

Macroprudential Policy Implementation in a Heterogeneous Monetary Union

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DISCUSSION

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ECB Conference

"Heterogeneity in currency areas and
macroeconomic policies"

The views expressed are my own and should not be attributed to the Eurosystem or
the ECB.

Timely paper on extremely relevant policy issue!

- ✓ Effectiveness of LTV ratio policies in mitigating real estate bubbles and excessive credit: important policy question
- ✓ Spillovers among countries with considerable cross-border financial activities (EU/EA)
- ✓ This paper contributes to the policy debate by examining the implications of countercyclical LTV ratios in a 2-Country model of the EA

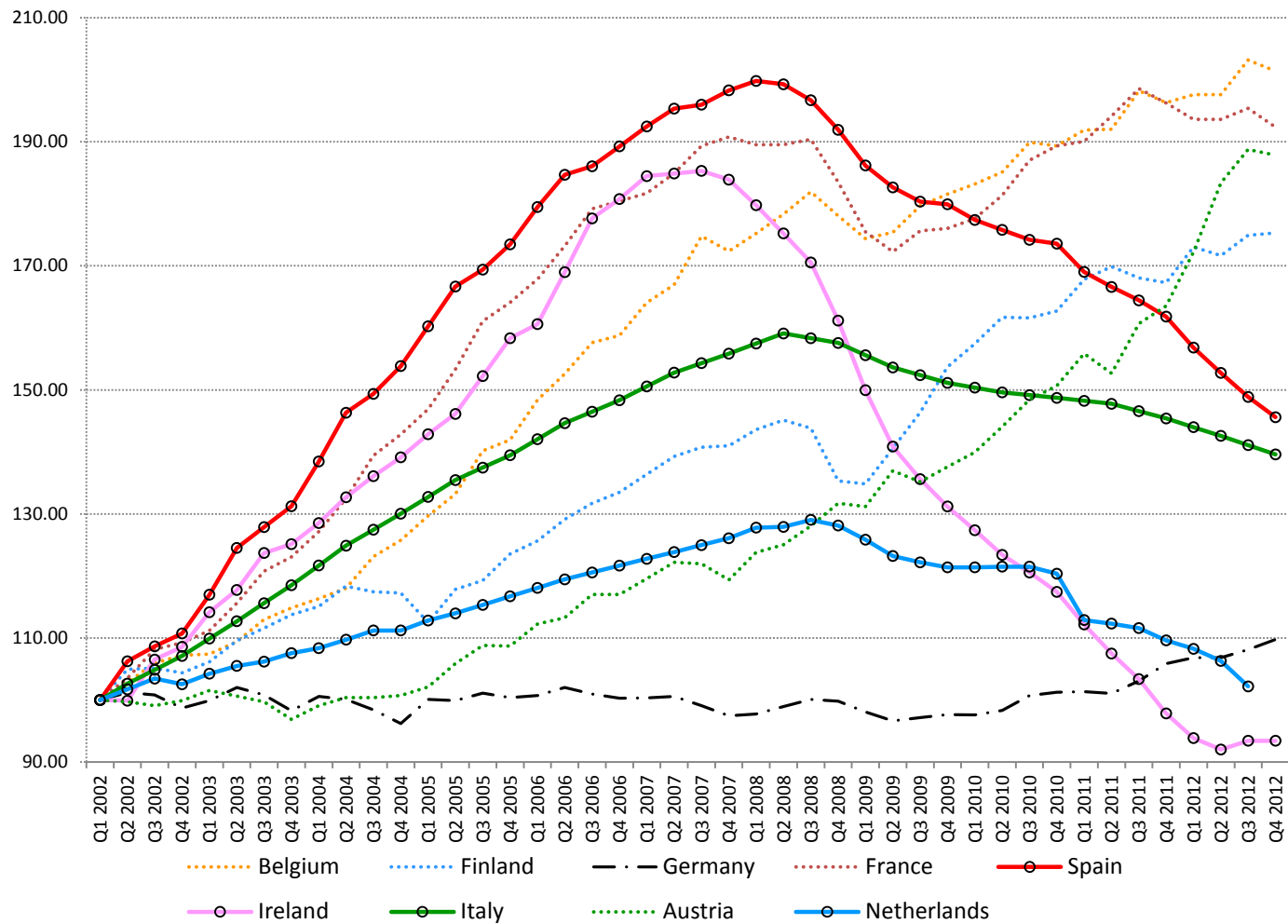
Summary: This paper...

- ✓ ...explores the effects of macro-prudential policy in a monetary union
- ✓ Framework: two-Country model DSGE model with nominal rigidities and credit frictions
- ✓ Macroprudential Tool: countercyclical LTV rule that responds to output and house prices
- ➔ Documents how the optimized LTV rule affects the transmission of productivity shocks

Comments

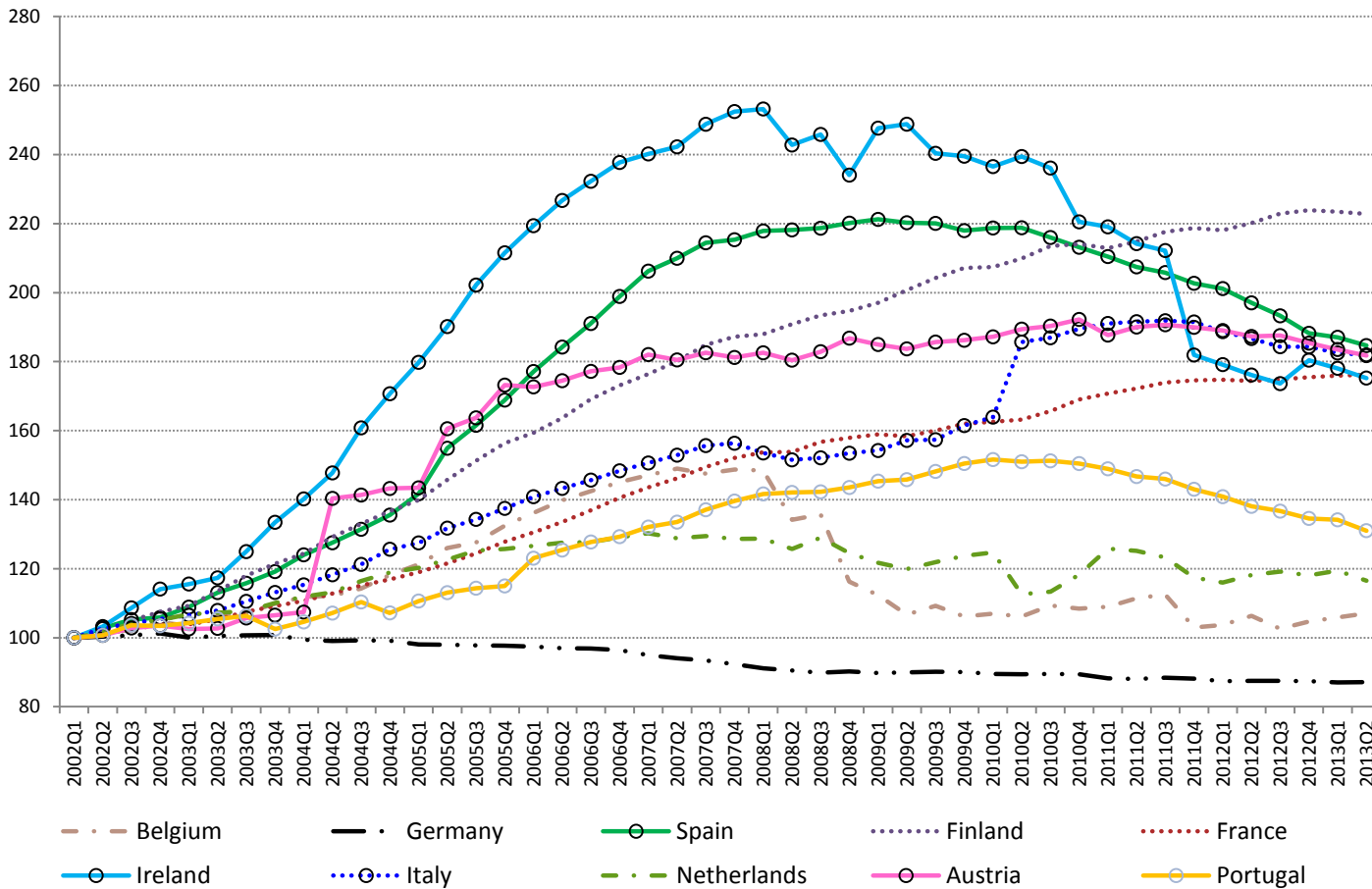
1. Heterogeneity in real-estate markets
2. Goal of Macroprudential Policy
3. Design of Macroprudential Policy in EA

(1) HETEROGENEITY: Residential Property Price developments

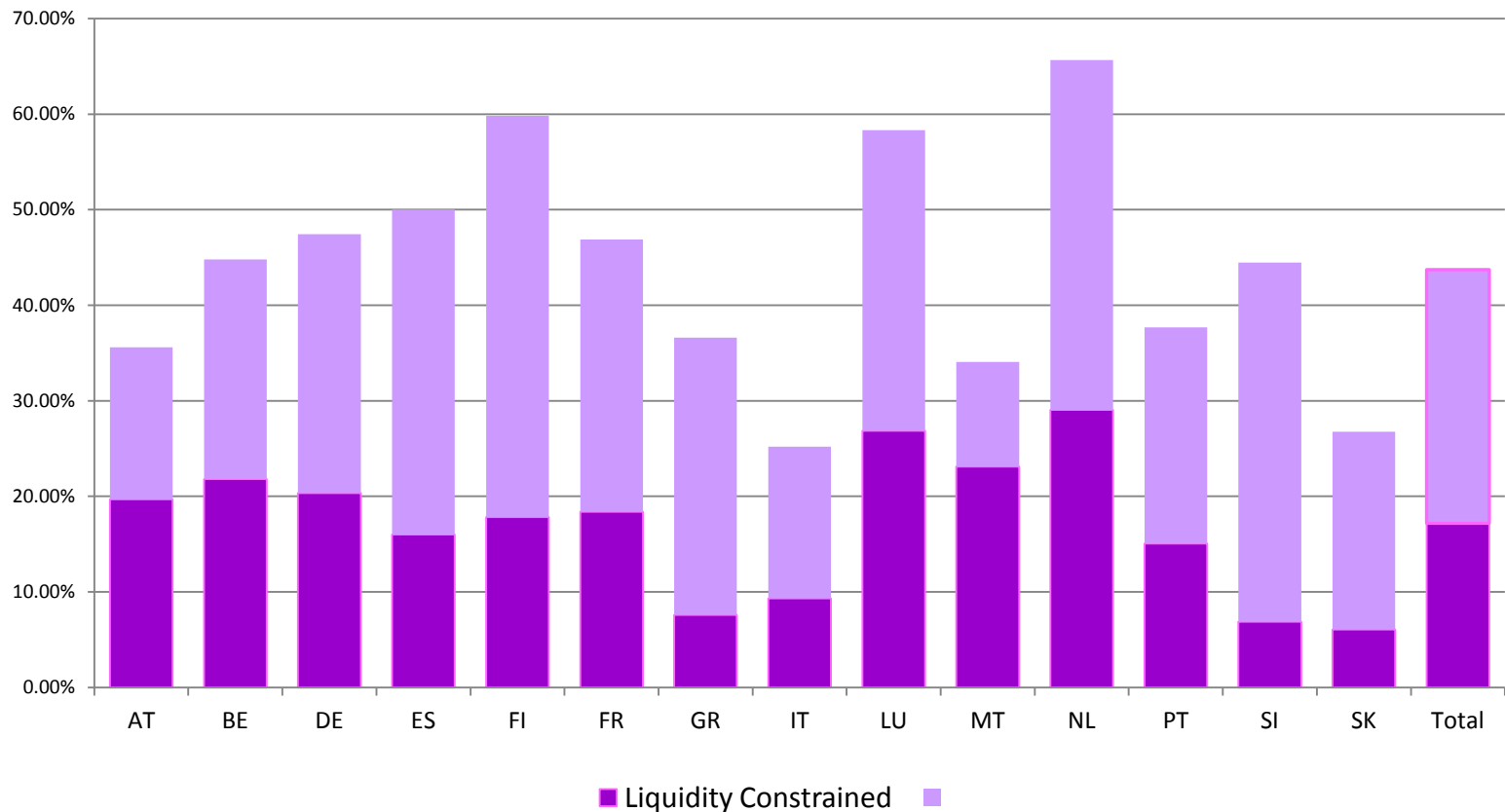


(1) HETEROGENEITY: Households Total Loans to GDP

amount outstanding (2002Q1=100)



(1) HETEROGENEITY: Proportion of Indebted Households

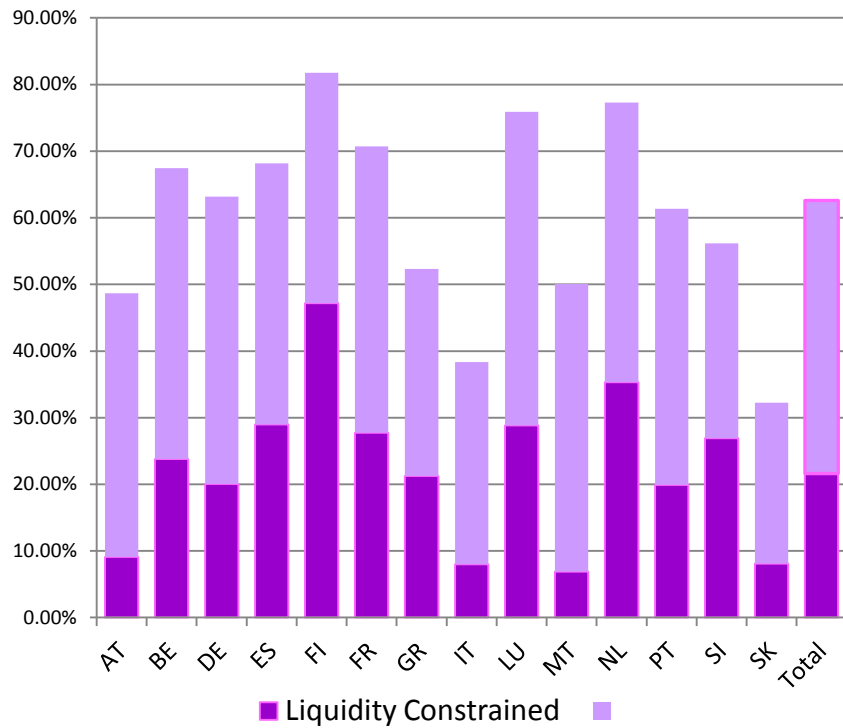


Source: 2008-2010 SURVEY Household Finance and Consumption Network (HFCN)

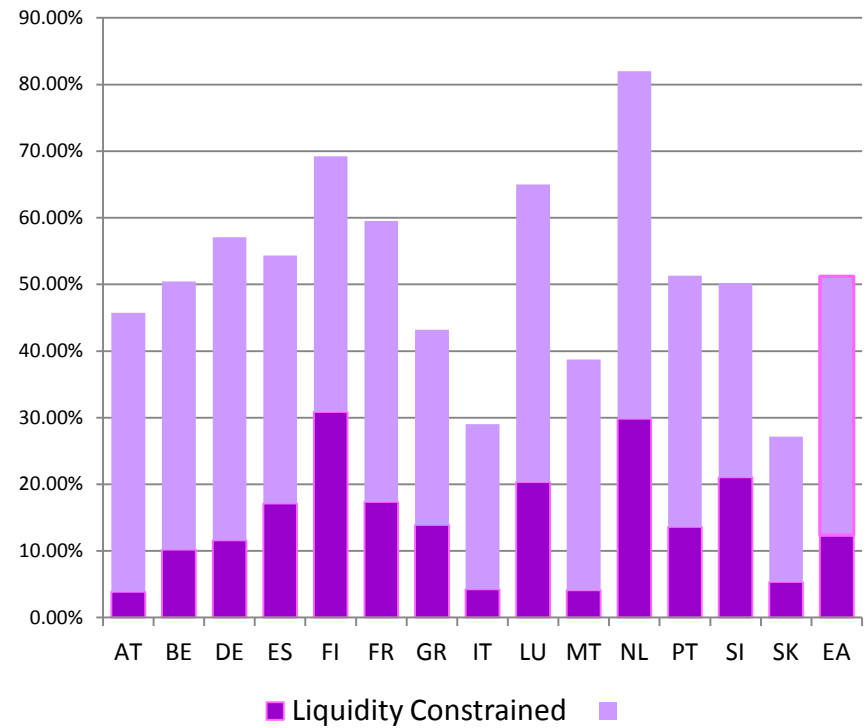
Kaplan and Violante (2012): Liquidity constrained if liquid assets below two months of total households gross income

(1) HETEROGENEITY

Share of Wage Income of Indebted HH



Share of Housing Wealth (primary residence) of Indebted HH



(1) HETEROGENEITY

Rubio (2013): studies the sensitivity to changes in parameters that can be used to proxy heterogeneity

What are the key features of the data (heterogeneity) captured by the model?

➡ still a need for rigorous model calibration/estimation s.t. model becomes suitable for quantitative policy evaluation

(2) Goal of MaP in a DSGE Model

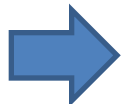
- ✓ Rubio (2013): explores the role of LTV ratio that responds in a countercyclical manner to changes in house prices and output for the transmission of productivity shocks.



Model with no financial risk/imbbalances

Domestic credit: loans spreads do not reflect household risk.

Cross-border borrowing: internationally traded bond (foreign debt) yields interest = policy rate: no a country specific risk!



What is the inefficiency/externality that MaP tries to minimize?


(2) Goal of MaP in a DSGE Model

Goal of Macroprudential policy: to reduce systemic risk/mitigate financial imbalances

Lack of a rationale for the adoption of macroprudential measures (building up of imbalances; inefficient credit booms; bubbles)

 stabilizing fluctuations

(2) MaP in a DSGE Model

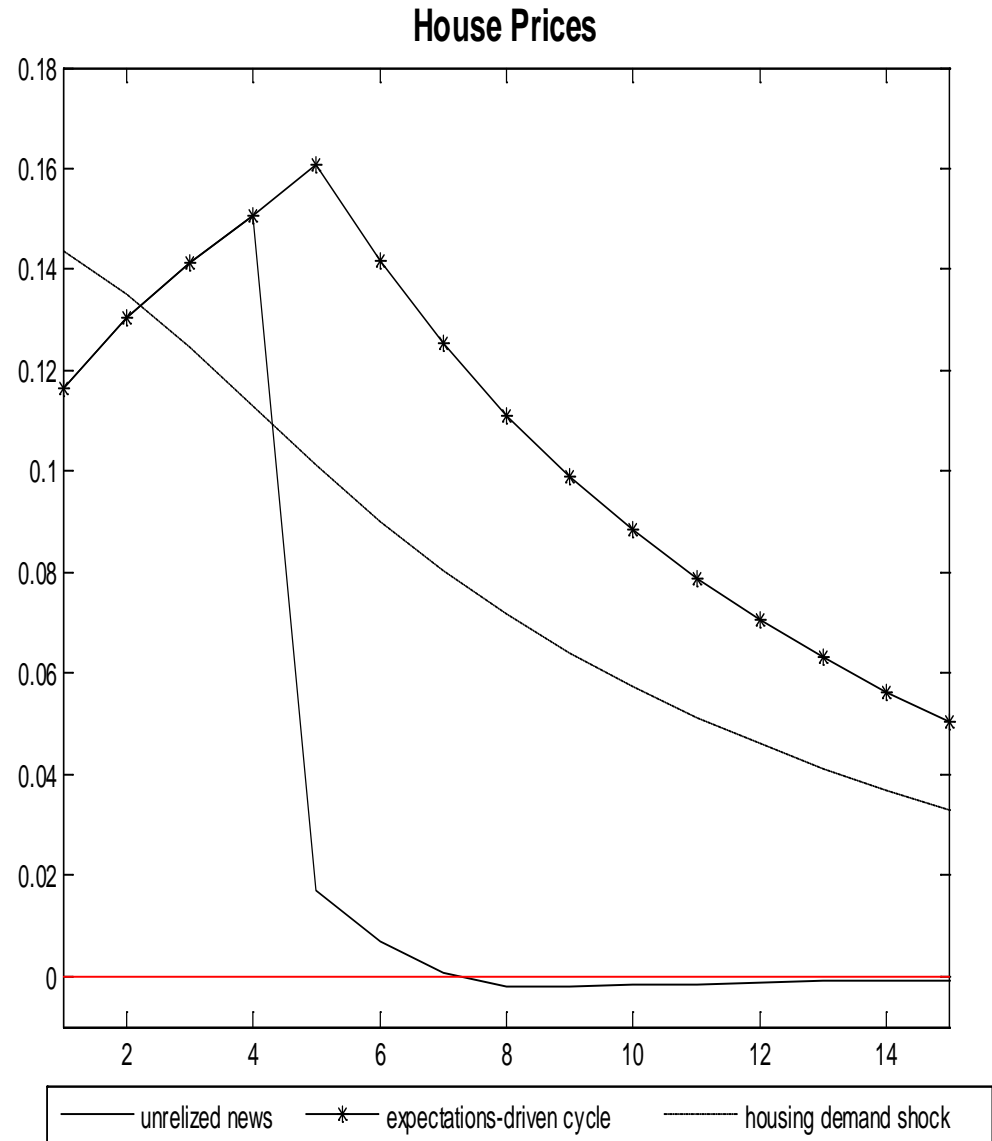
- ✓ **Integrating financial instability in an aggregate model: Great challenge!**
 - ✓ Rationale for the adoption of macroprudential measures in previous DSGE models: **bank risk** (imperfect diversification, insured liabilities) **or by boom-bust cycles in credit and asset prices**
-  excessive lending/ risk taking
- ✓ Macroprudential policy align banks/households incentives and prevent excessive lending/risk taking

Expectations and Boom-Bust Cycles

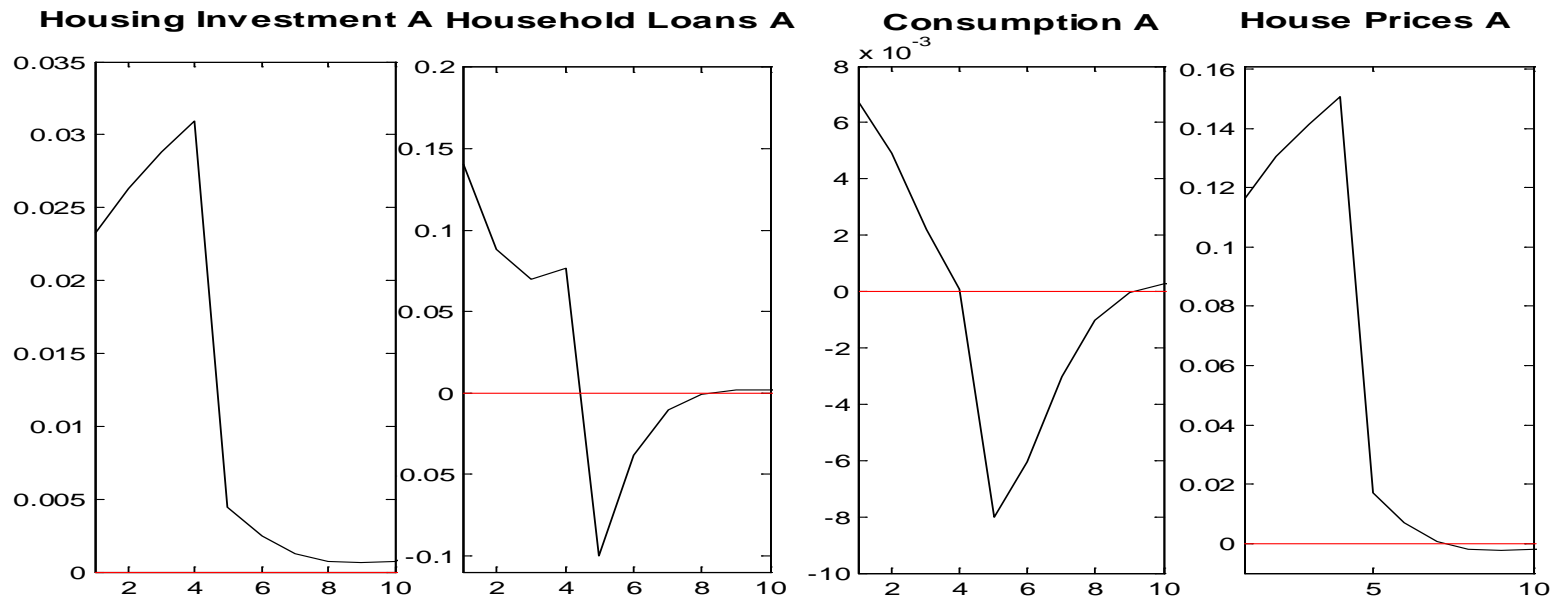
Changes in expectations may be an important independent driver of economic fluctuations.

Several factors can generate housing boom-bust episodes

➔ optimism about future house price appreciation due to anticipated changes in fundamentals.



OVER-BORROWING INDUCED BY NEWS-SHOCK-DRIVEN CYCLES



Boom: emerges when agents expect a future increase in housing prices, which fuels current housing demand and lifts housing prices and debt immediately

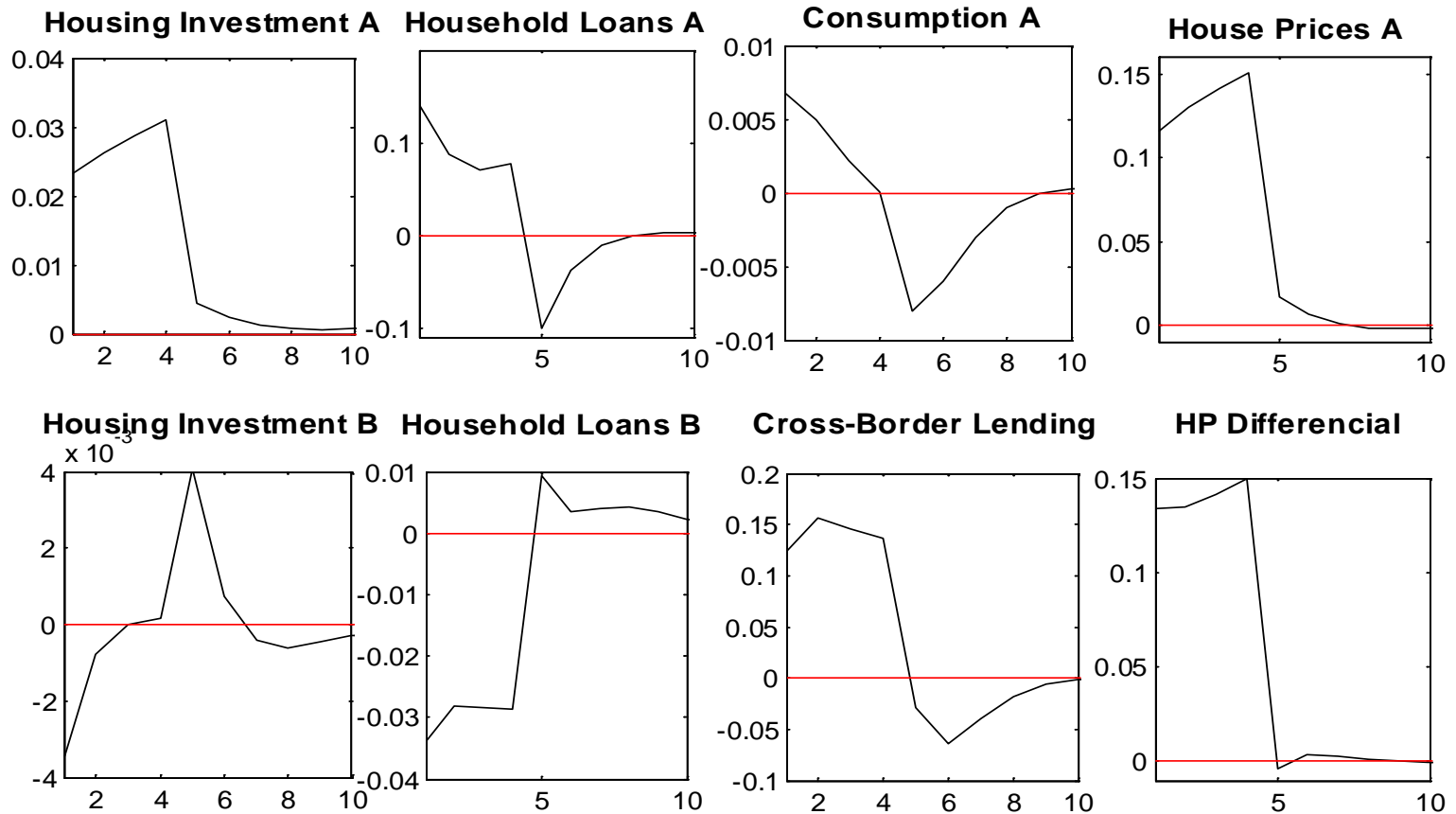
Such behavior involves speculation it can be subject to error!

Burst: unrealized expectations distort consumption, borrowing and investment plans above the equilibrium level

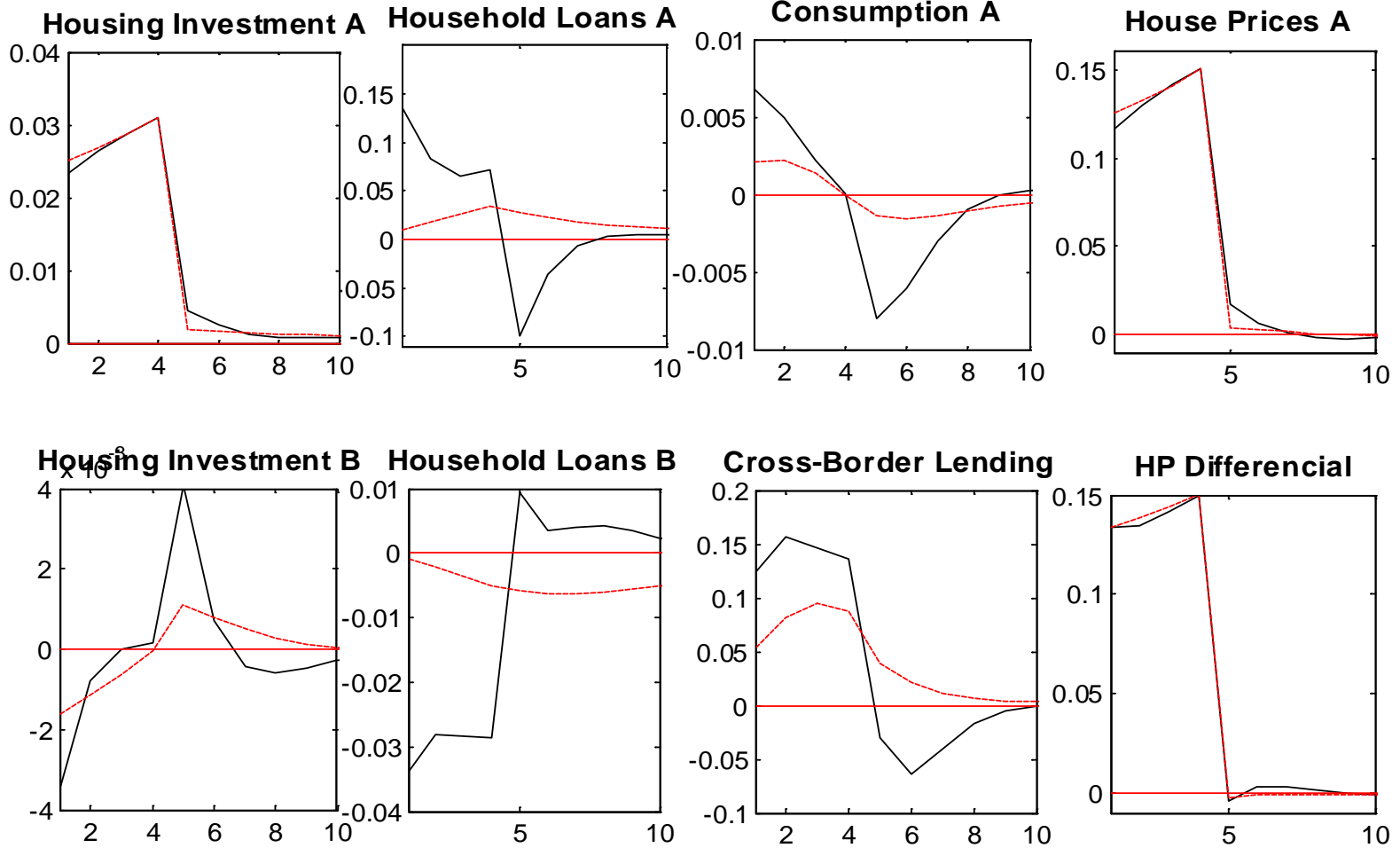


sudden reversals have negative effects on economic and financial decisions, which generate a potential role for policy intervention.

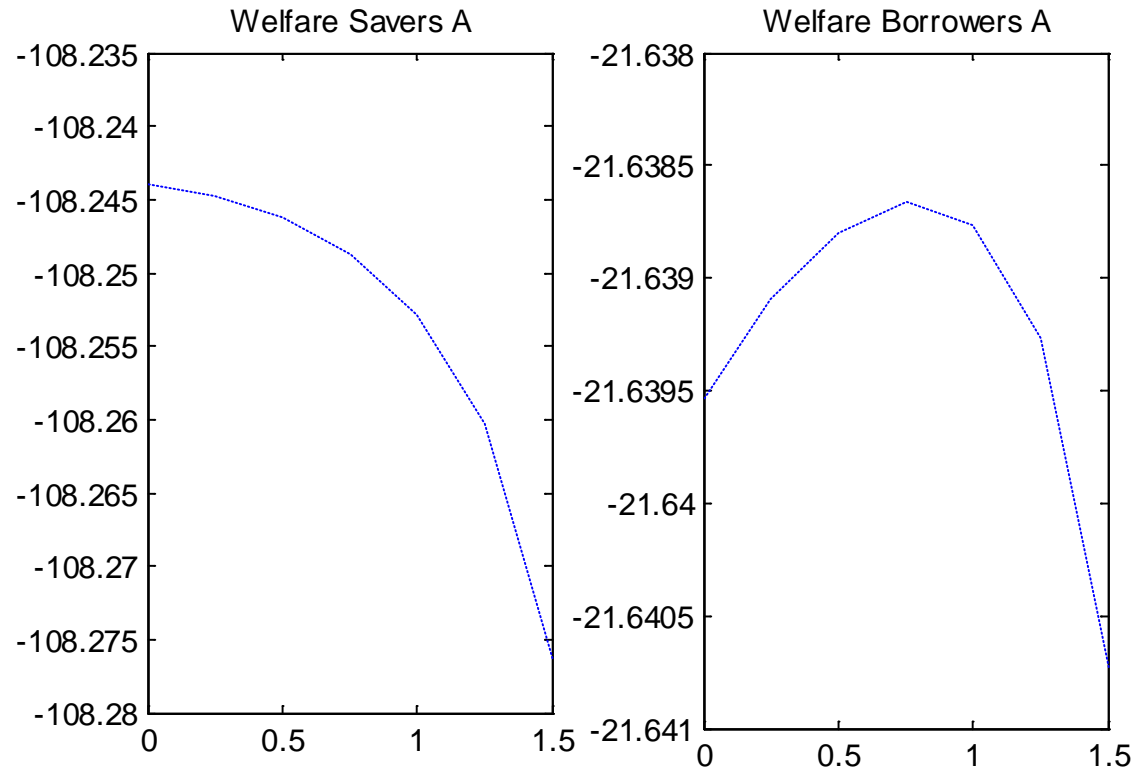
Spillovers



Active LTV Ratio Policy



LTV & Welfare



Still...

- Do the parameters in the Taylor rule make a difference to the performance of different LTV rules?
- How much can be achieved just by monetary policy alone? Or by other MaP tools?

(3) MacroPrudential Policy in the EA

- ✓ Rubio (2013): LTV ratios that counter-cyclically respond to Output and House Prices.

BUT...regulatory instruments against financial imbalances in real-estate markets

- Targeting borrowers: NATIONAL
 - **Loan-to-value limits (LTVs)**
 - **Loan-to-income (LTIs), debt-to-income limits (DTIs) or debt-service-to-income limits (DTSIs)**
- Targeting banks: **Single Supervisory Mechanism (SSM)**
- **Sectoral capital requirements**
 - Direct: Systemic risk buffer, subsidiarity case for own funds
 - Indirect: Higher risk weights (RWs) or higher loss given default (LGDs)

MacroPrudential Policy in the EU

Prime goal of the **European Systemic Risk Board (ESRB)** : *prevention and mitigation systemic risks in EU.*

- avoid periods of widespread financial distress
- contribute to the smooth functioning of the internal market

Institutional Framework:

- **Capital Requirements Directive (CRD IV)/ Capital Requirements Regulation (CRR)**

Macro-prudential tools for banking regulation

- **Creation of Banking Union**

(3) Macro-Prudential Policy in the EA

- The ECB will be responsible for the effective and consistent functioning of the **Single Supervisory Mechanism (SSM)**
 - to ensure the safety and soundness of the European banking system and to increase financial integration and stability in Europe.
 - ECB will cooperate with the **national competent authorities** of participating EU countries.
 - Direct supervision of “significant” banks of joining countries
- ➡ Aiming at systemic risks SSM can make instruments more restrictive (but not relax them)
- Euro area countries participate automatically in the SSM
 - **Separation from monetary policy** (objectives, tasks, policy instruments, organisation and reporting lines etc.)

(3) MaP in EA: Cross-country coordination problems

✓ **Between regulatory instruments against widespread imbalances in real-estate markets:**

- Targeting banks: SSM
- Targeting borrowers: NATIONAL LEVEL

Should we study if LTVs/DTIs be made dynamic and coordinated across Europe abstracting from banking regulation?

✓ **Between Monetary and Macroprudential policy**

✓ **...with not joining EU member states**

Conclusion

- Policy-relevant paper
- Main results: Active LTV policy is desirable in a monetary union!
- Are these general results?