New Macro-Prudential Measures to Mitigate Volatility of Capital Flows

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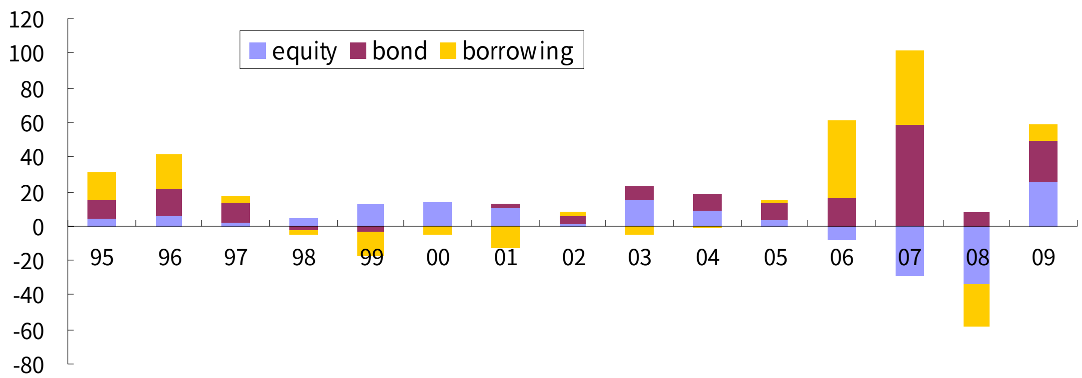
Disclaimer: This note is provided as a supplementary material to the official press release to help non-Korean speakers understand the press release.

Ⅰ. Background

The past two financial crises highlighted the need for dealing with volatile capital flows: Excessive capital inflows during boom periods and sudden outflows in times of bust created a severe financial crisis, and even with its strong economic fundamentals, Korea has witnessed sudden capital outflows due to the global financial crisis in late 2008.

Of the various categories of capital flows, those associated with increases in banks' borrowing need special attention. Since 2006 the volatility in banks' external borrowing began to magnify prior to the onset of the crisis, and its level of volatility was higher than any other portfolio investments.

< Capital flows to and from Korea (1995-2009, billion USD) >



Such high volatility is due to Korea's heavy dependence on foreign trade and its open and liberalized capital market. Like many other emerging and developing economies, Korea with a small and open economy is highly vulnerable to the fluctuations of the global economy and the consequent capital flows.

It is time to undertake macro-prudential measures to curb excessive volatility of capital flows. **Thus, the Korean government will reinforce macro-prudential measures to reduce capital flows volatility within the current framework of the open and liberalized economy**. The Korean government plans to establish minimum "safety net" beforehand in accordance with internationally agreed standards in order to avoid potential risks and increase its resilience to a financial crisis. It is important to note that the government does not intend to control capital flows such as levying financial transaction taxes or requiring variable deposit requirement (VDR).

Meanwhile, these measures are to be implemented from mid-July 2010.

Ⅱ. Specific Measures

A. Implementing macro-prudential measures

Specific policy responses are:

- Ceilings on FX derivatives positions of banks
- Regulations on foreign currency bank loans
- Prudential regulations for improving FX soundness of financial institutions

1. Introducing New Ceilings on FX Derivatives Positions

New limits for FX derivatives positions of domestic banks and branches of foreign banks will be set.

FX derivatives trading (including FX forward, FX swap, cross currency interest rate swap (CCIRS), non-deliverable forward (NDF), etc.) between banks and enterprises, shipbuilders or asset management companies, led to the increase in short-term overseas borrowings, which was one of the main factors behind the surge in short-term external debt in 2006~2007. Specifically, about half of the increase in total external debt of USD195 billion in the same period is credited to the increase in FX forward purchased by banks. However, under the current rules banks can buy FX derivatives contracts without any limitations.

Thus, the government sets new limits on FX derivatives contracts of domestic banks and branches of foreign banks. The ceilings on domestic banks' FX derivatives contracts will be no more than 50% of their capital in the previous month. In case of foreign bank branches, the ceilings will be set at 250% of their capital in the previous month, given that their current level is around 300%.

The new restriction will be implemented in a flexible way. First, the ceilings will be adjusted on a quarterly basis depending on the future economic conditions, market situation, and the impact on the business activities, etc. Second, the measures will come into effect with a three-month grace period considering the burden of banks to decrease FX derivatives positions at once. Furthermore, the principle of "grandfathering" will be considered: For example, in case the existing FX derivatives position is more than the positions of the New Ceilings, the banks can maintain their existing positions of FX derivatives for maximum two years.

2. Reinforcing the Regulations on the Use of Foreign Currency Bank Loans

The regulations on the use of bank loans in foreign currency will be tightened.

Recently banks' foreign currency funding, which sharply declined in the wake of the recent financial crisis, is likely to increase significantly on the back of a strong economic recovery and arbitrage transactions. It is necessary to prevent excessive foreign currency bank loans from turning into systemic risks.

Thus, the regulations on the use of bank loans in foreign currency will be tightened. In current rules, foreign currency bank loans should be for overseas use only, but purchasing domestic facilities is an exception. The fundamental rules will be maintained: **Foreign currency financing should be operated for overseas use only.** However, the exception will be applied only to small and medium-sized manufacturers: **Small and medium-sized manufacturers will be exceptionally allowed to operate it for the purpose of purchasing domestic facilities**, to the extent that total foreign currency bank loans of small and medium-sized manufacturers stay at the current level. And the reinforced regulations will be applied only to new bank loans in order to alleviate the impact on the business activities

3. Improving FX Soundness of Financial Institutions

Authorities will tighten existing regulations on banks' foreign currency liquidity.

First, the government will tighten existing regulations on foreign currency liquidity of domestic banks: "Regulations on foreign currency liquidity ratio" and "Regulations on the ratio of mid- to long-term financing" currently applied to domestic banks will be reinforced. **In the same context, branches of foreign banks will be recommended to set up their own liquidity risk management mechanism, which is already applied to domestic banks in Korea, in order to enhance their ability of liquidity risk management.** This new system for the branches is similar to that of the UK, newly adopted after the 2008 crisis.

B. Improving Crisis Response capabilities

The Korean government will continue to enhance its ability to absorb volatility of capital flows in a long-term view.

Specific measures are:

- Monitoring capital flows
- Building up global financial safety nets

1. Monitoring Capital Flows

A headquarter for monitoring capital flows will be established inside the Korea Center for International Finance (KCIF) for regular and comprehensive monitoring and managing an early warning system. The system will be designed and upgraded constantly to forecast the possibility of a crisis caused by capital flows.

2. Establishing Global Financial Safety Nets

To prevent future financial crises, the need for establishing global safety nets through international cooperation has been growing as emerging economies with high external dependence have severely suffered from FX liquidity crunch during the recent global financial crisis. **Building up global financial safety nets will be pursued as the Korea Initiative at the Seoul G20 summit.**

At the same time, the funding system and the monitoring ability of the Chiang Mai Initiative Multilateralization (CMIM) will be advanced to improve crisis response capabilities of the Asian region.