Discussion of Claudio Borio's

Macroprudential policy and the financial cycle: Some stylised facts and policy suggestions

Discussant:

Lasse H. Pedersen

Overview of Discussion

- A large amount of research by Borio and BIS

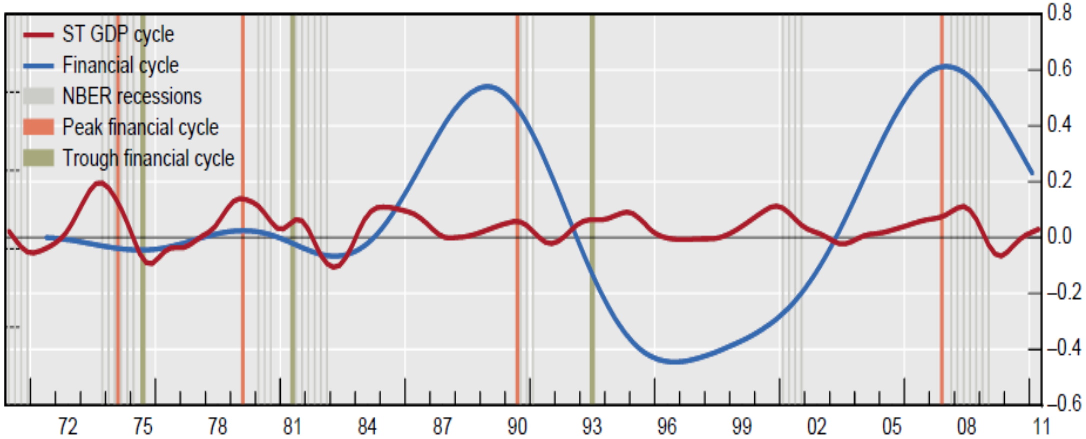
- Interesting perspective and policy observations
  - Systemic risk
  - Financial cycle

- My discussion: Brief review + comments

Review of 7 Properties of the Financial Cycle

Financial cycle:

1. is summarized by credit and property prices
2. has a lower frequency than traditional business cycle
3. has peaks that coincide with financial distress
4. can be identified in real time
5. helps measure potential output
6. depends on regulation, monetary policy, supply shocks
7. has busts that are associated with balance-sheet recessions



Review of 7 Properties of the Financial Cycle + Comments

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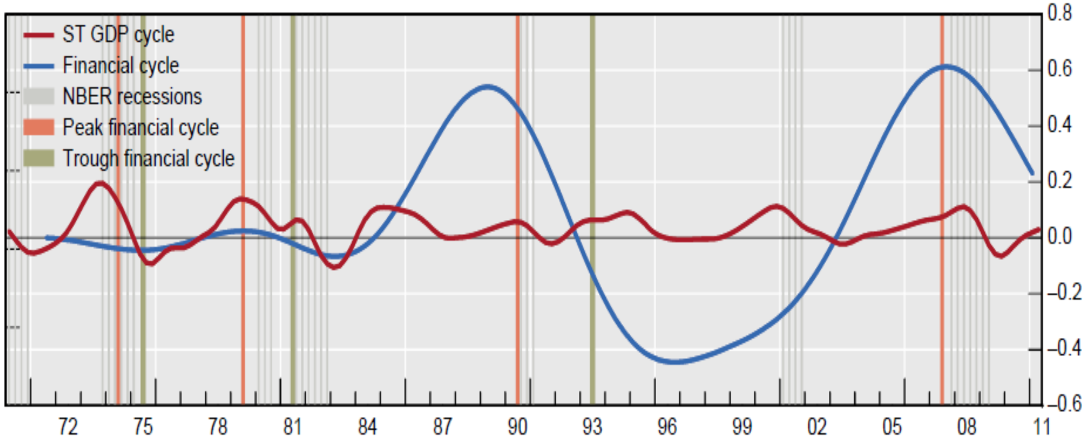
My view:

Filtering
Stationary variables?



Review of Policy Observations

Borio: beware of

1. macro stress tests as early warning devices
   - Fail to capture spiral effects

2. network analysis
   - Aggregate effects more important

3. overestimating the effectiveness of macroprudential policy
   - Difficult due to the long cycle
   - Focus on leverage: loan-to-value and debt-to-income

4. overburdening macroprudential policy
   - Use multiple tools:
   - monetary policy that leans, fiscal policy, etc.

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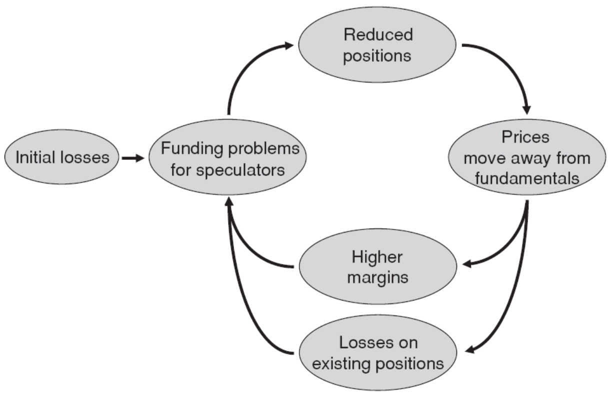

Brunnermeier and Pedersen (2009)

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My view:

Acharya, Pedersen, Philippon, and Richardson (2010), *"Measuring Systemic Risk":*

- Focus on financial sector's
  - aggregate capital and
  - leverage
  - systemic expected shortfall

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Geanakoplos and Pedersen (2013), "*Monitoring Leverage*"

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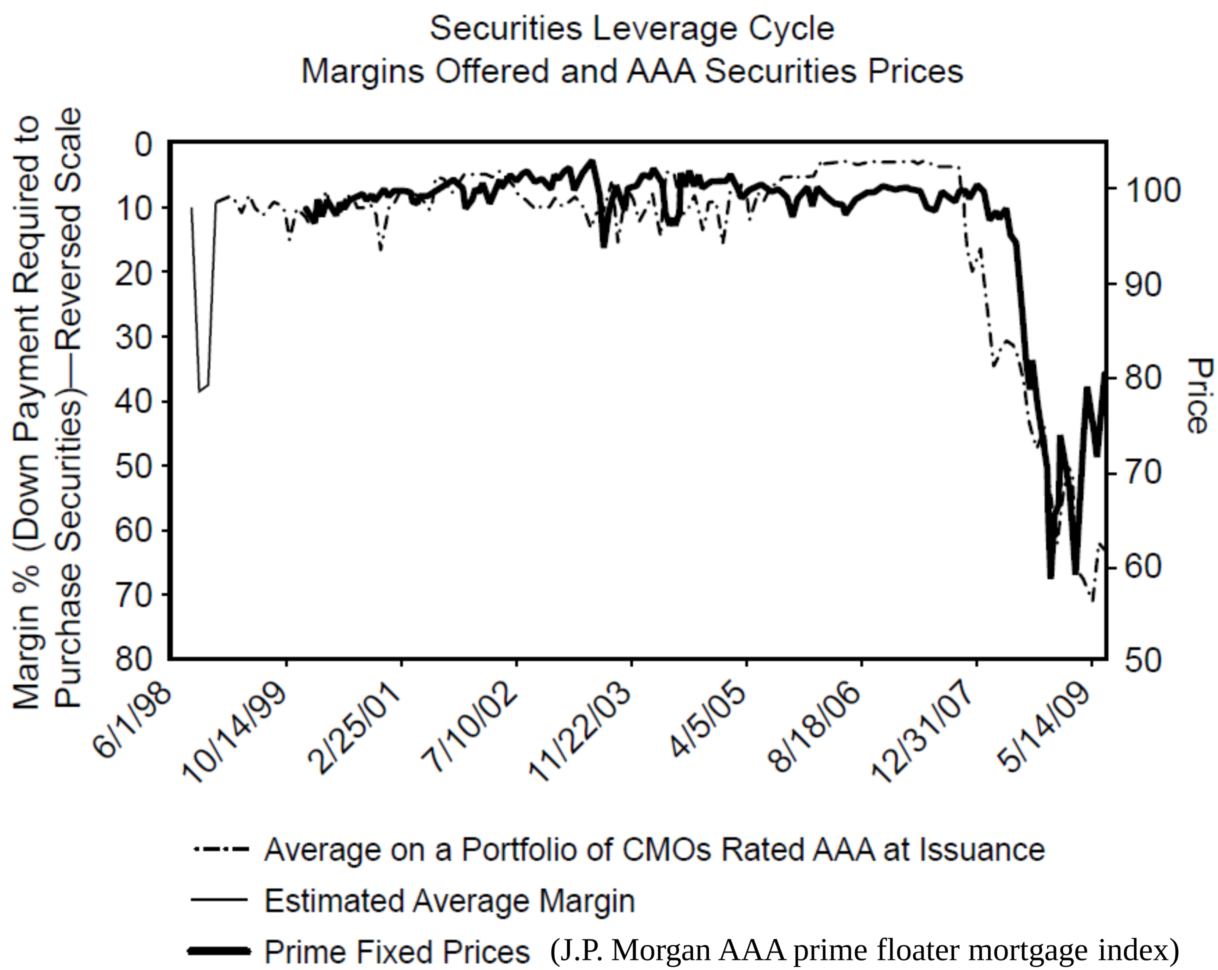
Cycle for House Prices and Margin Requirements: Financial Markets

- Actual margin requirement for mortgage-based securities

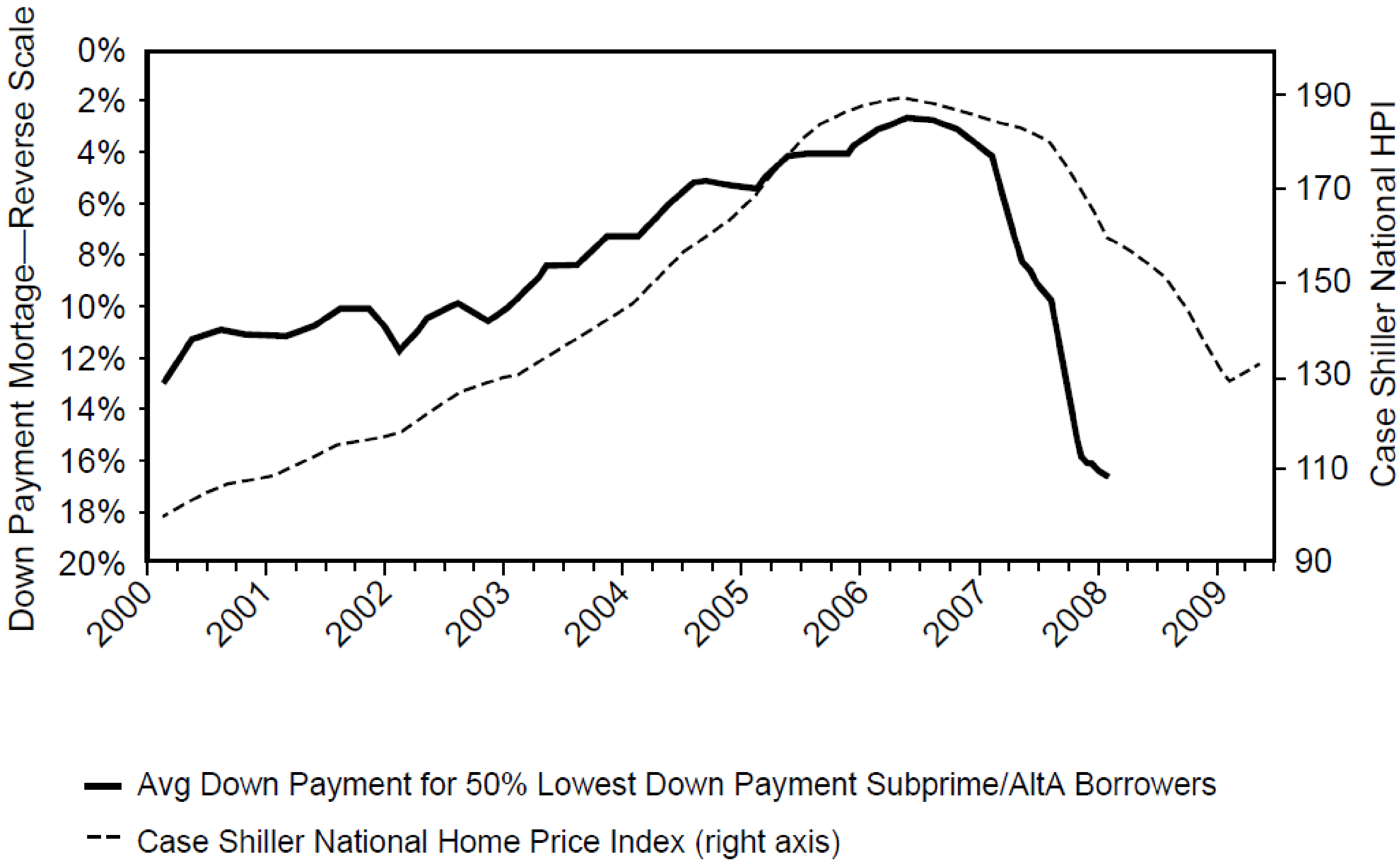


(J.P. Morgan AAA prime floater mortgage index)

- Source: Geanakoplos and Pedersen (2013), *Monitoring Leverage*

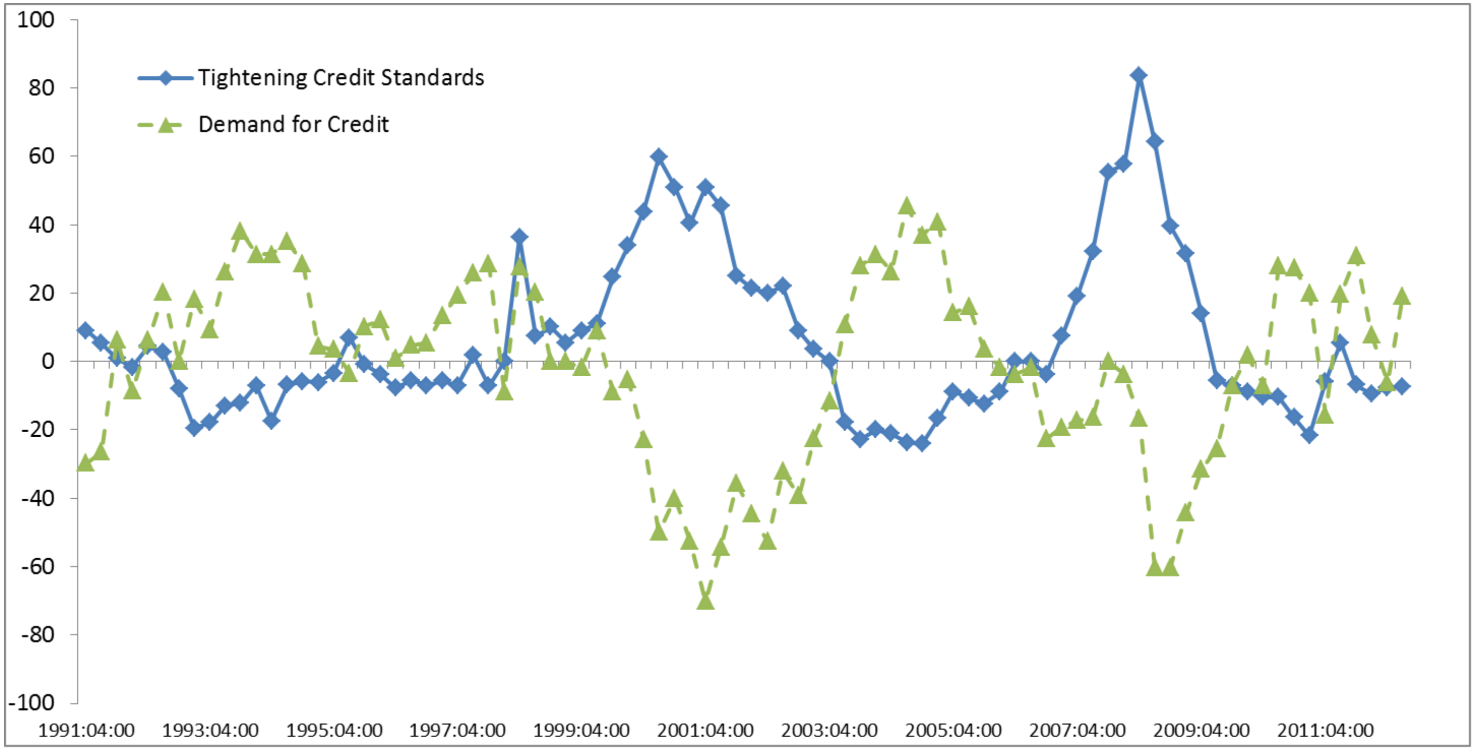
Cycle for House Prices and Margin Requirements: Home Owners

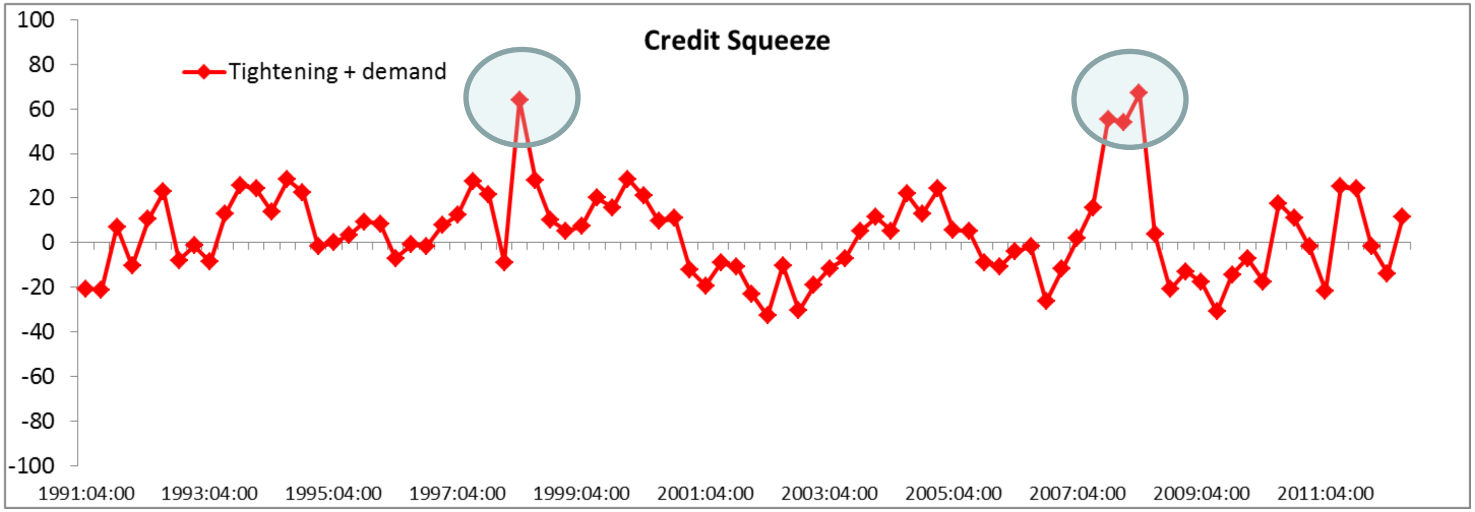
- For home owners, **margin requirement ≈ down payment** (for constrained households)



- Source: Geanakoplos and Pedersen (2013), *Monitoring Leverage*

Credit Cycle





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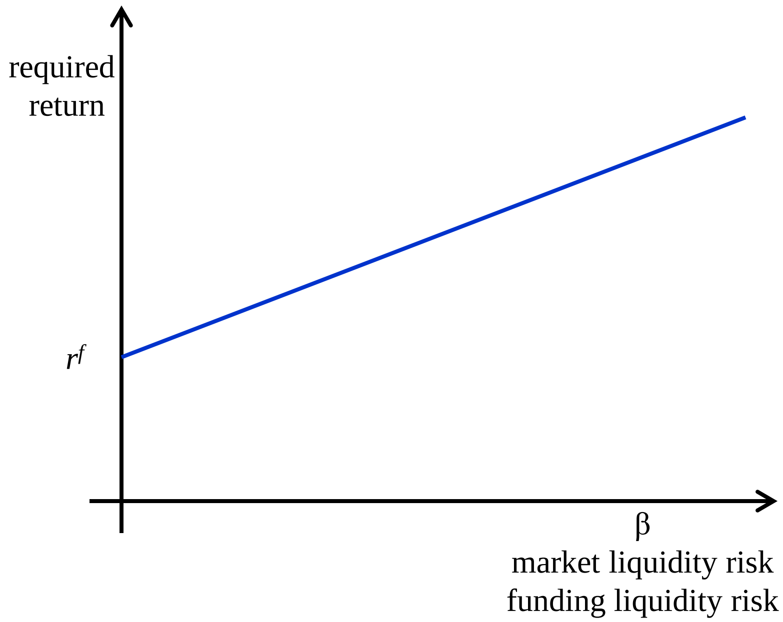
My view:

Ashcraft, Garleanu, and Pedersen (2010), *"Two Monetary Tools: Interest Rates and Haircuts"*

A Second Monetary Tool Focused on Liquidity and Leverage



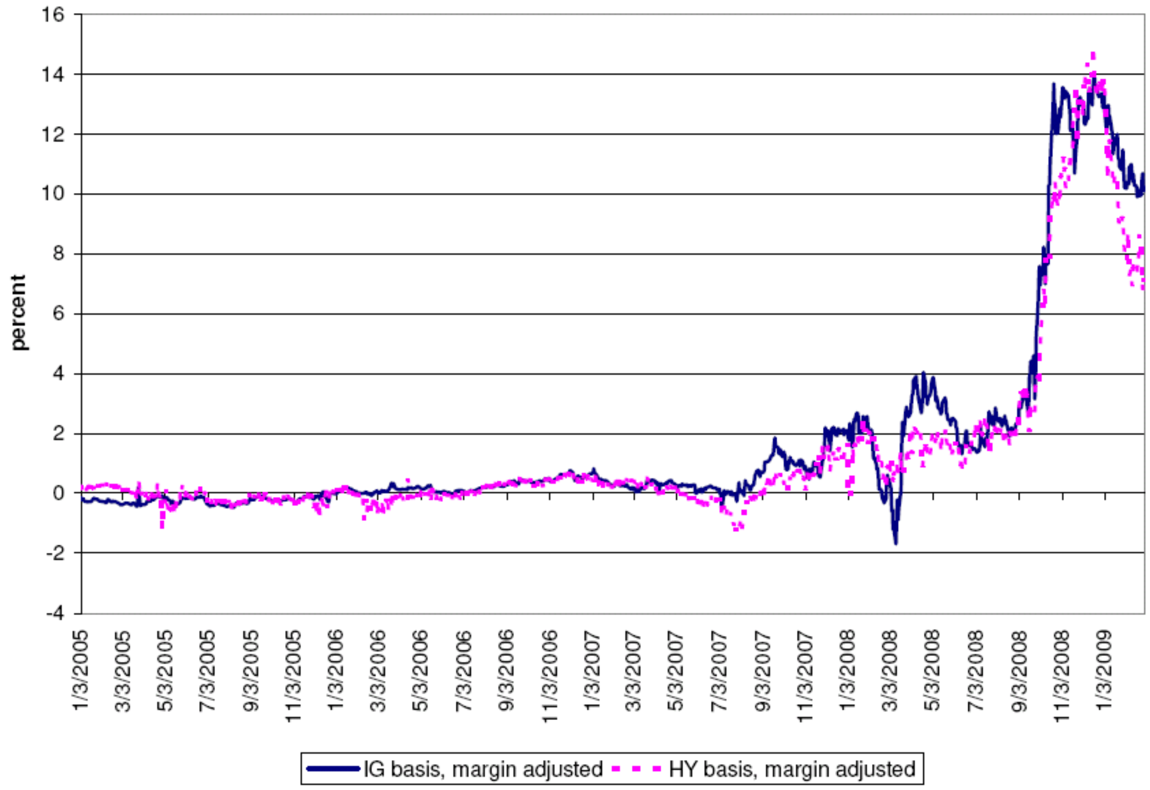
Source: Ashcraft, Garleanu, and Pedersen (2010), *"Two Monetary Tools: Interest Rates and Haircuts"*

Funding Crises

Proposition (Margin CAPM)

The equilibrium required return for any security s is: $E_t(r^s_{t+1}) = r^f + \beta^s_t \lambda_t + \psi_t m^s_t$

Failure of the Law of One Price $\Rightarrow \frac{E(r^{bond,i}) - E(r^{CDS,i})}{m^{bond,i} - m^{CDS,i}} \cong \psi_t$



Source: Garleanu and Pedersen (2011), *"Margin-Based Asset Pricing and Deviations from the Law of One Price"*

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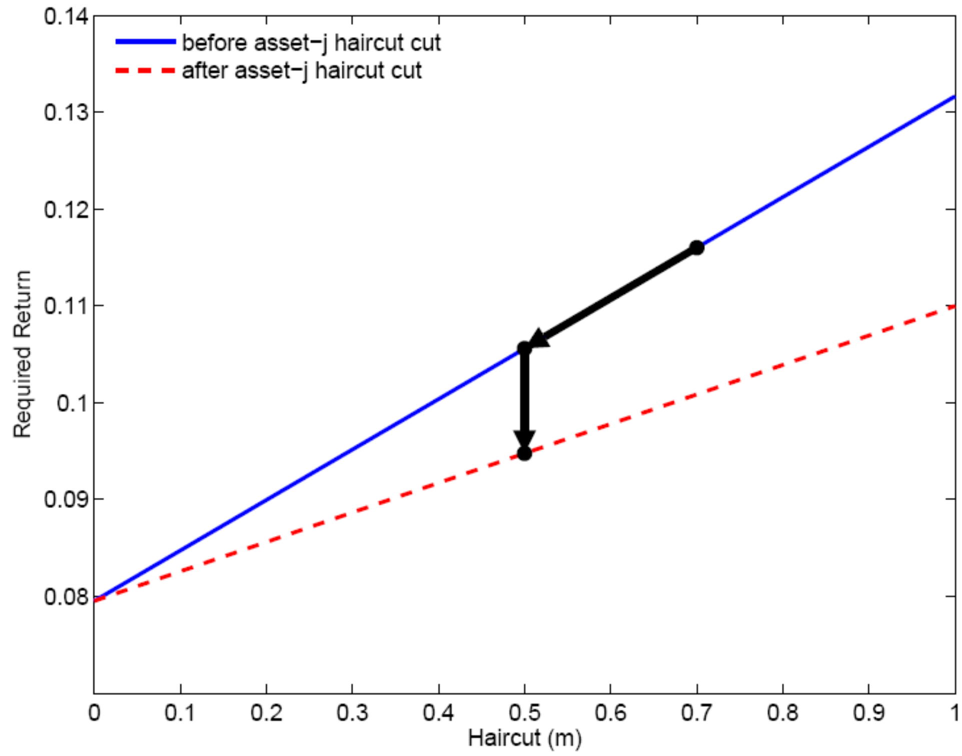

Source: Ashcraft, Garleanu, and Pedersen (2010), *"Two Monetary Tools: Interest Rates and Haircuts"*

Conclusion

- Interesting perspective and policy observations
- Financial cycle appears relevant and useful
- Thoughtful voice of caution ("beware of…")
- Consistent in several ways
  - Monitor capital, leverage, and margin requirements
  - Credit squeezes can be identified
    - Direct evidence
    - Interest rate spreads and failures of Law of One Price
  - But how much leverage is too much?