Issues in the Governance of Monetary, Microprudential and Macroprudential Policy

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1 Introduction

This section collects essays related to the governance of monetary, microprudential, and macroprudential policy. The essays are based on the presentations delivered at the Workshop "How do monetary, micro- and macroprudential policies interact?", hosted by the Oesterreichische Nationalbank hosted on December 2, 2019, but have been expanded and nuanced based on the discussions at that event.

The Global Financial Crisis (GFC) and its aftermath led to major changes in monetary and financial sector policies, and to the governance arrangements for those policies. The GFC was seen at least in part as representing a failure on the part of the authorities to identify and address the build-up of systemic risk in the financial sector. In response, existing (micro)prudential regulations, supervisory, and crisis management practices were strengthened. In parallel, macroprudential policies and decision-making procedures gained prominence, and were strengthened and formalized.[1, 2] Monetary policy was redirected to cushion the immediate effects of the crisis and then to promote recovery, often with the use of innovative instruments (such as quantitative easing, negative interest rates, or US Dollar funding facilities). These changes in policies necessitated changes in institutional arrangements, the old structures having lost credibility due to perceived failures before and during the GFC.

[1] Macroprudential policies had been deployed before, for example, to dampen rapid credit growth and reverse currency substitution in emerging market and transition countries, but the term was not in widespread use.

[2] See for example Bolton et al (2019); Calvo et al (2018); Khan (2017); and Masciandaro and Quintyn (2016).

Two of the most important changes in the governance of financial sector policies relate to macroprudential policy and financial crisis management. At the country level, a mandate for macroprudential policy action was legislated, and a mechanism to coordinate among relevant agencies was established. The European Systemic Risk Board was set up at the European level, and at the global level institutions such as the Financial Stability Board are meant to promote communication on, and coordination of macroprudential analysis and actions. A parallel development can be seen in the development of mechanisms for crisis management, with the designation of national resolution authorities but also the establishment of national coordinating mechanisms; the establishment of the Single Resolution Mechanism in Europe; and the activation of resolution colleges for cross-border banking groups.

These changes provoked new thinking about the coordination of the relevant policies — microprudential and macroprudential policies are clearly closely linked, and their interactions with monetary policy are strong and complex — and how that coordination can be accommodated in decision-making and accountability mechanisms. Countries have introduced various governance arrangements to this end. Yet so far in the post-GFC period these arrangements have not been put to a severe test, and the optimal structure is still subject to debate.

To introduce this set of essays, the next section summarizes elements of governance as applicable to public policy, what makes for good governance, and some challenges. Several specific issues of topical importance will be set out in the last section.

2 Concepts of governance for the public sector

2.1 The concept of governance

The term "governance" is generally taken to cover the rules, structures and practices by which decisions are made and their implementation overseen.[3] Elements may include, for example, the overall mandate of the institution concerned; the decision-making and review responsibilities of various officials and committees; reporting requirements; provisions to avoid conflicts of interest; and provisions for

[3] The G20/OECD (2015) "Principles of Corporate Governance" states that "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." (p. 9). The Basel Committee on Banking Supervision in Bank for International Settlements (2015) define corporate governance as "[a] set of relationships between a company's management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. It helps define the way authority and responsibility are allocated and how corporate decisions are made."

stakeholders to intervene. A distinction is often made between internal governance provisions, such as the respective roles of the Board and the Supervisory Board, and external governance provisions, such as requirements to publish audited results.

Good governance helps ensure that decisions are reliably taken and effectively carried out in a deliberate manner, based on adequate information, in pursuit of the institution's mandate. Promoting the pursuit of the institution's mandate, rather than, say, the personal interest of managers or some unstated political goal, is the central element of good governance. This end is served by mechanisms to prevent conflicts of interest from arising, and those to effect ex post accountability. But good governance also involves decision making that is considered and effective in practice; being well-intentioned is not enough. Hence, good governance involves also ensuring that relevant information and analysis are taken into account and that decision makers have available adequate instruments. Moreover, good governance arrangements have to be robust across circumstances, so that decision making continues to function well even as outside shocks and diverse forces impact the institution.

Governance for the public sectors is broadly similar to that for the private sector, but has certain distinctive features.[4] A public sector institution such as a central bank or a prudential regulator typically has defined management and Board responsibilities, decision making procedures, and accountability mechanisms, which are functionally similar to their private sector counterparts. The controlling interests of any institution, be it public or private, will seek to ensure that the institution is not "highjacked" by others for their own purposes, and to this end will put in placed both ex ante and ex post controls. Accounting and audit rules are broadly similar in the public and private sectors.

2.2 Governance of public policy authorities

A distinctive feature of the governance in public sector is that it is subject to a special legal regime. Including in the areas of monetary, microprudential, and macroprudential policy, many of the high-level governance arrangements are set by law, and indeed the agencies are typically public law bodies rather than, say, corporations. The central bank law normally defines the central bank's monetary mandate (at least in broad terms); its powers (e.g., to gather information or to use certain instruments); decision-making arrangements; and reporting requirements. Similar provisions apply to microprudential and macroprudential policy-making and implementation. Moreover, in the public sector, provisions for funding and those for the appointment and dismissal of officials constitute important elements of the gover-

[4] See for example Almqvist et al (2012); Bertelli (2012); and International Federation of Accountants (2001).

nance arrangements that differ from those typically seen in the private sector. Public sector officials often enjoy special protection from legal liability for official actions taken in good faith, and in many jurisdictions the state can override other interests for compelling "raisons d'état." The decision-maker regarding legal provisions on public sector governance, and regarding most high-level appointments, is the government itself, as representative of the stakeholders, that is, the polity as a whole.

Moreover, a public sector institution faces exceptional challenges in measuring effectiveness and linking effects to particular actions, which challenges complicate the design of governance arrangements. The ultimate purpose of a public institution relates to general welfare over the medium term, which is not readily measurable or closely linked to specific decisions. Therefore, the public sector typically establishes intermediary goals, or a hierarchy of intermediary goals. A high-level goal might be "price stability." Even that has to be translated into something more specific and near term, such as "CPI inflation close to 2 percent over the next two years."

For the discussion here, it is worth noting that inflation targets are easier to define, and their achievement easier to measure on a timely basis, than objectives related to financial stability. For microprudential policy, "success" consists of individual financial institutions acting prudently, but still some institutions will fail.[5] Another part of "success" consists of handling exits with a minimum of disruption or other externalities. For macroprudential policy, "success" consists in limiting risks to the system as a whole, and in building buffers to mitigate risks that cannot be eliminated. Prudent behavior, resolvability, systemic risks, and systemic robustness are not readily measurable or aggregatable. For both micro- and macroprudential policy, successful policies may be characterized by the absence of major events for prolonged periods, while policy errors may become evident only many years after decisions are made.

In this connection, accountability is complicated by the distributional issues that arise in public policy matters more than in the private sector. It is generally thought that public policy should yield actions that are equitable, in terms of benefits and costs. Monetary policy regarding interest rates, acting on a macro level, may affect the broad classes of borrowers and savers in opposite ways. Macroprudential policy may create more narrowly-defined winners and losers (or those who think of themselves that way). A tightening of housing finance rules is likely to be opposed by builders, first time buyers, etc. even if the measure is designed to preempt a market crash that would harm them severely. Microprudential policies tend to affect the most narrowly defined groups, such as "shareholders of banks" or even "sharehold-

[5] Commercial banks' own governance arrangements are subject to regulation and supervision for both prudential and market conduct reasons (see BIS (op. cit.); Dermine (2013); and Litan et al (2004)).

ers of bank X." The distributional implications of prudential policies, combined with the challenges in measuring their success, make it more difficult to apply the distinction between "goal independence" and "instrument independence" in these areas compared to in the monetary policy area. In addition, the different distributional aspects of the policies under consideration need to be taken into account in governance arrangements, if only because they all face some risk of regulatory capture.

Regulatory capture in the narrow sense refers to a regulatory agency being "captured" by the entities that it is meant to oversee and therefore to act sometimes in their interest rather than the public interest.[6] Regulatory capture in the wider sense refers to a regulatory agency being "captured" by a special interest group, such as the party of government or the agency's own staff. This definition allows for the possibility that "capture" is a matter of degree and complicated by competition between interest groups. For example, large and small banks may differ in the prudential policies that they would like to see, and savers and borrowers may differ in the monetary policy stance that they favor. The government of the day may want an agency to support one of its favored policies, even in contradiction to the agency's mandate (e.g., to be more expansionary than warranted by concerns over inflation or financial stability). However, the career staff of the agency may put up resistance because they value their status and independence, and demand a quid pro quo (perhaps some desired legislation, or more autonomy in setting their budget and salaries).

Related to the possibility of regulatory capture in the wider sense is the widespread tendency towards "blame avoidance." Officials (and politicians) may be very concerned to avoid being held responsible for bad outcomes, or even for outcomes that are the best available but hurt certain powerful groups. "Blame avoidance" is a common phenomenon in institutions. It may take the form, for example, of delaying decisions, of strictly following precedent or of ensuring that laws and regulations are followed to the letter (notably with regards to the sharing of information).

There is a large literature on the governance of monetary and prudential policy, generally concerned with how to achieve and preserve the right degree of independence and far-sightedness in the face of "political" pressures.[7] In addition to the possibility of regulatory capture, a major concern is time inconsistency and the commitment problem: in monetary policy, it may be tempting to convince economic agents that inflation will be low, and then surprise them with higher inflation in order to induce higher output. Since economic agents anticipate this possibility, expected inflation will remain high and reducing inflation will be costly. Likewise in

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6 An extensive review of the literature is provided in Mitnick (1980) and Wilson (1980).

7 See for example Cuikerman (1992); Arnone et al (2007); Eijffinger and Masciandaro (2014, 2018); Financial Stability Institute (2007); Goodhart and Lastra (2017); and Meade (2012).

prudential policy one may want agents to expect strict enforcement of rules and no bail outs, but then exercise forbearance or provide bail outs after an adverse shock. The proposed solution is to give the monetary or prudential authority a mandate to pursue longer term objective(s) rather than the short-term gains mentioned, and to insulate it from contrary political and other forces. This independence must, however, be matched with accountability in order to remain legitimate and guard against misuse by the authority itself. That credo, on which there is a wide-spread consensus, is embedded in most modern central bank laws (Issing, 2018). These mechanisms are incorporated also, for example, into Principle 2 and also Principles 1 and 3 of the Basel Core Principles for Effective Supervision (BCBS 2012).

A closely related literature looks at how to balance clarity of mandates against the need for coordination in what are acknowledged as closely related and interacting policies.[8] Monetary policy has stability implications, and micro- and macroprudential policies affect monetary policy transmissions and macroeconomic conditions generally. Hence, one would want positive or negative spill-overs to be taken into account, and often choices about trade-offs must be made. Yet, it is impractical to decide everything in a fully integrated manner. Moreover, such integration, with non-commeasurable objectives over different time horizons, would make accountability hard to achieve, and may be politically unacceptable.

3 Current issues

These general principles for the good governance of public policy, and the threats to it, are fully applicable to the sphere of monetary and prudential policy in the post-GFC world, with some added complications and peculiarities. On the one hand, events over the past decade or more have underscored the importance of international cooperation in dealing with truly systemic disruptions and vulnerabilities. That cooperation might be bilateral, regional or European, or global. On the other hand, the traditional dichotomy between monetary and prudential regulation and supervision has become the trichotomy of monetary, microprudential, and macroprudential policy. These policies are not separable from policies in the area of bank resolution, and others.

The interactions are bi-directional and often involve feedback loops. For example, unconventional monetary measures may affect the interaction between monetary

[8] Tucker (2016) provides an overview of recent thinking and practice. European Systemic Risk Board (2014) addresses the allocation of macroprudential powers in relation to other policy areas. See also for example Claessens and Valencia (2013); Danielson and Macrea (2018); Della Pellegrine et al (2010); Edge and Liang (2017); Koetter et al (2014); Martinez-Miera and Repullo (2019); Masciandaro and Quintyn (2009); Masciandaro and Romelli (2019); and Vilmunen (2008).

and macroprudential policies.[9] The unconventional measures work in part by lowering yields, i.e., raising asset prices, which may have more effect in certain sectors rather than other. Plausibly, commercial and residential real estate prices are stimulated quite quickly by the easy monetary conditions. To some extent that is desirable, but the process may risk getting out of hand, while a broader-based recovery lags behind. Therefore, macroprudential policy may have to be applied, say, through borrower-based measures, but in a way that does not vitiate the monetary stimulus.

Also the novelty of the current situation, with many relatively new institutions untested over many complete cycles, raises issues of how one establishes credibility and autonomy. Newer authorities can sometimes helpfully "borrow" reputation and autonomy from more established authorities. In particular, there has been discussion of macroprudential policy "borrowing" gravitas from monetary policy.[10] Central banks are among the most stable institutions in the polity even of new countries. They tend to be well funded, well connected domestically and internationally, and well protected by special legal provisions. Hence, it is suggested that central bank involvement in, and a degree of responsibility for macroprudential policy will promote resistance to capture by special interests, and more long-sighted, bold decisions. The downside is that the central bank's own reputation is thereby at stake: first, it might have to make decisions trading off financial stability against inflation, so that its monetary policy credibility is weakened.[11] Second, it might come under criticism both when macro-financial risks are realized, and when risks are not realized and the measures are seen as unduly onerous.

In this context, the following questions related to the optimal governance of policies are worth addressing:

- New competencies in the area of micro- and macroprudential supervision might challenge the traditional views on the independence of central banks and supervisors. For example, supervisory intervention might affect property rights, require the imposition of sanctions, or even motivate public bail-outs, and thus require introducing a fiscal component and important distributional consequences. What is needed in terms of enhancing communication, transparency, and accountability of central banks and other agencies? What are the limits of the independence of central banks and prudential supervisors? What are the biggest institutional challenges for central banks and supervisors in terms of credibility?
- One key aspect is the availability of data, information and analytical capacity to fulfill the various mandates. As banks play a major role in the financial system, information and expertise on individual banks are a prerequisite for financial stability analysis, especially in crisis situations. How can one maximize synergies

[9] Ferrero et al (2018) provides an example.
[10] See for example Chwieroth and Danielsson (2013).
[11] See for example Dalla Pellegrina, Masciandaro, and Pansini (2010).

among monetary, micro- and macroprudential policies while protecting confidential information?

- A major element of the European response to the GFC was the creation of the Banking Union, which should eventually have three pillars (the Single Supervisory Mechanism, SSM; the Single Resolution Mechanism, SRM; and the European Deposit Insurance System, EDIS). This remarkable achievement does, however, bring with it new complexities. These complexities are both internal and also in relation to national structures and other European institutions, notably the ECB in its capacity as monetary and SSM authority. How can the relevant governance structures be made fully effective and even streamlined? What challenges remain and how can they be addressed?

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