Governance & Development: Views from G20 Countries

Session 4 **Presentation**

Macroprudential Regulations: Challenges and Implications

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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.

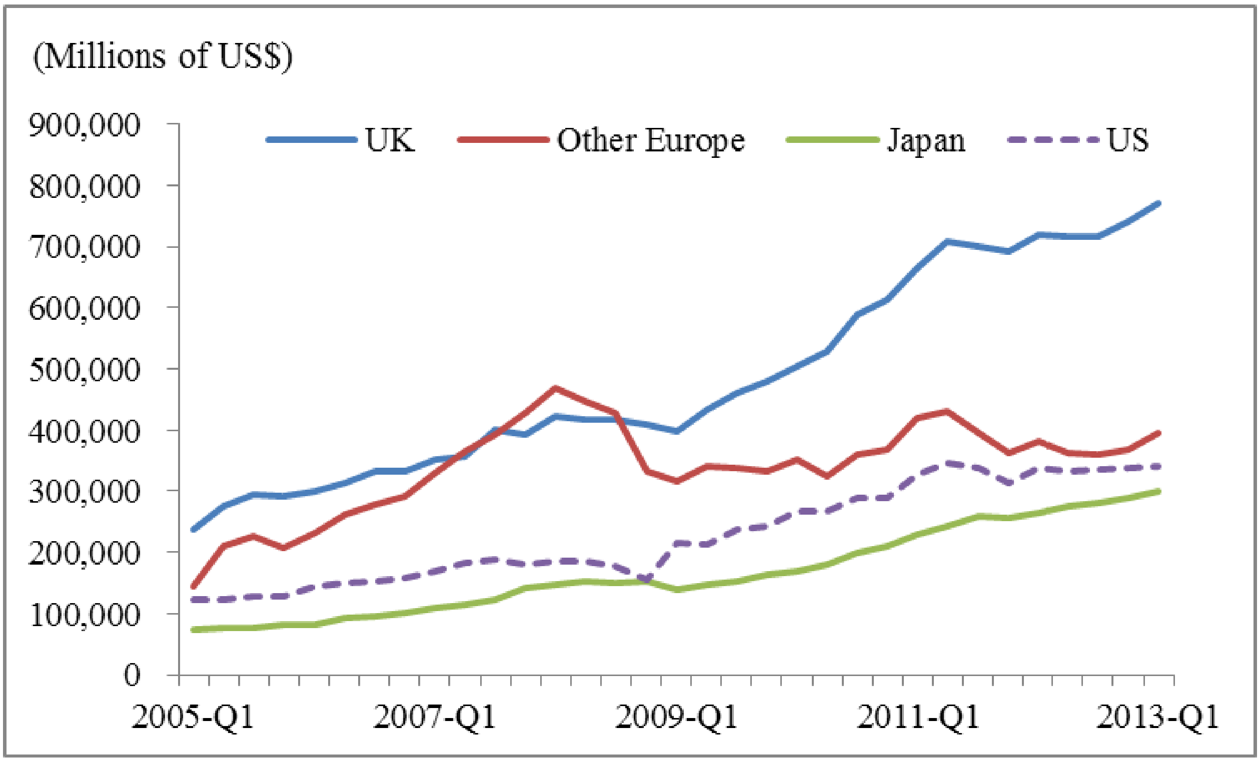
Basel III

- 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.

International Bank Foreign Claims Vis-a-Vis Non-JP Asia



Source: BIS, Consolidated Banking Statistics (Ultimate Risk Basis)

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

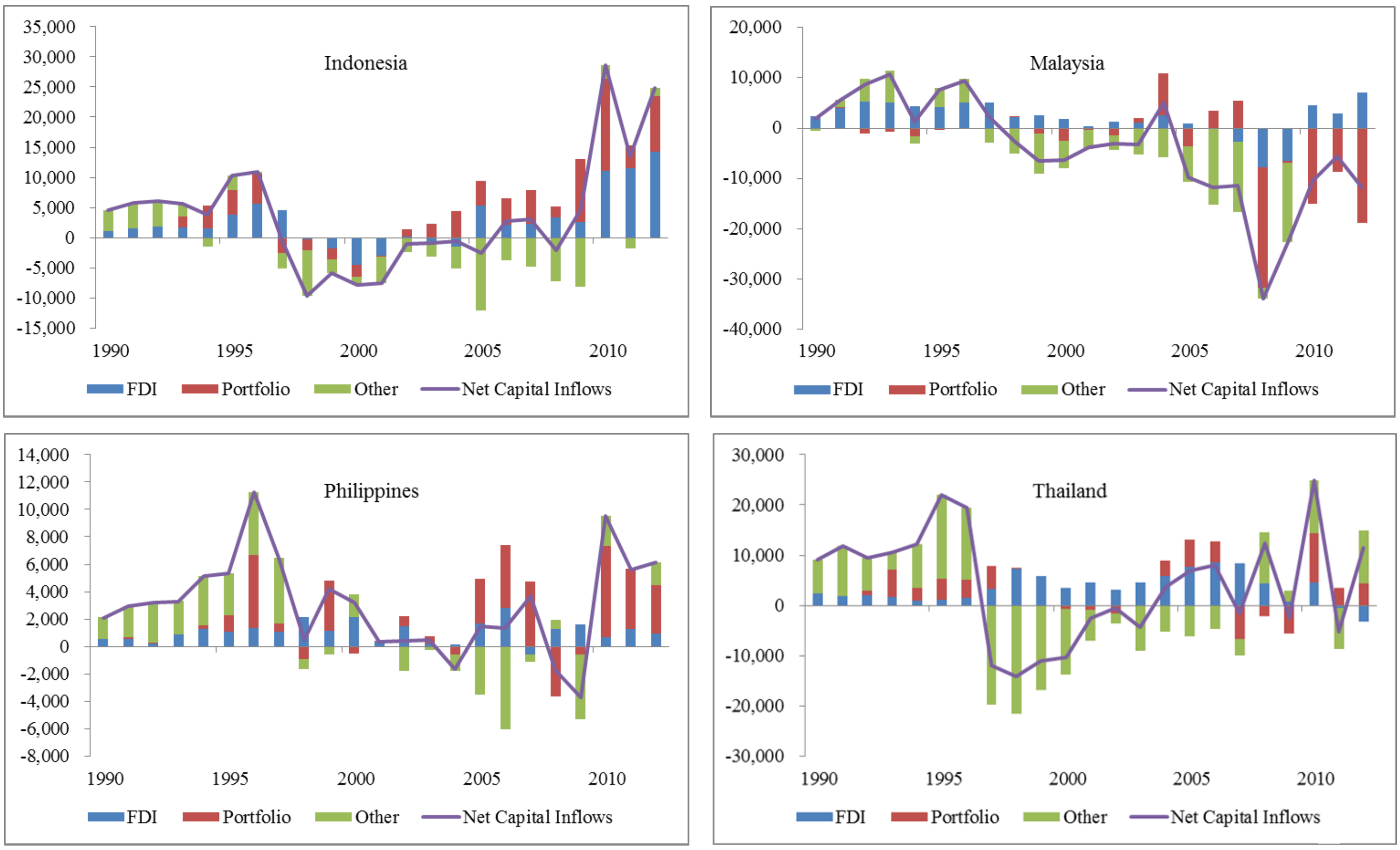
- International coordination in macroprudential regulations is indispensable to limit the scope for arbitrage opportunities among internationally active SIFIs.
- International cooperation at a regional level is also important to reduce the risk of cross-border distortion and spillover arising from unilateral 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).

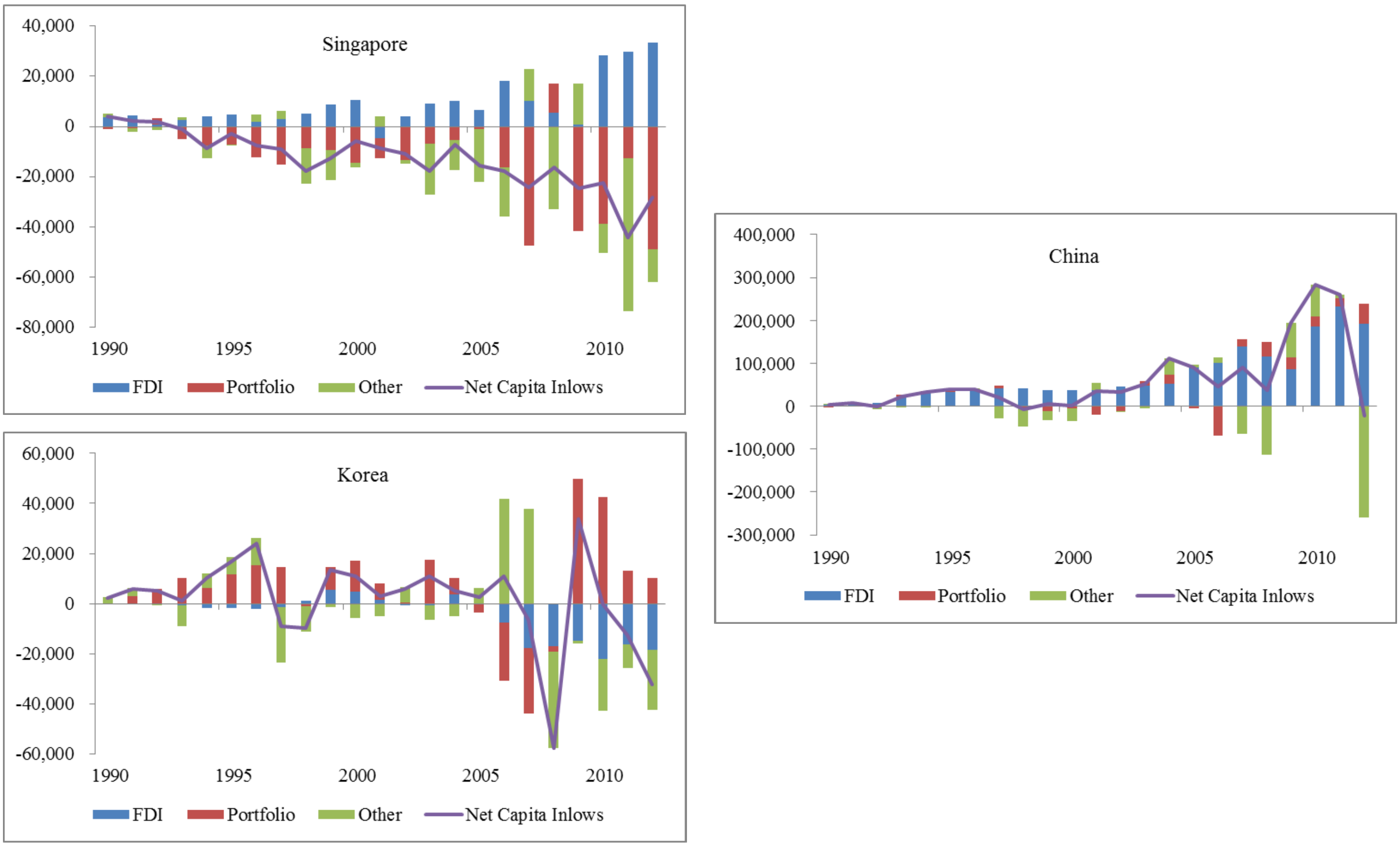
Capital Inflows in Asia

(Millions of US dollar)



Source: IMF, International Financial Statistics

(Millions of US dollar)



Source: IMF, International Financial Statistics

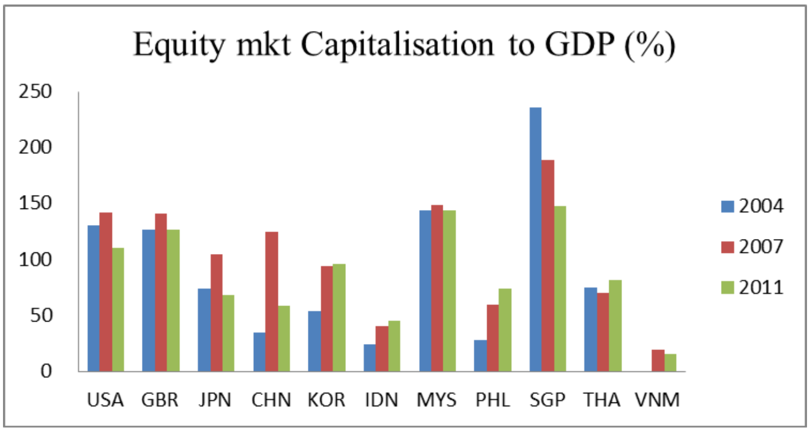
Underdeveloped Capital Markets

- 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'.

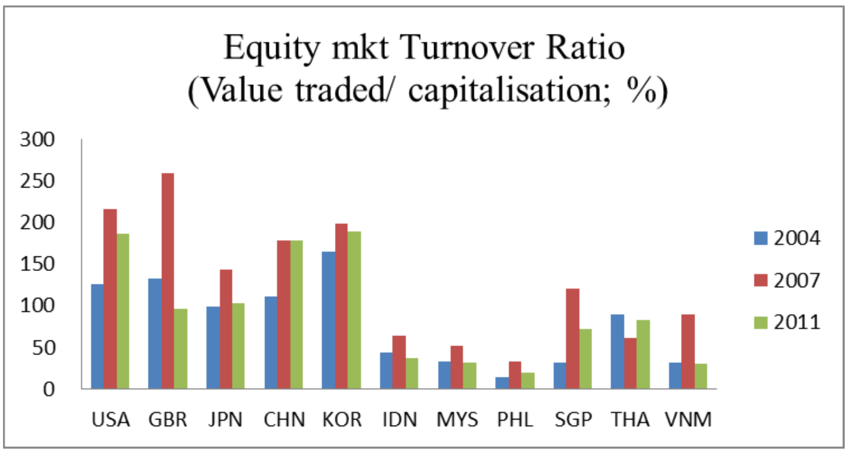
Limited Market Liquidity

- 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

	Life insurance premium volume to GDP (%)		Mutual fund assets to GDP (%)		Pension fund assets to GDP (%)	
	2007	2011	2007	2011	2007	2011
Japan	6.6	*7.1	16.4	12.7	23.8	*23.7
Korea	7.7	7.2	31.4	20.3	3.9	*3.9
China	1.7	2.1	12.4	4.6	-	*0.7
Indonesia	1.1	*1.1	-	-	2.2	-
Malaysia	3.1	2.9	25.3	28.3	47.8	-
Philippines	1.1	0.9	1.4	1.1	-	*3.5
Singapore	5.8	5.2	-	-	51.0	*60.0
Thailand	2.3	3.1	18.8	-	5.2	*5.7
Vietnam	0.8	0.6	0.3	-	-	-
United States	4.0	3.7	82.0	77.6	77.0	69.2

Source: World Bank *Golbal Financial Development*

* Data for 2010

Thank you for your attention