The Global Financial Cycle and Prudential Regulations

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Federal Reserve Board

Workshop on Financial Stability

RIDGE/Banco Central del Uruguay

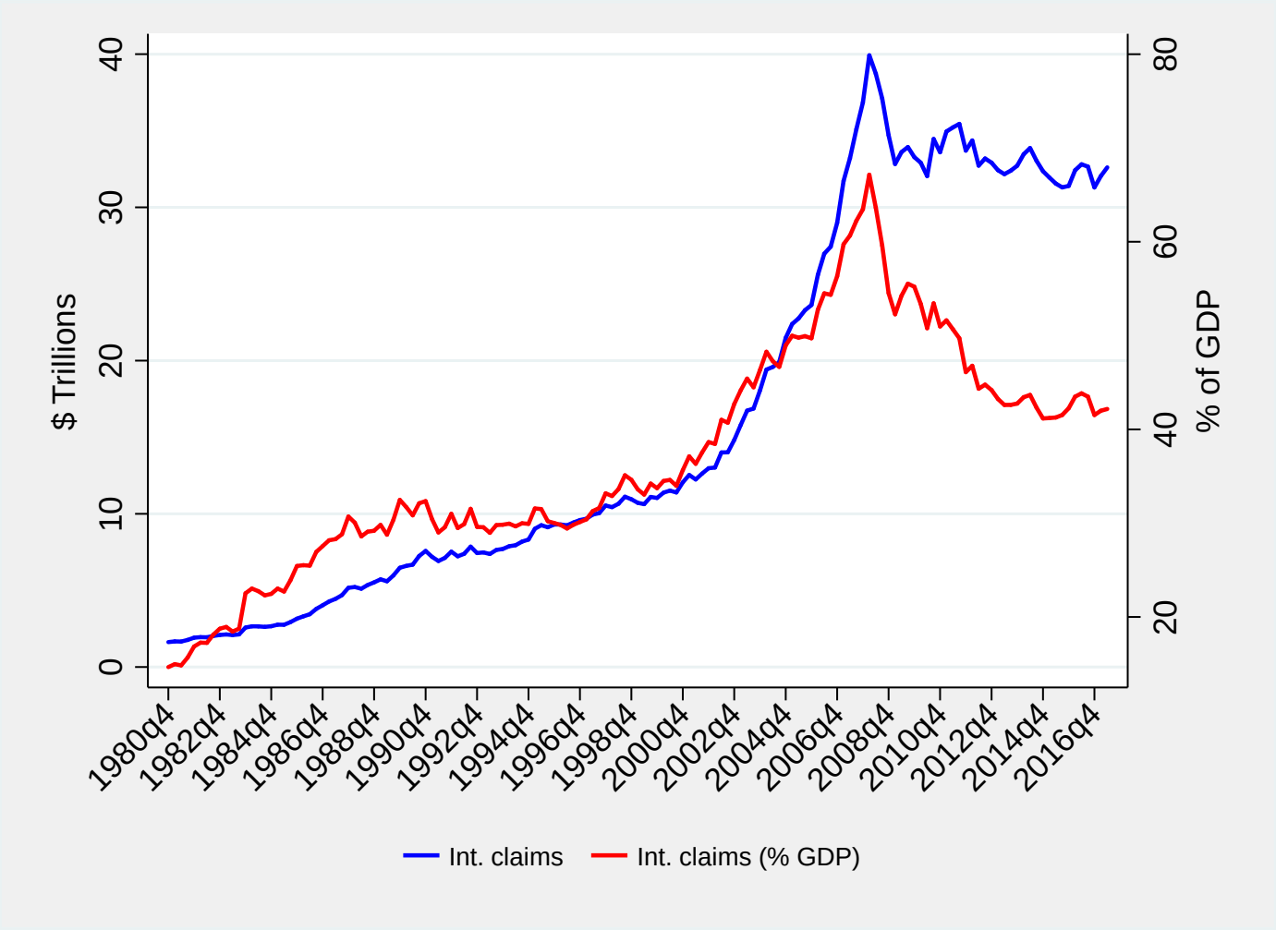
December 7-8, 2017

The views expressed in this presentation are those of the author and do not necessarily represent those of the Board of Governors or the staff of the Federal Reserve System.

Main issues

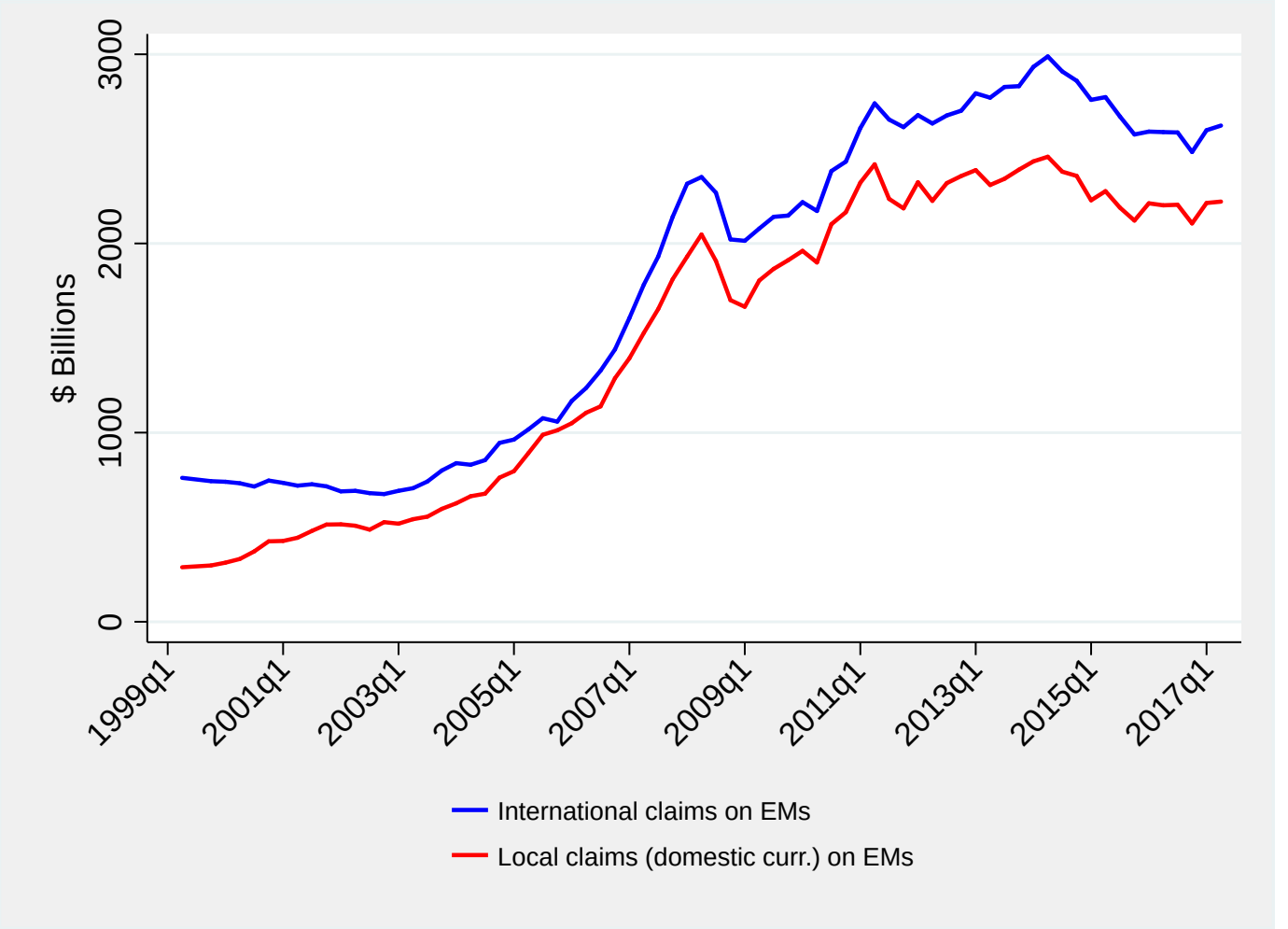
- Trends in international financing.
- Has the global financial cycle changed?
- The global financial cycle and prudential policies.

Global banking increased rapidly prior to the Global Financial Crisis, but has leveled off…



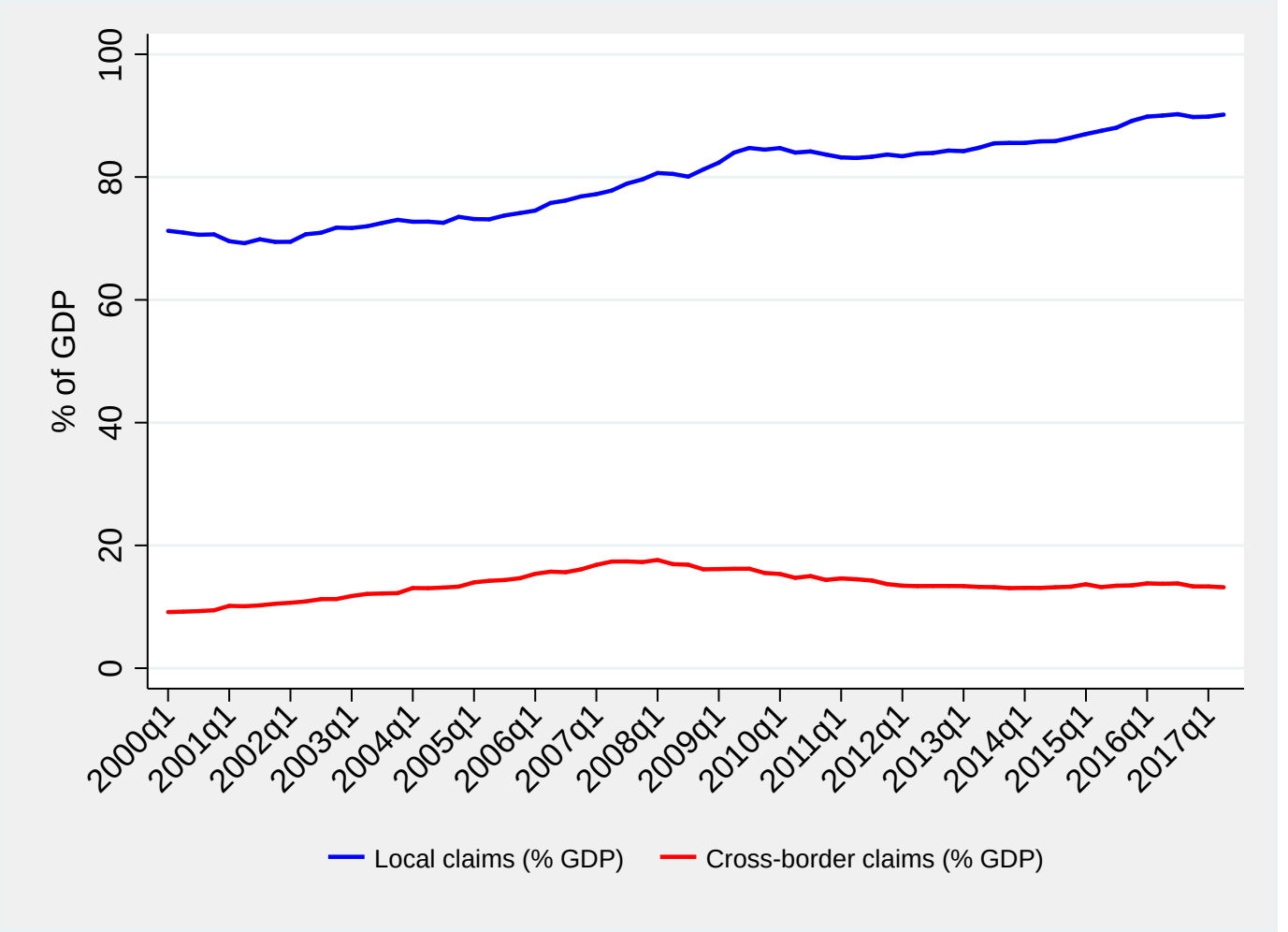
Source: BIS statistics.

Including the claims on emerging market residents



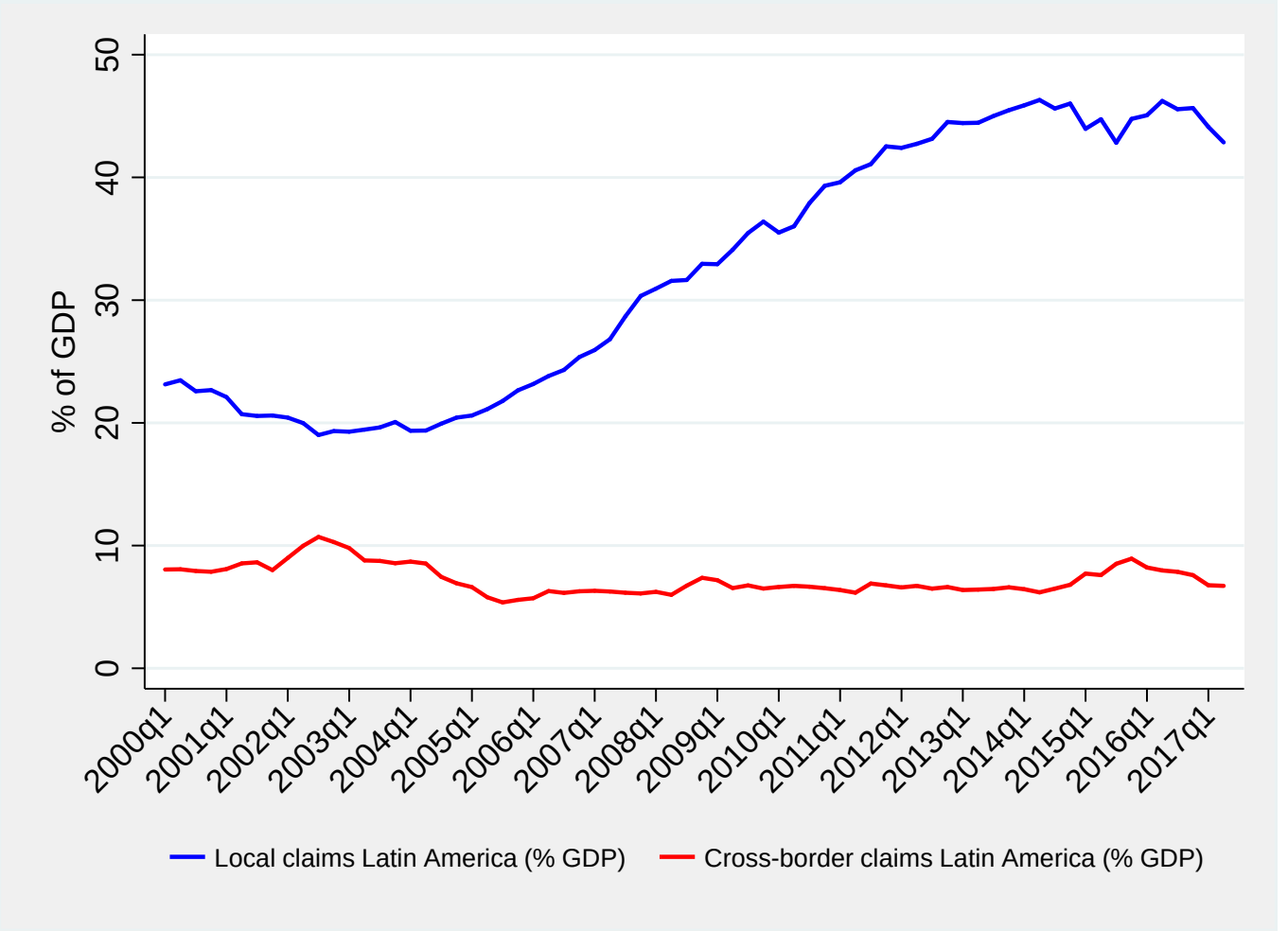
Source: BIS Consolidated Banking Statistics.

Domestic credit still the largest source of financing…



Source: BIS Statistics.

Also true in emerging markets (e.g., Latin America)

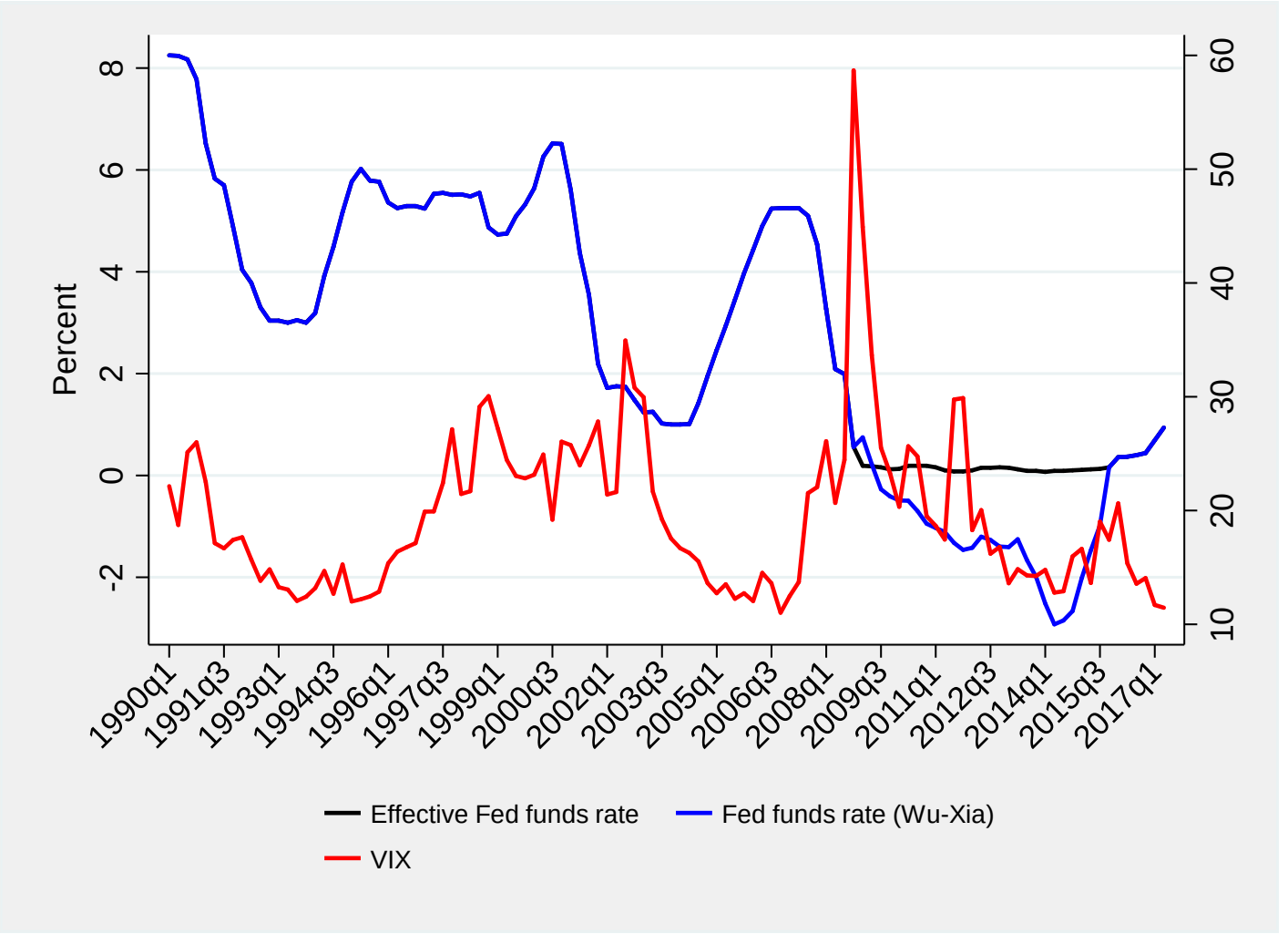


Source: BIS Statistics.

The Global Financial Cycle (1)

- Monetary independence may be affected by a global financial cycle (Rey, 2013).
  - The cycle is typically measured using asset price movements (Miranda-Agrippino and Rey, 2015), and correlates with measures of uncertainty (VIX) and financial stress.
  - The global financial cycle is affected by U.S. monetary policy, through bank lending and risk-taking channels (Rey, 2016).

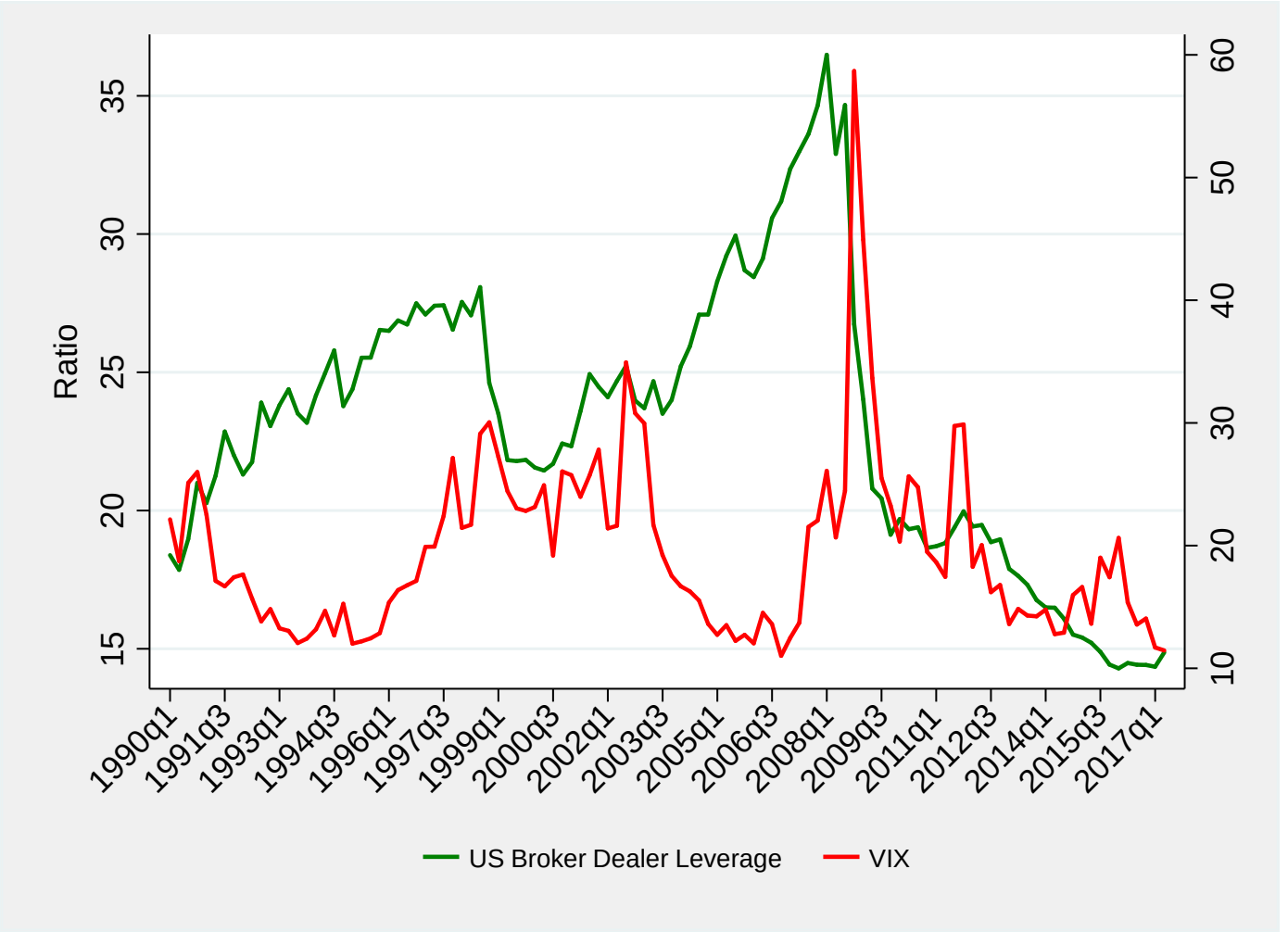
The VIX and U.S. monetary policy



U.S. monetary policy is weakly correlated with VIX.

Source: Haver Analytics.

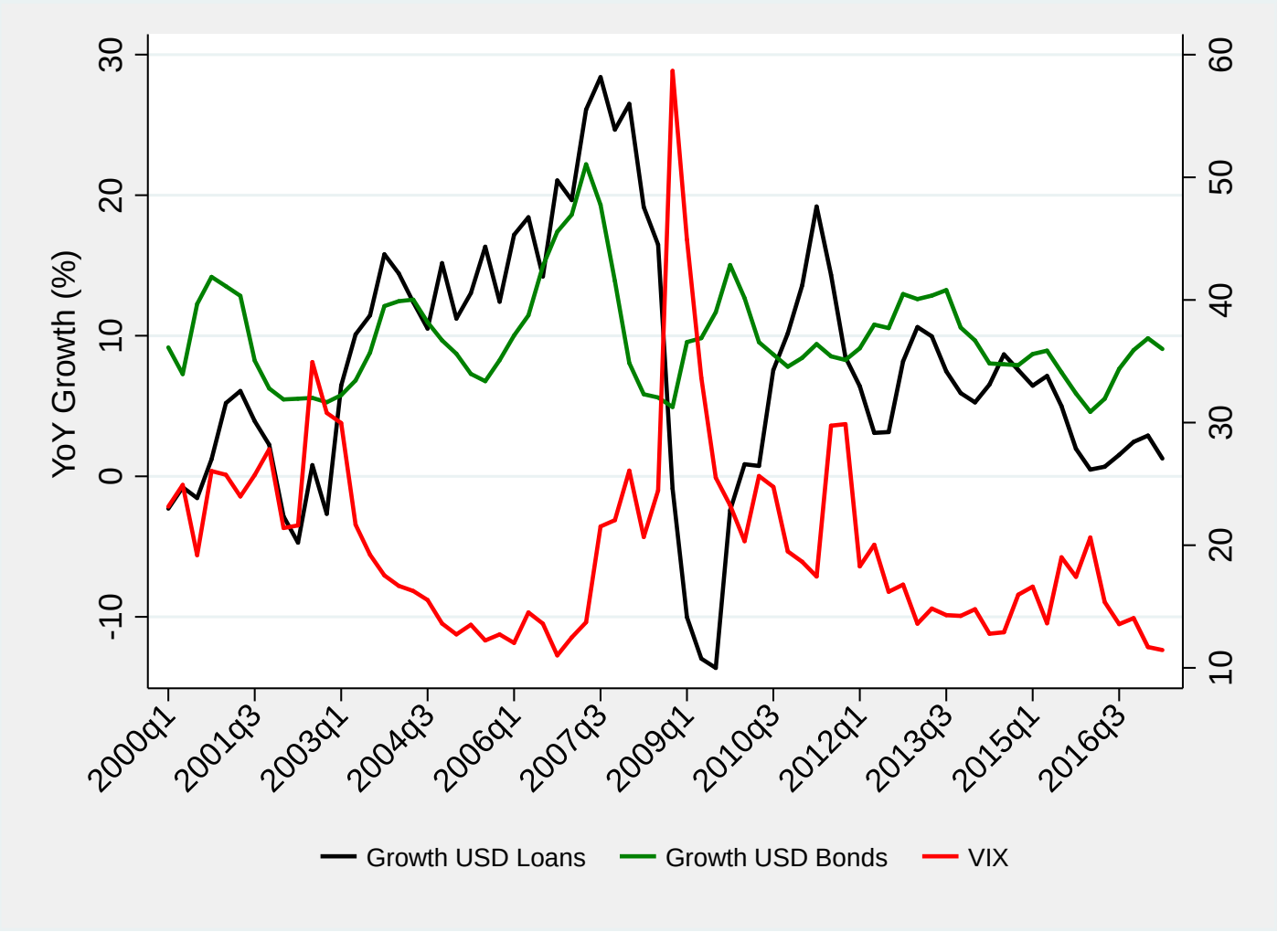
The VIX and U.S. broker-dealer leverage



Leverage is one of the transmission channels of the global financial cycle.

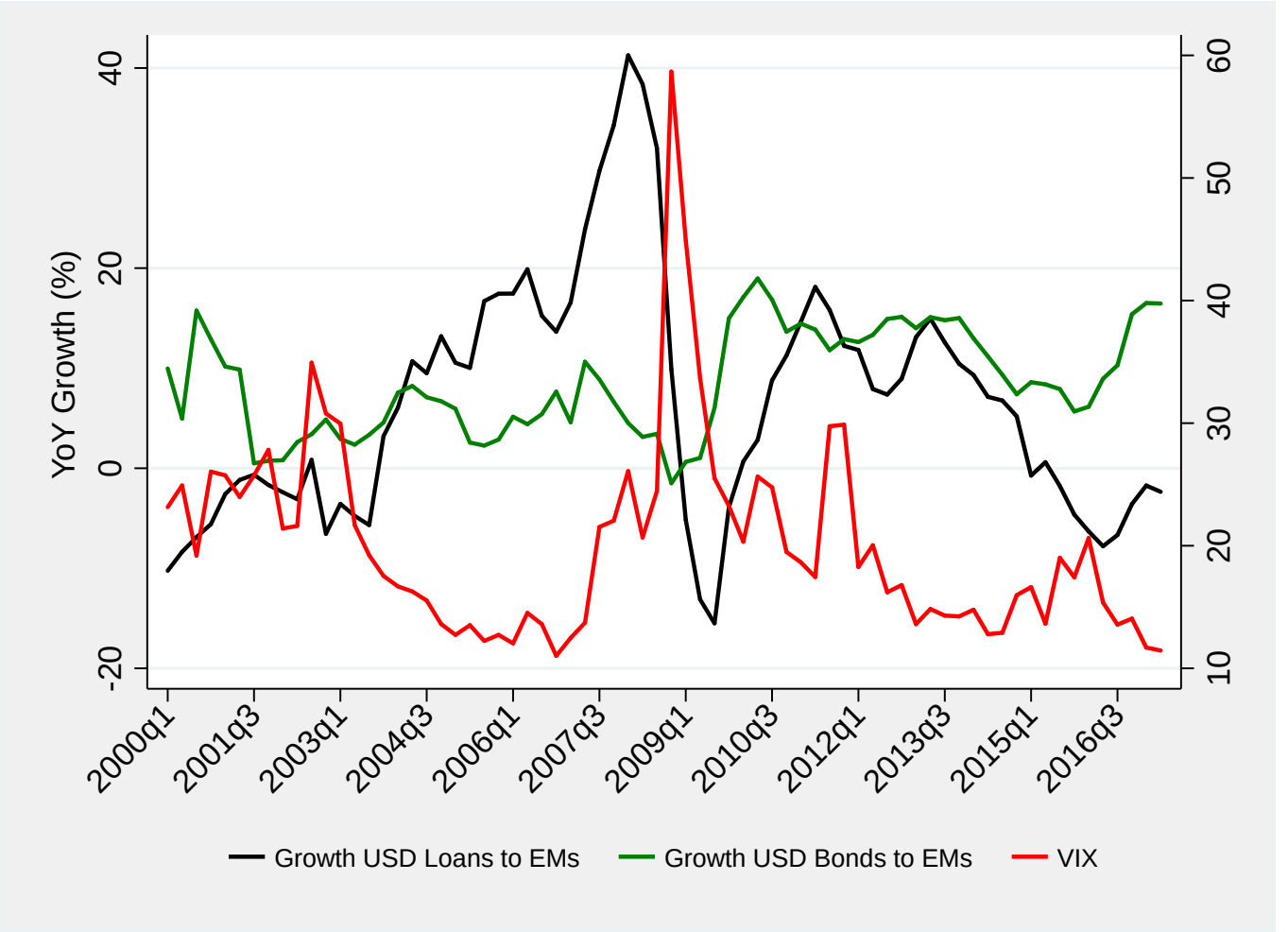
Source: Haver Analytics.

VIX, USD lending, and USD bond issuance



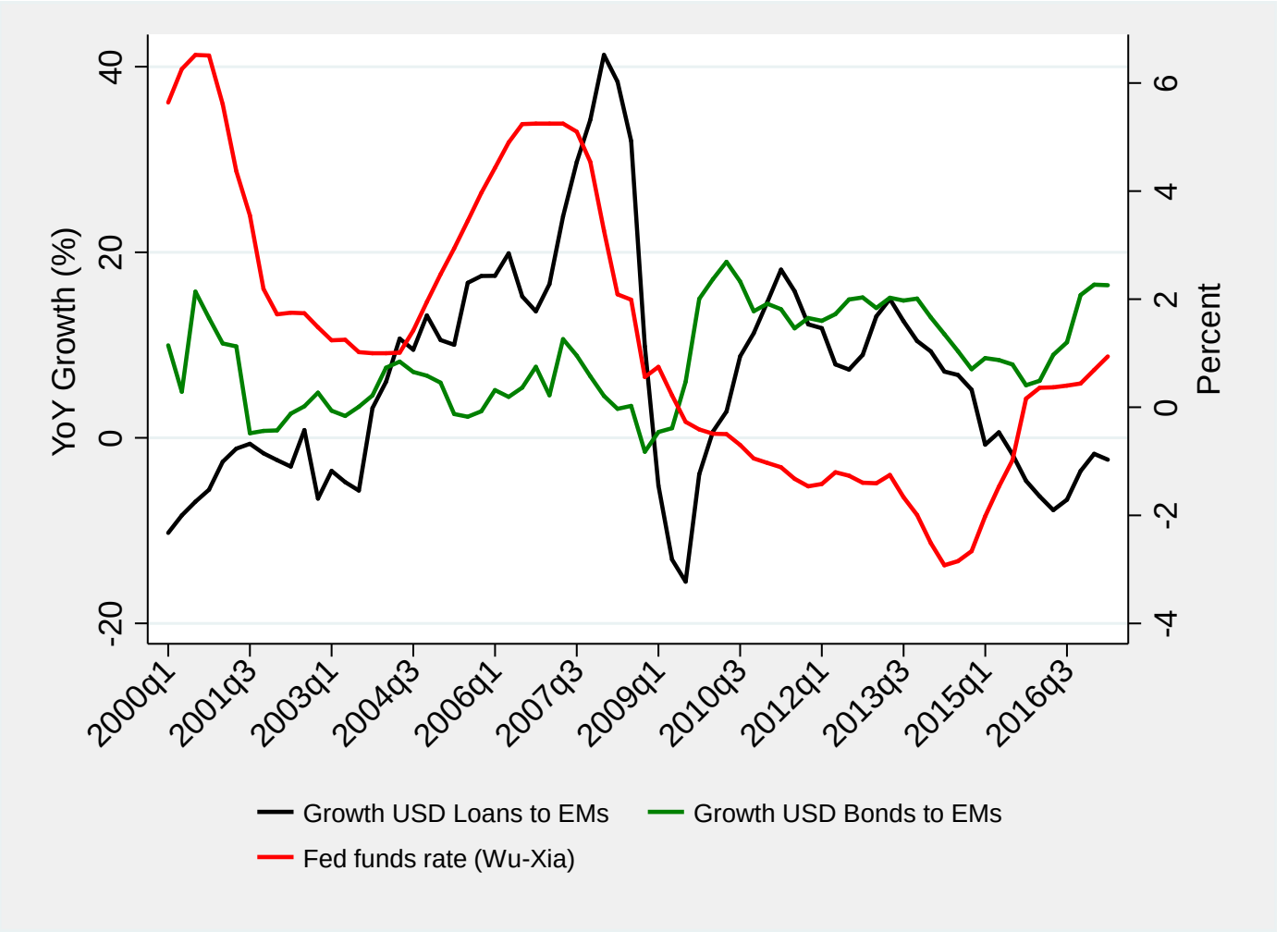
Source: BIS Statistics and Haver Analytics.

VIX, USD lending, and USD bond issuance by EM nonbank borrowers



Source: BIS Statistics and Haver Analytics.

US monetary policy, USD lending, and USD bond issuance by EM nonbank borrowers



Source: BIS Statistics and Haver Analytics.

The Global Financial Cycle (2)

- The importance and determinants of the Global Financial Cycle appear to have changed (Avdjiev et al., 2017).
- Its impact on capital flows may not be quantitatively important (Cerutti, Claessens, Rose, 2017).
- However, there are still measurable spillovers from AE policies that may affect EMs through financial channels (Iacoviello and Navarro, 2017).

Prudential policies and the Global Financial Cycle

- Interventions and cooperation should be justified (Korinek, 2017).

- Effect of prudential policies:
  - Capital requirements may reduce banks' international claims (Berrospide et al. 2017) and their sensitivity to domestic monetary policy (Correa et al., 2017).

  - Prudential policies in EMs may also curtail the impact of capital flows on domestic credit (Gomez et al., 2017).

Conclusion

- The Global Financial Cycle may depend on the structure and resilience of the global financial system at a given point in time.

- Key to reduce vulnerabilities in the domestic financial system to limit spillovers:
  - Leverage.
  - Maturity transformation.
  - Currency mismatches.