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Macroprudential Regulations: Challenges and Implications

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*Views expressed here are those of the author and do not represent the views of any organisations.

Macroprudential Regulations

• The recent financial reforms have put emphasis on macroprudential regulations.
• MRs aim at reducing systemic risks arising from procyclicality, leverage, liquidity spirals, and too-big-to-fail problems.
• MRs are intended to complement conventional microprudential regulations and macroeconomic policy.
Basel III

- Basel III aims at reducing systemic risks by raising minimum capital requirements (both in terms of quantity and quality), creating counter-cyclical & SIFI buffers, and introducing leverage ratio & liquidity requirements.

Overall Benefits of Reform

- Tighter regulations will increase safety margins and reduce the likelihood and severity of crises. However, it comes at a price of increased costs for financial intermediation.

  - Elliott et al. (2012) estimate that the current financial reforms would raise lending rates by 18 bps in Europe, 8 bps in Japan, 28 bps in the US in the long run.

- Whether the benefits of a financial reform outweigh its costs depends on how well a new regulatory framework works in reducing systemic risks.
Challenges:
Implementation Capacity

- Can the authorities identify systemic risks well in advance of a financial crisis?
- Can the authorities develop reliable indicators that provide clear guidance for their decision to activate counter-cyclical measures?
- Can the authorities act decisively based on soft evidence of a potential crisis rather than hard evidence of an actual crisis?
Challenges: Regulatory Arbitrage

• The effectiveness of macroprudential regulations can be undermined by regulatory arbitrage, leading to the migration of financial transactions to unregulated segments.

• Targeted and discriminative regulations can encourage regulatory arbitrage. China’s growing risk of shadow banking system is the consequence of discriminative regulations favouring SOEs.

Challenges: International Coordination

• International coordination in macroprudential regulations is indispensable to limit the scope for arbitrage opportunities among internationally active SIFIs.

• International cooperation at a regional level is also important to reduce the risk of cross-border distortion and spillover arising from unilateral actions by neighboring countries.
Macroprudential Regulations in EMEs

- EMEs’ macroprudential regulations often focus on capital flow management because their exposure to international capital flow volatility is a major source of instability.
- While capital inflow controls can be helpful to curb hot money, outflow controls tend to be ineffective and even harmful when they are used as a substitute for policy adjustments.
- Empirical evidence indicates that the presence of capital controls has a detrimental effect on financial development in the long-run (Chinn and Ito, 2002).

## Capital Inflows in Asia

(Millions of US dollar)

Source: IMF, International Financial Statistics
Underdeveloped Capital Markets

- Asian countries are unable to channel surplus saving into domestic investment presumably due to underdeveloped capital markets.
- Asian countries reply on external funding to finance development, increasing their vulnerability to external shocks.
- A well-developed capital market is indispensable for sustaining development and escaping ‘middle-income trap’.
Limited Market Liquidity

• Limited market liquidity is one of the key challenges facing Asian capital markets.

• Deep and liquid capital markets can better absorb external shocks and serve as a spare tire in the event of disruption to a bank financing channel (Felman et al., 2011).

• Greater foreign participation in domestic markets leads to better price discovery and less price volatility (Prasad and Rajan, 2008).

Equity Market Liquidity

Source: World Bank, Global Financial Development
Domestic Institutional Investors

- Broadening the base of DIIs will help to improve market liquidity in Asia.
- There is a substantial scope for increasing the coverage of pension and insurances.
- Regulations on the investment of DIIs are generally conservative, limiting the scope for diversifying investment allocations.
- The government can promote the development of DIIs by adopting international best practices for these regulations.

### Institutional Investors in Asia

<table>
<thead>
<tr>
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<th>Life insurance premium volume to GDP (%)</th>
<th>Mutual fund assets to GDP (%)</th>
<th>Pension fund assets to GDP (%)</th>
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<td>7.2</td>
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Source: World Bank Global Financial Development

* Data for 2010
Thank you for your attention