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Macro-Financial Policy and the Evolving Role of Central Banks

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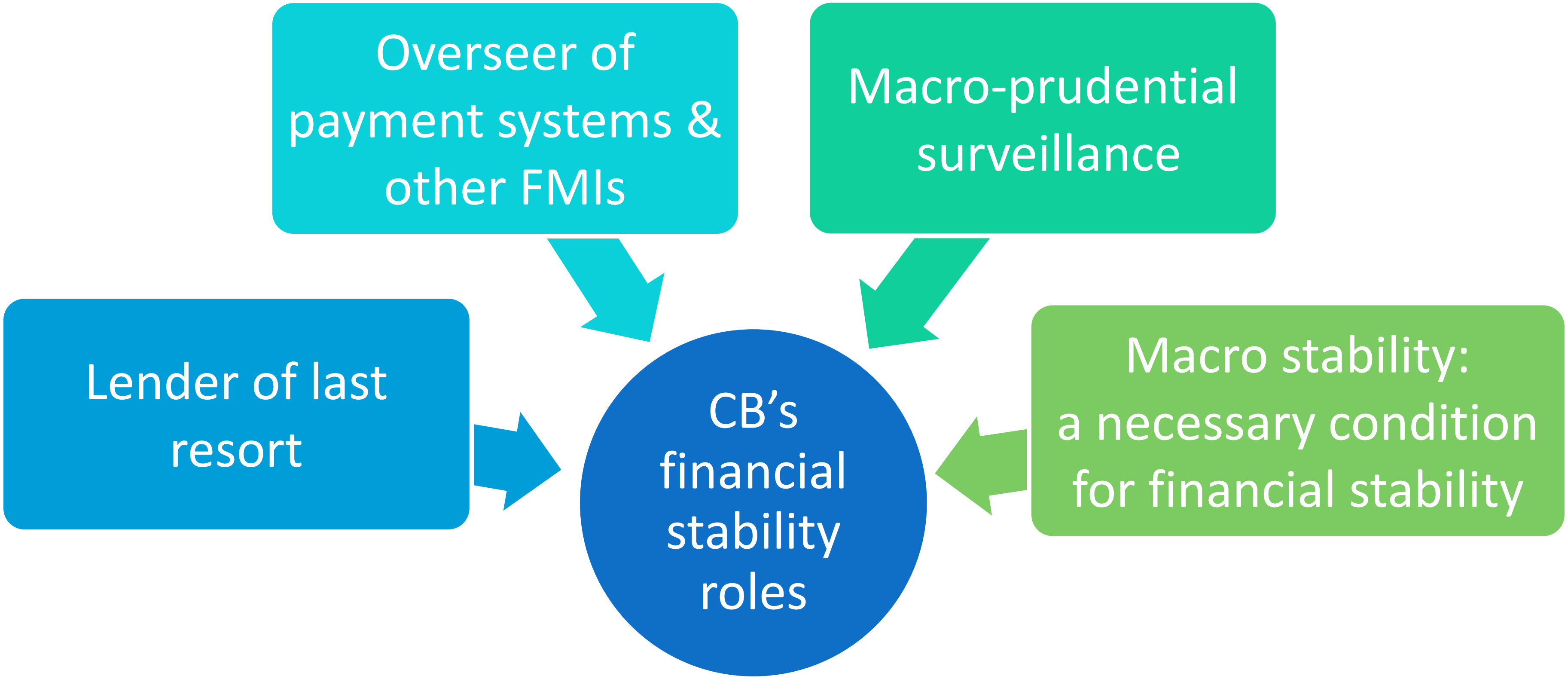
Central banks have always played an important role in financial stability



Global financial crisis: Sparked a re-consideration of CB’s role

Financial innovation & inadequate financial regulation & supervision

Failure of financial stability regime

Global financial crisis of 2007-08

Central banks not the source, but seen as culpable.

Re-inventing role of central banks in financial stability

"Before crisis" role - More "reactive"

Macroprudential surveillance
- Limited depth & transparency

Macroprudential policy & tools
- Inadequate coordination & tools

Lender of last resort
- ~Bagehot's rule

"After crisis" role - More "preventive"

Macroprudential surveillance
- More focused, analytical & transparent

Macroprudential policy & tools
- More responsibility & coordination
- More effective tools (e.g. stress testing)

Lender of last resort
- More facilities, eligible FIs & collateral

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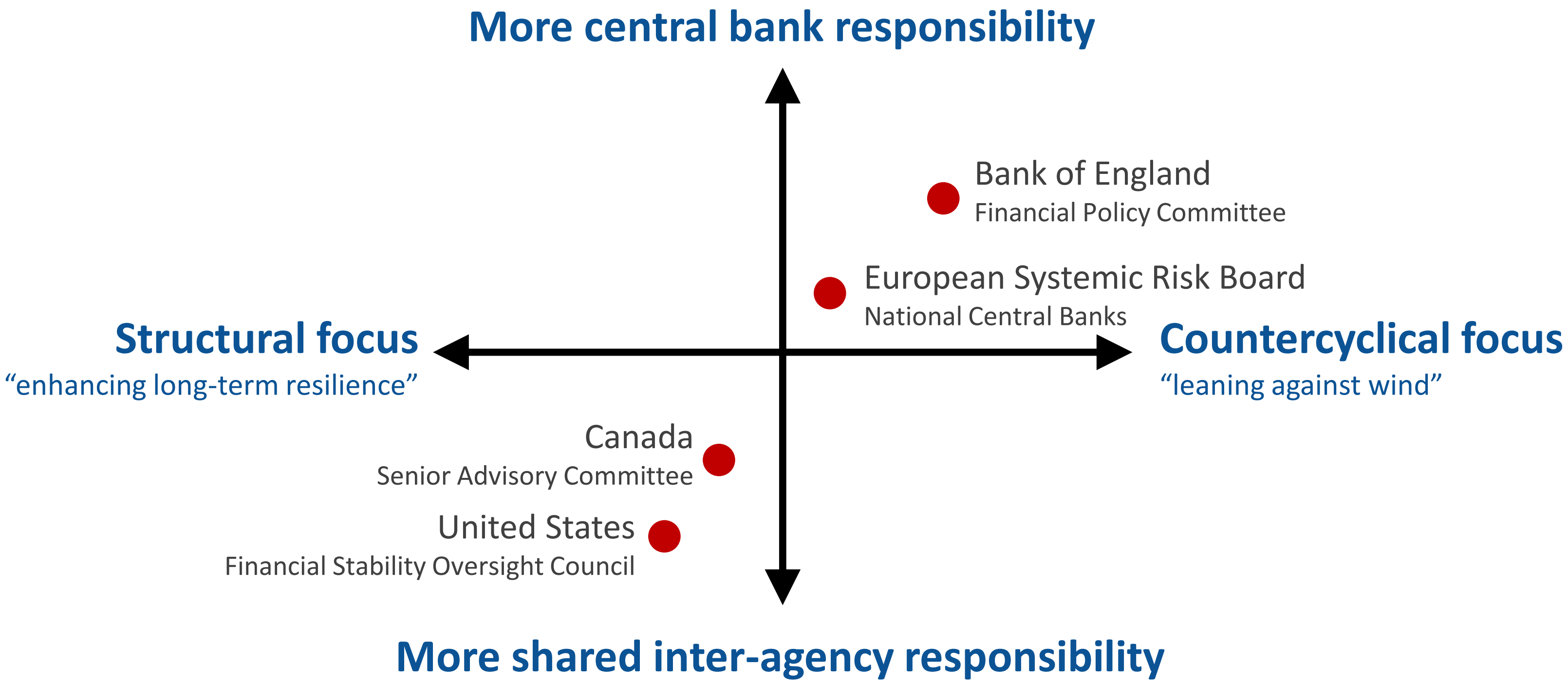
Macroprudential frameworks vary across jurisdictions

Illustrative representation



Canada

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Bank of Canada's systematic approach to assessing vulnerabilities: Key vulnerability: *Elevated level of household indebtedness*

		Potential Sources of Vulnerabilities			
		Leverage	**Funding/Liquidity**	**Pricing of Risk**	**Opacity**
Sectors	**Financial sector entities**	• Ratio of assets to equity • Regulatory leverage ratio	• Regulatory liquidity measures • Ratio of loans to deposits • Liquidity of investments	• Return on equity • **Underwriting standards**	• Amount of risk disclosure
	Shadow banking	• Ratio of assets to equity	• Terms of assets and liabilities	• **Underwriting standards** • Haircuts • Concentration of risk	• Financial innovation (new products, new practices)
	Asset markets and housing		• Market liquidity metrics (e.g. bid-ask spreads)	• Asset valuations • Implied and realized volatility • Risk premiums	• Over-the-counter trading volumes
	Nonfinancial sector: **- household** **- corporates** **- government**	• **Debt/credit-to-income ratios** • **Debt service costs** • **Composition of debt**	• Holdings of cash and liquid assets		• Proportion of unlisted corporations

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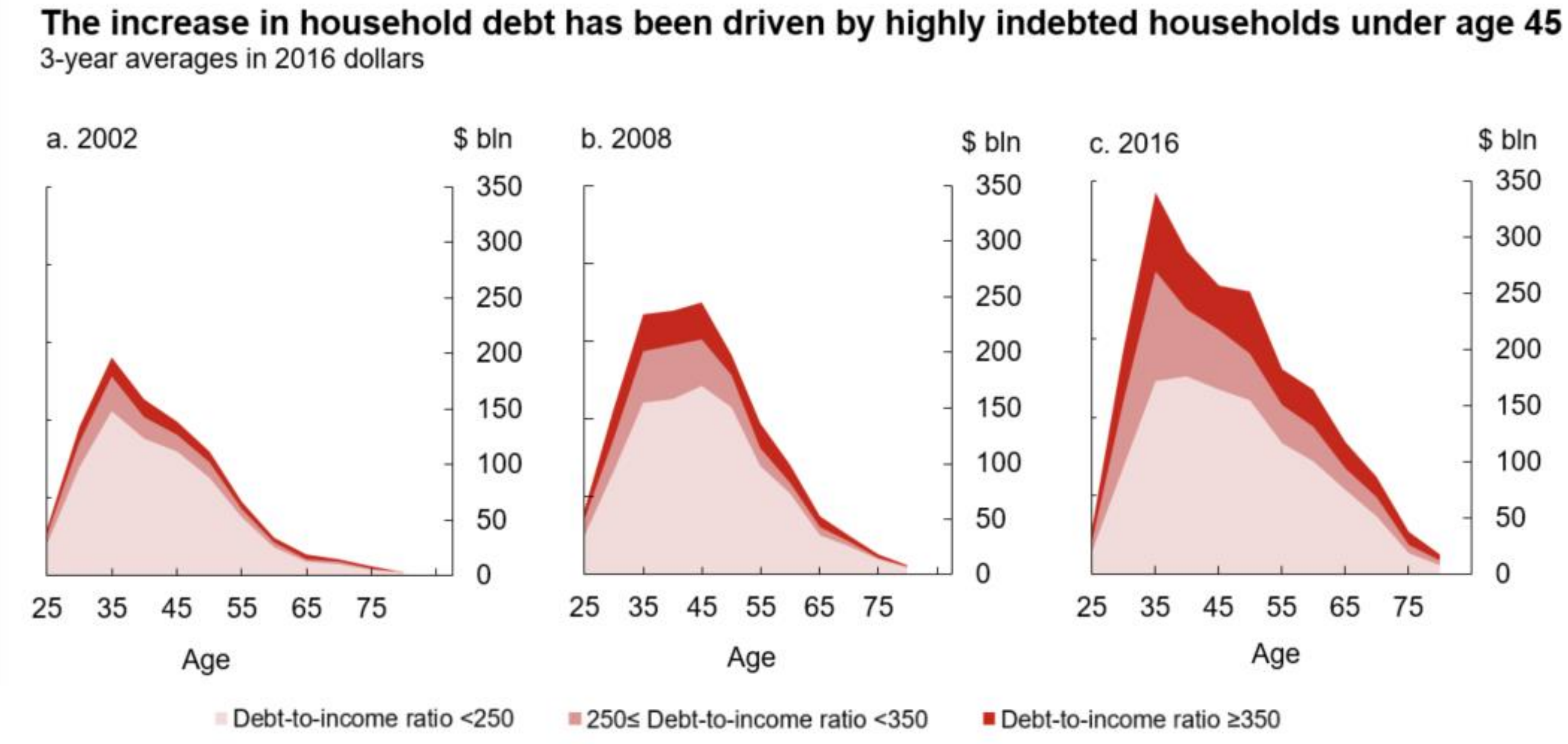
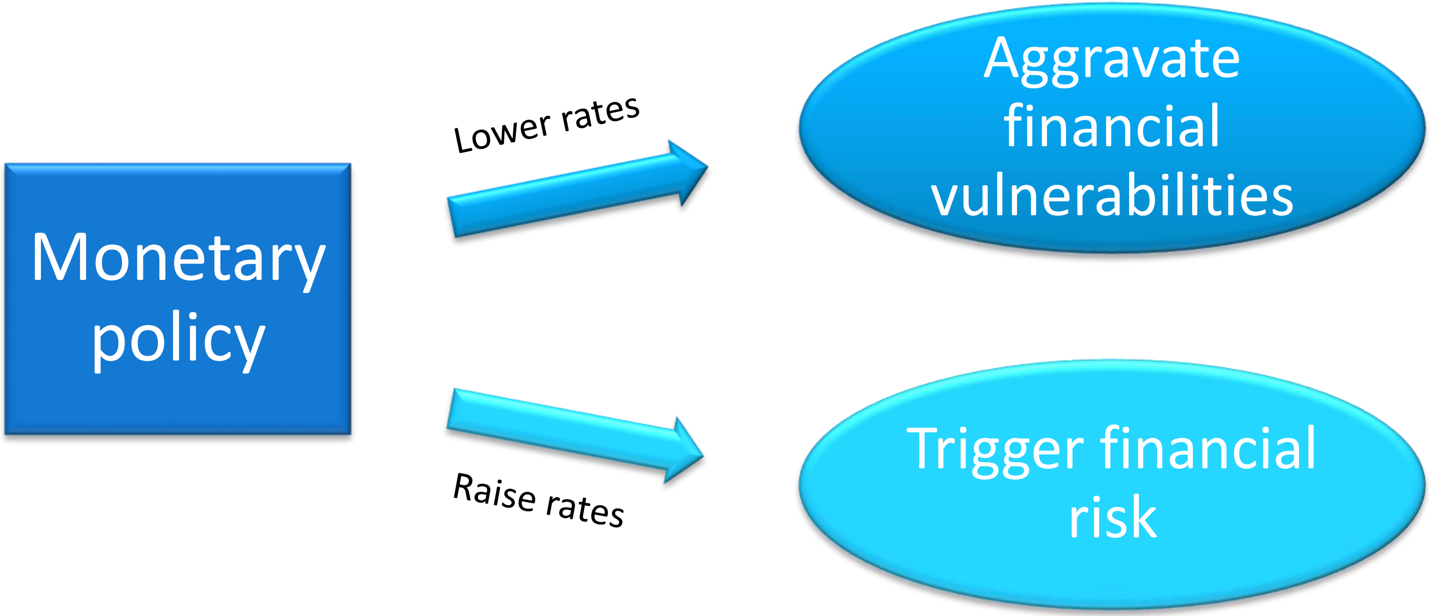
Household indebtedness vulnerability increasing in Canada



Sources: Ipsos Reid, Statistics Canada and Bank of Canada calculations

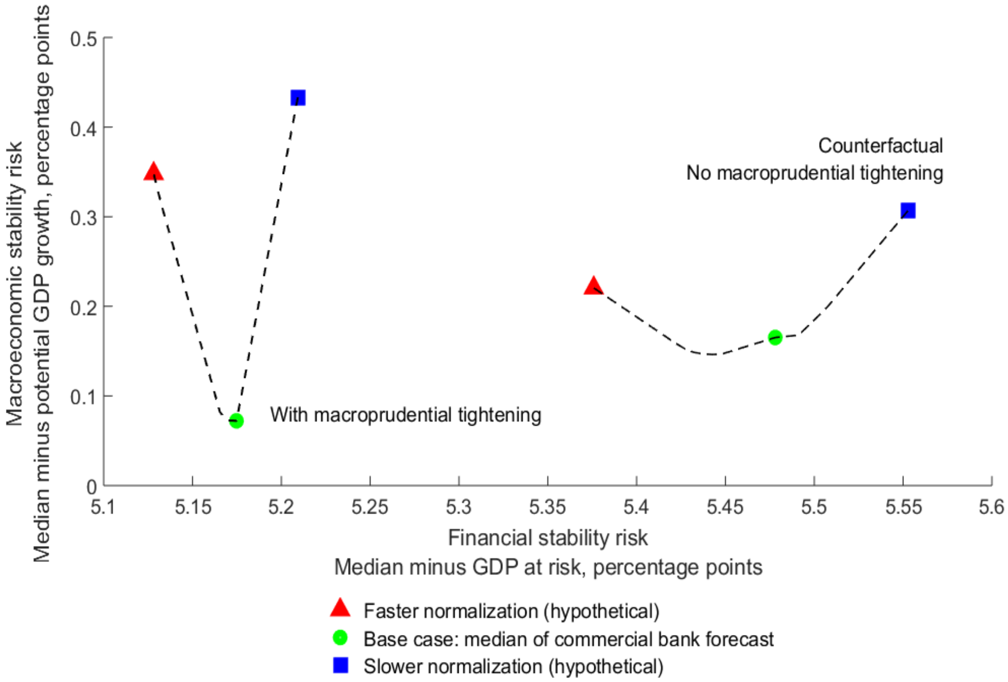
"Low for long" scenario: Tension between monetary policy & financial stability



Approach: Adjust rates gradually and be flexible about horizon; use macroprudential policy to complement monetary policy

Macroprudential policy is effective in mitigating financial stability risks

- **Policy:** Tightened mortgage underwriting requirements
  - ➢ Larger down payments
  - ➢ Shorter amortization
  - ➢ Debt service stress tests: +200bps



Key messages

Post GFC: Central banks taken on a more active and preventive role

Central banks are well placed for this role

- System-wide macro-financial perspective and analytic capacity

Specification of the role depends on institutional structure

- More central bank responsibility versus shared inter-agency responsibility
- Macroprudential policy: countercyclical versus through-the-cycle resilience

Monetary policy should focus on inflation objective, but have a flexible horizon