

The Theory and Practice of Macroprudential Regulation

Introduction to a Special Issue of the International Journal of Central Banking

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One of the main lessons from the financial crisis over the past three years has been the need for the establishment of a macroprudential supervisor that oversees the health and stability of the *overall* financial system. The principles, tools, and transmission channels of such a new macroprudential policy framework are, however, not yet fully understood. The second financial stability conference of the *International Journal of Central Banking* (IJCB), hosted by Banco de España in Madrid on June 17–18, 2010, dealt with the topic of “The Theory and Practice of Macroprudential Regulation.” This issue of the IJCB contains selected papers and commentaries presented at that conference.

The first two papers deal with empirical work on the importance of bank capital and financial conditions of banks for their lending and the monetary transmission mechanism more generally. Jose Berrospide and Rochelle Edge (Federal Reserve Board) use a number of different methods for gauging the size of the effect of bank capital on the extension of bank credit. They find modest estimated effects and apply these estimates to investigate the impact of TARP capital injections. José-Luis Peydró (ECB) discusses the paper and points to some of the difficult identification problems associated with distinguishing between credit demand and supply effects. In the second paper, Ramona Jimborean and Jean-Stéphane Mésonnier (Banque de France) use a novel approach to show that common factors extracted from individual banks’ liquidity and leverage ratios do predict macroeconomic developments in France. They also find that these bank factors are, however, largely irrelevant for the transmission of monetary policy once the development of credit aggregates is taken into account. In his discussion, Don Morgan (Federal Reserve Bank of New York) suggests that the framework may also be used to look at the macroeconomic effects of changes in bank capital and liquidity. In his commentary, Mark Gertler (New York University) provides a framework for thinking about the link

between banking crises and real activity, and presents some suggestive evidence of the importance of bank credit risk in the current recession.

The third paper, by Francisco Covas (Federal Reserve Board) and Shigeru Fujita (Federal Reserve Bank of Philadelphia), shows that capital requirements significantly contribute to magnifying output fluctuations, using a general equilibrium model where the financing of capital goods production is subject to an agency problem. In his discussion, Javier Suarez (CEMFI) puts the framework used in the context of the wider literature and argues that the assessment of the likely effects of a significant rise in capital requirements may differ substantially in alternative models that pay explicit consideration to the frictions that affect the dynamics of bank capital accumulation. In his commentary, Douglas Gale (New York University) reviews the impact of capital requirements on risk taking and takes on the classical risk-shifting argument that underlies the claim that capital reduces risk. Gale points out that this partial equilibrium argument ignores the factors that determine the supply and cost of capital. He shows that, in a model in which managers have target rates of return which force them to “reach for yield,” the conventional effects of greater capital on risk taking are turned upside down.

The fourth paper deals with empirical approaches to determine which financial institutions are systemically important. Chen Zhou (De Nederlandsche Bank) considers three measures of the systemic importance of a financial institution within an interconnected financial system and argues that size is not necessarily a good proxy of systemic importance. In his discussion, Stefan Straetmans (Maastricht University) expands on the benefits and shortcomings of multivariate extreme value analysis for measuring systemic risk. In his commentary, Jean-Charles Rochet (University of Zurich) presents a different perspective on regulations aimed at containing systemic risk. He proposes adopting a platform-based (instead of institution-based) regulatory perspective on systemic risk and encouraging a generalized move to central counterparty clearing.

Finally, under the heading of “It’s Broke, Let’s Fix It,” the final paper, by Alan Blinder (Princeton University), presents a number of principles of sound regulation as well as a list of major recommendations and reviews the regulatory response in the United States in this area. At the conference, this paper introduced a panel discussion

with Jean-Pierre Danthine (Swiss National Bank), Charles Goodhart (London School of Economics), and Jean-Pierre Landau (Banque de France). Jean-Pierre Danthine reviewed the Swiss experience of new capital and liquidity regulation and indicated that, although the balance sheets of the large Swiss banks have shrunk significantly, there has so far been little effect on lending. Charles Goodhart emphasized the importance of designing bank taxes well in order to prevent externalities and pointed to legal problems stemming from insufficient harmonization of national laws. Finally, Jean-Pierre Landau made a distinction between a buffer and an incentive approach to macroprudential regulation, noting that different instruments (such as capital requirements) may not necessarily serve both.