

Linkages between Macroprudential and Microprudential Supervision

By C.A.E. Goodhart
Financial Markets Group
London School of Economics

A. The Problem

GFC taught us to respect the Minsky analysis that Macro-economic stability (the Great Moderation) did not entail Financial Stability.

There is also, however, a second lesson, i.e. that measures to achieve micro-stability ('house in order') may similarly not entail macro-stability.

Two main reasons:

- a) Micro-pru commonly designed as requiring everyone to behave in a similar way to the 'best'. Thus, quasi-consciously, enhances self-similarity. W. Wagner and A. Persaud. Self-similarity (on 'best') will strengthen against idiosyncratic shocks, but weakens against systemic shocks. The latter are more important!
- b) Portfolio insurance. For any individual agent, whether individual investor or bank, best way to ensure maintenance of value, (assuming market values given), is to sell declining assets and buy rising assets. FT and Indices.

A sophisticated form of momentum trading. But if enough agents do it simultaneously, macro-disaster follows. 1987, 2008, etc.

This problem was made much worse in 2007/9 by a run-down of own-asset-liquidity in the belief that funding liquidity via borrowing in wholesale markets would always suffice. When these markets froze, there was no alternative.

Three myths:-

- 1) Macro-stability entails Financial Stability.
- 2) Financial Stability, plus Basel II, entails assured Solvency.
- 3) Solvency allows for Funding Liquidity always to be available.

What to do?

Especially following a bust, such as GFC, micro-pru will be reinforced, so even more self-similarity. Equity ratios vastly increased, (at great cost), but RWA ratios may be appropriate at micro-level, not at macro-level; Carry trade in government debt; residential mortgages.

Need for liquidity measures. LCR, (be kind to Central Banks), interaction with Capital strength, NSFRs, (but MBS).

Macro-pru in a boom, but market will determine in a bust.

What can, and should, a Central Bank do in a bust?

- LOLR, but against what and to whom? Stigma.
- SLS, swap more liquid for less liquid assets.
- Market maker of last resort? CE.

What are, or should be, the limits of Central Bank action in pursuit of financial stability? What conjunction with fiscal authority? Does it affect 'operational independence'?

Who Should Do What?

Central Banks criticised for failing to foresee or to prevent GFC.

Yet now much more powerful:-

ECB	SSM, macro-pru
BoE	PRA
Fed	

Not everywhere, e.g. Riksbank.

Separation is possible, but

- Can anyone but CB provide essential liquidity?
- Is Financial Stability an inherent CB objective?
- If CB has to be involved with Financial Stability, must it know basic micro-level conditions?
- W. Buiter's suggestion.
- What are limits to CB's actions in this field?