MACROPRUDENTIAL POLICY AFTER THE CRISIS:
FORGING A THOR'S HAMMER FOR FINANCIAL STABILITY IN ICELAND

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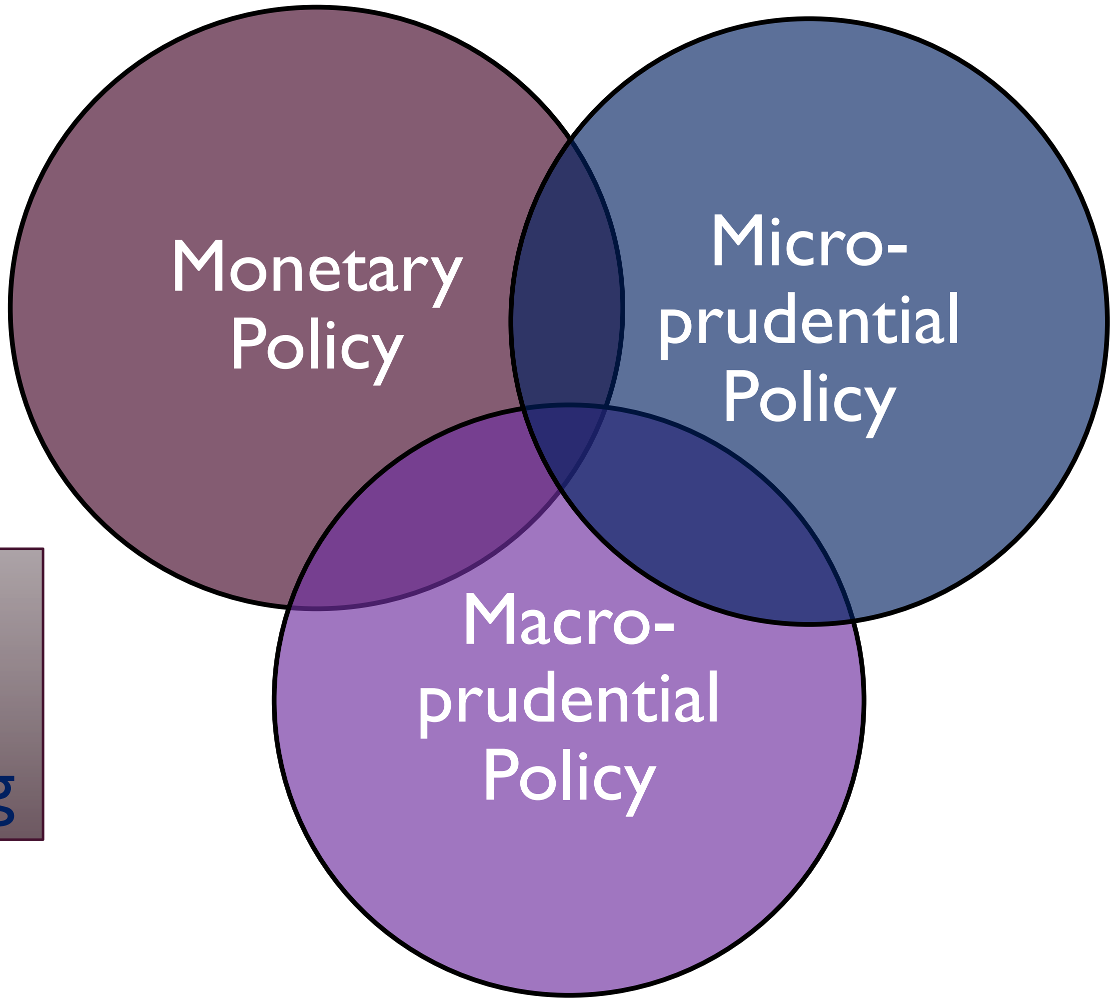
Summary of report prepared at the request of the Task Force to review monetary policy in Iceland

June 6, 2018

3M FOR MONETARY AND FINANCIAL STABILITY



All on equal footing

TOPICS

- **Role of Macroprudential Policy**
  - International Experience & Lessons
- **Macroprudential Tools in Iceland**
  - Existing vulnerabilities
  - Existing tools
  - Suggestions
- **Institutional Framework for Macroprudential Policy**

ROLE OF MACROPRUDENTIAL POLICY

- Critical part of macroeconomic management
  - Addressing excessive credit expansion and strengthening resilience in the overall financial system
  - Reducing key amplification mechanisms of systemic risk
  - Mitigating structural vulnerabilities related to the role of important institutions in key markets
- 5 broad sets of tools

Capital & reserve requirements	Liquidity requirements
Credit regulations	Resolution/ systemically-important

Capital controls

Emerging evidence on what works —and side effects

ICELAND: KEY VULNERABILITIES

- Size
- Limited economic diversification
- Role of tourism
- Housing and real estate market
- Natural and geological events
- Concentrated banking system
- Pension funds
- Openness
- Foreign currency exposure

Not just a "small open economy" as discussed in economic textbooks—but a small open economy on steroids

MACROPRUDENTIAL POLICY TO DATE

- Substantial progress

Capital & reserve requirements	Liquidity requirements	Capital controls
Credit regulations	Resolution/ systemically-important	

- Adopted most international standards, banks currently exceed many of these standards by comfortable margins
- Noteworthy accomplishments:
  - Counter-cyclical capital buffer
  - Attention to foreign currency exposure
- ***Yet given vulnerabilities, more should be done***

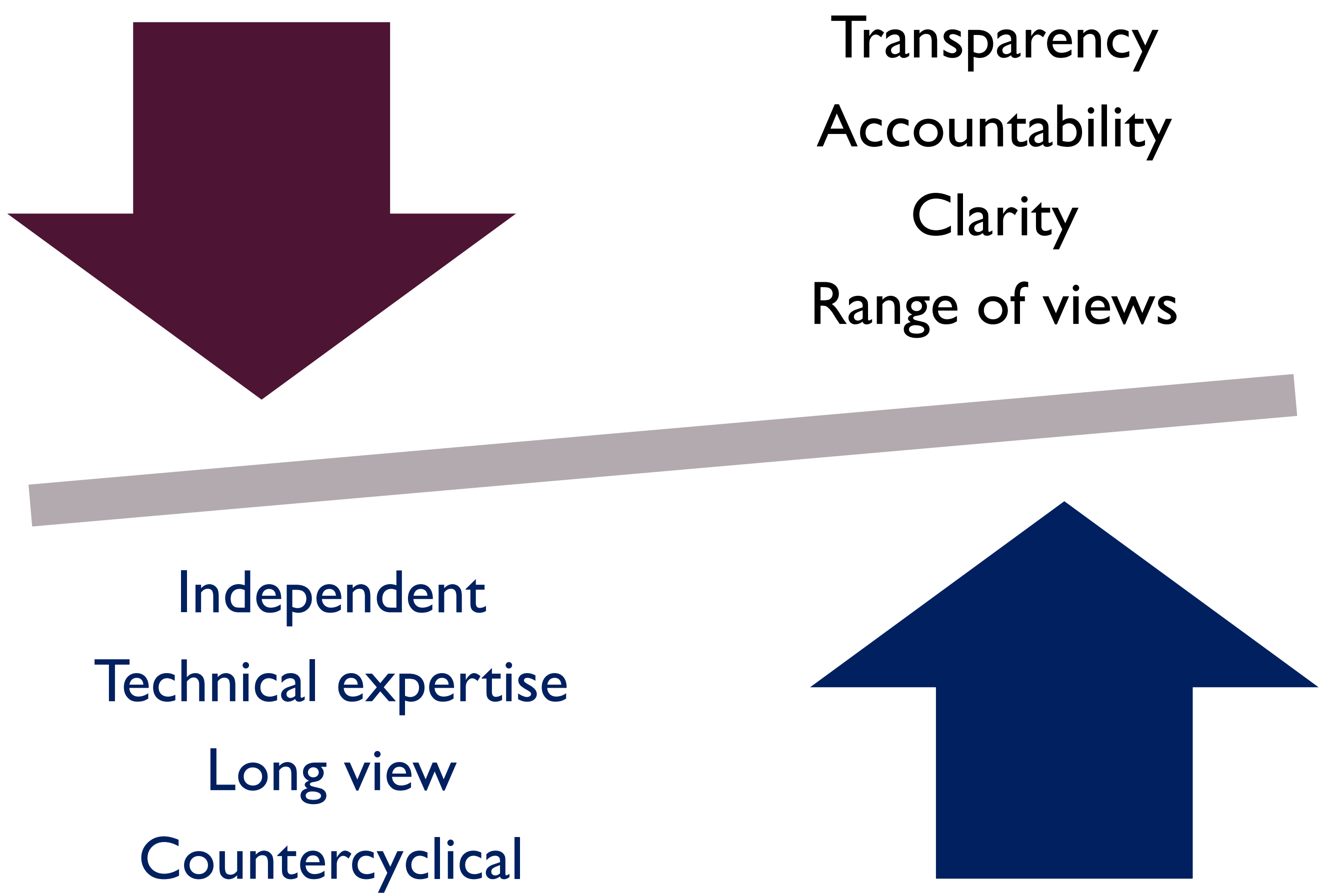
SUGGESTIONS: MACROPRUDENTIAL TOOLS

1. consider using the CCyB more aggressively;
2. adopt additional reserve requirements on foreign currency deposits;
3. adopt additional reserve requirements for aggregate exposure to specific sectors (such as tourism and fishing) for the SIFIs;
4. monitor liquidity regulations to ensure that they account for gross financial exposures (not just net exposures);
5. ensure sound and multifaceted regulations on mortgage exposure;
6. increase consideration of pension funds in the macroprudential framework;
7. build on the current framework of stress tests to model more severe scenarios and better understand key economic vulnerabilities;
8. establish limits on interbank exposure;
9. ensure the legal authority to enact moderate, market-based capital flow management measures is in place, but adjust and tighten the standards under which the capital flow measures are triggered

KEY CONSIDERATIONS

- **Continued assessment of costs vs. benefits**
  - Effectiveness
  - Unintended consequences
- **“Take away the punchbowl” when times are good**
  - Not just “clean up after the party”
  - While supporting growth and full employment

DIFFICULT BALANCING ACT



INSTITUTIONAL FRAMEWORK FOR MICRO AND MACROPRUDENTIAL POLICY

- New Deputy Governor at CBI for financial stability (macro/micro regulation)
- *For Microprudential Policy:*
  - Move microprudential regulation from the Financial Supervisory Authority to the CBI in division headed by a new Deputy Governor.
- *For Macroprudential Policy:*
  - Responsibility, oversight & implementation of macroprudential policy to CBI
    - Dedicated division leading work for the SRC that is based in the CBI and focuses purely on macroprudential policy, including implementation
    - Government continued involvement through co-chair position on FSC
  - Construct well-articulated and concrete frameworks and triggers for the use of macroprudential tools
  - Move oversight of capital flow management policies to the FSC

PROPOSALS FOR ALL 3MS

- Strengthen the role and responsibilities of all the Deputy Governors
- Recruit independent, external members on each of the Committees
- Ensure a high level of accountability and transparency for the Committee, as well as individual Committee members
- Promote some degree of information sharing and coordination between the 3M Committees, including partial overlap in Committee memberships, while still supporting the independence of each Committee in order to meet its mandate
- Ensure each of the Committees has a framework that supports a "long view"
- Have a flexible legal framework in place to ensure the tools to attain each Committee's mandates are available

DIFFICULT BALANCING ACT

Transparency

Accountability

Clarity

Range of views

Independent

Technical expertise

Long view

Countercyclical

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