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Opinions

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Macro Prudential and Monetary Policy

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The Global financial Crisis during 2008 to 2009 had occurred even with the proper inflation managements. The world economy before the global financial crisis enjoyed the low inflation and high growth. Since most central banks targeted inflation, the monetary policy was lenient. Also, the policy rates were very low when compare with the previous period. Those relaxed monetary policies created the booms in financial markets and especially the real estate markets in the world flourished. As we all witnessed, however, the real estate market burst and the financial crisis took place. Monetary policies around the world have succeeded in achieving price stabilities but have failed to prevent the financial crisis.

Therefore, the needs for a policy other than monetary policy arose after the financial crisis. The monetary policy properly managed inflation before the global financial crisis and even after the crisis. If we exclude the first half of 2008, when the crude oil price overshot, the inflation in the world was no problem. Moreover, many countries experienced deflations after the crisis. However, the price stability did not guarantee the financial stability. Hence, the additional policy to regulate the financial sector was needed in order to prevent the recurrence of the financial crisis. The required policy has to have some characteristics that make it different from the former micro prudential regulations on the financial sector. One of the typical micro prudential measures is targeting on preventing the bankruptcy of a financial institution, since the financial institution's bankruptcy costs the government or the taxpayers in the course of restoring financial system. Thus, the typical micro prudential measures might not concern the financial institutions' activities during the economic booms, since the probability of bankruptcy is low during such times. Nevertheless, it is desirable to restrict the financial institution's activity during the booms in order to prevent them from creating a bubble in financial market. Considering the micro prudential measures alone, the financial institution's activity can be procyclical with business cycle, which may magnify the business cycle. So we call this sort of policy a macro prudential policy, because it intends to maintain the macroeconomic stability by regulating the financial sectors or the markets.

Korean monetary policy makers have already applied the macro prudential measures before and after the global financial crisis. Before the crisis, the LTV (Loan to value) and DTI (Debt to income) requirements were imposed on real estate related debts in Korea. As a result, the real estate price increase during the early 2000's in Korea was mild when compared to those in the US or Europe. During the global financial crisis, the debt withdrawals of foreign investors from Korea created the turmoil in Korean financial market and economy. Hence, the macro prudential measures after the crisis focused on restricting the foreign capital flows of bank debts and bond market. The debt inflows increased after the crisis and policy makers wanted to limit the capital flows in order to minimize the possible negative effect in case the reversal of flows takes place. These policies also restricted the liquidities into Korean financial market during the economic booms. The maturity structure of banking sector's external borrowing lengthened after such regulations and this may have strengthened the macro soundness of not only financial sector but also the whole economy against external shocks.

The capital requirements on banks can be another macro prudential measure. Until now, the capital requirements did not vary according to the business cycle, since it has been considered as a micro prudential regulation. This resulted in allowing the banks to increase the credit during the booms and reduce it in recession with the constant capital requirement. We can alleviate this problem by requiring more capital during the booms than in recessions. In this aspect, the Basel III capital requirement was designed to have enhanced capital requirements during the times when the policy makers think that the economy is in its up-phase.

There are several things that we ought to be careful about while applying the macro prudential policy and monetary policy together. First, we need to have a good coordination of the two policies. Macro prudential policy burdens the financial sector and the monetary policy does the same during the booms. Therefore, if one policy is applied without considering the impact of other policy, then policies might overdo their jobs. Second, we need to find a proper indicator to judge the business cycle. We need to figure out the booms and recessions in order to apply the macro prudential measure. While we have ample experience of implementing monetary policy, we have relatively few regarding the macro prudential policy. The previously discussed macro prudential policies only concern the financial sectors and thus, we need to find the related business cycle indicator from the financial sectors. The Basel committee on banking supervision recommends using the credit to GDP ratios, but it also recommends having supplementary indicators that are suitable for each economy. Third, we should know how to resolve the conflicts between micro prudential and macro prudential measures. For instance, the capital requirements during recession must be tightened in order to keep the financial institutions alive, but they must be relaxed to be countercyclical.

As the financial market gets more complicated and developed, we need to search for policy instruments other than monetary policy in order to keep the financial market and economy healthy. And this demand for additional policy tools and the necessity for investigating the relations between policies are calling for more research. KIEP