Reflecting on global economic turbulence and dealing with crises

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Outline

1. Global financial cycle
2. Policy tools and crises
3. Implementation
Global Financial Cycle

• Fluctuations in financial activity (risk taking, credit creation, asset prices, capital flows, spreads, leverage) on a global scale (Rey (2013)).

• Growing body of evidence on the importance of the Global Financial Cycle and of the dollar:

  ➢ Macroeconomic data: One global factor in asset prices explains about 25% of fluctuations in risky asset prices around the globe. One global factor explains about 20% of fluctuations in capital outflows (or inflows).

  ➢ Microeconomic data: detailed data on Turkish banks (Baskaya et al. (2017)) find that 43% of local credit growth is explained by capital flows.
Monetary policy driver of the Global Financial Cycle

• Miranda-Agrippino and Rey (2015) shows that US monetary policy is a key driver of «global risk appetite».

• US monetary policy affects leverage of US broker dealers and of large Euro area and UK banks as well as credit creation and asset values.

• Most crises are “credit booms gone bust”.
Macro policies and the crisis

• Before the crisis: macroprudential policy too weak or inexistent.

• During the crisis: Central banks acted decisively to deal with crisis with limited support from fiscal policy.

• Now (recovery): Excess burden placed on central banks in some regions.
Macroeconomic stabilization tools

• Asymmetric game where ECB has a euro area wide objective while fiscal policy is determined by perceived national interests.

• If countries with fiscal space do not expand enough, monetary policy will make up for this (and is more likely to be at the Effective Lower Bound)

• Looser monetary policy implies countries with fiscal space perceive even less need to expand.

• Core countries have a wrong macro policy mix (monetary too loose, fiscal too tight).
Euro area current accounts (% EA GDP)
Limited ammunitions for next crisis

- Central banks close to ELB or at ELB.

- Various constraints (or perceived constraints) on fiscal policy.
More ammunitions?

• Macroprudential policy useful addition: Country specific so can help insulate from global financial cycle. Can help modulate monetary policy in the euro area.

• Countercyclical buffer: up during economic expansions. Gradual build-up has little effect on activity. Buffer can be released quickly if credit conditions tighten in a downturn. Can then reinforce effect of monetary policy easing.

• Looking forward: Macroprudential policies may provide more ammunitions for a downturn.
Implementation

• Degree of sophistication of framework for macroprudential tools should be at least similar to monetary policy framework.

• Phillips curves need to incorporate risk in the financial sector.

• We need to forecast downturns far enough in advance.
Real-time diagnosis: realistically possible?

• Need enough lead time to activate the countercyclical buffer CCyB (12 months to activate).

• Many systemic risk measures are coincident and do not have much forecasting power

• Simple early warning models currently used—credit to GDP gap (detrended); DSR,...; logit models with 3-4 variables, tend to be unreliable; overfitting issues.
Real-time diagnosis

• Powerful machine learning aggregation techniques. Able to cover a large set of variables. Aggregates many models optimally: converges to the best convex combination to predict probability of pre-crises. (Fouliard, Howell and Rey (2019)).

• At any point in time, gives the most informative models (hence we may have an idea where the danger lies for targeted interventions).
Macroprudential actions

- One could think of CCyB, DSR, LTV, sectoral capital surcharges on real estate sector exposures; restrictions on forex exposure; removing distortions subsidizing real estate borrowing; etc...

- We have only some preliminary understanding of the relative effectiveness of tools. Need much more data on details and intensity of macro pru interventions for policy evaluations.

- We know too little about costs of various policies.
Macroprudential actions: large social value

• Benefit analysis for the US
  • GDP shortfall in 2010 Q4 estimated at: 8.5%

✓ CCyB offset to credit crunch (3% of GDP)
✓ Each pp reduction in household debt to GDP increases GDP pc in bust by 0.3 to 0.5%: 2004-07 increase in household debt: half of shortfall (4% of GDP).

Source: Kashyap et al. (2018)
Conclusions

• Plausibly large benefits if macroprudential policy well implemented.
• This implies we need macro-pru authorities with:
  ✓ Powerful diagnosis tools (online-learning...)
  ✓ Wide remits (financial actors and debtors)
  ✓ Hard powers
  ✓ Refined cost benefit analysis tools (academic models connecting the dots, especially boom phase, policy evaluation, experience)
  ✓ Accountability: pedagogy, transparency.
Political Backlash: Reaction to macroprudential policy in France in prominent economic magazine and paper

Translation: « Help! The Ministry of Finance is ready to limit access to credit for companies » (06/2018)

Followed in the article by: « Who had this crazy idea? Overheated brains of high civil servants? »

Followed by « French banks do not understand this decision inconsistent with the monetary policy of the ECB » (03/2019)