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Special issue of *International Economics***Macprudential Policy: New Challenges*****Guest Editors:****Camille Cornand[†], Cyriac Guillaumin[‡], Julien Idier[§]**

The 2008-2009 financial crisis was unprecedented because of both its size and duration. Some feel it is akin to the 1929 crisis and yet even more severe, especially because of growing financial integration, deregulation, and financial innovations. This crisis foreshadows future financial difficulties, caused especially today by excess liquidity that could lead to a new bubble in financial markets. All the dysfunctions observed on the financial markets over the past ten years have called for a radical renewal of our conception of the regulation of the financial system, in particular by complementing it with a macroprudential approach. Indeed, while the macroprudential view is not new, it has returned to the forefront through the emergence of numerous instruments, at both the macro and micro levels, in response to global financial instability. Over the last decade, policymakers have gained experience in applying macroprudential instruments, in particular in the banking sector, and economic research in the field of financial stability has largely developed. Against this background, it is now time to evaluate the effectiveness of these instruments but also to draw directions for novel fields of research and new macroprudential instruments to tackle new risks. This is the very purpose of this special issue of *International Economics*.

Macroprudential policies are defined as a set of public policies aimed at preventing systemic risks that could compromise a sustainable financing of the national economy. Even with some nuances, this definition frames the action of most macroprudential authorities across the world. Several key aspects of this definition have strong implications in the conduct of such policies (and some are quite subtle!).

In the first place, macroprudential policies are used in the plural. This clearly reflects the diversity of the regulatory instruments and sectors targeted by these policies. If they were focused on the banking sector right after the great crisis of 2008, macroprudential policies have also been deployed on new actors in the financial system such as insurance companies or investment funds: the entity-based aspect of macroprudential policies is now wider. They have

* We dedicate this special issue to the memory of H el ene Raymond-Feingold, deceased in 2017.

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also diversified in terms of targeted risks: although priority was given to the size of financial players after 2008, in particular with the implementation of systemic bank buffers, new risks are now better accounted for as liquidity, leverage, and concentration. In addition, reflections are currently carried out to better apprehend and understand how to consider new risks such as cyber, pandemic, or climate risks.

Macroprudential policy is *preventive* by nature. Preventing risks requires being able to anticipate their emergence and/or their consequences if they were to materialize. This is always a delicate exercise, entailing a trade-off: authorities can either correctly detect weak signals of risks and take early action at low cost, accepting to be perceived as paranoid, or else do nothing, imposing no cost to the economy, but with the risk of being blamed for not having prevented crises. In the end, macroprudential policies, as any policy based on the principle of prevention, are easily perceived as useless, since their *ex-ante* (costly) effectiveness necessarily lessens or even hides the potential difficulties that could have shown up in their absence: by constraining the financial system, macroprudential actions impose short-term costs to the economy, optimizing benefits in the future by avoiding or limiting the impact of expected crises. This preventive nature of macroprudential policy distinguishes its action from that of resolution policies.

Macroprudential policy targets risks that are *systemic*. This makes macroprudential policy complementary to but also different from microprudential policy. More precisely, it implies that the design of macroprudential instruments internalizes the negative externalities that individual behaviors impose on other agents in the financial system. Some fully optimal behaviors at the individual level—(such as investment decisions, strategies, or business models)—may not justify any microprudential action. However, at the aggregate level, by negatively impacting the overall level of risks in the financial system, such behaviors may need to be addressed by macroprudential policies. Take the example of leverage: while optimal at the individual level, and hence requiring no specific microprudential policy, it can contribute to the build-up of considerable aggregate risk if increased by all agents simultaneously, thus requiring the use of macroprudential policies.

The ultimate objective of macroprudential policies is to ensure a *sustainable* financing of the economy. As already mentioned, macroprudential policies work on a *ridgeline*: too restrictive, they hamper the financing of the economy; too loose, they do not allow sustainable financing of the economy due to excessive procyclicality. The notion of sustainability thus directly refers to the amplitude of the financial cycle and the threat of this excessive alternation of bullish movements followed by devastating crashes. This is why macroprudential policies operate in two ways: cooling the upside of the cycle and ensuring shock-absorbing capacity in the downside.

Finally, macroprudential policies are often conducted at the *national* level, targeting the national economy. At the national level, the diversity of the funding sources, the openness of the economy and financial system, and the actors composing the financial industry give rise to a set of specific macroprudential instruments, macroprudential governances, and finally, macroprudential policies. The latter may therefore differ across countries. These differences do not prevent coordination mechanisms at the international level. Some institutional forums have been created to play such a coordinating role (like the Financial Stability Board, Basel Committee on Banking Supervision, International Association of Insurance Supervisors, or International Organization of Securities Commissions). However, *national* macroprudential policies are pledged with the risk of spillovers such that any action (or inaction) in one country may raise the risk in another country as communicating vessels. Strong interconnectedness

across actors worldwide or the existence of a worldwide financial cycle are key driving forces that have to be considered.

Each paper selected for this special issue explores at least one aspect of macroprudential policies depicted above. Taken all together, they reflect the first aspect, namely the *plurality* of regulatory instruments.

The first paper by Raphaël Cardot-Martin, Fabien Labondance, and Catherine Refait-Alexandre evaluates whether, and to what extent, macroprudential policies applied to banks (as higher solvency or leverage ratios) have been successful in limiting the probability of crises. Among other aspects, this paper illustrates very well the *preventive* nature of macroprudential policies. Using a probit model, it shows that such macroprudential policies have been successful in reducing the occurrence of crises in the European Union over the period 1998 to 2017, but the level of percentage of the leverage ratio as implemented by Basel III may not be sufficiently high to adequately reduce the probability of banking crises.

The second paper by Stéphane Déés and Julio Ramos-Tallada considers the potential unintended consequences that the implementation of macroprudential policy could have. It echoes the *national* dimension of macroprudential policy conduct and its potential repercussion on the level of financial risks beyond borders. Focusing on the case of France, the authors study the effect of prudential policies set by French authorities, namely tightening of capital requirements and concentration limits on banks' exposures to specific borrowers over the period 1999 to 2017. They show that these two policies induced a reduction in bank inflows to France, which (virtuously) strengthened the effect of prudential policies in that country. However, this effect has been mitigated by the concomitant rise in foreign bank affiliates' local claims on French residents, brought to light owing to a counterfactual analysis (had the capital requirement policy not been implemented).

The third paper by Cristina Badarau and Corentin Roussel illustrates how macroprudential policies target a *sustainable* financing of the economy along the financial cycle by showing how time-varying capital ratios can be a stabilizing tool against financial instability. More precisely, using a DSGE model, the authors compare the performance of a prudential rule that uses fixed capital buffers to that of a time-varying rule for capital requirements in the face of a negative shock on the banks' capital. The higher performance of the latter rule is due to the provision of an implicit countercyclical dimension and the inclusion of progressive adjustments of individual constraints to account for the specific situation of each bank. These two features perfectly exemplify the complementarity between micro- and macroprudential policies: as they both appropriately limit the risk of financial distress at the individual level and effectively contain systemic risk due to their countercyclical dimension, the proposed time-varying capital requirements approach simultaneously fulfills the micro- and macroprudential purposes.

The last two papers pose new challenges on how macroprudential policies could play a role as regards new *systemic* risks that could affect the financial system: pandemic and climate risks. The paper by Iuliana Matei shows how the Covid pandemic has affected the financing of the economy by heterogeneously impacting sovereign spreads of the European Monetary Union. Pandemic risks belong to the class of risks that are the most difficult to foresee, in the sense that they are challenging to anticipate early enough (once early signals are perceived), such that a macroprudential approach of such risk can hardly be *preventive*. However, reading this paper, we can wonder if a more *ex-ante* pro-active macroprudential policy against unexpected risks (as higher cautionary buffers for financial actors) could have reinforced the positive impact found on sovereign spreads of other public interventions such as fiscal supports.

This absence of macroprudential firewalls for disaster risks is the topic of the last paper by Gaëtan Le Quang and Laurence Scialom. The authors offer a critical overview of the current state of macroprudential regulation loopholes regarding these extreme risks and propose a new approach based on a definition of risk that goes beyond financial risk to include the non-measurable nature of climate-related financial risks. This new macroprudential framework that would help re-orientate financial flows from “brown” to “green” could integrate the increase of the regulatory capital ratio of banks for “brown” financing, the supplementation of the latter instrument owing to sectoral leverage ratios (to limit excessive debt on asset classes backed by carbon-intensive sectors), the definition of minimum floors and maximum credit limits and/or the conduct of a policy of credit guidance to channel financing towards more sustainable sectors, the restriction of the concentration of banks’ exposure to high carbon sector to make sure that they do not exceed a certain fraction of their core capital, the activation of the systemic risk buffer to increase the capital of banks most exposed to transition risk, to mention but a few instruments.

This special issue of *International Economics* draws new lines for further research regarding macroprudential policies. It first points to the poor adaptation of current preventive measures and the opportunity to design appropriate incentives in a novel macroprudential framework in the face of exogenous, unexpected shocks that do not originate from the financial system itself. Another potential challenge for macroprudential policy finds its roots in the rapid development of new asset classes such as cryptocurrencies, cryptoassets or new non-bank financial intermediaries that could contribute to the emergence of financial crises. Then, macroprudential policy may have huge redistributive effects (e.g., the ones targeting borrowers). While beneficial in bad times, badly designed they may exclude low-income households from the mortgage market in good periods. Finally, macroprudential authorities’ recent actions or inaction call for a proper governance debate. The organization of macroprudential authorities, including or not central banks, ministry, market authorities, bank supervisors, is not neutral on macroprudential decision-making. It seems appropriate to invite a reflection on the mandate of macroprudential authorities and how conflicting they can be against the existing mandates of authorities contributing to macroprudential policy decision-making. More stringent independence of macroprudential authorities should be questioned in the future.