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Macroprudential policy going forward

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Following the Great Recession, many central banks have tightened macroprudential policy (MaPP). Years later, their macroprudential stance remains tight in an effort to maintain financial stability. In our research, we find that MaPP reduces household consumption by increasing savings and decreasing borrowing. At the same time, we find that MaPP leads to higher firm investment, at least, in the long run. There is also evidence that MaPP leads to a redistribution of wealth. Finally, we show that these effects depend mainly on the type of policy instrument and the country's stage of development.

In the last decade or so, macroprudential policy (MaPP) has re-emerged as one of the main policy questions plaguing central bankers. But what do we actually know about the real effects of MaPP? Not much. There is very little research on the effects of MaPP on individual behaviour. Broadly speaking, the existing literature can be divided into two groups. A first set of papers finds that MaPP hammers output (e.g., Lim et al., 2011; Cerutti et al., 2017). A second set of papers suggests that MaPP can affect income distribution (Frost, 2018; Delis et al., 2014; Acharya et al., 2020). However, these papers rely on regression models that cannot address the endogeneity of the MaPP choice and they usually rely on aggregate measures of credit

and output, which makes it hard to disentangle the transmission channels of MaPP. In our research, we combine traditional econometrics with recent advances in machine learning to study the impact of MaPP on the real economy. In particular, we look at how it affects consumption and investment (Teixeira and Venter, 2022), individual savings behaviour (Teixeira, 2022a) and wealth inequality (Teixeira, 2022b). In Teixeira and Venter (2022), we show that MaPP reduces household consumption in the short and long run, while increasing firm investment in the long run. We also find that LTV and DSTI ratios have a deleterious impact on household consumption while the LTV ratio has a positive effect on firm investment.

Finally, we find that the effects of MaPP on consumption and investment are not immediately felt. Indeed, they only become pronounced three years after the implementation of MaPP (Figure 1). A potential explanation for this is that LTV ratios mainly target home loans, which need time to adjust.

Figure 1: Dynamic Impact of MaPP on Household Savings Rate, 2000-2019
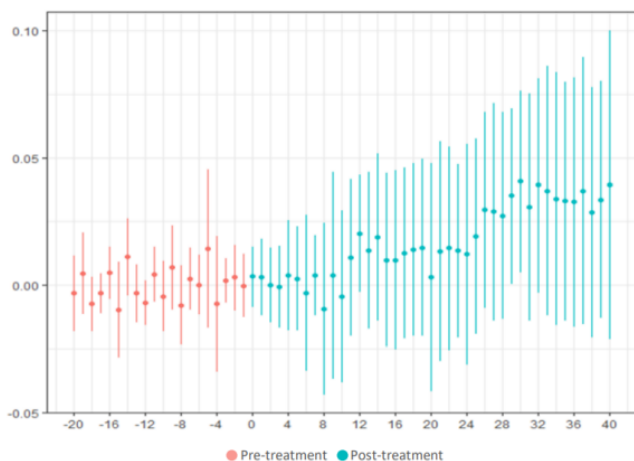
Note: The x-axis is the length of exposure to the treatment. A length of exposure equal to 0 corresponds to the average effect of implementing macroprudential policy across groups in the period they first implement macroprudential policy; equal to -1 corresponds to the period before groups implement macroprudential policy and equal to 1 corresponds to the first period after initial implementation.

In Teixeira (2022a), savings are an important transmission channel through which MaPP affects growth. The results in this analysis indicate that the effects of MaPP depend crucially on the incentives of people to borrow and save. This, in turn, determines the type of policy instrument that should be considered by central banks. If the goal is to increase savings with little impact on borrowing, then policy tools that establish higher collateral requirements may be more effective. If, instead, the goal is to reduce leverage, then policy tools limiting the amount of debt to income appear to be most useful. The right balance of policies must take into account the existing stock of savings and credit in the economy. In general, the adoption of MaPP will reduce leverage in advanced economies and promote savings in emerging economies. Finally, the results show that MaPP is a more effective tool to reduce borrowing, while the interest rate is a more appropriate tool to inject liquidity in the system.

Recent work suggests that MaPP also affects wealth inequality (Teixeira, 2022b). This happens because the relatively poor get trapped in a cycle of low credit and rising asset prices which causes wealth to become more and more concentrated. For this reason, the relatively poor struggle to increase their wealth over time. These effects are more pronounced for DSTI ratios than LTV ratios. These results point to a potential trade-off between financial stability and financial inclusion. Does this mean, then, that we should loosen or even drop MaPP? Not necessarily. It means that we should carefully consider the interaction between MaPP and the policy rate. Central banks should continuously adjust MaPP in much the same way as monetary policy. But given that MaPP has the ability to drive private spending and wealth inequality, central banks should also be cautious about using it liberally.

Policy Implications

There is a widespread belief that MaPP is not merely a weapon in the arsenal of crisis economics but an absolute necessity to prevent a financial crisis. But at what cost and to whom? Our research suggests that MaPP reduces household consumption in the short- and long-run, while increasing firm investment in the long run. It also shows that MaPP leads to a significant redistribution of wealth that hits the relatively poor. These results varly considerably with the policy tool and the country's stage of development.

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