Foreword

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Bank Negara Malaysia and the Bank for International Settlements (BIS) co-hosted a research conference on "Financial systems and the real economy" in Kuala Lumpur, Malaysia, on 17–18 October 2016. This conference was the culmination of the BIS Asian Office's two-year research programme on the same theme that the Asian Consultative Council of the BIS launched in February 2015. The conference brought together senior officials and researchers from central banks, international organisations and academia.

The research papers presented at the conference covered macroprudential policies and firm financing; household credit, growth and inequality in Malaysia; capital structure in emerging Asia; foreign banks and credit conditions in emerging market economies (EMEs); household credit and the effectiveness of monetary and macroprudential policies in Asia-Pacific; and household indebtedness and debt repayment capacity in Malaysia.

Governor Muhammad bin Ibrahim of Bank Negara Malaysia hosted the conference dinner. Deputy Governor Abdul Rasheed Ghaffour of Bank Negara Malaysia gave opening remarks. Paul Tucker (Chair, Systemic Risk Council; and Fellow, Harvard Kennedy School) delivered the keynote address. The conference included panel discussion by Deepak Mohanty (Executive Director, Reserve Bank of India), Johnny Noe Ravalo (Assistant Governor, Bangko Sentral ng Pilipinas), Paul Tucker and Hyun Song Shin (Economic Adviser and Head of Research, BIS). Former Deputy Governor Nor Shamsiah Mohd Yunus of Bank Negara Malaysia chaired the panel.

This volume is a collection of the speeches, papers and prepared discussant remarks from the conference. This foreword summarises the contents of the conference and provides a synopsis of the discussions for time-constrained readers.

In his opening remarks, Deputy Governor Ghaffour delivered three key messages. The first was that policymakers should deliberate on the purpose of taking on debt. In particular, he pointed out that what really matters is who takes on debt and how they use it, and stressed the need for balancing the objectives of financial development and financial stability. The second message was that over-regulation, if not properly balanced and sequenced, might restrain economic growth. Finally, he emphasised the need to embrace innovations in financial technology for sustainable growth.

Paul Tucker's keynote address asked the question, "What is macroprudential policy for?" from the viewpoint of central bank independence. He first pointed out that recent discussion on macroprudential policy focused mostly on tools and processes, but not much on its purpose. Then he stressed that, since unelected authorities tend to implement macroprudential policy, the authorities need to have a clearly defined objective or mandate to perform their jobs, such as building up more buffers in the financial system to improve resilience. He concluded that when

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central banks actively pursue macroprudential policy as unelected power insulated from the politics of government, threats to central bank independence might be emerging in advanced economies (AEs), and that EMEs could provide intellectual and practical leadership in the area of macroprudential policy.

In the first conference paper, Meghana Ayyagari (George Washington University), Thorsten Beck (University of London) and Maria Soledad Martinez Peria (International Monetary Fund) show that changes in macroprudential policies affect credit flows to small and medium-sized enterprises in both AEs and EMEs, and that in EMEs these policies have a major effect on young firms. In addition, they find that in EMEs macroprudential policies targeted at borrowers are generally more effective than those targeted at financial institutions. In his discussion, Jae Ha Park (Korea Institute of Finance) points out the unbalanced nature of the sample of firms across countries, and suggests alternative econometric approaches for robustness checks as well as alternative ways to interpret the key empirical results of the paper.

Jiaming Soh, Amanda Chong and Kue-Peng Chuah (Bank Negara Malaysia) contribute an empirical paper asking whether different types of household credit affect income growth and income inequality in Malaysia by using macro-level data as well as micro-level data based on household surveys conducted in 2009 and 2014. They show that housing credit is positively associated with future income growth, but that consumption credit is not. Regarding income inequality, they find mixed results: the macro-level data indicate that housing credit has a positive relationship with income inequality, but the micro-level data suggest a negative relationship. As the discussant to the paper, Yongheng Deng (National University of Singapore) suggests a more sophisticated modelling strategy to account for potential endogeneity and a tabulation of the unconditional and conditional distributions of key variables in the two surveys.

The paper by Vidhan Goyal (Hong Kong University of Science and Technology) and Frank Packer (BIS) presents measures of leverage as well as regressions for the determinants of leverage for a comprehensive sample of listed firms in seven economies in emerging Asia between 1991 and 2015. They find that recent trends in leverage are less marked than those in the credit-to-GDP ratio. For the sample as a whole, neither the mean nor the median, nor the upper tails of the distribution, show any upward shift in recent years. The country leverage regressions suggest that standard firm characteristics that help to overcome leverage differences across the whole sample may be less important in jurisdictions with stronger institutions. The discussion by Dragon Tang (University of Hong Kong) points out that it is somewhat surprising that the leverage of Asian firms remained stable during the last decade of the sample, and suggests interpreting changes in leverage in the context of the developmental stage of the countries' financial markets.

In their paper on international bank credit flows to EMEs, Patrick McGuire and Torsten Ehlers (BIS) show that direct and indirect cross-border credit were key drivers of domestic credit booms prior to the 2007–09 Great Financial Crisis. Once these cross-border credit flows are controlled for, countries with higher foreign bank participation rates had less severe credit booms than those with lower rates. They explain that this finding reflects the stabilising role of foreign banks' local operations, which are often locally funded, and conclude that what matters is the type of bank claim rather than bank ownership. In his discussion, Glenn Hoggarth (Bank of England) highlights the usefulness of analysing the various dimensions of international credit jointly.

Moritz Schularick (University of Bonn) and Ilhyock Shim (BIS) assess the effects of changes in interest rates and macroprudential measures on various types of credit growth. In particular, they show that both changes in the domestic policy rate and changes in the domestic policy rate instrumented by the US policy rate significantly reduce growth in household and housing credit over a two-year horizon. They also find that general bank credit tightening actions, such as increases in reserve requirements, reduce credit growth over one to four years, and that housing credit tightening actions such as higher loan-to-value ratios are effective only on housing credit over one to two years. Discussant Woon Gyu Choi (International Monetary Fund) suggests that instruments for domestic policy rates to control for foreign policy can include unconventional monetary policy measures taken by the Federal Reserve, the European Central Bank and the Bank of Japan. He also points out that the paper could benefit from taking into account the recent debate on macroeconomic trilemma or dilemma in using instrumental variables for estimation.

In the last conference paper, Muhamad Shukri Abdul Rani, Siti Hanifah Borhan Nordin, Chin Ching Lau, Sheng Ling Lim and Zhen Shing Siow (Bank Negara Malaysia) explore the relationship between the debt service ratio (DSR) and individual borrowers' ability to withstand negative shocks in Malaysia. In particular, they use borrowers' income and debt data obtained from a Bank Negara Malaysia internal database to calculate the borrowers' financial margin, and apply various simulated economic and financial shocks to the financial margin of these borrowers to identify the potential deterioration in their debt repayment capacity. Their simulation results show that, in the pre-shock scenario, borrowers across all income groups are more likely to have a negative financial margin if their DSR is above 60%, and that in the post-shock scenario, they are more likely to have a negative financial margin if their DSR is above 40%. In her discussion, Sock-Yong Phang (Singapore Management University) suggests that factors responsible for the increase in household debt for Malaysia can include not only demand and supply factors but also institutional and behavioural factors. She also points to a likely overestimation of the probability of default of households in the paper. Finally, she emphasises the systemic perspective, noting that the same negative shocks affect corporate debt and household debt simultaneously.

The conference concluded with a policy panel on the theme of "Balancing policy objectives in Asia: leverage vs long-term economic growth", which was chaired by former Deputy Governor Shamsiah. In his panel remarks, Mohanty first pointed out the stress in India's banking sector was largely due to increased leverage in the corporate sector. Then he explained that, in order to avoid high corporate debt levels in India straining firms' debt-servicing capacity, the Reserve Bank of India introduced: (i) a scheme for sustainable restructuring of stressed assets; and (ii) prudential measures to disincentivise banks from limiting their incremental exposure to large borrowers. Ravalo acknowledged that the sharp build-up in both corporate and household debt had not been matched by a commensurate increase in income in the Philippines, but that there were non-trivial data gaps that prevent an unambiguous conclusion on whether or not financial stability concerns were already present. He also pointed out that central banks need to collaborate with other financial authorities to effectively deal with financial stability concerns over non-financial corporate and informal market borrowing by households.

In the same panel, one panellist stressed the importance of understanding better the interaction of macroprudential policy and monetary policy, of identifying financial stability risks from a greater role of non-bank financing and of promoting coordination among banking, insurance and securities regulators. Finally, another panellist explained the similarities between monetary policy and macroprudential policy in the sense that both affect the choices by borrowers, creditors and financial intermediaries. He also pointed out that since 2002, the policy rates of both AEs and EMEs have remained significantly below the level prescribed by the Taylor rule.