapting: Remaining effective in promoting objectives over time			
Evaluating monitoring/analysis, metrics/targets, tools, and thresholds	Medium	Very low	Very low
Making timely adjustments to above as necessary to remain effective	Medium	Very low	Very low

Very low Low Medium High Very high

The gaps in our macroprudential frameworks…

- are not a new problem…

“The most important characteristic of sound supervisory policy is that its impact on the banking system and the economy as a whole be salutary, rather than considering only each individual bank in isolation, as has unfortunately been customary among examiners.”

- Bach, Journal of Finance, Dec 1949

“But if the banker plays an important role [in the broader economy], the supervisory agencies should be on the side of encouraging a generally beneficial use of this role. The goals of banking supervision must run beyond the "soundness" of their individual institution and simple rules of safety; they should comprehend the encouragement of sound developments in the banking system as a whole.”

- Robinson, Journal of Finance, Mar 1950

- …but there is renewed urgency…

“Going forward, a critical question for regulators and supervisors is what their appropriate ‘field of vision’ should be. Under our current system of safety-and-soundness regulation, supervisors often focus on the financial conditions of individual institutions in isolation. An alternative approach, which has been called systemwide or macroprudential oversight, would broaden the mandate of regulators and supervisors to encompass consideration of potential systemic risks and weaknesses as well.”

- Chairman Bernanke, “Reducing Systemic Risk,” August 2008

Real time learning and adapting needs robustness to achieve sustainable growth goal

Chairman Greenspan, 2005:

- …advances in complex financial products… have significantly lowered the costs of, and expanded the opportunities for, hedging risks…The new instruments of risk dispersal have enabled the largest and most sophisticated banks, in their credit-granting role, to divest themselves of much credit risk by passing it to institutions with far less leverage… **These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system** than the one that existed just a quarter-century ago. After the bursting of the stock market bubble in 2000, unlike previous periods following large financial shocks, no major financial institution defaulted, and **the economy held up far better than many had anticipated**.

Chairman Bernanke, 2008:

- …more fundamentally, the turmoil was the product of a global credit boom, characterized by a broad underpricing of risk, excessive leverage by financial institutions, and an **increasing reliance on complex and opaque financial instruments that have proven to be fragile under stress**. The unwinding of this boom (and the associated financial losses) has led to the withdrawal of many investors from credit markets and deleveraging by financial institutions, both of which have **acted to constrict available credit to households and businesses**.

On the role of LSAPs and negative interest rates

- During the financial crisis, many advanced economy central banks hit the zero bound on overnight interest rates
  - This had the effect of reducing the efficacy of the main tool deployed in pursuit of macroeconomic objectives
- Situation motivated the deployment of two “new” types of tools
  - Large scale asset purchase programs
    - Mostly viewed as acting through a portfolio balance rather than monetary base channel
  - Reducing overnight rates below zero

On the role of LSAPs and macroprudential objectives

- LSAPs and negative rates were primarily deployed to achieve macroeconomic objectives, but may also be relevant for macroprudential objectives
  - For example, the use of LSAPs might exert influence (intentional or unintentional) over macroprudential conditions
    - Buying certain asset back securities vs. changing regulatory risk weights on certain asset back securities
  - In terms of ease of implementation, a purchase tool might be faster and easier than many of the other tools referenced in the context of macroprudential objectives

- Many open questions
  - Would we understand what mix of purchases would improve the safety and soundness of the system (however, this applies to other tools as well)?
  - More generally, can we yet measure our macroprudential objectives well enough to reliably deploy any tool to achieve them?
    - E.g., is the mix or pace of credit creation macroprudential or macroeconomic?