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Implementing Macroprudential Policies

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I. Introduction

Why Macroprudential Policy Framework (MPF)?

- Recent global financial crisis proves that stability of individual institutions is not enough to address systemic risk.
  - Distribution of risks within the system matters a lot
  - Real-financial and cross-border linkages need to be revisited
- MPF as an overarching framework to address the stability of the financial system as a whole
  - Address correlated risks and risk mismatches

Key aspects of MPF

- **Objective:** To limit systemic risk
- **Scope:** Financial system (and real-financial linkages)
- **Instruments/governance:**
  - Prudential tools targeted to sources of systemic risk
  - Effective coordination across policies

1. Identification/measurement of systemic risk (e.g. filling data gaps)
2. Timely Use of Policy Tools
3. Coordination between macroprudential and other policies (e.g. monetary Policy)

Effective Macroprudential Policy Framework

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Recent developments

Macroprudential Policy Tools and Frameworks
(Progress Report to G20 by FSB, IMF and BIS, 2011)

- **Important steps were taken with regard to policy instruments and governance structure.**

- **Progress toward new macroprudential tools to deal with procyclicality and interconnectedness**

  - **Basel III : strengthening Basel II(core capital, LCR, NSFR)**
    + Macroprudential overlay(reduce systemic risks from procyclicality & interconnectedness)

  - **FSB : agreement over framework to tackle risks posed by SIBs**

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Ⅱ. Identification of Systemic Risk

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Identification and monitoring of systemic risk

- Systemic risk measures should capture both time and cross-sectional dimensions of systemic risk.

- Various approaches used in practice

  - Indicator-based monitoring, stress tests, use of calibrated metrics, etc

- No agreed framework yet as best practice

  - May need to be tailored to country-specific circumstances

  - Implications for international coordination of MPF

Improving data and information (1/3)

- Addressing data/information gaps would be the first step toward improved identification and monitoring of systemic risks.

  - Governance structure of MPF may matter in this regard.

- Best efforts should be geared toward:

  ① Greater and timely availability of relevant data

  ② Better use of acquired data for policy formulation

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Improving data and information (2/3)

① Greater availability of relevant data

- FSB WG on Data Gaps has been working on the issue, but there are roads ahead.

- Establishing an agency dedicated to data collection could be an option.

  - ➢ Office of Financial Research (OFR) of the US could be a useful benchmark

* OFR, established by the Dodd-Frank Act, is dedicated to collect and make available, to regulators and to the public, more and better financial data.

Improving data and information (3/3)

② Use of acquired data for policy formulation

- **Regulators may lack capacity and/or resources to use acquired data properly.**

"…Important data could end up languishing in dark corners of cyberspace. …. In July, US regulators will take important step forward when they start receiving detailed, timely trading data from hedge funds, for the first time, BUT there is a catch, although these reports are now flooding in, *what is still critically unclear is whether the regulators have the resources and incentives to use data properly*."

(Gillian Tett, Financial Times, March 9, 2012)

Ⅲ. Domestic Coordination and International Cooperation

Institutional Arrangements

- Institutional arrangements for MaP should be conducive to effective control of systemic risk
  - Clear objective
  - Providing incentives and tools for authorities to act commensurate with that objective
  - Supporting accountability and transparency of decisions
  - Ensuring effective coordination across policy areas

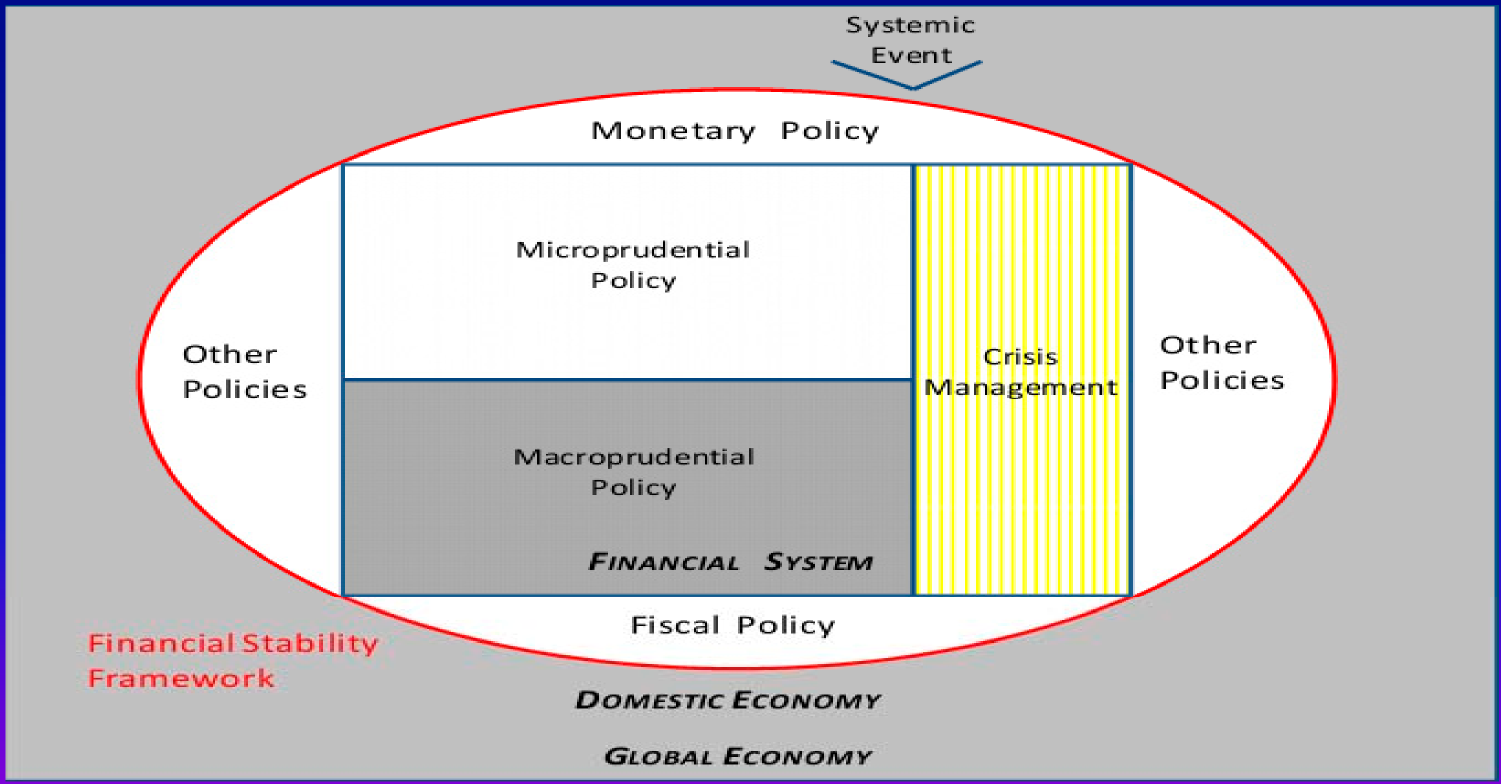
Governance Models

- Three stylized MPF Models (IMF 2011): (1) **full integration**, (2) **partial integration**, (3) **Separation**
- In Korea, "There is no 「*e pluribus unum*」." (Separation)

Degree of Integration	Full Integration	Partial Integration (Twin Peaks)	Separation
Ownership of MaP Mandate	**Central Bank**	**Committee (or Central Bank)**	**Multiple Agencies**
Examples	Czech Republic, Ireland, Singapore	UK, France, US., Belgium, Holland	Australia, **Korea,** Canada, Switzerland
Pros	Free information flow Strong Incentives Easy policy coordination	Depending on ownership of MaP mandate (Committee or Central Bank?)	Assured Autonomy and Accountability
Cons	Lack of accountability and coordination with Government	The same as above	Impeded information flow Potential "gap" or "overlapping"

Domestic Coordination (1/4)

- **Hard to define boundaries of MaP as many other policies also matter for financial stability**



Source: IMF(2011)

Domestic Coordination (2/4)

- Monetary policy (MP) and MaP are distinct but nevertheless need to be well coordinated.
  - Two-way causality between price and financial stability
  - Monetary policy could become a victim of its own success (e.g., Global Financial Crisis preceded by Great Moderation).
  - Not all asset price appreciations are bubbles (e.g., asset price increases driven by productivity growth).

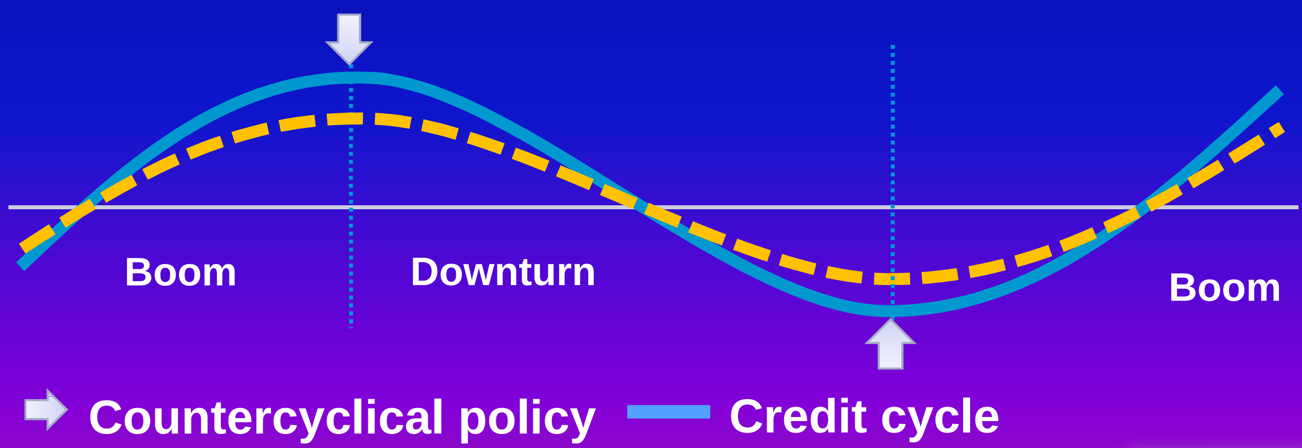
Domestic Coordination (3/4)

- MaP should be used as complementary backstop to monetary policy (and other macro policies).
  - Inappropriate use of MaP as substitute for monetary policy could do more harm than good (planting the seed for future financial instability).
  - Credit booms and general asset price appreciation would call for monetary policy response.
  - Asset bubbles in an isolated market would likely be better addressed by Map than MP.

Domestic Coordination (4/4)

● Potential Tensions between Prudential Authorities

Cycle	Boom	Downturn
Macro-Authority	Credit expansion ⇒ Systemic risk ⇒ Buffer deployed	Credit contraction ⇒ Systemic risk ⇒ Buffer released
Micro-Authority	-No worry (no mandate for systemic risk) -Concern about lowering of FI profitability by limiting of asset allocation	-Unease (since capital is lower when most needed) -Concern about negative signaling effect



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International Cooperation (1/3)

- MaP involves international dimension—particularly if related to capital flows.
  - Global integration of capital markets
  - Cross-border spillovers and regulatory arbitrage
- Global solution is desirable but no adequate global jurisdiction.
  - Financial externality from under-regulated capital flows
  - Exchange rate adjustments—often limited in scope
  - Better and fair to address the source of risk

International Cooperation (2/3)

- International cooperation could fill at least in part the gap left by lack of global jurisdiction.
  - ➢ But incentive for cooperation could be weak at national level (myopia, one-way externality).
- International cooperation on MaP would thus require
  - ➢ Institutional mechanism to promote common understanding of threats to global financial stability
  - ➢ Steps to ensure that MPF of individual countries are mutually consistent

International Cooperation (3/3)

- **Broader scope of international cooperation particularly in the context of AME-EME financial cooperation**
  - **Information sharing between AM and EM central banks (e.g., FSB Regional Consultative Group for Asia)**
  - **CB currency swap lines**
  - **Global or regional financial safety nets**
  - **Moral suasion, peer pressure**

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IV. Useful Questions

Useful Questions for Future Research (1/2)

- What are possible unintended consequences of strengthened MPF?
  - Discouraged even appropriate risk-taking for growth
  - Higher funding costs faced by EMEs
  - Endogenous response of banks (e.g., changing business models to circumvent regulations)
  - Bank profitability versus safety: Where to settle?
- Should we expect banks (and non-banks) to live with low ROEs (since banks safer than otherwise)?
- Would strengthened MPF provide stronger incentive for greater financial integration by EMEs?

Useful Questions for Future Research (2/2)

- How important and likely would regulatory arbitrage be in the design of international cooperation?
- What would be the easy-to-implement modality of international cooperation on MPF?
  - Harmonized MPF across countries or discretionary but flexible control of MaP measures?
- Capital controls versus MaP: Where to draw the line?
- CB independence: How would it affect domestic policy coordination?

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Thank You!

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