MONETARY AND
CAPITAL MARKETS

Monetary and Macroprudential Policy

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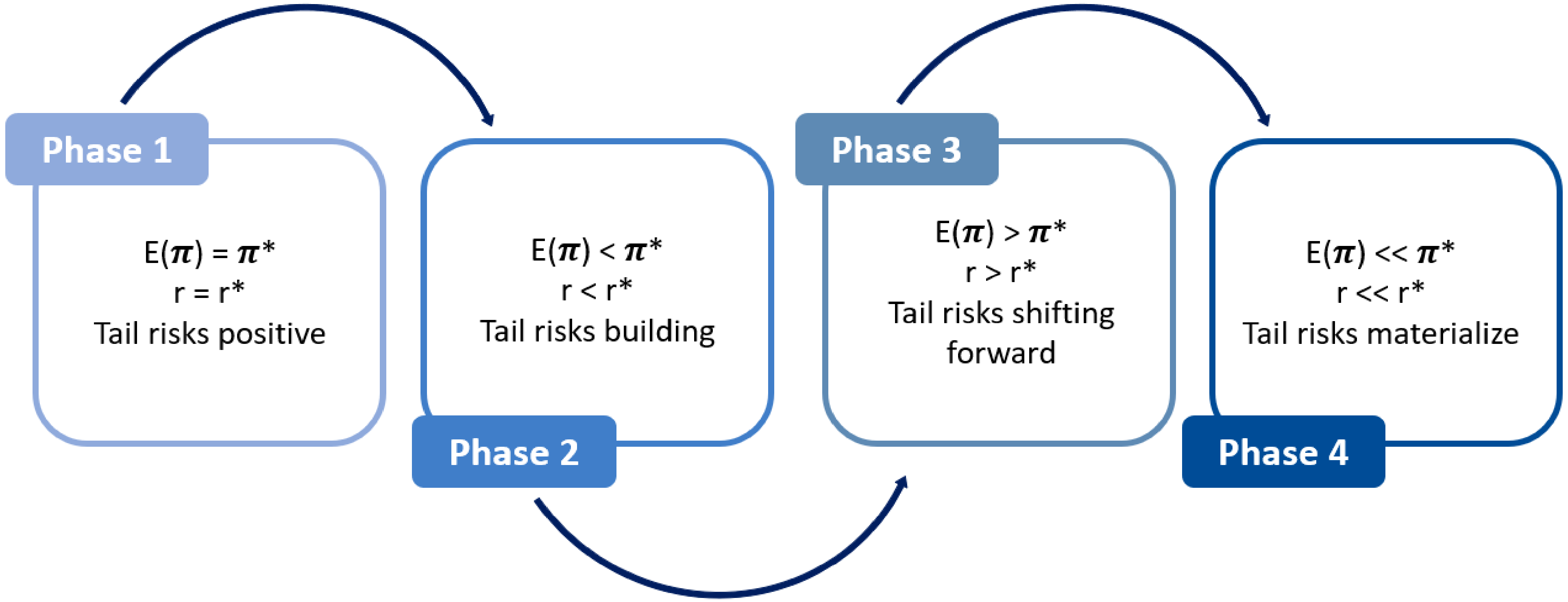
Four phases of financial conditions



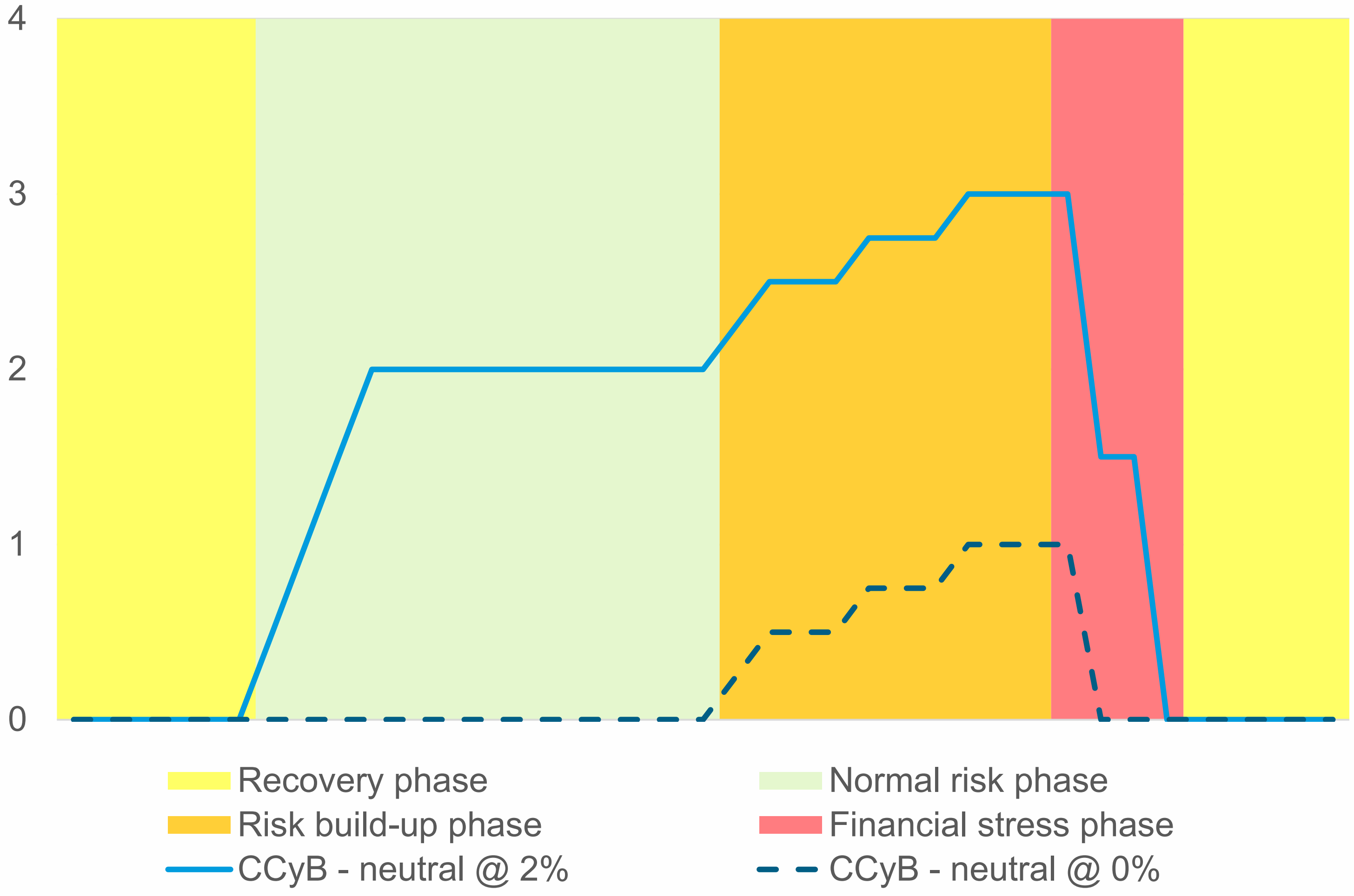
What to do now — Phase 3?

From GFSR (October 2023 Global Financial Stability Report):

- *Countries should continue to build buffers to help guard against future losses and to support the provision of credit through periods of stress.*
- *For example, authorities may raise countercyclical capital buffers or sectoral systemic risk buffers, should circumstances allow.*
- *Such buffers could be released if stresses, such as increased defaults, were to materialize in future.*
- *To avoid procyclical effects, the raising of buffers should be conditioned on the absence of signs that credit is already being constrained by the adequacy of banks' capital.*

Positive neutral CCyB: Building up capital unless banks are capital constrained

- Build-up starts when the supply of credit is not constrained by capital requirements.
- Early warning indicators (EWIs) and stress tests can signal need for increases beyond the neutral level.
- Indicators for financial stress signal the release.



Benefit of Building Buffers Can Be Positive if Monetary Policy Tightens

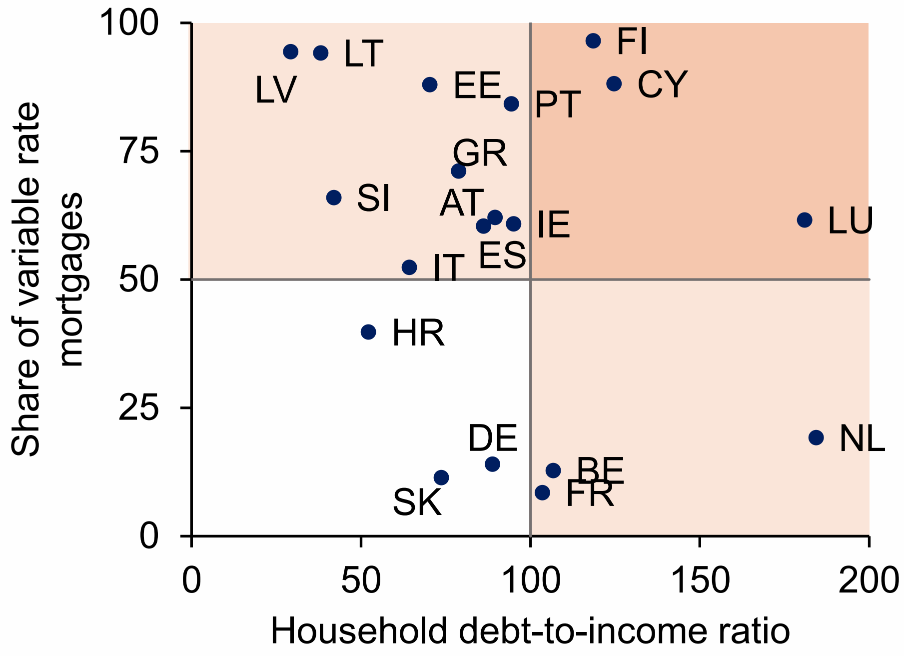
Net benefits of building capital buffers can be positive when monetary policy tightens:

- Buffers help build resilience against vulnerabilities that can materialize when rates rise.
  - Higher policy rates can increase the risk of borrowers defaulting in future, increasing the benefit of capital buffers.
- Higher policy rates also boost margins initially, as pass-through of policy rates to deposit rates is typically incomplete or slow.
  - Higher profits reduce the cost of building buffers from retained earnings.
- Excessive tightening should be avoided.
  - Increases can be made conditional on the absence of signs that credit is already capital constrained.

Pace of building up the CCyB should reflect benefits and adjustment costs

- Assess stock of existing vulnerabilities
- Assess strength of mitigants (e.g., existing BB tools)
- Assess whether lending is constrained by capital
  - Banks' profitability
  - Level of voluntary buffers
  - Lending surveys.

Euro area: Household debt and variable rate mortgages issuances
(percent)



Source: ECB; Eurostat; Haver Analytics; and IMF staff calculations
Note: Share of variable rate mortgages is the share of mortgages for home purchases with interest fixation of less than one year. Share of variable rate mortgages are the average shares of new loans from January 2005 to August 2023.

What if stresses materialize — Phase 4?

Monetary policy needs to become accommodative to support credit and activity.

- Tight macroprudential settings should be relaxed to help reduce financial stresses and support provision of credit through adverse conditions

- Relaxation can also support transmission of monetary accommodation (evidence from COVID pandemic).
- Which macroprudential tools should be relaxed?
  - Depends on nature of stress (solvency, liquidity, asset prices).
  - Depends on which tool is becoming binding, thereby adding to the force of adverse macro-financial feedback.