Macroprudential Policy and Credit Spreads

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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:
  
  ![Graph showing correlation](image)

  - 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 these

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

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