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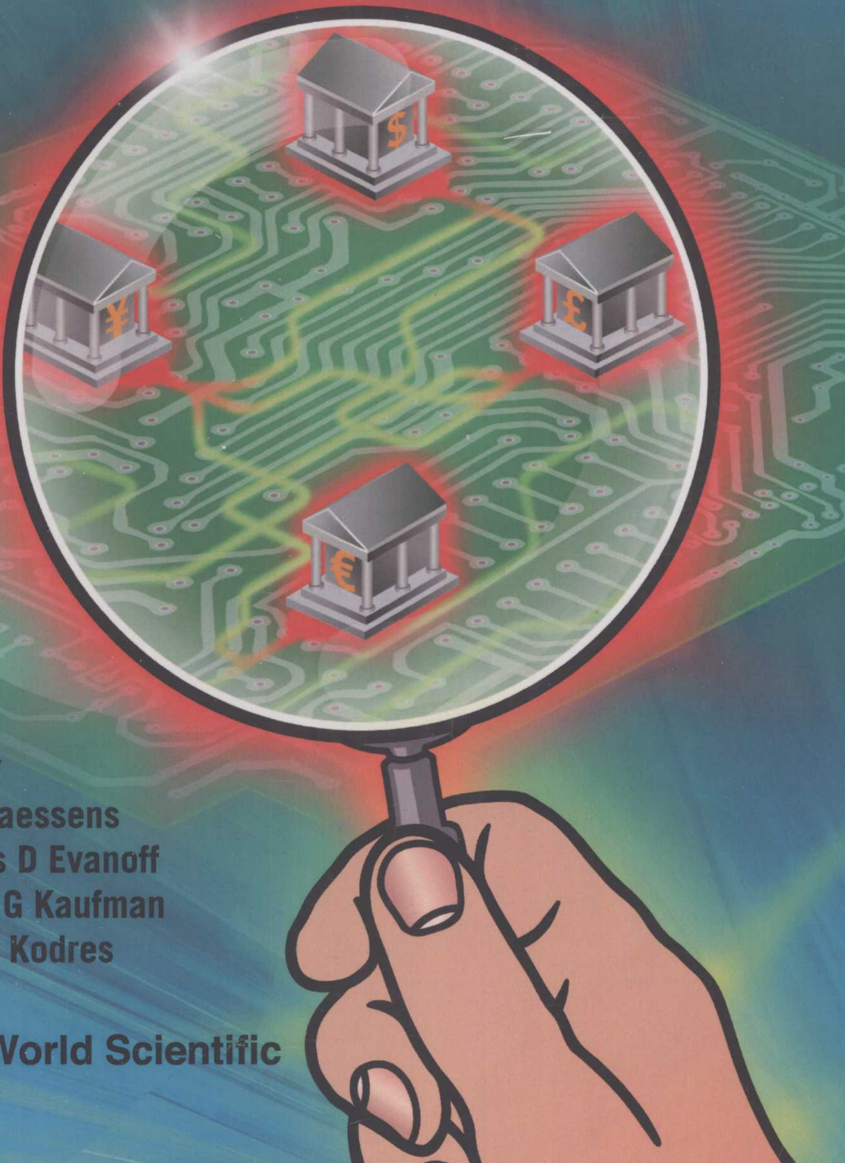
MACROPRUDENTIAL REGULATORY POLICIES

The New Road to Financial Stability ?



edited by

Stijn Claessens
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NEW JERSEY • LONDON • SINGAPORE • BEIJING • SHANGHAI • HONG KONG • TAIPEI • CHENNAI

Published by

World Scientific Publishing Co. Pte. Ltd.
5 Toh Tuck Link, Singapore 596224
USA office: 27 Warren Street, Suite 401-402, Hackensack, NJ 07601
UK office: 57 Shelton Street, Covent Garden, London WC2H 9HE

British Library Cataloguing-in-Publication Data
A catalogue record for this book is available from the British Library.

World Scientific Studies in International Economics — Vol. 17
MACROPRUDENTIAL REGULATORY POLICIES
The New Road to Financial Stability?

ISBN-13 978-981-4360-66-1
ISBN-10 981-4360-66-X

Typeset by Stallion Press
Email: enquiries@stallionpress.com

Printed in Singapore by World Scientific Printers.

MACROPRUDENTIAL REGULATORY POLICIES

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World Scientific Studies in International Economics

(ISSN: 1793-3641)

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*Published**

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PREFACE

The global financial crisis of 2007–2009 has occupied many over the past few years on how best to contain it and to manage its aftermath. When the 13th annual International Banking Conference, sponsored by the Federal Reserve Bank of Chicago and the International Monetary Fund, was held at the Federal Reserve Bank of Chicago on September 23–24, 2010, the focus of attention of banking practitioners, policymakers, regulators, researchers, and academics was turning from crisis containment to future crisis prevention. This timing importantly determined the forward-looking nature of the subject of the conference — *Macroprudential Regulatory Policies: The New Road to Financial Stability?*

Conference participants analyzed the theory behind macroprudential (financial system level) regulations and discussed the inadequacy of past supervisory practices that relied exclusively on microprudential (individual firm level) policies. There were also discussions of how macroprudential regulations may interact with other public policies, particularly monetary policy; what information needs exist and what specific tools exist to implement macroprudential policies; and where the new regulator should be housed and what organizational structure it should assume. Finally, participants considered how regulation should proceed at both the domestic and international levels.

The conference was attended by some 170 participants from 25 countries and international organizations. As at past conferences, the participants on the program and in the audience were drawn from both the private and public sectors and included a wide representation of bankers, academics, policymakers, and regulators. This volume contains the papers presented at the conference, the comments of the assigned discussants, and the special keynote addresses. Publication of these presentations by recognized experts in the area is intended to disseminate to a broader audience the ideas, analyses, conclusions, and recommendations developed at the conference, in the hope that the lessons indentified can, at a minimum, mitigate, if not prevent, future crises.

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ACKNOWLEDGEMENTS

Both this volume and the conference held at the Federal Reserve Bank of Chicago in September 2010 represent a joint effort of the Federal Reserve Bank of Chicago and the International Monetary Fund. Various people at each organization contributed to the effort. The four editors served as the principal organizers of the conference program and would like to thank all the people who contributed their time and energy. At the risk of omitting someone, we would like to thank Julia Baker, John Dixon, Ella Dukes, Ping Homeric, Hala Leddy, Rita Molloy, Kathryn Moran, Loretta Novak, Elizabeth Taylor, Ron Vlasic, and Barbara Van Brussel. Special mention should be accorded Helen O'D. Koshy and Sheila Mangler, who had primary responsibility for preparing the manuscripts for this book, as well as Sandy Schneider and Blanca Sepulveda, who expertly managed the conference administrative duties.

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I. SPECIAL ADDRESSES

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PROTECTING THE STABILITY OF GLOBAL FINANCIAL MARKETS

Paul A. Volcker*
Economic Recovery Advisory Board

This conference is designed to cast light on an important subject: how do we collectively better assure our capacity to protect the stability of financial markets that have become highly sophisticated, complex, and increasingly global, but by the evidence also opaque and exceedingly fragile.

It is a challenge for the United States. We are a country with a variety of overlapping regulatory and supervisory agencies that nonetheless have serious gaps in oversight and regulatory authority. It is a still broader challenge given the international integration of markets and the differing regulatory traditions and authorities.

So how do we deal with the challenge?

"Macroprudential Regulation" is one concept set forth in this conference.

I will confess that I am not really comfortable with that nomenclature. I suppose there is some analogy with "micro" and "macro" economics, a distinction that itself can be challenged

* Paul A. Volcker is currently the Chairman of President Obama's Economic Recovery Advisory Board and a former Chairman of the Board of Governors of the Federal Reserve System.

theoretically. As a practical matter, macro-economics does not have a coherent and generally accepted doctrine. In the midst of economic crisis, conflicting approaches strongly advanced.

Does "macroprudential regulation" suggest some agency will have authority to not only oversee financial markets and all significant financial institutions, but also establish and enforce particular rules for "hands-on" banking and securities regulators? If so, what role is left for existing, more specialized, and independent regulatory agencies, including central banks? How do the existing institutions for international coordination — specifically those at Basel responsible for bank capital standards — fit into the picture?

The Group of Thirty will shortly issue a report that hopefully will help cast light on some of these issues. Interesting enough, the authors spent some time defining just what is meant by a macroprudential approach. They settled on the term "macroprudential policy," a broad, but seemingly less specific role for the new oversight body than "regulation."

Certainly, whatever the precise semantics, there is a need felt for an approach toward oversight and regulation that goes beyond concerns about particular markets and particular institutions. The financial crisis has conclusively demonstrated that existing regulatory approaches focused on particular institutions and markets failed to appreciate the rapid growth of new markets and new financing techniques. Those typically highly engineered and opaque approaches turned out to have most serious implications for the safety and stability of the system as a whole. Arguably, even if the risks had been recognized, there was a lack of regulatory and supervisory tools and approaches, nationally or internationally, adequate to deal effectively with the potential problems.

In essence, there was a regulatory lacuna — no institution or institutions that recognized a responsibility for surveillance and oversight of the financial system as a whole. The increasingly close interdependencies in a heavily engineered world of securitization and derivatives escaped full understanding. Altogether, developments that should have raised critical questions for the stability of the system — most obviously the rapid rise of subprime mortgages and credit default swaps — were, if not entirely unnoticed, poorly understood and essentially uncontrolled. Ironically, those developments were, in fact, greeted by most market participants and a number of regulators as contributors to market efficiency and stability.

Naively, I have thought that central banks, whether or not explicitly charged with surveillance of financial markets, typically recognized that their broad official responsibilities for monetary policy, as lender of last resort and for regulating the banking system, implied concern with the structure and performance of financial markets generally.

What has happened is that commercial banks, the natural counterparts and constituency of central banks, have become less dominant in financial markets, most particularly in the United States and the United Kingdom. The major banks have morphed into such large and diversified institutions as to be considered beyond risk of failure. At the same time, there were intellectual currents in central banks, in markets, and in academia that have played a part in what in retrospect appears to have been regulatory inattention.

Central banks had learned the central importance of maintaining price stability — a good thing. At the same time, as the risks of inflation subsided, the thought that markets could flourish without intrusive regulation became compelling. After all, markets were highly efficient, able to reallocate risk in a manner that would diffuse the damage of isolated failures without systemic damage. By adroit adjustment in monetary policy in a context of price stability, financial strains associated with economic cycles or occasional incidents of "irrational exuberance" could be managed effectively by means of interest rate adjustments.

In essence, the failure to adequately foresee the growing possibility of a full blown financial crisis and to take measures to deal with that possibility was both institutional and intellectual.

Looking back at the origin of the financial crisis, I do not join the school of thought that attaches the central responsibility to monetary policy. Rather, in my judgment, it is the prolonged disequilibrium in the world economy, the diverse and ultimately unsustainable patterns of consumption and savings in the United States and some other countries, growing imbalances in international trade and payments, and finally dangerous excesses in housing markets that account for the severity of the recession and the elated financial turmoil.

The fact is that those imbalances and speculative excesses were facilitated and extended by innovations in finance. The persuasive rise of securitization, with all its complexity and opaqueness, the sense that hedging and derivatives could successfully contain and diffuse risk, the widely hailed fluidity and liquidity of markets — all these contributed to ease the borrowing, the high leverage, and the truly unprecedented levels of debt that made the markets so vulnerable and recovery so difficult.

There are those who suggest that in the wake of crisis, the enormous losses for some, and the uncertainties that remain, institutions and markets have been chastened by experience. The excesses and weaknesses are being self-corrected. Certainly, there is some truth in those observations. But we also see signs of longing — and not just longing — for pre-crisis patterns, with its rewards of extraordinary profits and compensation from risk-taking. We also know from experience that memories may be short when large rewards are at stake. Hence, the strong need for basic reforms of financial markets.

In approaching the needed reform, we should not be beguiled by thinking that we are dealing with such sensitive and efficient financial mechanisms that somehow economic growth will be placed at risk by sensible and needed regulatory intervention; including, for instance, higher capital requirements and more conservative leveraging. To the contrary, to the extent that the complexity, the opacity, and the ultimate fragility of financial markets has contributed to the depth and extent of the recession