Financial innovations, indebtedness and coordination of monetary and macroprudential policies

Jan Frait
Executive Director
Financial Stability Department

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Desirable and objectionable financial innovations

• Besides positive effects for customers, financial innovations in some cases increase the elasticity of financial sector and its capacity to extend much more debt to private sector.
  - A macroprudential authority should be reserved to innovations of this sort.
• Traditional area where innovation may not be entirely desirable is mortgage financing.
  - Such as mortgages with interest-only schemes, deferred payments of interest and principal, extensive stretching of maturities…
• The consequences of major increases in leverage and indebtedness could be widespread.
  - These may create challenges, or even traps, for both price stability as well as financial stability policies.
  - Both monetary policy and macroprudential policy should take this into account.
Macroprudential policy (MaP) and monetary policy (MP) tools are not independent.

- They affect both credit and monetary conditions via their effect on lending standards and credit growth.
- Anything that affects the availability and price of credit also affects credit growth and thus also monetary policy transmission (Frait, Komárková and Komárek, 2011).

Central banks therefore have to carry out analyses of policies interactions and strive for their coordination (Malovaná and Frait, 2017).

- In some situations it may be desirable for them to act in the same direction.
- In other situations the two need work in opposite directions while still being a “clear case”.
“Clear case” mixes

- **Working in the same direction** (pursuing MP objective supports MaP goal):
  - financial crisis and recession → lower interest rates → support of credit and demand → debt service stabilization → asset price stabilization → economy back to normal
  - MaP should be loosened (banks should be allowed to use previously accumulated buffers).

- **Opposite direction** (pursuing MP objective harms MaP goal):
  - inflation below target → low policy interest rates → banks and their clients view risks as low → easing of lending standards → fast credit growth → asset price growth → rise in demand for credit to purchase assets → risk of excess credit and asset price boom
  - MaP should be tightened (MaP tools should be used to preempt excessive credit growth).

- There could be number of less clear cases!
The right policy mix depends on the intersection of two different cycles – the business cycle and the financial cycle.

Different properties of both cycles make coordination of both policies challenging (Frait, Malovaná and Tomšík, 2015).

Suitable combinations of responses of the two policies below:

- In truly good or bad times the choice appears obvious.

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Less clear cases or potential conflicts

- Sometimes it may be difficult to decide on the right mix.
- During a period of financial boom, a reduction of interest rates to combat below-target inflation due to, for example, currency appreciation, could further increase credit growth and demand for risky assets.
- The right response is to tighten MaP, how about pre-emptively tighten the monetary conditions too?

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 Monetary and macroprudential policies interactions

• Proper coordination of the two policies might be very difficult due to different probabilities of failure to fulfill the two main objectives:
  • risk of not meeting inflation target in the short term implied by the forecast will be viewed as most likely development,
  • materialization of systemic risk that builds up will be seen as potential in the medium term only.
• Preference is often unlikely to be given to the financial stability objective, as this would require a consensus that the risk of a future financial crisis has exceeded a critical level.
• A holistic approach is therefore needed.
The mandate of the Czech National Bank

- to maintain price stability,
- to maintain financial stability and see to the sound operation of the financial system in the Czech Republic,
- to issue banknotes and coins, manage the circulation of currency and administer clearing between banks,
- to supervise the entities operating on the financial market.

Through monetary policy we seek to preserve price stability, i.e. low and stable inflation. Through macroprudential policy we foster financial stability and resilience of the financial system, which are necessary conditions for the maintenance of price stability. Through the joint action of monetary policy and macroprudential policy, we contribute to maintaining confidence in the value of the Czech koruna and safeguarding the stability of the macroeconomic environment.

By supervising the financial market and creating prudential rules and rules of conduct towards clients we protect the clients of persons and institutions carrying on business on the financial market.
CNB’s monetary policy in recent cycles

• Both interest rate policy and exchange rate policy help economy to **take off** from recessionary times and **moderate upsurge** in good times.
• After terminating FX rate commitment (Brůha and Tonner, 2017) in August 2017, 7 **policy hikes** followed plus some CZK appreciation.
CNB’s recent macroprudential policy actions

- Increasing the **CCyB rate** several times to 1.5% with effect from 1 July 2019.
  - In some cases Pillar 2 add-ons for macroprudential reasons required.
- **Setting and tightening LTV limits** for mortgages.
  - Currently the upper LTV limit of 90% and the aggregate limit of 15% for loans with an LTV of 80%–90% applied.
- **Setting DTI and DSTI limits** for mortgages.
  - an upper DTI limit of 9 times the applicant’s net annual income,
  - an upper DSTI limit of 45% of the applicant’s net income.
• High indebtedness may constrain the use of policy interest rates as a countercyclical macroeconomic policy tool.
  • Low interest rates in number of countries nowadays make debt-servicing cost low despite high levels of debt.
  • Even a relatively small increase in level of lending rates could lead to much higher default rates, decline in consumer lending and disinflationary pressures.
  • This may explain policy rates close to zero or even negative in some countries.
• Low interest rates, debt sustainability and price stability are thus mutually connected and self-enforcing (Maddaloni and Peydró, 2013; Juselius, Borio, Disyatat and Drehmann, 2017).
Coordination of MP and MaP as a way of avoiding a policy trap

- In economies with high level of debts, macroprudential policy could become unwittingly a **substitute for monetary policy**.
  - If not controlled by the central bank and if constrained by political considerations, a trap may emerge.
- The CNB is doing and will do so its best to **preempt** such a situation.
  - Macroprudential tools in the area of housing lending should prevent the household from taking too much debt.
  - Counter-cyclical capital buffer, systemic buffer and Pillar 2 add-ons help to maintain the banking sector resilient.
  - Monetary policy works in tandem with macroprudential policy.
Thank you for your attention

Jan Frait  
Financial Stability Dept.  
Czech National Bank  
Na Prikope 28  
CZ-11503 Prague

E-mail: jan.frait(at)cnb.cz

Information on financial stability and CNB macroprudential policy is available at

References


