

# The Governance of Monetary and Prudential Policy in Good Times and Bad

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## **1 Introduction**

The theme of this paper is how economic and especially financial conditions may affect the efficiency and effectiveness of governance arrangements for monetary, microprudential, and macroprudential policies. Some negative factors threatening good governance may be very acute in certain circumstances, and others may be chronic in other circumstances.

One implication is that desirable governance arrangements should be resistant to the full range of negative factors. These arrangements are not easy to change and so they should be designed for the medium term, giving reasonably good results across diverse circumstances and challenges. Moreover, it will be suggested that governance arrangements should be designed to be especially resistant to threats that intensify during stress periods, and specifically banking crises. This asymmetry arises because the decisions that have to be taken in the difficult circumstances of a crisis may have major impacts, for example, on the distribution of losses and the future structure of the financial system. Uncertainty is elevated, and the downside risks are unusually large. Moreover, crisis action may be very difficult to adjust later, let alone to reverse, whereas an action taken in “peacetime” can often be revised once the consequences can be seen. Every country with a significant financial system is potentially vulnerable to booms and busts, so the question of how to build governance arrangements that work effectively in a crisis is widely relevant.

The paper is thus normative in intent, but is informed by evidence from many countries during the run-up to the Global Financial Crisis (GFC), the GFC itself, and the subsequent period of slow growth and normalization. It also reflects experience of other cycles of boom, bust and recovery, in advanced countries and elsewhere. Governance issues related to monetary, microprudential, and macroprudential

policies that arise in those different phases of the macro-financial cycle will be expanded upon in the concluding section.

## 2 Governance challenges and macro-financial conditions

Many of the factors that can affect the achievement of good governance in monetary, microprudential, and macroprudential policy can best be seen if one considers experience across a range of macro-financial conditions. The demands placed on these policies, the difficulties of decision making and implementation, the interaction among these policies, and the forces of regulatory capture will differ across the scenarios.

The three scenarios considered here are (a) a period when risks are building up, perhaps in the form of rapid credit growth or rising asset prices, and possibly over an extended period; (b) an acute crisis period, when a major portion of the banking system is threatened with failure; and (c) an extended recovery period characterized by a “balance sheet recession” similar to that seen post-GFC. The scenarios, based on the large literature on financial stability and crises, are stylized versions of what has been witnessed in many countries and periods.<sup>1</sup> The GFC had certain distinct features, and is especially relevant today because its after-effects have been especially long-lasting and profound. Other features were similar to what was seen in other crises, at least in kind.

For the purposes of this exercise, it is useful to assume that there are distinct monetary, microprudential, and macroprudential authorities. They may all be housed in one legal entity, but they have separate mandates and powers, and at least potentially could have separate chains of command, accountability mechanisms, and information systems. It will be necessary to refer also to other public sector institutions, especially the Ministry of Finance.

### 2.1 Governance in the lead-up to a crisis

Probably the most common situation faced by monetary and financial sector policymakers is when the economy is performing reasonably well and vulnerabilities are not pronounced, but some potential threats to monetary and financial stability may be becoming apparent. Perhaps consumer price inflation is moderate, and the balance of payments and the government indebtedness are not of great concern.

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<sup>1</sup> See for example Bayoumi (2017); or Claessens et al (2010) on the GFC. See Borio and Lowe (2002); Diamond and Rajan (2009); Drees and Pazarbasioglu (1998); Goldstein (1998); Laeven (2011); Laeven and Valencia (2013); and Reinhart and Rogoff (2013) on crises in other regions and periods.

However, in these favorable conditions, there may be relatively rapid expansion in credit or asset price increases.

In such circumstances, the interaction between macroprudential and microprudential policy making will be relatively intense. Macro- and microprudential policies share many of the same instruments (e.g., capital requirements) and indeed data sources (e.g., bank balance sheets). The focus of their analysis may be well-aligned; both macro- and microprudential authorities will want to track credit supply conditions, probabilities of default, loan to value ratios, etc. The macroprudential authority will need microprudential data in order to conduct stress tests. Also, the microprudential authorities have a role in monitoring compliance with any macroprudential measures and their effectiveness. If, for example, the macroprudential authority imposes a higher risk weight on bank lending to the residential real estate sector, it is the microprudential authority who is in a position to observe whether or not banks are actually altering their risk weights and their lending behavior. The microprudential authority is also probably best placed to notice whether or not the measure is somehow being circumvented, perhaps through disintermediation via nonbanks. Hence, there is a strong need for coordination, information flows in both directions, and shared analysis.

Meanwhile, macroprudential and monetary policy making will interact and possibly be complementary. Macroprudential-monetary connections and the extent to which these policies are substitutes have been much discussed. Macroprudential policies can be targeted at particular sector and markets, which is their strength and their weakness. In contrast, monetary policy is a “blunt instrument,” but it also “gets into all the cracks” and is therefore less vulnerable to being circumvented. Policies in the two areas affect the effectiveness of the respective tools. For example, higher risk weights on residential mortgages may tighten the availability of credit for home buyers and those seeking a home equity loan, and therefore lead to more saving and ultimately an altered response to monetary impulses. In the other direction, monetary policy decisions related to domestic interest rates and stabilization of the exchange rate may affect the impact of macroprudential measures aimed at reducing currency substitution. Hence, there is a strong need for coordination, information flows in both directions, and shared analysis.

However, microprudential and monetary policy making will have less direct connection in relatively benign circumstances. The microprudential authority needs to know the macro conditions in which banks operate (overall growth rate, slope and level of the yield curve, etc.) but have little concern over shifts in the monetary policy stance over the short to medium term. Likewise the monetary authority is not concerned about the condition of individual banks or even sub-sections of the banking industry. Funding markets are functioning normally, credit is flowing, savings are accumulating in accounts. Even the exit of a major bank, if handled well, is not of macro-financial importance.

Perhaps the main governance concern in such a scenario is a form of regulatory capture that favors inaction bias and the maintenance of accommodative policies in all three areas. In the financial sector, the successful firms that are leading the expansion in credit — by value and number of transactions — will lobby against tightening. These firms are likely to have the resources and the positive public image to make this lobbying effective. Other firms may be more cautious, but they have little motivation to expend resources on preventing what they perceive as the foolishness of their rivals. At the political level, supporting the continuation of good times and the expansion in the class of beneficiaries may be conducive to electoral success. The government of the day may have other objectives, such as developing the financial system and attracting international banks, which may have to be weighed against micro- or macroprudential objectives. Within the authorities, officials may see opportunities to expand their resources and autonomy, instead of contesting the dominant narrative.

One feature contributing to these tendencies is the fact that public and parliamentary scrutiny of policies in all three areas may be light so long as no major difficulties arise. Considerable deference is usually shown towards acknowledged experts in often arcane matters. Prudential regulations are complex, and supervisory practice hard to monitor. Monetary policy gets more media coverage, but here too non-specialists cannot match the analysis based on an immense information set that a central bank can claim in support of its decisions. As mentioned, the consequences of monetary or prudential policy actions appear mostly in the medium-term, so only the financial sector, with the most direct interest, has the incentive to examine them closely.

Monetary and prudential authorities with clear mandates and committed staff will resist these pressures. To play on Keynes' remark, nobody is eager to take away the punch bowl once the party gets going, but some authorities may take pride in maintaining a degree of sobriety. Institutions are guided by their mandate and culture. In this, it is helpful if the institution has a long memory, especially of past difficulties, and a long forward time horizon, so that it remains vigilant about medium-term risks. Those perspectives require autonomy and institutional stability that extends beyond the political and even the macro-financial cycle; the authority needs to believe that it will have responsibilities and be held accountable when eventually something goes wrong.

Another helpful tendency is for cooperation and communication links to strengthen over time. In normal conditions, different authorities and their staff are engaged in repeated interaction. They learn the tasks on which they need to cooperate, and how to cooperate. Committees and working groups are set up, and routines become established. The legally permissible degree of cooperation and information sharing is defined. Individual officials get to know one another, and, in this repeated game, are concerned about their reputations for being well-informed,

technically able, cooperative, etc. Being helpful to colleagues in another authority may even be rewarded eventually with a post in that authority — a kind of inter-agency capture can occur.

## 2.2 Governance during a crisis

The forces at work change abruptly when a crisis breaks out. The policy questions, the time available for decision making, the magnitude of individual decisions, and the immediacy of effects are all transformed. Established patterns of behavior and relationships can all be swept away. A number of phenomena seen during a crisis are worth highlighting:

- The financial consequences of decisions can be very large. The authorities will have to determine the provision of liquidity support; capital injections, possibly in connection with nationalization; perhaps quasi-fiscal support for various stakeholders; and the restructuring and eventually the liquidation of large institutions. The costs to the public sector, or to other claimants, might amount to a significant share of GDP.
- Moreover, the consequences are often irreversible. Especially declaring a bank “failing or likely to fail” and then initiating resolution or liquidation precludes a return to the status quo ante. Others will avoid doing business with the bank until it is somehow resolved and demonstrably returned to health. Once assets are purchased and liabilities assumed, they cannot be restored. In contrast, most “normal” policy decisions such as adjusting a discount rate or a capitalization requirement can be reviewed and adjusted as needed.
- Decisions have to be taken quickly. It is well-established that delay in taking action can greatly increase the cost of a banking crisis and the arbitrariness of outcomes, either by allowing time for some creditors to flee and for assets to be stripped, or by allowing transition into a worse regime, such as outright default and systemic contagion.
- Moreover, these decisions have to be taken on the basis of very imperfect information. The authorities are likely not to have full information on the true value of a bank’s assets; its liquid assets and liabilities; its off-balance sheet commitments; and its direct and indirect connections to other institutions. Price signals may lose their information content or become very volatile. Furthermore, decisions should to the extent possible be contingent on hard to predict factors such as market reactions to any intervention; the scope for reviving the failing bank’s business; and the chance that other institutions will have to be intervened.
- The banking system is likely to become segmented. Some banks will enter a vicious circle, but others will enjoy safe haven status. Certain funding markets may shrink; some players may be excluded altogether or have to pay a high and

variable premium. Hence, aggregates and benchmarks may become misleading, and monetary policy transmission disrupted.

Under such circumstances, monetary and microprudential policies (including bank resolution) may become closely intertwined. For example, the central bank may be called upon to provide emergency liquidity support to banks, but it should do so only to viable banks and on the basis of adequate collateral. The microprudential authority would normally have much more of the relevant information and capacity to assess the viability of a bank than would a monetary authority, and the microprudential authority might also be much better placed to assess the value of collateral (e.g., if it consists of securitized loans). In the other direction, the monetary authority would normally be well informed about short term market developments, such as segmentation and rising risk premia, because it is constantly involved in these markets. It is also aware of flows in the large value payment system and excess reserve balances. Such information is crucial in the microprudential determination of “failing or likely to fail” and of possible contagion effects.

Macroprudential policy, with its medium-term orientation, is of less importance in the midst of a crisis. Macroprudential policy is about defusing vulnerabilities and building buffers. Once a shock impacts, the macroprudential authority has to make sure that the buffers are usable and some measures are suitably reversed (for example, a counter-cyclical buffer might be eliminated, but a systemic risk buffer may still be warranted). Hence, coordination of macroprudential with either monetary or microprudential policy becomes less important during the relatively brief period of intense crisis.

The direction, intensity, and sources of regulatory capture will shift with the onset of crisis. Those who are at risk of major losses will have the greatest interest in influencing policy, that is, the conflict will focus on the distribution of the eventual burden. Agents may try to exert this influence on the monetary authority (for example, to provide emergency liquidity on more generous terms), the microprudential authority (for example, to delay intervention so that some claimants can extract their assets), or the government (for example, to limit the bailing in of claimants once intervention takes place, perhaps even by changing legislation). Because the financial stakes are high, many agents will be prepared to expend considerable resources in these efforts. And whereas in good times bank management and owners have among the strongest incentives to attempt regulatory capture, in crisis times claimants on banks, and also distressed borrowers may be determined to minimize their exposure to potential losses. Also, some sections of the financial industry that favored relatively tight prudential regulation during good times, as means of supporting clients’ trust in the industry and protecting themselves from competition from less well-capitalized rivals, may switch to favoring forbearance once they themselves come under pressure (Hardy, 2006).

Meanwhile, the incentives for officials may change abruptly in ways that favor “blame avoidance.” The tendency may become more acute during a crisis because of the possibility of very large costs being incurred. In addition, the reputational, accountability-related, and even juridical consequences are magnified. The staff of the authorities concerned will wish to protect their professional reputations among their peers and thereby their career prospects. They will be aware that a financial crisis will provoke intensified oversight, for example, in the form of parliamentary inquiries and investigations by the media. One possible consequence is the abolition or radical reform of the institution for which they work and which offers them career prospects. Furthermore, crises and especially bank interventions normally give rise to numerous and drawn-out court cases as interested parties seek to unload burdens. These cases may mostly be directed at the relevant authorities, but even individual officials may be sued for negligence, acting *ultra vires*, or misfeasance. In sum, a crisis is likely to incentivize interest groups to lobby to have rules bent to their benefit, while incentivizing officials to obey rules more strictly.

“Blame avoidance” is just one factor likely to interfere with cross-authority cooperation during a crisis. Another factor is that a crisis is *per se* not a routine event, so authorities cannot be very practiced in using relevant procedures for cooperation and information sharing. Moreover, crisis management involves other agencies that are normally not so involved in the business of prudential and even monetary policy. A crisis entails the activation of the resolution authority, possibly the deposit insurance fund, and, in cross-border cases, resolution colleges. The government in the form of the Ministry of Finance typically plays a crucial role, especially if resolution funding is needed. However, the relevant ministerial departments may include those concerned, for example, with debt management, rather than those that deal with fiscal-monetary coordination or financial sector regulation and are the habitual counterparts of the monetary and prudential authorities. Finally, bank intervention may involve competition authorities and the courts, who normally operate in a separate policy space with quite different objectives. Therefore, routines are absent, and cooperation is not supported by a “repeated game.”

### **2.3 Governance after a crisis**

Recovery after acute financial crises tends to be slow because various sectors have to rebuild their balance sheet strength. As we have seen post-GFC, sluggish growth with weak investment and low consumer price and wage inflation can be very persistent. Central banks over the last decade have responded with unconventional measures, including quantitative easing (large scale purchase and retention of government and other securities), long-term refinancing, and negative policy rates. “Cleaning up” the financial sector can take a long time as NPLs are slowly worked

off; weak existing institutions survive in the low interest rate environment; and even stronger institutions focus on organic growth rather than consolidating the sector.

Post-crisis conditions may imply that monetary and microprudential policies need to be coordinated relatively closely. The structural changes occasioned by a crisis, and especially those following the GFC, imply that the banking system is not as homogeneous as in the pre-crisis period. For example, some banks may retain substantial excess liquidity while others are dependent on central bank refinancing, or some banks still with substantial NPLs or high-risk weighted assets may be unresponsive to stimulus measures. Monetary transmission is affected by this fracturing, and therefore the monetary authority would benefit from access to microprudential analysis of market segmentation.<sup>2</sup> For the microprudential authority, an important factor in analyzing banks' soundness and identifying supervisory priorities is the time line for normalization of monetary policy, for example, by returning to positive rates.

Slow recovery from a banking crisis-induced recession may prompt calls for more easing of micro- and macroprudential policies, but over the last decade national authorities seem to have been vigorous in strengthening both. In particular, concern over "inaction bias" in macroprudential policy has so far proven to be unfounded (see International Monetary Fund (2018), and European Systemic Risk Board (2019)).<sup>3</sup> On the one hand, memory of the crisis is still vivid, so tough measures are accepted by a broad range of stakeholders. On the other, the relatively new macroprudential authorities may wish to establish precedent and reputation for being pro-active and unbending to sectoral pressures.

### 3 Summary and conclusions

The challenges to good governance in the areas of monetary, microprudential, and macroprudential policy vary greatly according to external circumstances. Those challenges are likely to be greatest and most consequential during times of crisis, when momentous decisions have to be taken quickly and with patchy information; the distribution of burdens will be intensely contested; informal mechanisms based on reputation and repeated cooperation are weakened; and when success can be measured only against more dire counterfactuals.

One would want to establish governance structures and practices that yield satisfactory results across a full range of possible situations, and in particular favor the avoidance of very severe outcomes. Those mechanisms should help ensure that

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<sup>2</sup> Monetary policy transmission may be enhanced by microprudential measures to strengthen the banking system.

<sup>3</sup> This assertion is based on evidence from a post-crisis period only, rather than from a complete cycle.



decision makers have as much relevant information as possible and adequate tools, but also that their incentives are aligned with the longer-term public interest. Accountability and transparency are important, not only to align incentives, but also to lend decision-makers legitimacy; preserving autonomy requires demonstrating that tools are being used sensibly in pursuit of the assigned goals. Specifically in the three policy areas being considered here, governance mechanisms need to trade off the advantages of narrow mandates (better accountability, perhaps more decisiveness) against the need for taking spill-overs into account.

These considerations suggest certain elements should be incorporated, including:

- Well-defined and narrowly assigned responsibilities for making decisions in crisis management. The careful procedures and ex ante checks and balances that can be used in normal times may prove very costly when immediate action is needed. It should be clear what is a decision of government (about fiscal or distributional matters), and what is a decision of the microprudential or resolution authority. In this connection, the accountability mechanism should allow for the need to decide quickly under conditions of uncertainty.
- An explicit legal obligation to engage in cooperation, coordination, and information exchange across the authorities, insofar as compatible with confidentiality commitments. The fulfillment of this obligation would itself be a subject of accountability and transparency. In particular the close connection during crisis times between microprudential/ resolution policy and monetary policy should be anticipated. Thus, decision-making responsibilities maybe divided by “Chinese walls,” but these walls should have windows.
- Strong protection for authorities responsible for crisis management in terms of security of tenure and limited legal liability. Analogous protections seem to have helped central banks be more autonomous and adopt a medium-term perspective. They cannot be afforded to government itself, but they can help stiffen an authority’s resistance to short-term pressures from special interests.

At a high level it is difficult to go beyond these recommendations, in part because connections to other policies have not been considered. Microprudential policy is closely bound up with policy in such areas as consumer protection, market conduct, and anti-money laundering. There are linkages also to the payment system and debt sustainability, for example.

Different country circumstances warrant different approaches to governance of policy in these three areas, and in particular a country’s international situation will help determine what governance arrangements are appropriate and feasible. Membership of a monetary and banking union is one crucial factor. But some of the various and variable challenges to governance that arise at the national level are very apparent at the regional and multinational level.

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