International Workshop on 'Macroeconomic Management and Financial Regulation in Core Countries and the Periphery', organised by CAFRAL, Levy Economics Institute & IDEAs, India Habitat Centre, New Delhi, India, 6-10 January, 2014

Workshop Report

DAY 1: JANUARY 6, 2014

Session 1: Introduction to the Workshop: Mapping the global policy and regulatory terrain

C.P. Chandrasekhar (Jawaharlal Nehru University, IDEAs) welcomed all participants on behalf of IDEAs, CAFRAL and Levy Institute. He began on the note that the broad idea behind the workshop is to look deeply into the emerging discourse and debates on regulation and macroeconomic management in the post-crisis scenario across the world. Though the focus now has shifted towards a set of macroprudential regulations while ensuring injection of liquidity into the system, the issues on rule based versus macroprudential regulations need to be revisited in a world fraught with systemic risks. With that objective in mind, practitioners of regulation in different context – mainly from Asia and Africa – have been invited to look into the details of these issues.

Usha Thorat (Director, CAFRAL) outlined major issues linking macroeconomic management and financial regulation which affect all countries, particularly the countries in the periphery. She poined that there is always scope and opportunities for individual discretion for different countries according to its need and specificity. However, despite the country-specific differences there are certain impacts that policies of the core countries may have on the periphery. The recent example was the currency depreciation in India during July 2013. With the decoupling hypothesis falling apart, the issues of financial stability then come to the foreground along with the issue of inclusive nature of economic growth.

Different concerns of different countries to ensure inclusive growth without hampering price and financial stability also involve monetary policy and fiscal policy because the global slowdown affected all countries and the fiscal stimulus is utilised in some form or the other. So, there are both convergences and conflicts among monetary and fiscal policies along with fiscal stabilisation policies.

As central banks have two sets of instruments – monetary policy and macroprudential instruments - creating buffers and cushions through these instruments in the system becomes very important. Similarly, creation of sector-specific safeguards in sectors like real estate is also equally important as real estate markets have been the source of financial instability in the recent past.

Similarly, capital control, financialised commodity markets and their contribution to financial instability are other areas where prudential measures need to be applied after detailed and continuous discussion. Since today’s financial world is so much interconnected the issue of handling the exit from unconventional monetary policies in the core also creates huge concern for the countries in the periphery. With that, the instruments like foreign exchange intervention, exchange rate policy and controlling the currency mismatch also become very important. However, the focus should be also on mobilising domestic savings and capital, and minimising the dependence on foreign capital. Here she also emphasised the need of financial cooperation between the core and periphery to avoid policy mismatch. As public funding shrinks generally all over the world and private funding creates tension and instability in the system, the issue of mobilising resource for developmental work like infrastructure is also very important in this context.

IMPLICATION OF NATIONAL MONETARY POLICY RESPONSES TO THE CRISIS

Session 2: Exceptional Monetary Policy in Response to the Crisis: US, Japan and the EU

Jan Kregel (Levy Economics Institute) started by highlighting the panic response of monetary policies in the time of crisis. He began with the case of Japan. This was during the Reagan era when tax cuts were imposed to boost the US economy along with a contradictory monetary policy of regulated money supply growth. As a result of those US policies, both fiscal and external deficit rose sharply and finally the US dollar faced devaluation. There had been a surge of capital inflow towards Japan during this phase as Japanese Yen became an alternative investment instrument. As a result of this, Japan was faced with a position where large capital inflows, appreciating currency, increasing stock market prices, and increasing land prices, led to build up of a very large bubble. Japanese central bank wanted to increase interest rate to cut off the speculation, but by that time the US growth rate had plummeted and America prevailed on Japan to keep their interest rate low. Japan kept their interest rates almost down to zero and resorted to fiscal stimulus to energise their economy. Unable to deal with the rising fiscal deficit, the Japanese economy collapsed subsequently. That was the first major instance of a similar crisis the world is experiencing now – but due to a different reason – namely, inappropriate and incompatible domestic policies taken by the US.

This also shows that though the effect of a crisis may look similar to others but the reason for and origin of all the crises are historically different. In the USA, even during the Great Moderation there had been low intensity crises. For example, Citibank was in trouble since the 1980s and by 1996 the real estate bubble started showing first signs of collapsing which culminated into the 2007-08 collapse. That transformed into a financial system crisis in an interconnected financial world and subsequently resulted in a full-fledged economic crisis.

In the UK also there had been real estate bubbles and highly indebted households. When a relatively small mortgage bank, Northern Rock, faced a bank run while expanding its balance sheet by borrowing short term in wholesale money market, the whole system collapsed in a cascading effect. Similar stories started enacting themselves in other parts of the Europe as well. The French banks earlier thought that they would beat the American investment banks in their own game and started expanding, and finally collapsed. Last in the series of crises is the European sovereign debt crisis. While Greece actually stared at the possibility of a default, other countries like Spain, Italy and Portugal also showed distinct signs of vulnerability.

So, the basic reasons behind all these crises are different but there is one similarity in central bank responses to these crises. That is the central banks' willingness to expand their balance sheets to absorb assets that private sector were unwilling to hold, and to provide the private sectors assets that they were willing to hold. In effect, those assets were finally the claims on the central banks itself. However, now the issue in discussion is the set of means by which the central banks can restore normalcy in their balance sheets once again. Various forms of extraordinary unconventional monetary policies employed in different countries, mainly by introducing easy money and lower rates, reflect that trend.

If we look at the comparative GDP performance of major affected countries then we can see that the USA and Japan managed to recover, though not fully. Compared to that if we look at the countries which tried to mend government's balance sheet along with supporting financial institutions (in other words, tried to support financial system along with a reduction in government deficit), these countries were unable to reach the GDP performance of last quarter of 2007. Greece, the UK and the EU (overall) are such economies. As growth rates continue to fall in those countries, the difficulty of moving those assets out of government's balance sheet increases.

Session 3: Implications and Importance of Central Bank Independence in the Aftermath of the Exceptional Measures

Arturo O'Connell (Central Bank of Argentina) started his presentation by emphasising the need to learn about exceptional measures in the wake of the crisis – especially from developing countries and emerging economies by means of interaction. Crafting reforms for banks, even those labelled as structural ones, has been an active sphere of activity in the last few years. Most attempts at actual restructuring, however, have barely left the documents where the proposals were drafted like those in Vickers and Liikanen proposals or Volcker rule.

No consensus has been struck on a different permanent role for central banks beyond the present day crisis, not even on their role in preserving financial stability. Thus, the expression "exceptional measures" has been concocted as a fragile fig leaf to justify policies that are unacceptable for the orthodoxy of last quarter of a century about accepted roles and norms of central banks. But these policies immediately, even prematurely, are abandoned as soon as so-called "green shoots" of a recovery appear.

Among the first few crises to hit developing countries, there were the banking crises in Southern Cone countries in Latin America at the beginning of the 1980s – mainly in Argentina, Chile and Uruguay – as a result of widespread domestic and external financial liberalisation. These financial crashes took place much before the more well-known debt crises. Argentina suffered major banking crises in March 1980, and something similar happened in Chile and Uruguay in 1981. Both fiscal costs and output loss of these crises, with respect to the prevalent trend and as a proportion of their GDP, were substantial compared with the present day crisis.

Arturo O'Connell felt that the central bank's ambit goes beyond just inflation control – more so when there is a distinct need to boost demand in the economy in the absence of a pro-active and effective fiscal stance, due to various reasons including lack of political willingness. The more fashionable plank of "independence" in the recent past should not deter the Central Bank to shift away from this accountability and responsibility. There is also a need for a group thought process within the central banking system, and ultimately it is a fight to resist the measures by which the focus of the financial system is shifted towards the private sector – by invoking so called "independence" in the central bank and by making it a non-interfering financial agency in the macro system.

DAY 2: JANUARY 7, 2014

IMPLICATIONS OF POLICY RESPONSES TO THE CRISIS ON GLOBAL ECONOMIC PERFORMANCE

Session 1: The Persisting Crisis in Europe: Implications for the rest

Prabhat Patnaik (Jawaharlal Nehru University) began on the note that the idea of a group of countries either having a common currency or a system of fixed exchange rates between their respective currencies, and in which there is a limit on government spending either because of sound finance, or balanced budget, is an idea which underlies the Eurozone. This, however, is not a new phenomenon as, in a sense, even the Gold Standard represented such a mechanism. However, what is different today is that unlike in the past when a set of factors operated to prop up the Gold Standard, they no longer exist today. Thus, given that the Eurozone has nothing to overcome this lacuna, there are certain fundamental flaws in it.

Using the macroeconomic identity, he argued that if consumption, government expenditure (because of fiscal responsibility legislation or balanced budget as in the case of the Gold Standard) and investment are functions of income, in such situations the level of economic activity depends on the magnitude of net exports or on the current account surplus. Further, the current account surplus itself, via the level of activity, determines the level of capacity utilisation and therefore the level of investment and hence the rate of growth of an economy. Thus, in a situation where a set of countries are tied together under a common currency and in which government expenditure is tethered to government revenue, countries with higher current account surplus relative to output would experience higher growth rate, while countries with current account deficit would experience lower growth rates. It follows, therefore, that in this kind of a world for an economy to grow it has to push out current account surpluses – something that Keynes had recognised as a feature of the Gold Standard and had attributed (although incorrectly) the historical occurrences of wars to the fact that countries competed against one another to get hold of markets to earn current account surpluses. There is, however, an alternative way in which an economy can grow in such a world i.e., by a change in the functions themselves through, say, a credit sustained bubble. A credit sustained bubble would change the nature of consumption function as well as the investment function. But such bubbles can neither be made to order nor can they be sustained for long.

Regarding the possibility of other mechanisms that can make such a system work, **Prabhat Patnaik**, noted that a deficit ridden country in need of raising the level of activity to get rid of the deficit, faces two specific problems that makes it difficult to rectify the problem. One problem is of financing the deficit. And the second problem is of low aggregate demand on account of the deficit. Since the deficit lowers the level of activity, which in turn impacts investment adversely, this prevents modernisation, increase in labour productivity and hence it prevents the country from getting into the competitive track. Therefore, a deficit tends to be self-perpetuating as it becomes difficult to overcome the deficit by re-acquiring competitiveness since new investments would not be undertaken in a situation of reduced level of activity. The other problem is that the deficit has to be financed, in the absence of which the level of activity would reduce further and the country would get into a worse situation. Therefore, it is not enough that the deficit be financed through capital inflows, but investment must also increase in the deficit economy.

The only possible way out of this problem, he argued, is if a leading country with current account surplus within the group, such as Germany, runs a fiscal deficit, say, by making transfers to its population. This would make the German population better off, raise the level of employment in the zone as a whole owing to an increase in aggregate demand and finally, it would reduce the imbalances within the group. The third effect arises because the demand generated by the fiscal transfers would result in an increase in demand for other countries' exports (assuming that German economy does not have much unutilised capacity). However, such a move would not happen for various reasons.

Discussing the reasons behind the success of the Gold Standard, **Prabhat Patnaik** opined that it was colonialism which made the mechanism successful. Britain, the leading country, ran a current account deficit vis-à-vis continental Europe and the United States. It not only financed this deficit but even made massive capital exports to these very regions and to other temperate regions of white settlement, by using the current account surpluses of the colonies vis-à-vis these regions, for which however the colonies never got any credit.

So, the end of the Eurozone crisis is far from being imminent. While a possibility for its abatement would arise if the world economy itself revives, there are no obvious stimuli that can bring this about. This is because the US is unlikely to run a larger fiscal deficit to pull the world economy out of the crisis because it is an economy with a current account deficit, which, unlike Britain in the pre-war period, cannot fall back upon any colonial "tribute." Besides, the opposition to fiscal deficits in the U.S. is strong. A coordinated fiscal stimulus by a number of countries acting together, such as what Keynes had suggested during the 1930s Depression, is as unlikely today as it was then. What remains as the only possible way out of the crisis is the development of a new "bubble." The Eurozone economies like the rest of the world economy are in effect waiting for such a new "bubble" to happen, which seems to be nowhere in sight, at least in the near future.

Session 2: European Policy Response and Regional Development: The case of Greece

The presentation of **Gennaro Zezza (Levy Economics Institute, University of Cassino, Italy)** focussed on Greece, where the sovereign debt crisis of Europe started. He, however, argued that the debt crisis is not the first cause of the European mess, and there were other causes underlying the imbalances in the Eurozone which eventually brought about the crisis. The crisis in Greece started in 2009 when the government had trouble rolling over its existing debt as they had largely gone above the agreed levels for the Eurozone, and later Greece turned to the Eurozone institutions and the IMF for help. In his opinion, if at this stage the Eurozone institutions had agreed to help the Greece government, by possible suspension of the 3 per cent limit to government deficit and giving the Greek government some more years to get their account in balance, there would have been no crisis in Europe, or at least the crisis would have been mitigated.

By comparing with a set of GDP data of the USA in the 1920s, he opined that Greek economy is still going downhill. Dramatic fall in investment was the cause for recession in Greece. Exports that shrank since 2008 with the global recession somewhat improved with the Troika Plan but not enough to counter the fall in other components of demand. As a result, unemployment has been rising dramatically.

He analysed the Greek economy using a model, consistent with the stock-flow approach, to make predictions about the economy for the next 3 years, if the Troika plans are implemented. The model suggests a prolonged recession which will improve the current account balance but will not reduce the government deficit sufficiently.

The Troika Plan tried to boost the economy with fiscal austerity, ostensible effort to increase tax revenue and an internal devaluation. However, the only trouble is that if a country is in a common currency area and wants to grow through exports (by reducing domestic wages) and if every other country in the area is doing the same, the relative position in terms of competitiveness does not change. It does not help to raise net export but on the other hand, if wages are falling faster than prices then the purchasing power of households reduce and consumption falls. So, adjustment only comes through a drop in imports arising from a drop in the welfare of households.

One of the most talked about option out of this mess has been an expansionary policy by Germany. Research shows that the amount of increase in the fiscal deficit required in Germany to end the imbalances is so large compared to historical deficit figures that it is very unlikely. This is very good in theory but in practice, given the German history, it is very difficult to implement.

Other solutions are Eurobonds to reduce the burden of debt of peripheral countries where some central institution will purchase Greek and Spanish bonds, and then finance it by selling Eurobonds with lower interest rates. This could help financing peripheral debt but will not eliminate any of the imbalances.

One option that can be considered is a Marshall Plan which is not really an individual solution but relies on foreign help. In the case of Greece this is feasible. **Gennaro Zezza** estimated the impact of a transfer of 30 billion Euro over 3 years that could be spent by incurring public investment and on sustaining production of public goods. Under this plan, 30 billion Euro would be sufficient only to get output back to the 2010 levels. It would not still be enough to have Greece regain all the lost ground, but then the government would not be spending by increasing its debt and will actually stimulate the economy which will raise tax revenues. Since the aid is coming from abroad this plan is not harmful to the current account as an increase in import due to an increase in income will match the money coming from abroad. Thus 30 billion Euro would yield limited results and a larger amount of funds would be required for the plan to be more effective. This amount of 30 billion Euro is apparently already available in the Eurozone institutions but the political will to give it to Greece is lacking.

Another alternative is to freeze public debt – where the government does not pay any interest on debts and the creditors agree to roll those over for as many years as required. Interest payments by Greek government are much lower than they were due to their improved credit conditions at around estimated 7 billion Euro per year. This means that over 3 years it will be around 21 billion Euro and pretty close to the total cost of the Marshall Plan at 30 billion Euro, but still the amount of money saved by the government can be used to finance investment and consumption. He also talked about a possible parallel currency in the form of petrol bonds denominated G-Euros, with only one-way convertibility. The government can introduce this G-Euro by paying social benefits in this currency and converting a portion of the loans from domestic financial sector in G-Euro and imposing that a portion of taxes should be paid in this new currency.

On a concluding note, he said that it is difficult to have a policy which helps recovery quickly, and a successful policy would have to couple freezing of foreign debt with an expansion of domestic economy through the parallel currency. Otherwise it will be difficult for Greece to emerge from the current tragedy.

Session 3: Dealing with Global Imbalances: Rebalancing in China and global financial deleveraging

C.P. Chandrasekhar (JNU, IDEAs) started the presentation by arguing that rather than depending on the immediate preceding events the US crisis needs to be seen in the context of the longer run transition of the US economy. It became clear by the late 1960s and 1970s that the US could not sustain the most remarkable feature of Post War capitalism, viz. the ability to sustain a combination of relatively reasonable rates of growth, low levels of unemployment and low levels of inflation. This was partly because, as argued by Kalecki, there is a tendency of wages to rise faster than productivity because unions get strengthened, and this can set off an inflationary spiral. This inability to sustain the Golden Age mainly culminated in a process of restructuring of the US capitalism simply because US capitalism was the hegemon and Dollar was the reserve currency. So, one has to see the changes in the US financial structure, in the proliferation of finance, rise of credit and non bank financial market instruments and agents, as parts of the process of that restructuring. It was an undermining of the regulatory framework in the US which had one of the strictest regulatory systems ever since the Glass-Steagall Act of the 1930s. That framework was gradually dismantled over the 1960s and 1970s, and finally resulted in the Financial Services Modernization Act that undid the Glass-Steagall Act completely. This triggered transition limited the path of economic trajectory as there was no other way to achieve the high growth trajectory the US had during the Golden Age phase.

Another version looks at the global imbalance where there is a huge current accounts deficit on the US balance of payments that emerged in the late 1960s and has been continuously increasing with some signs of changes. Thus underlying the crisis was a large current account deficit in the home country of the global currency and presumably much of this deficit was vis-à-vis the rest of the world. Looking in terms of countries, starting from 2006, the distances between USA and the two major current account surplus generators, China and Germany, are shrinking since 2009. Recent trends are stuck at a difference of around $400 billion, but relative to 2006 there has been a distinct shrinking of the gap. People generally talk less of the German problem and more about the Chinese problem here, but even if one looks at China alone, the difference has been reducing. The breakup of current accounts balances of the USA shows that the correction occurred during the period of crisis due to the significant contraction of growth and do not really show any secular trend of improvement. The trade deficit rises and falls along the lines of the GDP movements, suggesting that no changes in the fundamental economic structure have taken place. Thus there is not much of a real 'adjustment' taking place.

Another way to interpret this imbalance is that whatever happens to liquidity in the home of the reserve currency (i.e., the US) has obvious significance for the rest of the world. If a mistake is committed in the periphery, then the damage is inflicted on the periphery itself. If a mistake is committed in the core, it can cause damage to the periphery as well. This is why there was so much fear about the surge that occurred during 2012 and the first signs of tapering in June 2013 with outflows being experienced in many markets.

Here **C.P. Chandrasekhar** said that evidence suggests that there could have been some actual adjustments in the trade front. There can be three other notions of imbalance. One is the imbalance that reflects a structural problem like the loss of competitiveness of the US to the benefit of China which has gained competitiveness. The other is an old savings glut argument given by Ben Bernanke which is rarely referred to today. The third is an imbalance which manifests as debt financed private expenditure as the stimulus for growth. So, the excess of leverage is not just a problem of the US, but it is a problem for the rest of the world as well. This kind of across-the-globe capital flows result in a situation where there is change in the financial structures of other countries as well.

The landscape of manufacturing shows continued dominance in global manufacturing by few countries, a noticeable reduction in the shares of the leading OECD countries with sole gainer being China, and very small gains for other countries. Thus, it actually shows a limited spread of global manufacturing over two decades. However, contribution to GDP growth shows that China is making huge amount of investment to sustain its exports surplus. Gross capital formation plays a big role in China's GDP growth. Thus it is not really a mercantilist push that is resulting in this imbalance or leading to an imbalance in the US growth process.

Often the blame is put on the undervalued currency in China in particular. The argument of undervalued exchange rates suggests that there exists some equilibrium exchange rate independent of the fact that there is some degree of openness of the capital account. There is this notion that compared to some hypothetical competitive exchange rate currencies of these countries are now undervalued while earlier they were overvalued.

When over a period of time liquidity is generated in the periphery countries because of the monetary policies followed in the core – (i) there is financial liberalisation, (ii) it also makes those countries susceptible to boom-bust cycles, (iii) there are changes in financial laws to accommodate the financial carriers, (iv) the liquidity translates into substantial domestic credit till the process can continue, and (v) this helps to generate debt financed private demand. This not only applies to consumption demand but also to investment demand since credit from the banking sector is used to finance a substantial part of investments. Therefore, one ends up with a situation where one also rides the bubble. Beyond a certain period of time the ability to use debt financed private expenditure as a substitute for debt financed public expenditure as a stimulus to growth dies out, and financial fragility increases. This is then followed by a situation when there exists a huge volume of non-performing assets which makes the banking sector cautious and that triggers banks to cut on credit. It results in a loss of dynamism that sustained the growth for a considerable period of time. Such trends are also visible in China and Indonesia to certain degrees. This story is similar to what happened in Europe and the USA.

C. P. Chandrasekhar concluded his presentation by saying that when monetary policy of certain kind transmits itself in emerging markets to sustain cross border flows of capital in the form of a surge, then it is not just capital that is exported. It also exports the financial structure and regulation framework, and more importantly it exports a certain growth trajectory which is highly susceptible to bust, which can only be revived if only some other variety of the bubble is discovered again.

Session 4: Policy Responses to the Crisis – Impact on India

Usha Thorat (CAFRAL) made a presentation on the Indian policy response, especially that of the RBI, to the global financial crisis, in the period thereafter. In the build-up prior to the crisis that the economy as a whole and within that the industrial sector grew at a high rate. The high GDP growth in turn helped to increase revenues and reduce the fiscal deficit. However, due to the inflation build up in the economy repo rate, reverse repo rate, CRR and SLR were all increased. The main concern was capital inflow which were fuelled by global liquidity, and the high expectations of growth in India. To deal with overheating, by 2005 the RBI was envisaging putting in countercyclical measures in case the economy entered into a downturn. The policy responses, in the face of appreciation in the exchange rate and build-up of reserves, were mainly geared to sterilise the impact. The entire thrust of the capital control in India has been that while equity flows have been permitted, there has been control on debt inflows, with even hierarchy of controls being followed.

Coming to the policy actions taken in response to the impacts brought on by the global financial crisis, **Usha Thorat** said that a variety of measures, such as monetary measures; foreign exchange measures; debt management measures; macroprudential measures; and sector-specific measures, were taken. Other than the usual reduction in the policy rates and the reserve ratios, unusual measures such as provisioning of a special liquidity window through commercial banks for MFs and NBFCs were also taken. The MFs were facing huge redemption and finding it difficult to meet the requirements; and the NBFCs under similar circumstances found it difficult to roll over their commercial papers.

Similarly, in the foreign exchange market, in addition to the interventions in the spot and forward markets, extraordinary measures such as providing a special swap facility that allowed domestic banks with branches or subsidiaries overseas to borrow dollar from the domestic banking system temporarily, were also put in place. In terms of regulation the crisis provided an opportunity to relax the higher risk weights and higher provisioning norms introduced earlier. At the same time, certain relaxation was given in restructuring norms so that banks were not driven into a pro-cyclical mode and stop lending.

In the post-crisis period, while GDP growth picked up, inflation too went up significantly. To deal with inflation, the RBI started withdrawing the accommodative monetary policy and the repo rate was gradually raised. At the same time during 2009-11, given that the current account deficit too had risen significantly impacting the foreign exchange market, the exchange rate was allowed to appreciate (although the move was questionable) on the assumption that it would act as an anti-inflationary measure.

There was also some tightening of macroprudential measures in terms of increasing the risk weight for larger housing loans. For the capital account, a slew of measures were taken to liberalise debt inflows in order to finance the rising current account deficit and those included increasing FIIs investment into government debt, allowing ceiling on the external commercial borrowing to be raised, raising the interest rate caps on NRI deposits, increasing the ceiling on export credit and so on. However, these measures appeared to induce debt inflows and subsequent currency mismatches, which became a problem by July 2013. By then the rupee had depreciated significantly and the RBI responded by using monetary measures, including capping the amount that banks could borrow under the repo, increasing the MSF by 300 basis points, OMO sales to absorb liquidity, tightening the norms for liquidity to be kept on a daily basis, etc.

Usha Thorat argued that these measures, however, created turmoil in the government bond markets and the foreign exchange market, thereby implying that capital controls have to be stable and predictable otherwise it can lead to severe problems. However, things changed with the new RBI governor Raghuram Rajan taking office in September 2013. Various policy measures introduced included introduction of a foreign exchange swap window at concessional rate for NRI foreign currency deposits, increase in the limit on banks' overseas borrowing, reduction of MSF by 150 basis points. These helped to stabilise the market sentiments and stem the depreciation of the rupee. She concluded on the note that there are lots of challenges that the RBI needs to deal with in the near future to be able to revive growth and reduce inflation, even while facing problems such as tapering off of Quantitative Easing (QE) in the US, currency mismatches and likely fiscal slippages.

Day 3: January 8, 2014

BANKING REGULATION: THE RETURN TO BASEL

Session 1: Basel III as Anchor for Global Financial Regulation

Mario Tonveronachi (University of Siena, Italy) started by mentioning that Basel III is the anchor for international financial regulation but increasingly many central banks all over the world are getting sceptical about the existence of such an anchor, particularly after the crisis. Although initially instituted as an international standard to deal with internationally active banks, this accord later permeated into national legislations of different countries of the world. After the breakdown of Bretton Woods institutions, the task to address international imbalances fell on internationally active banks – either implicitly or explicitly. There had been a growth in international banks, and since the international environment is risky there had been an increase in cases of banking crises. Thus, the need to create some common rules was felt. Existing Basel Concordat was the document towards which the focus went to create a framework for consolidated supervision through consolidated balance sheets. Basel Concordat and its later versions like Basel II and III ostensibly are regulatory attempts to minimise the probability of a crisis to happen, but the solution to effectively deal with crisis in the banking system was and still is unresolved. This is the broader context in which Basel regulatory framework was established.

Basel norms are a series of principles and rules meant to create a regulatory and supervisory level playing field for international banks. General philosophy of Basel is regulation by prudential principle which means that the bank can take as much risk as it wants but the risks must be hedged with capital. Later in Basel 1.5, II and III the language of the accord changed and was extended to all types of banks, with special treatment for international banks. In earlier Basel draft first pillar consisted of only a few types of risks: in Basel I there was only credit risk, then in Basel 1.5 market risk was added and in Basel II operational risks were also introduced. However, these risks were not included conclusively.

Main innovation in Basel III is the introduction of global liquidity standard with supervisory monitoring. The first ratio introduced is the liquidity coverage ratio. Under this, a bank must maintain an adequate level of unencumbered, high quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute liquidity stress scenario as specified by the supervisors. This is ostensibly done to reduce the burden of central bank as the lender of last resort. However, the onus of defining a liquidity stress is solely on the supervisors' perception. Other one of the two ratios is net stable funding ratio, where the ratio of average stable funding to the required stable funding has to be more than 100 per cent. However, this ratio is still under discussion and not yet finalised.

In this context, he argued that it is, however, difficult and almost impossible to supervise the big and complex banks. For example, JP Morgan has more than 5000 subsidiaries and more than 5000 branches. To resolve the problems of this kind of a bank during crisis time turns out to be a gigantic task even for the best of supervisors. So, there is always a creeping and increasing doubt over resolvability of problems of such banks. Basel III also has the potential to produce unwanted structural results. This may sound a bit surprising as Basel norms are meant to introduce prudential norms, not structural changes. But a regulation based on incentives, with myriad ad hoc parameters, essentially has structural ramifications, particularly for the bigger banks. These banks would shift to shadow banking, and sometimes even to the trading book because of the incentive based regulation.

There is a lack of methodology to identify the extent of bank capitalisation. Practically, the regulatory structure given by Basel gives a framework for micro-stability. However, the existence of financial system is also to fund activities in real economy to induce growth. So, by increasing capitalisation of the banks and providing financial stability the entire financial system can become useless for the real economy, to a large extent. If the rate of growth of financial assets exceeds that of nominal GDP then there will be inflation in asset prices and subsequent creation of bubble in the financial market. Hence, instead of ensuring financial stability the international level playing field in banking can be created on the basis of similar or equilibrating nature of rate of growth of assets and rate of growth of the GDP.

Session 2: Shaping the Financial System and Its Regulation in the light of the Global Financial Crisis

Stephanie Griffith Jones (Columbia University, New York) started the presentation by saying that it would be more of a general presentation, reflecting a little bit about lessons learned from what has been happening in the recent years and also based on the crisis at hand. It would also be more about what is wanted from the financial sector and what kind of financial sector is needed to support the real economy and not disrupt it. The presentation focussed on macroprudential regulations or what can also be called as counter cyclical regulations.

The first point that **Stephanie Griffith Jones** raised is that if thought from a broad perspective, the international community seeks to sustain an inclusive growth as its main economic aim. In a globalised economy, all countries want to remain competitive to sustain their growths. One needs financial sectors that support these aims, and encourage and mobilise savings by protecting the safety of savings, ensuring the savings are channeled in efficient investments as well as helping manage the risks both for individuals and enterprises. This is broadly what financial sector is supposed to do. The financial sector can have damaging effect on the real economy and thus there should be few crises arising from this sector because they have very high costs – fiscally and perhaps more importantly in terms of development.

From a theoretical perspective, with the logic of allocative efficiency financial liberalisation was encouraged with very little regulations, both domestically and externally. Latin America was the first mover in financial liberalisation in the late 1970s. Just after liberalisation there was a big debt crisis in Latin America that led to what is now known as the lost Decade of development. However, the idea was sold by mainstream economists that these were transitory problems which would be overcome once these markets matured and deepened and became more like developed countries, especially that of the US and the UK. This was deeply challenged by the North Atlantic crisis, starting in 2007. Access to low cost funding did not seem to improve as expected due to financial liberalisation especially for SMEs, nor for long time investments like in infrastructure. Indeed, it was seen that during and after a crisis, credit channels became blocked, especially for long term credit to the private sector. During a crisis the pro-cyclical nature of domestic finance and capital flows became increasingly evident.

At a broad level, this is also a problem of political economy because during the boom part of the cycle when economy is growing along with increasing wage and employment nobody would be politically motivated to increase regulation – even if a regulator or an academic predicts imbalances and suggests regulations.

These controls in the context of the boom bust cycle should also apply to capital flows, particularly to developing countries, as witnessed in a major way in Latin America in the late ‘70s and ‘80s. Speaking about surges and reversals, **Stephanie Griffith Jones** said that there have been discussions in this regard about certain stocks. But the problem is not just certain stocks because the problem is not just about certain form of capital coming in but the fact that it tends to flow out and lead to problems. Also, the problem of pro-cyclicality of the rating agencies has not been fixed. It was first noted for developing countries but the problem was not addressed. It has now been noted for developed countries as well. They did not pick up the problem of

Greece, and once it became evident they rapidly downgraded Greece and Spain and so on. They accentuated the crisis instead of smoothening it out.

Perceived success of financial stability leads to increased financial risks. In order to be like "modern and developed" country like the USA, a lot of confidence is imparted on the domestic structure, and the sense of threat is lost. Academics call this 'disaster myopia,' and this is when, by loosening regulatory standards, by the permissiveness of excessive financial liberalisation, a country unwittingly sets the basis for the next crisis.

Coming to a broader issue of the desirable size and structure of financial sector in both low and middle income countries, she noted that there is a view that the bigger the financial sector the better it is for long term growth. In 2000 it was suggested that financial depth reduces volatility of output up to a point, beyond which (estimated to be 80 to 100 per cent of GDP) output volatility increases. After the crisis, even the mainstream institutions like the BIS and the IMF have started saying the same thing that finance is good but up to a point. It is not just about the size and the growth of the financial sector but is also about the structure. There is lot of empirical work which suggests that if the lending goes for investment in productive assets rather than feeding speculative bubbles or consumption, it will have greater growth effect. The other issue is the possible role of development banks. Ever since the crisis, there has been an increasing interest in expanding the role of national and regional development banks.

Stephanie Griffith Jones summed up by saying that there is a case to be made for a system which is diversified, for several reasons. If one focuses more on private and large banks, the system is likely to be imbalanced. Firstly, there should be competition between diversified financial intermediaries, and both public and private sector should become more efficient. Secondly, if there are less of interconnected risks between private and public sectors, there are less systemic risks. Thirdly, different financial institutions have different risk bearing capacities. Big private banks may be good for lending to big multinationals, developing banks is good for counter cyclical lending and low end institutions are good for lending to SMES. Such a structure could help achieve inclusive growth better, than a structure where the whole financial sector has evolved spontaneously and is dominated by just one type of institution, whether public or private.

Day 4: January 9, 2014

IMPLICATIONS OF THE CRISIS RESPONSE FOR NEW REGULATIONS

Session 1: Impact of the Crisis on Financial Market Commodity Investments: Implications for developing countries and global financial stability

The first presentation of the day was made by **Jayati Ghosh (Jawaharlal Nehru University, IDEAs)**. In her presentation she focussed on the issue of the commodity futures markets and the impact it has on food and fuel prices globally, with specific focus on food prices. She began by pointing out that the movement in commodity (food and oil) prices has been particularly volatile since 2007, and a lot of this has to do with financialisation.

As the price movements since 2007 show, the supposed benefits of a futures market has not fructified due to the fact that the commodity futures market itself has changed through deregulation. The most important change in this regard has been in the US – which is the place where the prices of a lot of important commodities are effectively determined. The first such change relates to the Commodity Futures Modernisation Act of 2000 which deregulated the futures market in several ways by, for example, allowing unregulated exchanges, allowing swap deal, exempting over-the-counter (OTC) commodity trading (outside of regulated exchanges) from Commodity Futures Trading Commission (CFTC) oversight. These changes allowed all kinds of investors, including hedge funds, pension funds and investment banks, to trade commodity futures contracts without any position limits, reserve requirement, disclosure requirements, or regulatory oversight. As a result, the value of such unregulated trading increased massively and stood at $9 trillion at the end of 2007 which was more than double the value of the commodity contracts on the regulated exchanges. This was in fact a fallout of what had been happening in the global financial sector. However, there was a reversal in this phenomenon by the summer of 2008, when as a result of the huge losses in the US housing and other markets it became necessary for many funds to book their profits and move resources back to cover losses or provide liquidity for other activities. Thereafter, the post-crisis recovery measures provided further incentive for such financial activity as credit was eased for major banks, which faced a near-zero interest rate regime. Successive rounds of quantitative easing and "extraordinary measures" have continued to fuel financial players' appetite for commodity indexed investment. In short, commodity markets became like other financial markets, prone to information asymmetries and associated tendencies to be led by a small number of large players. Hence, the supposed benefits of price discovery and hedging were no longer available because price signals became wrong, misleading and driven by investor behaviour of some large players.

On the issue of regulations, **Jayati Ghosh** said that during the crisis the discussions around the Dodd Frank Act in the US regarding regulating OTC trading seem to have been anticipated by the investors. This is reflected in the significant movement in trading from OTC to regulated exchanges in both commodities and oil. While this does seem like a good development, a lot more needs to be done. These include bringing all commodity transactions into regulated exchanges with strict imposition of capital requirements, margin requirements and position limits; putting strict limits on the entry of financial players into commodity futures markets, through positions limits and other means; eliminating the "swap-dealer loophole" that allows financial players to enter as easily as commercial players; banning futures markets for grain trade in countries where public institutions play an important role in grain trade; and bringing in capital controls of different sorts on short-term capital flows in developing countries, particularly to prevent their destabilising impact. However, while the G-20, the US and the EU have made a whole lot of proposals, nothing has been implemented yet.

Rather than restricting all financial players, as many had argued for, the regulations aim to put restrictions only on proprietary trading and High Frequency Traders (HFT). Therefore, the regulations being put in place are still extremely inadequate, and incentives still exist for commercial players to profit from behaving like financial players – implying that commodity price volatility is going to persist and will continue to create financial and real damage for developing countries. In the last few years, rise in global prices of commodities like wheat and rice, has been accompanied by an equally sharp rise in retail commodity prices in India and other developing countries. However, in times when global prices have declined, prices in developing countries have not seen much decline. As a result of the financial crisis, developing countries are saddled with already large fiscal deficits, and owing to capital outflows they are also faced with currency devaluation which makes food imports more expensive in local currency. It is necessary that developing countries get into international arrangements particularly into things such as co-operating on strategic grain reserves, commodity boards, which play an important role in stabilising world prices. In addition, compensatory financing mechanism of the IMF needs to be activated in cases of sudden food price spikes and finally, there is an urgent need to control finance to stabilise food prices.

Session 2: Exceptional Monetary Policy in Response to the Crisis: The EU (continued from Day 1)

In the second part of his presentation, **Jan Kregel** began by pointing out that as he had mentioned in his previous presentation, the crisis in Europe was different from that in the US. Besides, the ECB is also different from the Federal Reserve. The ECB functions under a set of Statutes that cannot be directly controlled by any national legislature. One of the fundamentals of that Statue is that the ECB cannot lend directly to any member state. This turns out to be one of the crucial problems because the crisis that the EU faced is one which involved both the sovereign states and the financial systems of the sovereign states. So, the major difficulty that the European nations face is the provision of roll-over financing for their outstanding debts.

The ECB was faced with a dilemma and it created a number of financing arrangements in order to solve this. The first major programme that was implemented was the Securities Markets Programme. This was an attempt of the ECB to support sovereign issues of the governments in difficulty by dealing in the secondary market as the Statutes prevented them from providing direct support. It had the dual objectives of providing support for the prices of the sovereign debt of the countries in difficulty on the one hand, which helped to support the prices of the assets held by the Northern tier banks, primarily German and French banks, and on the other by buying them in the secondary market they provided an exit route for these banks to get rid of those assets from their balance sheets. In this context, **Jan Kregel** noted that just as the US bought off impaired assets of its banks, the ECB too was doing the same by trying to take these off the balance sheets of the banks at a minimum loss. Secondly, the ECB also introduced enhanced credit support for the banks. Basically what it has done is that it allowed the banking system to pool or securitise virtually any impaired asset in the system into "marketable" bonds. And these bonds, which received a "guarantee" from the sovereign state, could be taken to the ECB and produce liquidity from the central bank or receive funding against that asset. In general, what then happens is that the liquidity the national commercial banks receive through this process is used to buy national government bonds. This in turn implies that while a part of the sovereign debt, that originally created this problem, has been written down through a series of "haircuts," a part of this is still being held by the ECB, or by one of the mechanisms that had been set up by the EU to hold these assets, or by the commercial banks of the nations. In essence this means that an increasing proportion of the national debt is being held by the national banks.

There are however, several problems that can arise with such a mechanism. One of them relates to the disintegration of the integrated capital markets since instead of being held by any other country's banks, a country's sovereign debt is being more and more held by the local banking system. This implies that the risks associated with the sovereign debt too are being increasingly concentrated in the banks of that particular country. In short, this implies that the idea of delineating the sovereign risk from the banking risks has not been resolved at all. Regarding the non-ECB support mechanisms, he said that all of these were basically meant to provide common European Union funding to produce rollover funding for outstanding government debts. Regarding the various mechanisms introduced, in particular with regard to the currently functioning European Stability Mechanism (ESM), he said that the basic problem is that being common funds they include all of those member states that have impaired government debts, so that if a situation arises in which funds are required to support a government, it is unlikely that countries with impaired government debts would be able to meet their contributions. Further, in the case of a sustained deterioration in government bond prices across the Southern tier countries, it would mean that a large number of countries such as Italy, Spain, Portugal, Spain and even possibly France, would not be able to meet their contributions. In addition, if other countries involved which are also unlikely to be able to contribute, such as Austria, Cypress, Estonia, Finland, Iceland, etc. is taken into account, it means that it is only Germany that would be left with the responsibility of funding the mechanism. He concluded by saying that fundamentally it means that the political problem in terms of the bail-out boils down to whether the German government would be willing to provide support to the Southern tier countries in order to write off those outstanding debts.

Session 3: Derivatives Markets in Currencies: The need for regulation

Sabri Oncu (CAFRAL) started by quoting BIS triennial survey, published in September 2013, that the already big global currency market is growing exponentially and the current daily turnover is about $ 5.3 trillion which is 9 per cent of global GDP. Going by the current trend, the market is expected to increase to $ 10 trillion by 2020. Another important fact is that speculative activity in the market is quite significant.

In macroprudential view of systemic risk, all financial institutions may be exposed to some common factor(s). In the case of Turkey, it is the exchange rate factor of Turkish Lira vis-à-vis the US dollar. Since many of the Turkish financial institutions, especially some commercial banks, deal in short term foreign exchange market this exposure has the potential to create some bank runs. However, contagion and common factor exposures are not mutually exclusive. In general, the micro-prudential and macro-prudential views are not necessarily mutually exclusive. As far as currencies are concerned, systemic risk is not only about the failure of a significant part of the financial sector that leads to a reduction in credit availability, but also with the adverse effects it has on the real economy. The entire economy may collapse due to such exposure to international currency market. In such scenario the banks may get exposed to volatility of international foreign exchange market and the private sector may turn out to be acting like shadow bank.

One look at the foreign exchange market turnover since 1998 reveals that among all kinds of transactions the derivative market dominated the trade, not the spot transactions. Another point to be observed is that foreign currency (FX) swaps dominate the foreign exchange market as major instrument used. Of course, these FX swaps are traded over the counter and are subject to less and less scrutiny. Foreign exchange trade is also increasingly getting concentrated in the largest centres, viz. the UK, the US, Singapore and Japan. By April 2013, 71 per cent of total currency trades were concentrated in these centres. The concentration is expected to rise further and investigations are going on for alleged manipulation of currency trade in the UK, the US and Singapore. If we compare participation in currency trade by different entities as of April 2013, then reporting dealers consist of 39 per cent of trade, smaller banks 24 per cent, institutional investors 11 per cent, hedge funds and propriety dealers 11 per cent, non-financial customers 9 per cent and others. Interestingly it seems that arbitrage for non-financial customers, for which the instrument is devised, accounts for only 9 per cent of the market. Though it is difficult to predict the individual motives of other participatory entities, it seems that speculation is the largest motive prevalent in the market rather than arbitrage or hedging risks.

The key element of derivative markets reform is the central counter party (CCP). The idea is to standardise derivative transactions of two parties, mandatorily cleared by the CCP, so that in case of non-obligation by one party the CCP can fulfill the obligation, thus guaranteeing performance. The proponents of CCP argue that without full standardisation markets will remain opaque and lack transparency, and the lack of formalised training and poor price discovery allow the dealers to earn substantial economic rent from trading. The critics of the CCP argue that the OTC format is essential to enable users to customise solutions to match underlying financial risks. They also say that the flexibility of the OTC market is essential to financial innovation. However, post-crisis both the terms “customisation” and “innovation” have become hugely suspicious.

Summing up, **Sabri Oncu** said that the most of the regulatory arguments and proposals are mainly coming from the powerful countries in the West like the US and the EU. Rest of the countries are either silent on this front or falling in line with the powerful countries, although Brazil, Korea and India have shown some differences of opinion and resilience. However, keeping in mind the diversities of each country it is prudent for all the countries to assess their financial markets and then challenge the dominant view of the West which is the root cause of this crisis.

Session 4: Capital Account Management Techniques – What has worked where?

Kevin Gallagher started off by saying that in the wake of the financial crisis, a number of emerging markets and developing countries have been re-regulating cross border finance. It is a success and often it is overlooked that it is expanding the policy space to be able to do these re-regulation exercises in the global economic governance institutions. Having said that, he clarified that re-regulation is far from complete in the domestic levels of emerging markets, and even less in the global scenario.

His presentation outlined the issue of capital flows in the crisis and post crisis period, and how some emerging markets have been re-regulating cross-border finance. Many of these regulations are indigenous to emerging markets. The other point of focus would be some changes in the global economic governance. The IMF had some changes in its view of regulating capital flows and there have been big statement made in the G-20. The WTO may also now open up to regulating capital flows. However, the US bilateral trade laws are increasingly becoming outliers that outlaw regulating cross border capital flows.

Empirically, there is evidence that cross border financial transactions raise prices, and then there is an increase in international collaterals which domestic agents can borrow abroad. There was a surge of capital inflows in developing markets right up to the period of crisis in 2007, after which there was ‘flight to safety’ where there was a sharp outflow of capital from these markets. Such outflow leads to depreciation in the exchange rates, a decline in those asset prices, and gets amplified by what is called the ‘original sin’ which is the inability to pay those debts back.

Kevin Gallagher concluded on the note that cross border financial regulations are now justified more than ever, and one has to ‘fine-tune’ them to make them work. Emerging markets and developing countries have formed a new generation of regulations that promise to target the foreign exchange derivatives market. There is opportunity to gain more political space for such policies and there is more policy space in global economic governance institutions except for US treaties. Central banks or finance ministries cannot ignore trade treaties because these are issues coming under the purview of the commerce ministries. They need to focus on trade treaties as important commitments for monetary policies.

Session 5: RMB Internationalisation: A new stage of capital account liberalisation

Yu Yong Ding (China Society of World Economics) focused on the issue of capital account liberalisation and RMB internationalisation of China. According to him, there are five main purposes behind RMB internationalisation – (1) to reduce exchange rate risks, (2) to reduce the increase in foreign exchange reserves, (3) to increase competitiveness of financial institutions, (4) to reduce transaction cost of trade, and (5) to promote capital account liberalisation.

As a result of the introduction of RMB trade settlement scheme, RMB flows into Hong Kong. An offshore RMB market, known as the CNH market, was created in Hong Kong simultaneously with an onshore market in Shanghai, dubbed as the CNY market. Foreign investors who wish to purchase RMB assets can purchase Renminbis in CNH market and then invest in RMB assets via eligible banks in Hong Kong. When they unwind their RMB positions and take profits, they can convert their Renminbis proceeds back into dollars in the CNH market. Thus, international capital can move across the borders of the Mainland. Similarly, RMBs can be used via these two markets' interaction to export and import. So, essentially CNH market will act both as a gateway to outer world and as the hub for trading with mainland China. This is the contour of the proposal to internationalise RMB. Though it is easier to enter CNH market which is a free market, there are problems entering CNY market because of existing capital controls, and that is why this proposal tries to utilise the existing structure and to open the capital account.

In a way, capital account lilberalisation is needed to internationalise RMBs. Though China has liberalised its capital account for long term capital, but simple opening up of capital account will not do the trick – according to **Yu Yong ding**. The good point of utilising two exchange rate markets is that in this way China will be able to utilise US dollars better. Suppose 100 million US dollar comes in and by utilising CNH and CNY in the above mentioned way more Yuan is added into the system; then for a sufficient period of time that 100 million dollar will not be required and that amount can be used to buy US Treasuries which will add to China's strength.

However, he also feels that short term cross-border capital flows do not have the capacity to contribute much to the economy. China has opened its capital account for long term capital, but he feels that the sequencing of opening capital account is not very prudent because there is no well developed capital market or money market. The inter-bank call money rate is also not very well organized or market determined, and in the absence of these mechanisms determining interest rate by only opening capital account is not going to solve China's problem. Before resolving these problems a hasty opening up of capital account may be detrimental to Chinese economy and hence is his proposal for RMB internationalisation before capital account liberalisation.

Day 5: January 10, 2014

PRESENTATIONS BY WORKING GROUPS

Three working groups were formed with the participants from central banks and various other government agencies from various countries. In the last day, there were presentations by all three groups on related topics.