Macroprudential goals, implementation and cross-border communication

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Abstract

The People's Bank of China (PBOC) plays a critical role in the country's macroprudential regulation. In recent years, the PBOC has put in place a series of macroprudential tools and developed its macroprudential assessment (MPA) system. During implementation, the ex ante and ex post appraisal of macroprudential tools are essential and such tools, targeting both the overall financial system and specific markets, play critical roles in the macroprudential framework. Although challenging, effective communication helps policy implementation. In the context of globalisation, national macroprudential policy implementation can create spillovers, which implies the need for international coordination.

Keywords: macroprudential policy, the People's Bank of China, policy communication, cross-border effects

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I. Macroprudential goals and frameworks

Macroprudential policy aims to counter and relieve systemic financial risks in an overall and countercyclical context. To be specific, the three concrete goals include improving the ability of financial system to deal with shocks through the timely establishment and release of buffers; reducing the procyclical response between asset prices and credit to curb excessive growth in leverage, debt and unstable financing and to prevent the accumulation of systemic risks; and limiting the structural vulnerability arising from financial system interrelationships with a view to preventing important financial institutions from becoming "too big to fail".

Central banks all play critical roles here, even though macroprudential frameworks vary between countries. Currently, China's joint conference on financial regulation and coordination is led by the PBOC and includes as participants the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC) and the State Administration of Foreign Exchange (SAFE). The conference is the main channel for financial research that strengthens the coordination of financial regulation policy, instruments and implementation across markets to help improve financial stability and ease systemic financial risks.

The PBOC has been exploring the innovation of macroprudential tools for some time. Since the crisis broke, the PBOC has studied the example of the advanced economies, and it started to strengthen its macroprudential measures in 2009. In 2011, the PBOC introduced dynamic provisioning and started to link commercial banks' credit supply with their capital, systemic importance, and the stage of macroeconomic cycle. As the economy develops, the PBOC continues to improve its dynamic provisioning system and, in 2015, upgraded it into a more general macroprudential assessment system (MPA), including indicators for capital and leverage, asset and debt, liquidity, pricing, asset quality, risk of cross-border financing and the implementation of credit policy. Since 2015, the PBOC has strengthened its macroprudential management of cross-border capital flows, introducing measures such as provisions for the forward sale of foreign exchange, increased commission charges for speculative yuan trades, and the imposition of deposit reserves for offshore RMB deposited onshore. In May 2016, PBOC extended the scope of macroprudential management for cross-border financing to all financial institutions and companies across the country. The PBOC has also instituted loan-to-value (LTV) ratios on residential property lending.

On the one hand, macroprudential policy interacts closely with monetary policy, microprudential policy and fiscal policy, and is coordinated with them. On the other hand, these policies focus on different areas. Both macroprudential policy and monetary policy are based on macro and countercyclical adjustments. However, the former focuses on the stability of financial system, for example, by curbing leverage in the financial system, or in a specific segment, while the latter mainly emphasises the overall economy, aiming at stabilising prices and stimulating economic growth. As macroprudential policy complements monetary policy and affects its transmission, these policies should be coordinated.

Macroeconomic policy is closely connected with microeconomic policy in its tools and target, which is to prevent risks, but policy features obviously differ. As a result, information-sharing is necessary in the process of policy implementation. Microprudential policy aims to regulate a single institution with a view to ensuring stability, compliance and transparency, while macroprudential policy usually opts for countercyclical measures based on the analysis of macroeconomic situation by smoothing the procyclical fluctuations of financial system and preventing risk contagion across markets.

II. Implementation of macroprudential frameworks: Strategy, actions and tactics

According to the IMF and BIS, the process of implementing countercyclical macroprudential measures consists of six steps: research on macroeconomics and financial cycles; dynamic appraisal of systemic financial risks; countercyclical adjustment and intervention by choosing and implementing the appropriate macroprudential tools, as well as appraisal and calibration of policy tools; valid communication with public and markets; dynamic supervision of market indicator bias; and improvement of data quality and completeness.

The ex ante and ex post appraisal of macroprudential tools is important in macroprudential frameworks. The ex ante appraisal, carried out before the implementation of tools, aims to choose the appropriate tools and timing, while the ex post appraisal, carried out after implementation, aims at assessing the tools' effectiveness. The two phases target, respectively, macroeconomic and microeconomic variables. Structural macroeconomic models, simplified macroeconomic models and indicators analysis are commonly used to assess macroeconomic variables, but the choice of economic variables and the question of how best to quantify default risk are still debated. By contrast, microeconomic variables are based on individual financial institutions, using stress tests, panel data models and network models.

Macroprudential tools play an important role in preventing the accumulation of financial risks and strengthening the financial system's resilience. Some tools set overall countercyclical requirements, for instance, to counter systemic risks arising from the excessive expansion or contraction of credit in the banking system. Introduced for this purpose in the Basel III Accord, the countercyclical capital buffer has already been activated in some jurisdictions. China's authorities are also reviewing the related regulation. Other tools target specific markets, for example, in addressing the excessive expansion or contraction of housing credit. Some jurisdictions have used LTV and debt-to-income (DTI) ratios to dampen the mutually reinforcing dynamics of housing credit and prices, thus improving the stability of the housing market. According to an IMF study of 46 jurisdictions in 2013, LTV and DTI ratios have been applied in a respective 24 and 14 jurisdictions. Practical experience shows that these tools can successfully curb the procyclical risk build-up in housing markets, but it is still worth mentioning that market participants may evade regulation in specific areas by means of financial innovation. Central banks should therefore take the overall financial system into consideration when establishing macroprudential frameworks.

III. Communication and cross-border issues

It is important to strengthen public communication and guide market expectations. Improving the transparency of macroeconomic measures helps to gain public support and reinforce public regulation. Announcements by central banks help to focus the attention and discussions of market participants, but some challenges still exist. First, regulators may have no comparative advantage in terms of information over the market, raising a question over how effective their guidance of market activities may be. Second, the analysis framework of regulators may not be advanced enough to guide market participants. Third, regulators should pay attention to the effectiveness of their communication. If market participants do not receive credible information, the reputation of the central bank may suffer.

In an era of globalisation, macroprudential policy has far-reaching effects. On the one hand, effective macroeconomic policy helps to keep domestic financial risks in check, creating positive externalities. On the other hand, individual countries may be able to reduce any negative cross-border effects in trade and finance by strengthening macroprudential frameworks, so as to lessen the probability of a financial crisis. Macroprudential management also affects cross-border financing activities in that financial institutions may shift financial activities abroad and hence evade national regulations. Policymakers should accordingly take the international environment into account. If macroprudential policy is not coordinated internationally, financial risks may become concentrated in economies with laxer regulation. To address this issue, international authorities coordinate and formulate minimum standards, supplementary agreements and guidance. The Basel III Accord has introduced countercyclical capital buffer requirements and additional capital requirements for systemically important financial institutions. The next step is to utilise international platforms such as the IMF and BIS for international coordination.

Cross-border capital flows are a new factor in the global economy and some emerging market economies, including China, have begun to explore and strengthen macroprudential management, targeting foreign capital flows. The PBOC included foreign capital liquidity and cross-border capital flows in its macroprudential management from 2015, by targeting short-term speculation. Its countercyclical adjustments include charging risk provisions for the forward sale of foreign currency, applying the normal deposit provisions rate both to offshore and onshore financial institutions, and extending the scope of the programme for cross-border financing macroprudential management nationwide, which includes increasing the effective supply of foreign currency and curbing leverage and currency mismatch risk. The PBOC has focused its macroprudential management mainly on the foreign currency market and foreign debt, using public and transparent measures, with a view to improving the stability of financial markets.