New ways to control hot money bubbles

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Is there anything governments can do to clamp down on “hot money” flows? That question has prompted much hand-wringing in recent months, as emerging markets have battled strong currencies and asset booms.

This week produced fresh evidence of this fight: Korea announced that it was imposing new equity derivatives controls to deter excessive stock market speculation. This follows other controls announced in recent months in places ranging from Brazil to India on cross-border flows.

But as South Korea clamps down, investors would be well advised to keep a close eye on what happens next. For the crucial thing to understand about what is going on in Seoul is that this is not just aimed at frothy stock markets or cross-border flows; nor is it merely about weakening the currency.

Instead, what Korea is essentially doing is launching an intriguing experiment in macroprudential policy, focused on bank regulation, as much as anything else. Seoul, in other words, is turning into something of a financial Petri dish, testing ideas to see whether it is possible to grow a new regulatory and financial culture.

The outcomes of this experiment could be thought-provoking – not least because this experiment comes at a time when European and US regulators are also looking hard at whether it would be possible to apply more activist and intrusive “macro-prudential” policies to their banks.

To understand this, take a look at a policy paper that was presented by Hyun Song Shin, a Princeton economics professor, to an economics conference in Denver last week. Shin has spent much of the last year advising the Seoul government, and the experience has left him – like many observers – cynical about whether orthodox monetary policy and regulatory tools can ever cope with bubbles.

Until recently it was generally assumed that the best way to prick credit bubbles was for a central bank to raise interest rates. However, in the case of Seoul, raising rates has notably not worked, since it generally attracts more inflows, fuelling the bubble further. And while regulators have traditionally focused on bank capital to make financial systems safe – and are continuing to emphasise this in the Basel III debate – Mr Shin thinks this misses the point.

After all, he points out, high bank capital ratios do not stop banks from amassing assets in a boom; just look at Ireland for evidence of that. Worse still, the Basel focus on the “loss absorbency of bank capital ... diverts attention from the liabilities side of banks’ balance sheets and vulnerabilities from the reliance on unstable short-term funding”. And it is this liability structure which fuels bubbles – and subsequent bank failures too.

So, Korea is trying a different tack. Last June it introduced a leverage cap on banks’ foreign exchange derivatives positions, which aims to stop banks hedging forward dollar positions with carry trades (ie those held in Korean won and funded in short-term dollars). Now, more importantly, its parliament is preparing to debate a “macroprudential levy”.

This would impose a charge of up to 50 basis points on banks’ foreign exchange denominated liabilities, with the levy to be raised or lowered by the ministry of finance, depending on whether the ministry thinks there is a bubble. The idea is thus to deter Korean banks from taking out too much short-term debt, even if dollar funding is ultra cheap – in much the way that London’s congestion charge is supposed to deter drivers from using their cars.

Unsurprisingly, such ideas provoke horror among free market economists; not to mention some hedge funds and bank traders. And in reality it is still unclear whether such macroprudential experiments will actually work. But Mr Shin is optimistic: after all, he points out, since Korea’s leverage cap was introduced last June, there is some evidence that Korean bank lending has slowed (although the won itself has notably not weakened).

And if nothing else, regulators will be watching closely to see what happens next if the new macroprudential level comes into force in June 2011, as planned. After all, one of the problems with the “macroprudential” debate until now is that it has all seemed irritatingly nebulous; precisely because this has not really been tried before, nobody has really known what it might look like.
But, as my colleague Brooke Masters revealed this week, global regulators are moving towards adopting a more “macroprudential” approach towards bank capital. But the more Korea (and others) experiment with levies, caps and taxes on liabilities and capital flows, the more paradigms may shift. Stand by for plenty of debate this year; not least because quantitative easing looks set to create more “hot money” bubbles – not just in emerging markets but in the developed world too.

*Macroprudential policies beyond Basel III; Hyun Song Shin, 22 November 2010

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