Third BIS Consultative Council for the Americas Conference

"Financial stability, financial regulation and monetary policy"

Rio de Janeiro, Brazil, 26 - 27 April 2012

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The third research conference organised under the auspices of the BIS Consultative Council for the Americas (CCA) was hosted by Banco Central do Brasil in Rio de Janeiro on 26-27 April. The purpose of these conferences is to bring together central bank researchers and academics to discuss topics of common interest. Organised by a scientific committee composed of the directors of research of the eight BIS CCA member central banks[1], the conference included seven papers on "Financial stability, financial regulation and monetary policy." In this brief summary, I will highlight some of the issues raised during the course of the two day event. My comments are organised into three sections, following the three themes of the conference: (I) macroprudential policy; (II) banking system structure and (III) financial contagion.

I. Macroprudential policy

Starting with macroprudential policy, the first question could be: what is it? People have different views on which policies should be considered "macroprudential." Some take a very broad view, including virtually any policy that can help to stabilise the financial system. Under an expansive definition, capital controls or foreign exchange market intervention are considered macroprudential. However, the original idea -- to which I subscribe – is much more restrictive. Macroprudential instruments are the same as micro-prudential instruments, but set with the objective of addressing the build up of systemic financial risk. That is, with the express purpose of reducing the impact of the externalities arising from actions of individual actors in the financial system. Even under this more narrow definition, the list of potential tools is long. It includes capital adequacy

ratios, loan-to-value ceilings, loan qualification requirements, loan-loss provisions, margining practices, clearing and settlement requirements, and more.

Beyond the simple question of defining what you are talking about, there is the question of whether macroprudential policies should focus on quantities or prices; assets or liabilities; borrowers or lenders. There seems to be a great deal of recent interest in macroprudential policies that directly affect quantities. But most economists, and I am one of them, would go with the latter and affect costs. Influence the tradeoffs decision-makers face, change incentives, and then let them work it out. This will create fewer distortions. On assets versus liabilities and borrowers versus lenders, remember that what we are discussing is taxation. And, as is always the case, we need to understand the incidence of the tax to see what works best. Here we have a long way to go.

Finally there is the question of how macroprudential policy interacts with traditional macroeconomic policy. The paper "In the quest for macroprudential policy tools" presented by Daniel Sámano of the Bank of Mexico addresses this question and finds that macroprudential policies (in particular, a capital adequacy ratio) can be used to shield the real economy from financial sector shocks. Furthermore, interest rate policy and capital requirements can be used in a complementary way to reduce inflation and output volatility.

The paper "Interbank market and macroprudential tools in a DSGE model" presented by Hugo Vega and co-authored with César Carrera, both of the Central Reserve Bank of Peru, raises a number of related questions. One is how policymakers can influence the interbank market to enhance macroeconomic stability. In this paper, the authors investigate the interaction between the standard monetary policy interest rate tool and two alternative macroprudential tools that directly work on the interbank market: collateral haircuts and reserve requirements. They also find that macroprudential and monetary policy tools can be complementary. In the discussion, some people noted that implementation of liquidity requirements, especially in the form of traditional reserve requirements, will work better in some environments than in others. For example, in advanced economies like Canada or the US, reserve requirements are not currently viewed as viable tools for influencing commercial bank balance sheet management.

[1] Central Bank of Argentina, Central Bank of Brazil, Bank of Canada, Central Bank of Chile, Bank of the Republic (Colombia), Bank of Mexico, Central Reserve Bank of Perú and Board of Governors or the Federal

Both the Mexican and Peruvian papers highlight recent approaches in integrating the financial system into our macroeconomic models and underscore the need to continue work in this area.

II. Banking system structure

Turning to banking system structure, we can ask three general questions:

1) How is financial stability related to banking system structure?

2) How can we make the banking system more resilient under stress?

3) How can we attenuate the amplification of shocks?

Two papers presented at the conference provide perspective on these questions. In "The cyclical behaviour of bank capital buffers in an emerging economy: size does matter," presented by Andrés Murcia Pabón of Bank of the Republic (Colombia)[2], the authors show that the cyclicality of capital buffers (ie capital holdings in excess of the regulatory mandate) in Colombia depends on bank size. Large banks (measured by assets) increase capital buffers during downturns and decrease them during upturns, behaving procyclically and exacerbating business cycle fluctuations. In contrast, small banks' capital buffers are relatively acyclical remaining constant as aggregate activity waxes and wanes. The authors also find that banks with better access to capital markets maintain larger buffers during downturns.

An issue raised by this paper is whether capital requirements can be used as a discretionary policy tool. To illustrate the difficulty, note that capital adequacy requirements must necessarily be announced well in advance to give banks time to adjust. Furthermore, there is an issue of political opposition to increases in lending costs. And, finally, there is the issue of the interaction with interest rate policy that came up earlier. The practicalities of implementing a time-varying capital requirement are a source of great concern.

Finally in this part of the conference, in "The relationship between banking market competition and risk-taking: do size and capitalization matter?" Benjamin Tabak from the

Reserve System (United States).

[2] Co-authored with Andrés Felipe García Suaza (Universidad del Rosario), José Gómez González, and Fernando Tenjo Galarza (Bank of the Republic – Colombia).

Central Bank of Brazil and his co-authors[3] examine the relationship between bank competition and risk-taking in Latin America. Interestingly, they find that markets with high and low competition levels are more stable than those in between. Moreover, bank size and capitalization enhance stability in competitive regimes, while in collusive ones only capitalization matters. A question of interest is whether this finding supports a policy that would impose high capital requirements on everyone.

III. Financial contagion

The final topic of the conference was financial contagion. Again, we can start with three general questions:

1) Does financial globalization enhance stability?

2) What is the balance between improved resource allocation and the cost of cross-border transmission of shocks?

3) Is within-country transmission similar to between-country transmission?

The first two issues are explored in the model examined by Wen Yao of the Bank of Canada in the paper entitled "International business cycles and financial frictions." In Yao's setup, investors cannot credibly commit to repay their debts. As a result, cross-border investment is subject to leverage constraints which raises international growth correlations by transmitting shocks across borders. Financial globalisation thus increases the vulnerability of countries receiving foreign investment to shocks occurring in foreign jurisdictions. An important issue that could be explored further in this framework is whether, even after accounting for these costs, cross-border financial flows are still socially beneficial.

"When the rivers run dry: liquidity and the use of wholesale funds in the transmission of the U.S. subprime crisis", by Claudio Raddatz (Central Bank of Chile), shows that the more reliant a bank was on wholesale funding, the worse was its equity performance in the aftermath of the Lehman Brothers bankruptcy. Conference participants asked whether, even in the presence of this vulnerability, wholesale financing (including the shorter maturity or greater liquidity of assets held by banks) might not increase efficiency.

[3] Dimas Fazio from Universidade de Sao Paulo and Daniel Cajueiro from Universidade de Brasília.

In assessing the merits of reliance on wholesale financing, the costs of greater vulnerability during episodes of financial stress must be weighed against the benefits of greater efficiency.

"The cross-market spillover of economic shocks through multi-market banks" presented by Lamont Black (Board of Governors of the Federal Reserve System)[4] uses information on US housing markets to examine within-country transmission of shocks. There are three main findings: First, the housing market collapse in 2007-09 prompted multi-market banks to reduce local lending as a response to outside shocks. Second, the sensitivity of local lending to outside shocks depends on the share of the local market in the multi-market banks' portfolio. Third, the transmission of shocks across markets is mitigated by the banks' ability to offset changes in portfolio lending through changes in securitized lending.[5] These findings are of particular interest at a global level insofar as they may also help us understand the effects of a shock on the cross border operations of international banks. Also, policy implications warrant further exploration.

IV. Conclusions

To sum up, the papers presented at this conference, together with related discussion, provide a number of interesting insights.

First, using both monetary and macroprudential policies as complementary instruments can produce better macroeconomic outcomes (smoother inflation and smoother output). There is, however, a risk that the boundaries between monetary and macroprudential policies will become less clear-cut. Furthermore, it is not clear that high-frequency changes in capital adequacy requirements are feasible. More generally, we need a more complete understanding of the mechanisms of macroprudential policies.

Second, bank capital buffers appear to increase when banks have better access to capital markets. It is important to look at this in the context of Latin American countries where capital markets have become deeper and more liquid in recent years. Another

[4] Co-authored with José Berrospide (also from the Board of Governors) and William Keeton (Federal Reserve Bank of Kansas City).

[5] Portfolio loans are those originated by the bank and kept in its books, whereas securitized loans are sold to non-affiliated institutions.

question raised by the research presented at the conference is what the non-linear relationship between competition and financial stability implies for policy.

Finally, some researchers highlighted a number of ways in which financial integration can transmit external instability. The next step is to conduct a fuller analysis of the relative costs and benefits of financial integration.