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# PRUDENTIAL REGULATION FOR FINANCIAL STABILITY IN ECONOMIES WITH FINANCIAL DOLLARIZATION

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# The mechanism described in the paper

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The mechanism operates as follows: When non-resident banks perceive an elevated risk of default by a domestic bank, similarly to a run scenario, they reduce dollar funding to that bank. In response, the affected bank raises interest rates on dollar deposits and unwinds FX swap positions to meet non-residents' withdrawals. This response diminishes the bank's profitability and elevates its risk of default.

The impact, however, extends beyond this single bank. Financial distress at one bank affects other (non-distressed) banks by intensifying competition for dollar deposits. Non-distressed banks, losing cheap dollar deposits to the distressed competitor that has raised rates, similarly increase their own rates on dollar deposits, which narrows their profit margins and heightens their financial vulnerability.

This, in turn, prompts a further reduction in dollar funding from non-resident banks. Forced into a similar situation, these banks also unwind their FX swap positions. The collective unwinding depreciates the exchange rate, an impact that individual banks do not internalize. As the exchange rate depreciates, depositors shift from local to foreign currency deposits, positioning banks as net dollar borrowers. Regulations prohibiting open FX positions then drive banks to increase their dollar demand in the FX spot market, further intensifying downward pressure on the exchange rate.

# Relation with the FTP concept

When non-resident banks perceive an elevated risk of default by a domestic bank, similarly to a run scenario, they reduce dollar funding to that bank. In response, the affected bank raises interest rates on dollar deposits and unwinds FX swap positions to meet non-residents' withdrawals.

An increase in domestic FX deposits would not supply FX reserves to that bank. However, this bank may in fact increase FX deposits and loan rates if it faces risk premium on the FX money market.

This response diminishes the bank's profitability and elevates its risk of default.

The interest rate hike is a profit-maximizing response according to the FTP. Although higher loan rates may affect the bank's balance sheet's growth rate.

# Relation with the market structure and competition issues

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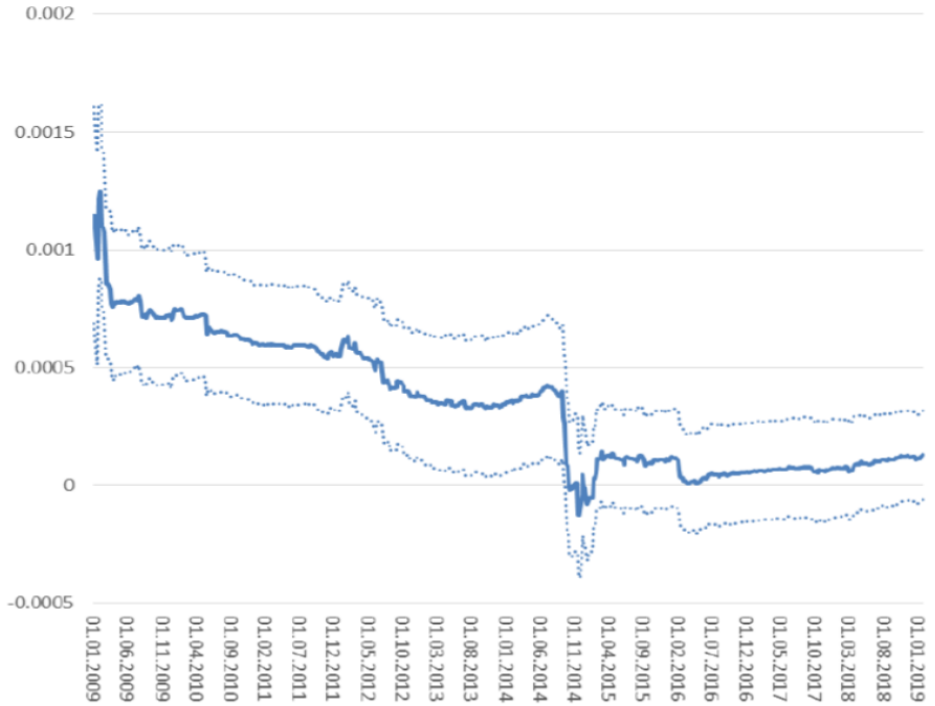
Do “UIP-adjusted rates” actually matter if the banks have balanced FX position?

Other banks face more competitive rates on FX deposits and less competitive rates on FX loans markets. The outcome is unclear.

# Relation with the ‘fear of floating’ concept

This, in turn, prompts a further reduction in dollar funding from non-resident banks. Forced into a similar situation, these banks also unwind their FX swap positions. The collective unwinding depreciates the exchange rate, an impact that individual banks do not internalize. **As the exchange rate depreciates, depositors shift from local to foreign currency deposits, positioning banks as net dollar borrowers.** Regulations prohibiting open FX positions then drive banks to increase their dollar demand in the FX spot market, further intensifying downward pressure on the exchange rate.

Time-varying sensitivity of changes in households’ deposits dollarization to ruble depreciation rate (± 2 standard errors)




Under this concept the source of initial exchange rate shock does not matter. What matters is the exchange rate expectations’ formation and the exchange rate regime (Barajas and Morales 2003, Khabibullin and Ponomarenko 2022).

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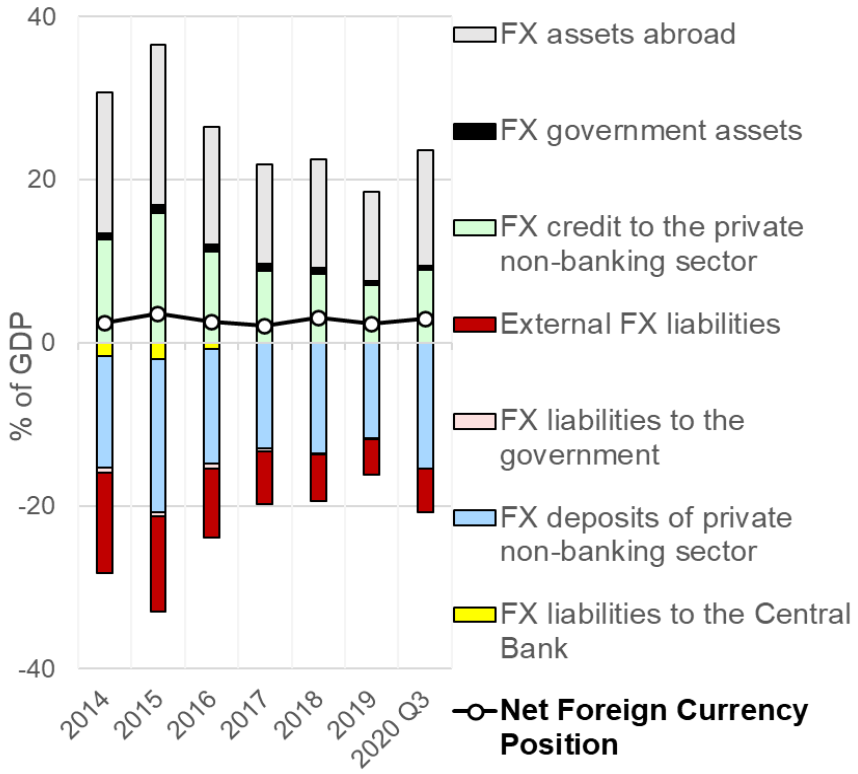
# Relation with the procyclicality of capital flows concept

I then apply the model to assess the effectiveness of a specific prudential measure aimed at mitigating inherent fragility within the banking system. Specifically, I introduce a 5 percent prudential tax on banks' borrowing in foreign currency from non-resident banks, as in Aoki et al.(2016) and Korinek (2010). The objective is to reduce the risks associated with banks' reliance on foreign currency funding through wholesale markets, which has been shown to be volatile.




Banks are not usually exposed to (direct) exchange rate risks. However banks' heavy reliance on domestic FX deposits and loans markets to make profit and crucial dependency on FX money markets' availability may indeed represent an unsustainable business strategy.