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Securing financial stability through macroprudential measures

While financial stability is not an explicit objective for most central banks, it is clearly an issue of concern given its implications for the real economy. Given the current environment of relatively robust economic growth and benign inflation, central banks and other relevant authorities should focus especially on aspects of financial stability. This is particularly urgent for countries suffering from high or rapidly rising household debt and corporate leverage, as well as those suffering from distressed bank loans.

Macroprudential measures complement monetary policy in securing financial stability. In view of the high degree of interconnectedness among financial institutions, a shock can spread rapidly across the entire system. Hence, there has been growing consensus that financial regulation should move from a “micro” approach based on individual institutions towards a “macro” framework. Macroprudential measures are aimed at reducing systemic risks and safeguarding the stability of the financial system as a whole, as opposed to microprudential measures which are targeted at specific segments or even institutions (table 1).

Table 1. Macroprudential vs. microprudential measures

	Macroprudential	Microprudential
Proximate objective	Limit financial system-wide distress	Limit distress of individual institutions
Ultimate objective	Avoid output (GDP) costs	Consumer (investor/ depositor) protection
Model of risk	Endogenous (in part)	Exogenous
Correlations and common exposures across institutions	Important	Relevant
Calibration of prudential controls	In terms of system-wide distress, top-down	In terms of risks of individual institutions, bottom up

Source: Claudio Borio, “Towards a macro-prudential framework for financial supervision and regulation?” BIS Working Papers, No. 128 (Basel, Switzerland, Bank for International Settlements, 2003). Available from www.bis.org/publ/work128.pdf.

Macroprudential measures could be classified as those that affect the demand for and the supply of credit, i.e. those that are borrower-targeted and lender-targeted (table 2). Among the former, commonly used tools include loan-to-value ratios, which impose a minimum down payment and discourage speculators from taking multiple loans, and debt-to-income ratios, which restrict an unaffordable increase in debt. These tools are associated with a reduction in credit growth, most notably in the housing sector.

Among the latter, reserve requirements are the most popular, but there are also sectoral capital requirements which force lenders to hold extra capital against loans to a specific sector, thus discouraging heavy exposure to that sector. Such measures targeting liquidity risks tend to restrain leverage and excessive growth in asset prices. Some lender-targeted measures, such as limits on foreign currency loans, are aimed at reducing the sensitivity of domestic credit cycles to cross-border capital flows.

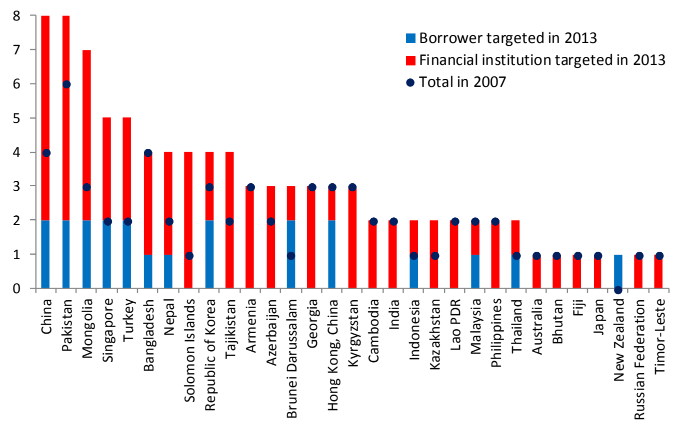
Table 2. Macroprudential measures targeting demand for and supply of credit

Tools affecting the demand for credit	Tools affecting the supply of credit
• Loan-to-value ratios	• Lending rate ceilings
• Margin requirements	• Interest rate ceilings
• Loan maturities	• Reserve requirements
• Tax policy and incentives	• Capital requirements
	• Portfolio restrictions
	• Supervisory pressure

Source: Douglas Elliott, Greg Feldberg and Andreas Lehnert, “The history of cyclical macroprudential policy in the United States” Finance and Economics Discussion Series, No. 2013-29 (Washington, D.C., Divisions of Research and Statistics and of Monetary Affairs, Federal Reserve Board, 2013). Available from www.federalreserve.gov/pubs/feds/2013/201329/201329pap.pdf.

Most countries in the Asia-Pacific region already had macroprudential measures in place prior to the financial crisis that started in 2008, but several countries have introduced additional measures in the wake of the crisis, many of which were targeted at the housing sector (figure 1).[1] Moreover, many countries have been improving their macroprudential frameworks, that is, not just the quantity of those frameworks but their quality as well. Macroprudential measures need to be formulated to respond appropriately to evolving economic and financial developments. In addition to known sources of systemic risks, policymakers should keep an eye on new and emerging sources of risk. For instance, China recently introduced a range of prudential measures aimed at slowing growth in banks' supply of shadow credit, reducing dependence on interbank funding and containing regulatory arbitrage. Such measures help reverse the growth in off-balance sheet shadow credit in the form of wealth management products.[2]

Figure 1. Number of macroprudential measures used in selected Asia-Pacific economies



Source: ESCAP, based on Cerutti, Claessens and Laeven (2015).

Although banks in the region are generally well capitalized, it is likely that mortgage delinquencies and corporate defaults will rise as financing costs rise. Non-performing loan ratios remain relatively low in countries where private debt has increased most, but there are some signs of deterioration in asset quality. Thus, bank supervision should be strengthened with respect to the quality of loans as well as exposure to foreign exchange and interest rate shocks. Stress tests could be introduced to ensure that banks not only have sufficient capital levels to absorb losses, but also governance structures and risk management processes that promote banking stability. At the same time, improving the credit history information of households and firms – for instance, through credit registries – could help lenders become better informed about the current debt of potential borrowers. In this regard, India's central bank recently proposed a new public credit registry. Efforts to enhance financial access for low-income households and small firms should be accompanied by financial education to inform borrowers of potential risks.

Country examples

A comparison of China's effort in curbing credit growth and India's experiences in reviving credit growth could shed light on the appropriate policy mix for different types of problems, including some measures which go beyond monetary and macroprudential policies.

China has seen a significant increase in non-financial private debt over the past decade. Several China-specific factors (namely high savings, current account surplus, small external debt and various policy buffers) can help mitigate the near-term risks of disruptive adjustments and buy time to address risks. These factors would likely not eliminate the eventual adjustment, however, but make the boom larger and last longer.[3] With the economy on a sufficiently high-growth path, policymakers are focusing more on securing financial stability. In 2017, the growth of the money supply (M2) slowed amid measures to curb excessive credit growth, especially non-bank credit, and to reduce debt held by State-owned enterprises. China's improved macroprudential framework also is aimed at addressing the increased reliance of banks on short-term wholesale funding and the increased opacity of intermediation. Finally, to contain regulatory arbitrage, China established a new committee on financial stability and development, members of which include the central bank and regulators of the banking, securities and insurance sector. In China, improving credit allocation and restricting State-owned enterprises are also critical measures for achieving private sector debt sustainability.

In India, the share of non-performing loans has doubled and defaults on corporate bonds and syndicated loans have surged in recent years. By mid-2017, distressed bank loans reached a record high of 9.5 trillion rupees ($148 billion), though more recent revelations suggest that the actual figure may be higher. The banking problem is closely related to high corporate leverage; thus, the two problems are known as the "twin balance sheet" challenge. If it does not effectively address the challenge, India will continue to face weak private investment and modest economic growth. The Government's policy initiatives have centred around the so-called 4Rs – recognition, resolution, recapitalization and reforms.[4] The central bank strengthened its asset quality review in 2015, which found significant quantities of non-performing assets. It introduced new schemes to facilitate debt-to-equity swaps and other forms of loan restructuring. Importantly, its new bankruptcy code has provided a resolution framework that will help corporates to clean up their balance sheets and reduce their debts. The Government also announced in late 2017 a large recapitalization package, equivalent to about 1.2 per cent of GDP, to strengthen the balance sheets of public sector banks.

These country examples illustrate that securing financing stability is important for sustained economic growth. The Asia-Pacific region has learnt from past experiences, including the 1998 Asian financial crisis and the 2008 global economic and financial crisis. Macroprudential measures have emerged as a critical tool for securing financial stability. As highlighted in this policy brief, macroprudential measures need to be formulated to respond appropriately to evolving economic and financial developments. Moreover, they tend to be more effective when deployed with complementary policy measures, as highlighted in the country examples.

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[1] Cerutti, Eugenio, Stijn Claessens and Luc Laeven, The use and effectiveness of macroprudential policies: new evidence. IMF Working Paper, No. WP/15/61 (Washington, D.C.: International Monetary Fund, 2015). Available from www.imf.org/external/pubs/ft/wp/2015/wp1561.pdf and United Nations, Economic and Social Commission for Asia and the Pacific (ESCAP), *Economic and Social Survey of Asia and the Pacific 2016: Nurturing Productivity for Inclusive Growth and Sustainable Development*. Sales No. E.16.II.F.10. Available from www.unescap.org/publications/economic-and-social
-survey-asia-and-pacific-2016-nurturing-productivity-inclusive.

[2] International Monetary Fund, *Regional Economic Outlook: Asia and Pacific – preparing for choppy seas* (Washington, D.C., 2017). Available from www.imf.org/~/media/Files/Publications/REO/APD/areo0517.ashx.

[3] Sally Chen and Joong Shik Kang, Credit booms—is China different? IMF Working Paper, No. 18/2 (Washington, D.C.: International Monetary Fund, 2018). Available from www.imf.org/~/media/Files/Publications/WP/2018/wp1802.ashx.

[4] India, Ministry of Finance, Economic Survey 2017-18, Vol. 1 (2017). Available from http://mofapp.nic.in:8080/economicsurvey/pdf/000_Preface_Ten_Facts_2017-18_Vol_1-18_pages.pdf.

The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This issue was prepared by Daniel Jeongdae Lee, Jose Antonio Pedrosa-Garcia, and Kiatkanid Pongpanich, under the guidance of Hamza Ali Malik. For further information on this issue, please contact Hamza Ali Malik, Director, Macroeconomic Policy and Financing for Development Division, ESCAP (escap-mpdd@un.org).

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