Rethinking the role of financial soundness: Financial infrastructure and long-term sustainable growth[♣]

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Thank you Chair,

Let me begin by thanking Bank Indonesia for the invitation. It is a pleasure to be here.

On the issue of financial soundness, it is certainly hard to overstate the importance of a sound financial infrastructure. In normal times, the financial sector plays a critical role in driving the real economy. But during times of stress, having a sound financial infrastructure is all the more important, because it is the viability of financial institutions that typically draws the line between a mild economic setback versus a full-blown crisis.

But what are the essential features of a sound financial infrastructure? Let me highlight three key elements that I believe constitute financial system soundness.

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First is the efficiency aspect. The financial sector must perform its core functions efficiently. To this end, substantial progress has been made in Asian emerging markets, partly by default as globalization and the rapidly growing economies in Asia have raised competition among financial institutions, and also by design given the continuing efforts by the authorities to deregulate and develop the financial sector. Making further headway on these fronts, therefore, should be a continuing process. And I think this is what Bank Indonesia is doing. Similarly, in our case, the Bank of Thailand recently launched the Financial Sector Master Plan 2, in which we outline the key principles and guidelines for further strengthening of the financial sector over the next five years. Chief among the agenda are our commitments to bring down financial transaction costs through further deregulation and promotion of more competition in the banking industry.

The second element of financial soundness is the integrity aspect. That is, financial institutions must be sufficiently immune to ‘runs’, which I define loosely as correlated and large-scale withdrawals of deposits, triggered by sudden loss of confidence in the solvency of banks concerned. On this, a key lesson for emerging markets from the global financial crisis is that the push for financial market development must be accompanied by constant efforts to review and bolster as necessary the supervisory framework and standards, so that financial soundness can be ensured without compromising the financial system's integrity.

The third and last element of financial soundness is the stability aspect. The financial sector, while playing an important role in supporting the real economy, can at the same time be the source of risk and instability to the real sector. As we know, the spillover effects from financial to real sector can take many forms. For example, the tendency for financial institutions to extend more credit during economic upswings, and scale back lending precisely during downturns, can contribute to the amplitude of the business cycles. This 'procyclicality' mechanism works to exacerbate real shocks, raise the degree of economic fluctuations, and in extreme cases can play a part in leading to financial or economic crises.

One remedy to this problem is to utilize the supervisory and regulatory function in pursuit of macroeconomic and system-wide stability objectives, particularly by reducing the degree of procyclicality. Such 'macroprudential' approach to regulation is rapidly becoming a received wisdom among academics and practitioners, and indeed is the guiding principle underlying the recently finalized Basel III proposal. While it is encouraging that practical implementation has already been set in motion, there remains a degree of opaqueness at the conceptual level about the desirable features that should govern the design of macroprudential policy. This point leads me to my second topic that I want to focus my talk on today, that is macroprudential policy and long-term financial stability.

In my view, there are three important issues regarding macroprudential regulation. The first is the objective of macroprudential policy, which conceptually is to safeguard financial stability. But, for practical purposes, the notion of financial stability is much more obscure compared to price stability, and the question of how macroprudential policy should be designed to target something that is loose in concept and difficult to measure in practice remains a challenge.

To address this, one approach has been to distinguish between the two facets of financial stability: the systemic importance of a given financial institution on the one hand, and the procyclicality of the overall financial system on the other. Such taxonomy implies that macroprudential policy should aim to improve the resilience of the financial infrastructure in these two aspects.

With respect to systemic importance, various measurement tools have been developed, ranging from the network externality approach to the concept of conditional value-at-risk or CoVaR associated with the works of

Adrian and Brunnermeier. The latter method has since been applied to the cases of Hong Kong and Thailand, by their respective central bank staffs.[1] On the second facet, there have also been attempts to get a handle on procyclicality quantitatively. Notably, credit-to-GDP ratio has been proposed as an intermediate indicator around which macroprudential policy such as countercyclical capital buffer can be designed.

While scientific work on the conceptual and measurement issues are still progressing, central banks implementing macroprudential policies will need to be content with something less holy. At the Bank of Thailand, implementing macroprudential policy involves monitoring a large set of indicators, covering seven important areas in which experience and history have shown are prone to financial vulnerability. Such a wide coverage is designed to make up for any shortfall in terms of scientific measurement and increase the chance of detecting financial imbalances as they begin to develop. This systematic monitoring framework is then augmented by careful deliberation of the policy measures that integrates analyses from both our supervision and monetary policy groups. So far, our experience with such approach has been positive.

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[1] Roengpitya and Rungcharoenkitkul (2009) “Measuring Systemic Risk and Financial Linkages in the Thai Banking System”, Bank of Thailand Discussion Paper.

Let me now turn to the second issue: Should the implementation of macroprudential policy be based on discretion or subject to rules?

To me, this is a complex and is still an unsettled issue. On the one hand, given the complex nature of how financial instability develops, regulators may understandably wish to retain some degree of freedom in choosing the timing and instrument to address the sources of risks as they emerge. In this sense, there appear to be good cases for the use of discretion. On the other hand, there is also a danger that discretionary prudential measures can add to the multitude of shocks and exacerbate rather than absorb them. Therefore, a sound practice of macroprudential policy should at least be partially governed by rules, in order to minimize the chance of adverse outcomes and to ensure that policy is consistent with the promotion of long-term financial stability. As you can see, there are strong validities on both sides.

The third issue is the international dimension of macroprudential policy. As I see it, going forward, the major source of risk to financial stability in Asian emerging markets is likely to be external. For example, the recent upsurge of capital flows can be a prelude to a number of common shocks to financial stability that can hit in the region in the future. In this environment, a unilateral approach to deal with the issue, through macroprudential policy, can be inefficient and may lead to more volatility as as investors engage in regulatory arbitrage across different economies. To address this dimension of the challenge, a more coordinated approach to macroprudential measures may be needed. Although steps towards formal coordination have yet to be established, ongoing close cooperation amongst regional economies has already resulted in a number of common platforms through which greater policy coordination can be conducted. For example, the Asean+3 Macroeconomic Research Office (AMRO) to be launched next year is already mandated to conduct economic and financial surveillance across the region. The office will be in a good position to study this type of policy coordination. In the meantime, more discussion among policy makers in the region should be encouraged, as we increasingly are facing common problems that are of a global nature. To this end, I would like to commend Bank Indonesia for organizing this international conference, which contributes tremendously to the region's discussion and efforts along this line.

It is on this note that I would like to end my remark. Thank you.