Chapter 39
The Effects of Macroprudential Policies on Financial Stability in Developing Countries

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ABSTRACT

In this chapter, the concept of financial instability is examined in terms of the policy instruments used by central banks. Although the policy instruments used in each country differ according to the country conditions, it is thought that the common factor among developing countries with a current account deficit problem is exchange rate volatility resulting from excessive credit growth and short-term capital movements. In this context, Argentina, Brazil, Chile, Colombia, Hungary, Indonesia, India, Mexico, Poland, South Africa, and Turkey are examined with regard to the effects of macroprudential policies on financial stability for the period between Q2 of 2006 and Q2 of 2017 by using the time-varying panel causality test developed by Dumitrescu and Hurlin. The results of the analysis indicate that excessive credit growth is a cause of the current account deficit. The same findings are also valid for interest rate. There is no obvious link between the exchange rate and the current account deficit.

INTRODUCTION

The idea that macroeconomic risks are affected by global financial markets in open economies has become increasingly widespread with the advent of globalization. Changes in risk perception owing to expansionary monetary policies by developed countries after the 2008 global financial crisis and capital flows becoming excessively volatile as a result of this approach are deemed as major macroeconomic risks. Capital flows are mostly directed towards developing countries, implying that domestic currencies of developing countries become overvalued and banks reach excessive credit levels. In other words, emerging economies encounter additional challenges owing to their vulnerability to inconsistent international capital flows. This situation has led to increased imports and an imbalance in demand,

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followed by the rapid deterioration of current account balances for developing countries. Disruption of short-term capital inflows, credit expansion and current account balances have caused financial fragility post-2008 financial crisis, thus leading many countries to re-examine their existing economic policies (CBRT, 2015; Hannoun, 2010) At this point, the most important change is the abandonment of the idea that financial stability will occur spontaneously when price stability is attained. At the same time, this idea has led to central banks using diverse and highly complex policy tools. Individual countries have developed different policy tools according to their circumstances to mitigate the effects of the global crisis. In this context, many countries have attached particular importance to variables such as credit growth and exchange rate, and have thus developed new policy instruments that can control these variables in order to provide financial stability. These instruments, which have been used to provide financial stability, together with price stability policies, used to monitor and mitigate the risks that may arise in the financial system, are included in macroprudential policies. These policies are mainly designed to reduce the adverse effects on the financial system and the real economy of the risks that may arise owing to financial problems. Financial sector stability plays a vital role in achieving sustainable economic growth. Overcoming market friction and encouraging economic growth is realized through effective financial institutions and markets.

In this chapter, the aim was to determine how macroprudential policies related to credit growth and exchange rate fluctuations affect the financial stability of developing countries with a current account deficit. The rest of the chapter is organized as follows. In the next section, the concept of financial stability is defined and the importance of financial stability is addressed. In the third section, the roles of central banks in ensuring financial stability are discussed and policy tools are examined. In the fourth part, a time-varying panel causality test is applied to 11 countries with a current account deficit. In the final section, the findings are summarized and recommendations for future research are provided. This chapter will make an important contribution as it assesses financial stability in terms of central bank policies.

BACKGROUND

Financial Stability and Macroprudential Policy

The 2008 global financial crisis created an environment in which most of the known facts about the dynamics of the economy were questioned in many countries and it was realized that focus on individual institutions alone could not efficiently counter the systemic risk to the financial market. Since the financial crisis, some of the most commonly asked questions are how to detect systemic risk and what steps would be taken to avoid such a formidable crisis again. The Financial Stability Board, the International Monetary Fund and the Bank for International Settlements (2009) describe systemic risk as "a risk of disruption to financial service that is caused by a deterioration of all parts of the financial system and has the potential to have important negative results for the real economy." The most general definition of systemic risk is the failure of the whole system, which seriously impairs financial markets and damages the economy widely because of the links and interdependencies between entities. In spite of doubts about how to manage systematic risk, there are opinions in the literature about how best to do so. For example, the Group of Thirty analysts (G-30, 2010) suggest using some macroprudential tools, such as avoiding systematically high leverage levels, providing the necessary liquidity for sound operation of the market, regulating market actions, and overcoming excessive credit growth. Clement (2010)