Macroprudential Policy and Credit Spreads

Margarita Rubio
University of Nottingham

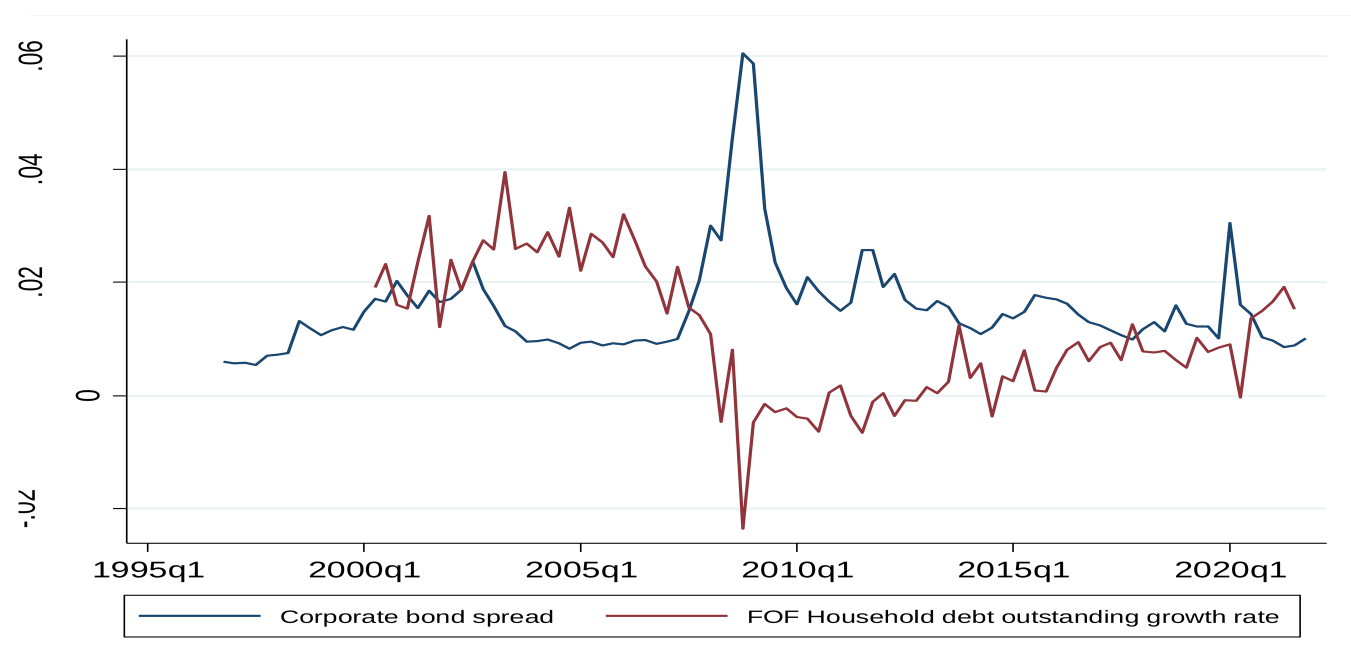
Veronica Veleanu
University of Surrey

Introduction

- After the 2008 GFC, there is an increased focus on **macroprudential and banking policies** to create a sound financial system
- The emphasis shifts to variables aimed at assessing the sustainability of credit growth and the level of system-wide risk
- Examples of such variables include **asset prices, GDP, and credit condition indicators**

Motivation

- There is evidence of a **negative correlation of credit spreads with credit growth:**



Federal Reserve Flow of Funds, total household debt outstanding

Correlation -50%

- As we approach a recession, mortgage and household debt fall dramatically (due to a drop in credit availability, higher delinquencies, etc.)
- The increase in the credit spread captures higher default risk, higher risk premiums, etc

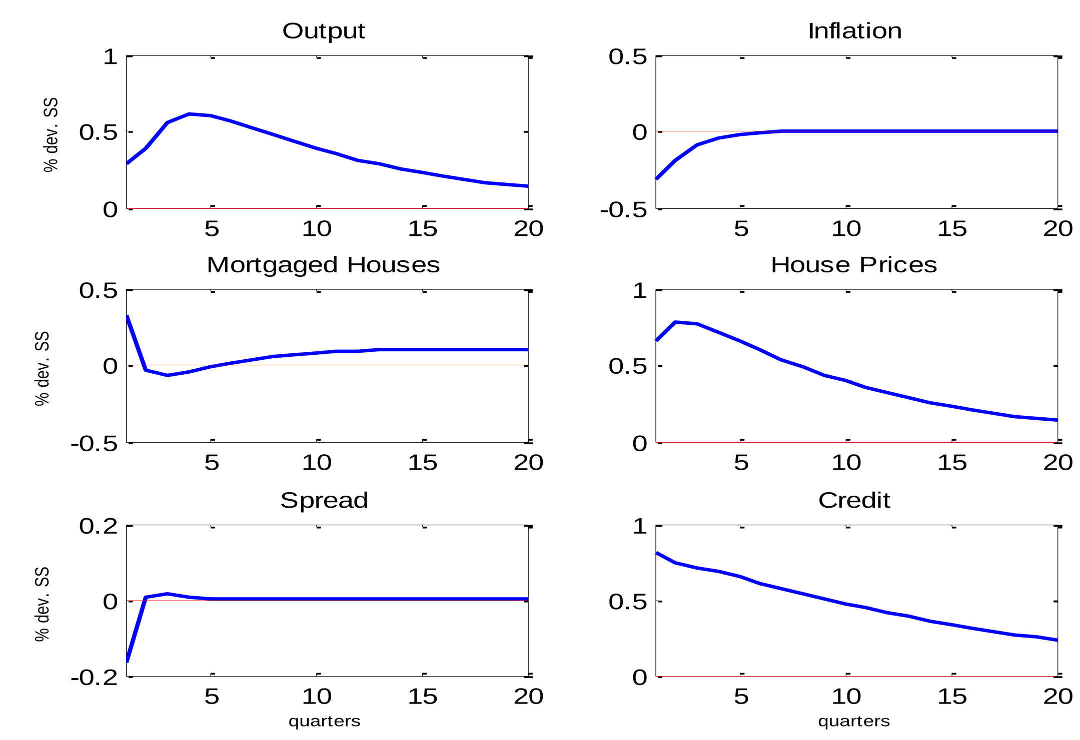
Research Question

- We propose **countercyclical macroprudential rules which respond to credit spreads.**
  - Is this rule welfare improving?
  - Under which conditions?
  - What is the optimal rule?

Model Overview

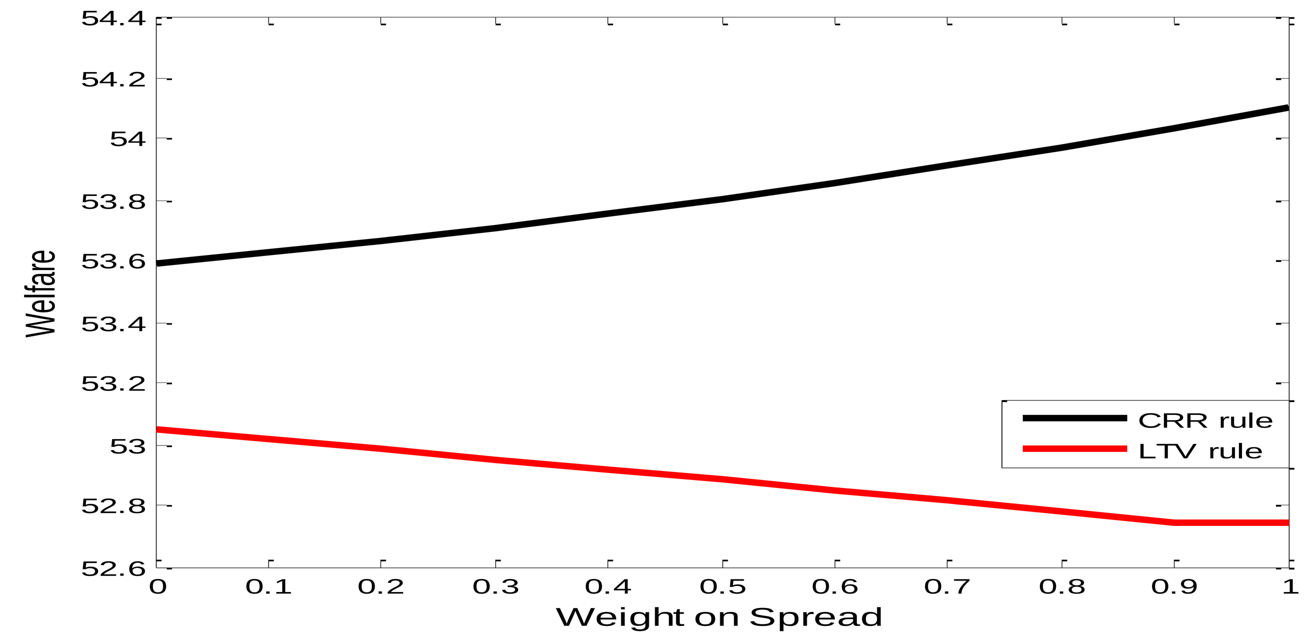
- **DSGE model** with housing
- Borrowers, savers, and financial intermediaries
- Borrowers are constrained in the amount they can borrow
- Banks are constrained in the amount they can lend; that is, they have a capital requirement ratio
- We explicitly introduce **credit spreads and macroprudential** policies to check for the relationship of those

Simulations



- Impulse responses to a technology shock
- Output increases, inflation decreases
- House prices and credit go up and credit spreads go down
  - The model predicts a **negative co-movement between spreads and credit/housing variables**

Optimal Policy



- Taking as a benchmark macroprudential rules that respond to credit, we introduce **credit spreads in the rule** to check if it is welfare improving
  - **A CRR rule responding to credit spreads and credit is BETTER** than a rule responding only to credit
  - **HOWEVER, an LTV rule responding to credit spreads and credit is WORSE** than a rule responding only to credit

Conclusions

- In this paper, we explore the use of **credit spreads** as an indicator for macroprudential policy
  - We first empirically analyse this relationship
  - Then, we build a **DSGE model which matches empirical evidence**
- We find that introducing **credit spreads in macroprudential rules is welfare improving for CRR rules** but not for LTV rules
- TO DO: Find the **optimal macroprudential rules**, which include a set of indicators, including credit spreads

margarita.rubio@nottingham.ac.uk

veronica.veleanu@surrey.ac.uk