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# Macropru's fatal flaw | VOX, CEPR’s Policy Portal

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The fatal flaw in macropru: It ignores political risk

**Jon Danielsson, Robert Macrae**

08 December 2016

Political risk is a major cause of systemic financial risk. This column argues that both the integrity and the legitimacy of macroprudential policy, or ‘macropru’, depends on political risk being included with other risk factors. Yet it is usually excluded from macropru, and that could be a fatal flaw.

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The purpose of macroprudential policy is to identify financial risks and take corrective measures before it is too late. If the measures are effective, systemic risks will be diminished, the severity of any negative events already occurring in the financial system will be contained, and the wider economy will be protected.

The successful implementation of ‘macropru’ demands three things of the financial authorities. First, they need estimates of systemic risk (and its impact on the real economy) from the early signs of a build-up of stress to the post-crisis economic and financial resolution. Second, they need the tools to implement effective policy remedies. Finally, given the power of the tools they wield, the authorities need legitimacy, a reputation for impartiality, and political support.

Most discussions about macropru focus on the first two conditions. Our concern is on the third. It is often assumed that macropru has the similar legitimacy to monetary policy, but we do not believe the comparison works.

For monetary policy, central banks have one measure (inflation), and two tools (interest rates and quantity of money) that have powerful but diffuse effects on the economy. The independent use of these tools by central banks is backed up by decades of research, including the work of Nobel prize winners. Given the importance of the mission, the clear understanding of the problem, and the still-fresh memory of the 1980s, it is not remarkable that democratic societies choose to give this power to unelected bureaucrats.

In contrast, the macropru policymaker is faced with a complex, ill-defined policy domain in which there is not a clear consensus on either the problem or the objective. The indicators at this policymaker's disposal are often imprecise and conflicting. The surgical implementation tools are often ineffective, and the powerful implementation tools are too blunt. Macropru also tends to result in clearly identifiable winners and losers, perhaps even more so than monetary policy. As a result, it is subject to intensive lobbying and political pressure.

This adversely affects both the legitimacy of the macropru regulator, and the regulator's reputation for impartiality. It makes it harder to mobilise the sort of political support that monetary policy can get. As a consequence, as we argued last year (Danielsson et al. 2015), except in times of obvious, dire emergency, macropru is likely to lose out to policy objectives like micropru when they inevitably conflict.

This may well frustrate the preventive role of macropru, condemning it to be solely reactive. For example, Sebastian Mallaby writes in his recent autobiography of Alan Greenspan (Mallaby 2015) that the Federal Reserve was aware of the risk from the volume of subprime mortgages. It was largely unable to act because Congress supported increased home ownership, and politicians feared a political backlash if this policy were curtailed.

It seems impossible to ignore the profound and intimate way that politics constrains macropru. Yet the macropru

agenda typically takes little account of political risk, and when it does the backlash may be immediate. Consequently, macropru regulators must tiptoe around politics, both as a major source of systemic risk and as the dominant constraint on their ability to act.

## Why political risk matters

When we look at major stress events in the financial system, only a few have arisen purely from excessive risk-taking by, and misbehaviour of, economic agents. Perhaps the best example is the 1987 stock market crash that originated in an automatic trading rule and portfolio insurance. This crash had limited impact outside finance. Most other stress events, however, have been strongly influenced by politics. The biggest systemic financial crises in the world were caused by war or a transition between political systems, such as in Russia in 1919, Germany in 1923, Japan in 1945 and China in 1949. The severe financial and economic crisis currently occurring in Venezuela is largely political.

In events of this magnitude the financial strains are merely one aspect of a near-total collapse of social institutions. It is unreasonable to expect any regulator to achieve much of value. There are, however, many less-seismic events that are also largely political in origin.

Take Brexit, for example. The only immediate financial or economic impact was a 20% drop in the value of the pound against major currencies. This is not in itself a systemic concern, but there were possible of systemic consequences via the fixed income markets (Csullag et al. 2016). During the referendum campaign, the Bank of England decided to warn of serious economic consequences if there were a vote for Brexit, putting itself on the losing side of an acrimonious political debate. As a consequence, it has come under repeated attacks from politicians. It is having to reaffirm its independence and request support from the post-Brexit UK government in a way that is unusual for a central bank. This clearly highlights the dangers facing central banks if they include politics in their macroprudential considerations.

Populist parties in Europe have their most realistic chance in a generation of achieving power. Given the strains and imbalances within the Eurozone it is not clear how they could be accommodated, and if current assumptions – such as the fungibility of euros – were called into question, the consequences could easily be systemic. Populism must therefore be a source of systemic risk, but how far can (or should) a civil servant working on macropru venture into this domain?

Similarly, the election of President Trump appears to signal a dramatic change in US economic priorities, with the potential for the Fed to make much larger adjustments to US interest rates. Given the vulnerability of fixed income markets to rising interest rates, and with the dollar replacing the VIX stock market volatility index as the 'fear gauge' of the financial markets (as argued by Shin 2016), the consequences could well be systemic. This is exactly the type of scenario the macropru authorities should focus on. On the other hand, it is hard to see how the Fed could react.

## The limits to macropru

Whatever independence is claimed, in practice the financial authorities are authorised by, controlled by, and gain their legitimacy from the political leadership. Not surprisingly, the mandate from political leadership is to look at financial and economic risk, not to look at risk that has been created by politicians themselves. This makes it hard for the financial authorities to incorporate political risk as a determinant of systemic risk, despite its importance.

As a result, political risk is largely missing from the macroprudential debate, despite having always been a major cause of systemic risk. This makes it institutionally difficult for the financial authorities to publicly anticipate crises that have predominantly political causes, and difficult also to mitigate crises once they happen.

## Conclusion

If financial regulators take steps to address political risk to achieve macropru stability, whether the succeed or fail

we are heading down a dangerous path. Being involved in a political debate with macroprudential consequences jeopardises their reputation for impartiality, threatens their independence, and affects their ability to execute both macropru and monetary policies.

If the authorities visibly react to political initiatives that affect financial stability, there is a danger this would be interpreted as frustrating or twisting democratic decisions. On the other hand, if the macropru authorities are not able to incorporate political risk in their analytic frameworks, how effective can they be?

The authorities face a dilemma. The inability to incorporate political risk in macropru, but the ineffectiveness of macropru if political risk is ignored, may be a fatal flaw in macroprudential policymaking.

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