Where Is the Prudence in Macroprudential Policy?

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Well-intended regulations are limiting access to capital—as well as the potential for growth. It could be another crisis in the making.

Milton Friedman once said that "when that crisis occurs, the actions that are taken depend on the ideas that are lying around." After the 2008-2009 financial crisis, there was no shortage of ideas for how to prevent catastrophic financial events from ever happening again. What ultimately resulted was forceful and wide-ranging regulatory responses that included Dodd-Frank, the Volcker Rule, Basel III, Solvency II, the Federal Reserve Supplemental Leverage Ratios… the list goes on and on. Today, policymakers have coined a term for the cog wheels of overlapping regulations: They call it "macroprudential policy."

While you may not be familiar with the concept of macroprudential policy, it is one of the most important factors in determining the long-term growth potential of the U.S. economy and the ability for all its citizens to share in that growth. Without significant adjustment, actions taken by policymakers today may come at a great cost to future generations.

The rationale for macroprudential policy is that it is in everyone's best interest to never face a financial crisis like the one we did in 2008-2009. Prior to the crisis, policymakers believed that it was generally hard to identify bubbles, but that once a bubble developed and subsequently collapsed, the tools existed to clean up the mess. This meant that capital, usually in the form of credit, would sometimes be allowed to flow to marginal borrowers, who ultimately would default.

In the new era of macroprudential policy, the theory is that regulations will restrain the availability of credit—even to the extent that some good borrowers may have not access to capital—in order to avoid allowing bad loans to exist. This means that growth, on balance, will be lower over the business cycle and there will be less upward pressure on interest rates. Credit will only be accessible by certain borrowers, some of whom are likely to become overleveraged and allocate capital into marginal investments, while other, more speculative credits, will have to access capital in the shadow banking system.

The principal problem with macroprudential policy is that the regulation of banks' ability to lend has become so restrictive that people who would normally qualify for a mortgage or a loan or who need capital to start a business can't get it. Proof of that is when Ben Bernanke announced that he couldn't get a mortgage. When you get to the point where we can't give the chairman of the Federal Reserve a loan on his house, then regulation has probably become too restrictive.

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For macroprudentialists, however, the risk of stalling the economy by restricting credit is a small price to pay for what is believed to be a regulatory system that will prevent catastrophic collapse. The macroprudentialists' argument is that even if the current web of regulations result in lower average growth in the economy over time, long-term output can still be higher by mitigating deep downturns and financial crises along the way. In the real world, however, these restrictive policies are making it more difficult for the economy to gain traction, to create jobs, and to invest in productivity gains necessary for sustainable growth. And, despite all of this macroprudential policy, debt continues to pile up—at 230 percent, nonfinancial sector debt to U.S. GDP is the highest on postwar record and climbing.

In the near term, the negative impact of macroprudential policy isn't likely to be obvious. The U.S. economy for the next few years will likely continue to be strong. But macroprudential policy will ultimately lead to mal-investment, which will result in lower levels of productivity, making the economy less resilient to increases in real interest rates. As the Fed begins “lift off” later this year or in 2016, there will be less headroom for rate increases before inducing a recession.

The bottom line is that a policy that intentionally leads to a misallocation of capital in the long run leads to lower levels of efficiency, productivity, and growth. That's just basic economics. What's worse is that by restricting access to capital only to the wealthiest borrowers, these policies fuel the income inequality that is already tearing at the fabric of our society. Lower growth and greater income inequality are the real economic crises. These crises cannot be cured by policies designed to prevent the economic crises of the past. When will policymakers awaken to this reality? As Milton Friedman suggests, it may take another crisis. Let's hope that it will not take another generation before policymakers find ideas “lying around” to unwind the current cobwebs of overregulation and set the stage for a stronger, more equitable economy.

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