

Choongsoo Kim: The need for more advanced forms of regulatory surveillance and macroprudential stability policy

Welcome address by Mr Choongsoo Kim, Governor of the Bank of Korea, at the Bank of Korea (BOK) – Bank for International Settlements (BIS) Conference on Macroprudential Regulation and Policy, Seoul, 17 January 2011.

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I bid a warm welcome today to all of you attending this conference, held jointly by the Bank of Korea and the BIS. Let me first single out for appreciation our keynote speakers, Governor Stefan Ingves of the Swedish Riksbank and Professor Hyun Song Shin of Princeton University. Their attendance as lecturers adds special luster to our proceedings. I anticipate that with their abundant experience and keen powers of discernment, these two experts will have great insights for us concerning the new policy tasks and changes in role of central banks since the global financial crisis. My thanks go out in addition to Eli Remolona, Chief Representative of the BIS Asia and Pacific Representative Office; Christine Cumming, First Vice President of the Federal Reserve Bank of New York; Ignazio Visco, Deputy Director General and Member of Governing Board of the Bank of Italy; David Longworth, Former Deputy Governor of the Bank of Canada, and to all of our other chairs, presenters and discussants, for your efforts to make this conference a success.

The global financial crisis has shown us the importance of shifting to a new paradigm in macrofinancial stability framework as well as international financial order. In particular, broad consensus in the international community has developed on the necessity of designing various tools, including macroprudential policies to counter the heightened mood of anxiety we now see everywhere concerning systemic risk. This being the case, the theme of our conference, “Macroprudential Regulation and Policy”, will be viewed with intense interest by central banks and regulatory authorities responsible for financial stability. I am sure that the invaluable comments and policy proposals raised during this week’s conference will be of great help to central banks and those in charge of government policy throughout the world.

Lessons of the global financial crisis

The global financial crisis that we are witnessing is the greatest shock to the world economy since the Great Depression of the 1930s, in terms both of its intensity and of its duration. Even now the financial markets have not fully recovered to their pre-crisis level of activity. Nor can we rule out the possibility of the current recovery faltering more than expected, in view of the prolonged crisis aftershocks such as the continuing contagion from the European debt crisis. Various new expressions have consequently made their way into the mass media, including talk of a “two-speed global recovery”, amid worries of widening of the gap in recovery between advanced economies and the newly emerging market economies, and of a so-called “three-way split”, envisioning divergent patterns of economic growth in the US, Europe, and emerging markets including China.

When we look back at the history of economic crises, we find that while they may have always been accompanied by massive financial and economic losses, they have also sparked reforms of existing systems. And so, as suggested by the expression “don’t waste a crisis”, if we can learn a lesson from it a crisis can also be a valuable experience. We therefore need to work our way toward practical and concrete proposals to avoid repetition of financial crisis based on the painful lessons we have learned from this most recent crisis. In this light, the conference this week will, I am sure, be a most timely and significant meeting of minds.

We can, I think, draw several vital policy lessons from the recent Global Financial Crisis.

First and foremost, no matter how sound the economy of a country is in terms of macroeconomic fundamentals, its financial system is closely tied to the international financial markets in a complex interlinked web. It may therefore be suddenly hit by the rapid worldwide spread of a shock from accumulated financial imbalances. In particular, the web of linkages spun between financial institutions acts to allocate risk efficiently when the going is good, but in times of turmoil serves as a channel for risk transmission. It follows that the risk to the financial system overall is massively larger than the simple total of the risks of individual financial institutions. It is therefore extremely important to manage risk on the basis of the financial system as a whole, given the difficulty of securing macrofinancial stability solely through the microprudential regulation of individual financial institutions.

Secondly, while financial innovation does indeed promote its efficiency, it can also act to cultivate financial imbalances. Furthermore, the speed of expansion of an economy's financial sector can, when it outpaces that of the real sector, may destabilize the macro economy. It is therefore hard to say for sure whether apparent financial development always plays a beneficial role in sustainable economic growth.

Thirdly, price stability cannot by itself guarantee financial stability. Where the economy maintains low prices and rapid growth for a lengthy period of time, an accumulation of financial imbalances threatening financial system stability can even perhaps be overlooked.

Last but not least, in a world economy of great mutual dependency between the financial and real sectors of the economy, to counter global financial crises we have no option but international cooperation. Fortunately, in the early stages of this last crisis, it proved possible to achieve successful international policy cooperation through the G20, the premium forum leading the international debate on world economic stability. Under the aegis of the G20, moreover, the Financial Stability Board and the Basel Committee on Banking Supervision efficiently headed up international cooperation in the sphere of financial regulation.

Macroprudential policy tasks

In the wake of the global financial crisis, the dangers of systemic risk propagation must be recognized and the macroprudential soundness of the economy as a whole enhanced so as to counter them. Prior to the global financial crisis there was insufficient understanding of financial systemic risk in countries around the world, and we cannot deny that the significance of such risk was underestimated. Similarly, in seeking to reduce the severe damage to the real economy arising from systemic risk, we need to move away from an emphasis on microprudential regulation, to an approach that also incorporates macroeconomic policy dimension.

Based on the aforementioned lessons from the global financial crisis that I mentioned above, countries around the world are now involved in drawing up various plans for underpinning sustainable and balanced growth, in a process centering around the G20. And at the last G20 Summit in Seoul, substantial outcomes were achieved in the move toward introduction of macroprudential policy-based financial regulation. This being said, a large number of issues remain unresolved, as the introduction of macroprudential regulation is still in its infancy.

Let me cite some examples. How should financial stability, which is the goal of macroprudential policy, be defined? And again, how can we reconcile macroprudential policy tools with our instruments of microprudential regulation? Further, how should we pursue financial stability jointly with monetary policy, which emphasizes price stability, and what institutional arrangements must be put into place to facilitate macroprudential policy cooperation with the supervisory authorities? On these and other issues, proposals either upon experience or upon concrete theoretical grounds have yet to be presented.

Meanwhile, correcting the disequilibria in the global economy is an overall imperative, not just for eliminating the factors behind the current crisis but also for securing stability of the

international financial order going forward. We should therefore step up efforts to resolve the global imbalances in trade and capital movements that were among the root causes of the global financial crisis. Although the issue of these global imbalances has repeatedly loomed as a problem in the past, the international community has barely undertaken joint efforts to reduce them.

I hope that before long a consensus will be reached, under the aegis of the G20, on indicative guidelines for current account positions designed to resolve the global imbalances.

The existing framework of global financial regulation was largely designed with advanced countries and the banking sector in mind. And because of financial innovation and the like, the financial system has undergone great structural transformation with the rapid growth of parallel “shadow banking system” encompassing investment banks, hedge funds and special purpose vehicles. In keeping with the reform of the financial environment, therefore, all major financial institutions in the markets, irrespective of their legal forms, should now be made subject to regulation. Furthermore, international consensus has also formed on the need for strengthening regulation of systemically important financial institutions (SIFIs). In practice, however, it has not been possible yet to draw up international standards for the selection of SIFIs, or for the method of their regulation. Within emerging market countries, similarly, the need for regulation of SIFIs has now clearly emerged and very thorough discussion of this issue is called for.

In addition, concrete research is required to identify how reorganization of the international financial order will impact the financial structure and the financial and capital markets of emerging market economies. What effects the new capital and liquidity regulations decided on at the recent G20 Seoul summit will have on our the current interest rate-oriented monetary policy must also be determined.

New factors restricting monetary policy may also be on the horizon. I am thinking here, for example, of the possibility of a conflict with interest rate policy arising from the liquidity control function of a countercyclical capital buffer, which is among the macroprudential policy instruments now being discussed.

Closing words

Historically, economic crises have led to crises in the field of economics itself. And economists and economic institutions by and large failed to predict the recent global financial crisis until it actually erupted, owing to their lack of understanding of speculation in the real estate market and of the behavior and competition structures of banks. And central banks too, can admittedly also not escape this criticism. At the same time, however, central banks’ role and position have risen since the crisis, given their energetic participation as lenders of last resort in the process of overcoming it, very different from during previous crises. However, there is also a heightened possibility now of a weakening of the central bank’s monetary policy credibility, due to conflict between its policy goals of financial system stability and price stability. In this context, as guardian of the financial system, the central bank is called upon by society to bear the responsibility for macroprudential regulation and policy, and to carry out the related tasks of analysis and examination.

In this context, as I have previously noted, the most vital and difficult mission now confronting us is the efficient management of systemic risk. And for this purpose I see it necessary to operate more advanced forms of regulatory surveillance and macrofinancial stability policy, to secure a more diverse range of policy instruments for ensuring soundness, and to further strengthen both international cooperation and market discipline. The recent debate in the G20 and the BIS on developing and introducing macroprudential policy instruments has now also been reinvigorated. Notably, with regard to newly emerging market countries, that are relatively more exposed to excessive market risk and foreign currency liquidity risk than advanced countries, detailed evaluation is needed of the influences on their financial

systems of introduction of the proposed new micro- and macroprudential regulatory tools. And attention must also be given to choosing the right combination of regulations that can bring about the largest synergy effects.

As we have seen during the recent global financial crisis, the bankruptcy of huge financial conglomerates can potentially weaken the function of market competition – not only by heightening systemic risk, but also due to too big or connected to fail expectations and the consequent possibility of government bailout. The macroprudential framework should thus be designed from a wholistic perspective, to prevent side effects arising from possible structural changes in the financial market and to shore up the function of the financial system in the long run.

I look forward to this conference hosting constructive and thorough discussions today and tomorrow on the meaning of macroprudential regulation and policy, on the tasks ahead, and on the role of the central bank in this regard. It will also be valuable if we can put our heads together to consider the impact of macroprudential policy on the real economy, and its relationship with other economic policies.

Drawing my remarks to a close, I should once again like to voice my deepest thanks to you all for setting aside some of your valuable time to be here. I know how chockablock the schedule is, but I do hope you will also have a chance, during your all too short stays here, to savor the beauty of the Korean culture and natural environment.