PROMONTORY

Washington, DC Atlanta Dubai London Brussels Milan New York Paris San Francisco Singapore Hong Kong Sydney Tokyo Toronto

The Effectiveness of Macro-prudential Policies in Controlling Financial Market Instability

OECD-ADBI 12th Roundtable on Capital Market Reform in Asia
Tokyo 7-8 February 2012

Dr. Jeff Carmichael
CEO Promontory Financial Group Australasia

©2012 Promontory Financial Group Australasia, LLP. All rights reserved.

Macro-prudential regulation in context

- Given previous 3 speakers I am going to look at the broader issue of macro-prudential instruments and policy
- "Macro-prudential regulation" is an awkward and potentially misleading term
- Its origins can be found in BIS literature from as far back as the late 1970s, although its meaning has evolved
- According to Piet Clement of the BIS:
  - First reference was probably in a 1979 meeting of the Cooke Committee
  - First public reference in an ECSC Report in 1986
  - Resurfaced after a decade in the 1995 Brockmeijer Report
  - More interest after the 1997 Asian Crisis
  - Andrew Crockett focused on the distinction in his 2000 address to the ICBS
  - From 2000 to 2007 there are around 5,000 references
  - Since 2008 there are closer to 125,000 references
- Yet still there is no clarity about what it means and even less about how it should be implemented – international capital flows are just one aspect

©2012 Promontory Financial Group Australasia, LLP. All rights reserved.

What does “Macro-prudential” really mean?

- The early literature appears to have used the term to refer to ‘systemic instability that can arise from financial activity’ … i.e. the link between prudential soundness and macroeconomic stability
- The 1997 Wallis Report noted that there were several sources of market failure that justified regulatory intervention – these included asymmetric information (or prudential) failures, and an ‘overarching systemic instability’ (externality) that can arise from a loss of confidence in a highly-leveraged system
- In creating the world’s first twin peaks model, the Wallis Committee then allocated ‘prudential’ responsibility to APRA and ‘systemic’ responsibility to the RBA
- In doing so, it noted that the tools for systemic stability “regulation” included:
    - Monetary policy
    - Regulation of the payments system
    - Lender of last resort facility
    - Monitoring of imbalances in financial markets and increases in systemic vulnerability
- Over time, the term macro-prudential has taken on a broader meaning and the toolkit has expanded rapidly

©2012 Promontory Financial Group Australasia, LLP. All rights reserved.

Macro-prudential vs systemic stability regulation

- More recent analyses of macro-prudential regulation distinguish it from systemic stability regulation not by the objectives but by the tools involved
- E.g. in its 2011 paper on macroprudential policy tools and frameworks the FSB defines macroprudential policy as one that “uses primarily prudential tools to limit systemic or system-wide financial risk”
- And that is where the problems start ……
    - First, if prudential tools are used for two different purposes (micro and macro) we have potential problems with governance, and
    - Second, we are entering a new world of expectations, in which monetary and fiscal policy are to be supplemented by some new prudential tools - in the expectation that they will succeed in preventing financial crises …. notwithstanding that monetary and fiscal policy have failed to do so -- **there should be warning signs all over this**

©2012 Promontory Financial Group Australasia, LLP. All rights reserved.

Macro-prudential tools

- While there is no unanimity about tools, the following have all been nominated
  - Counter-cyclical capital buffers
  - Through-the-cycle valuations of haircuts and margins
  - Countercyclical changes in risk weights to different sectors
  - Time-varying systemic liquidity surcharges
  - Systemic capital surcharge
  - Systemic liquidity surcharge
  - Capital surcharge on OTC derivatives not cleared centrally
  - Variations in LVR ratios
  - Dynamic provisioning
  - Capital for financial conglomerates
  - Cross-border supervision
  - Stress testing
  - Controls on international capital flows
- Problem 1: one tool, two objectives – Problem 2: one lever, two drivers
- Resolving this is not impossible but humans are fundamentally territorial …..

©2012 Promontory Financial Group Australasia, LLP. All rights reserved.

The expectations challenge

- Even if we resolve the governance problem there remains the challenge of effectiveness
- The irony here is that, after decades of deregulation, we seem to reinventing the discarded model in which monetary policy was seen as the tool to shape sectoral behaviour in the real economy – only now we want to use prudential tools to shape sectoral behaviour in the financial system
- To be successful we need to:
  - Identify imbalances before they become a problem
  - Select an appropriate prudential tool (or tools)
  - Decide how to calibrate it and when to time the intervention
  - Have the political and community support to intervene before the potential crisis
- This is an enormous ask – and we should start out expecting to fail!

©2012 Promontory Financial Group Australasia, LLP. All rights reserved.

Are there any macro tools that might help?

- Interestingly, the one tool that has some potential to be effective is 'prudential' controls over international capital flows
- The preceding speakers have addressed most of the recent evidence on the available tools and experience with them, particularly in the Asian region
- As I read the tea leaves, the main lessons from this experience are:
  - 'Prudential/semi-prudential' tools that can influence capital flows include: ceilings on FX forward positions of banks; imposing minimum holding periods on government securities; limits on short-term foreign currency borrowings by banks; reserve requirements on foreign currency deposits; variations in taxes, such as withholding taxes; and variations in LVRs on certain types of leverage (e.g. non-resident mortgages)
  - These tools are not a substitute for macroeconomic polices – they are most effective when they support appropriate macroeconomic policies
  - They work best when they alter relative prices (incentives)
  - They work in part because the potential conflict between the use of these tools for macro and micro purposes is minimal

©2012 Promontory Financial Group Australasia, LLP. All rights reserved.