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Workshop on Regulating Finance after the Global Crisis

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REGULATION OF FINANCE: WHAT IS NEW?

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I am thankful to the International Development Economics Associates (IDEAs) and the Centre for Banking Studies of Central Bank of Sri Lanka (CBSL) for giving me this opportunity to meet and discuss several aspects of regulating finance. I must compliment the organizers for outstanding arrangements made in terms of logistics for participants.

My presentations in the conference are focused on the noticeable changes in several aspects of regulation after the onset of the global financial crisis in 2008. The presentations which are in the nature of broad generalizations are divided into three sections, viz., regulatory approaches, the role of central banks and the opportunities and challenges before the developing countries in the current global environment.

Approaches to Regulation:

The objectives and philosophy of regulation have been redefined in the light of the experience with the global financial crisis. Firstly, systemic stability has been added as an explicit objective of regulation of financial sector, in addition to the consumer protection and stability of the individual institutions.

Secondly, the assumption that markets will correct smoothly and almost in a cost free manner to the economy, has been substituted by the recognition that countercyclical policy may be needed as part of regulatory framework. The countercyclical policy would also involve coordination of financial sector regulation with the related macro economic policies, in particular fiscal and monetary policies.

Thirdly, in view of the experience gained, the dependence on self regulation and soft regulation is reduced relative to external regulation, detailing of procedures and supervisory effectiveness.

Fourthly, national regulatory regimes, particularly in regard to banking, will have to be guided by the minimum standards of regulation that may be prescribed by an international body like Financial Stability Board. Monitoring of compliance by peer groups

will also be an element of ensuring conformity to national regulation with global regulation in respect of systemically important economies.

Fifthly, liquidity aspects of financial institutions are also included as an important aspect of regulatory detail.

Sixthly, incentives within the institutions in regard to risk taking and associated rewards are also brought into the regulatory ambit. Seventhly, the state of governance in financial intermediaries could also be included in the regulatory concerns by the regulators and supervisors.

Seventhly, in regard to the scope of regulation, the regulation may have to extend beyond banks to include non banks, though the rigour of regulation in regard to each category will depend on both the stability aspects and the consumer interests.

Eighthly, retail banking or traditional commercial banking has to be given special status, and their activities relating to investment banking or proprietary trading may be subjected to severe restrictions, and may even be prohibited.

Ninthly, in regard to financial markets, every effort will be made to encourage exchange traded products, and more generally, ensure the

safety of the financial products, in particular financial innovations, has to be subjected to appropriate regulatory oversight.

Finally, the infrastructure and eco systems of financial sector comprising accounting standards and credit rating agencies, also need to be subjected to greater scrutiny than before.

Actions:

The new approaches, on which there is a broad consensus, though not unanimity, are still under implementation as work in progress, and in some cases, under evaluation. The specific actions to bring the new approaches into operation are noticeable in advanced economies, particularly U.S.A., U.K. and Europe, where the financial sector has been most affected by the crisis. The regulatory actions taken in this regard so far need to be recalled.

Firstly, structural changes have been brought about through legislative measures in U.S.A., U.K., and to some extent, Europe.

Secondly, a characteristic of the new arrangement is the institutional set-up to ensure coordination of regulatory policies with other

policies, and more important, coordination among the regulations in financial sector.

Thirdly, there have been a few countries such as India, in developing countries, where coordinating arrangements between the regulators and between the government and the regulators have been undertaken.

Fourthly, at a multi lateral level, the Basel II.5 and Basel III are being evolved, and considerable progress has been made in terms of preparing guidelines for national authorities. In particular, systemically important financial institutions for the global economy are being identified, and additional regulatory requirements in regard to such institutions are being recommended.

Fifthly, the additional capital standards in regard to systemically important institutions are to be met over several years, and full compliance is expected in 2019.

Sixthly, the operational details on several aspects are still in progress, both at multi lateral and at national levels. However, Switzerland is conspicuous in prescribing stringent standards of capital adequacy to the large banks in its jurisdiction.

Issues:

There are several regulatory issues that are being addressed. Firstly, the precise requirement of capital both in terms of quantity and quality is being considered, keeping in view the requirements of systemic stability and simultaneously cost of raising additional capital, including the consequences on economic recovery underway and longer term economic growth. There are serious differences of opinion between the financial markets and regulatory standard setting bodies in regard to the possible impact on recovery and economic growth as a result of additional capital that is being suggested.

Secondly, there is a broad agreement about restrictions on leverage, but defining the various components that should go into computing leverage is still under discussion.

Thirdly, in regard to the size of the intermediaries, systemically important financial institutions have raised the issue of unlevel playing field and consequent adverse impact on their profitability as well as efficiency of global financial intermediation.

Fourthly, there is as yet no agreement about the boundaries between proprietary trading and trading on behalf of the clients.

Fifthly, the boundaries between retail banking and investment banking in case of ring fencing of the retail banking activities are still under discussion.

Sixthly, the scope of regulation beyond banks specially in regard to private pools of finances continue to be a source of controversy, particularly in view of the fact that their activities are concentrated in international financial centres who are keen to retain their business within their jurisdiction.

Seventhly, there is a recognition of need to regulate financial innovation, but the financial markets hold that innovations have a positive role to play, and hence they hold that the rigour of regulation may be minimal. There is, as yet, no indication that complexity that is involved in several financial innovations is being reduced. On the contrary, the operational details of regulation of derivatives markets in some jurisdictions seem to restrict the range of products to be regulated.

Eighthly, taxing of financial institutions, and transactions in financial markets have been proposed, and are under active consideration in several jurisdictions.

Ninethly, in regard to deposit insurance, there is a greater agreement now than before on the beneficial impact of deposit insurance.

Tenthly, several aspects of the cross-border issues and the relative roles of regulators of host and home countries, are still ambiguous.

Finally, the role of credit rating agencies and the accounting firms has been questioned, but a clear-cut globally agreed policy in regard to the improved approaches by regulators is yet to be evolved. Overall, the reliance of regulators on the rating by credit rating agencies is to be reduced.

Developing Countries: What is Different?

It is necessary to note that the regulatory actions that have been taken are concentrated mainly in the advanced economies that were most affected and have been in the nature of rolling back excessive deregulation that had already taken place, and excessive financialisation that has been observed in these countries. It will, therefore, be useful to identify the position of developing countries in this regard. Excessive financialisation has not been observed in the jurisdictions of most of the countries. Excessive complexity in financial products or innovations was an exception than a rule. Excessive leverage was noticed in isolated cases, but not in a

systemic sense. In most of the developing countries, particularly in Asia, banks and retail banking dominate the financial system. The extent of shadow banking in most developing economies is not significant, and hence it is possible to ensure orderly growth of the sector in future. To the extent the banks have not taken up significant investment banking and other off balance-sheet items, and have not taken significant recourse to the non core capital, the additional capital that may be required to satisfy the Basel III requirements may not be significant. In approaching the requirements of Basel III, developing countries are concerned with the trade-off between growth and stability, and in some cases equity. Many of the prescriptions under Basel III are oriented towards maintaining stability while developing countries have to ensure financing of structural transformation. The sectors that require priority would be infrastructure, small and medium industries, trade finance and agriculture, and the financial system may be reviewed with these objectives in view. Accordingly, credit allocation or even selective credit control may be warranted.

The economies where public sector banks dominate, such as China, India and Brazil, have shown impressive growth with significant resilience during the crisis. Hence, the approaches to public sector banking are being reconsidered particularly in Latin America, though there is recognition of the political economy considerations that may,

as observed in the past, undermine the efficiency of the public sector banks. Possibly, some presence of some public sector ownership or public sector character in banks has been beneficial to the system. In this regard, the role of development banks that could combine the advantages of public policy in directing resources to private sector is being revisited.

There is a concern in developing countries that the arrangements under WTO and free trade agreements may restrict their policy options in avoiding the contagion affects of the excess of financial sector in advanced economies in future. There are some who argue that the existing legally binding arrangements provide full freedom for regulatory actions by developing countries.

Finally, an important lesson for the developing countries from the fiscal crisis is the close link between fiscal headroom available for the country and the risks in its financial sector, keeping in view the vulnerability of external sector to shocks. Further, developing countries have reason to be concerned about the links between commodity markets and financial markets that would affect them through global crisis or through domestic links between commodity exchanges and exchanges in the financial sector.

In brief, the major challenge for advanced economies is re-regulation and correcting for the past mistakes while in regard to developing economies, it is rebalancing of the various components of the financial system in terms of its growth for the future. There are, however, broader issues in regard to global finance that should be causes of concern for both advanced and developing economies.

Concerns:

Firstly, the crisis has indicated that diversity of financial sector between advanced and developing economies, and in particular in Asia, relative to the western world, has served global finance well in times of acute crisis by moderating overall adverse impact. The current effort to have global coordination of financial sector regulation may have the benefit of coordination, but danger of diluting the scope for diversity and thus impact stability. There is no guarantee hat a new approach will be optimal or continue to be optimal to withstand the test of time.

Secondly, the importance of financial sector in both the origin and destination of capital flows has been recognised, and there is reluctant admission of the usefulness of prudential regulation over financial sector in managing excessive capital inflows. However, a comprehensive treatment of the issue of global capital flows and

space for public policy at national level has not been adequately addressed.

Thirdly, no distinction has been made between international banks which operate significantly in terms of cross-border financial transactions and multi national banks who were present in several countries, but essentially funding their operations domestically. The international banks are important vehicles of managing their operations taking an integrated view of regulation and taxation in different jurisdictions. Thus, harmonisation of regulation without harmonisation of tax regimes may not fully serve the purpose, while regimes of taxation being instruments of supreme sovereign authority, are difficult to coordinate. Recent efforts at coordination relate to exchange of information on tax-dodging often through the international banks.

Finally, the political economy seems to be strongly in favour of financial sector in many countries. In particular, when the sovereign is weakened due to global finance, the capacity of sovereign to manage the national economy in particular financial sector becomes restricted. Recent events in Europe seem to suggest that in a few cases, there could be a triumph of global finance over national democracy.

Global System and Central Banks:

In order to assess the redefined role of central banks, it is useful to recognise the landscape of global monetary and financial systems within which central banks operate. The global monetary financial systems are under stress due to the global financial crisis, and have proven to be less than adequate to meet the challenges of increasing globalised economy, and in particular, globalised finance.

Firstly, the inadequacies of the predominance of one country's currency as the global reserve currency have been noticed, and some alternatives have been proposed. There is some intellectual consensus in favour of encouraging Special Drawing Rights as a global currency, but the operational feasibility and details are yet to be worked out. The U.S. Dollar continues to be not governed by market discipline and not subjected to rules with the result that the international monetary system is described as a non system.

Secondly, there is some progress in regard to changing the governance in IMF and World Bank, though the progress is slow and the resources available to them are patently inadequate. G20 has been revived and made active, but its representative nature is questioned while its effectiveness is in doubt in terms of recent

activities. Absence of arrangements for dependable lender of last resort and orderly sovereign debt restructuring continue to be felt.

Thirdly, the global financial markets do not give comfort that they represent reasonably competitive markets leading to market efficiency. In particular, the dominance of the two credit rating agencies, two news agencies and four accounting firms continue to impart suspicion to the efficient functioning of the global financial markets. The operations of these institutions are often characterised by some conflicts of interests. They are considered to be very asymmetrical in their treatment of the economic conditions in developing and emerging market economies, relative to advanced economies.

Fourthly, there is an intellectual agreement with regard to improving the regulation of the financial sector, but the progress so far in regard to globally agreed standards is slow with considerable doubts about its effectiveness at operational level and the time span over which the improvements would take place. The Financial Stability Board is an improvement in terms of institutional structures. There are assurances of re-regulation in advanced economies and some rebalancing in the future path of regulation in developing emerging market economies. Overall, there are continued uncertainties about the optimal development and regulation of financial sector.

The current uncertainties and volatilities in the global economy and their likely persistence in the short-run will have to be managed by the central banks, keeping in view the continued inadequacies of the global monetary and financial structures and functioning.

Role of Central Banks:

The global financial crisis has brought about a significant change in the thinking on he role of central banks. These are essentially at the national level. Firstly, financial stability is being added as a mandate to the central banks. It is interesting to note that many central banks in the world have considered this mandate to be implied in any mandate of a central bank. However, this is now made explicit in some countries. This was required particularly in the case of those central banks which had inflation targeting as the dominant objective.

Secondly, with broadening of mandate, and prescription of multiple objectives, there is a widening of the range of indicators to be considered in the conduct of policy, and the range of instruments to be utilized to meet the range of objectives.

Thirdly, the use of indirect instruments, in particular short-term interest rate alone is now replaced by a willingness to undertake

recourse to both direct and indirect instruments in addition to unconventional measures.

Fourthly, the central banks are to be prepared for countercyclical policies. The political leadership and financial markets which are supportive of this policy during the crisis period may not be equally enthusiastic during the boom period. Further, the effectiveness of instruments available for the central bank that are useful in the period of boom, may not be equally effective in the period of boost.

Fifthly, the widening of the mandate of the central banks and the importance of coordination with other regulators and the government, warrants review of the balance between independence, accountability and coordination.

Sixthly, the central banks will have to increasingly take account of spillover effects of one's policies on other countries, and the impact of the policies of the other central banks on ones own central bank. This has to be managed by central banks within the formal legal mandate which calls upon them to be accountable to the government in terms of the interest of the domestic economy. Further, broader framework of coordination on global levels would invariably require close involvement of the guidance from the respective governments.

Seventhly, the management of capital flows especially in terms of its impact on the financial sector and the use of macro prudential regulations in this regard would warrant attention of the central banks.

Eighthly, the cross-border supervision would be a special focus for central banks in case they are also the regulators of the financial sector. In any case, the cross-border activities of financial institutions have significant impact on stability and would, thus, warrant the attention of the central banks.

Finally, monetary policy should take into account the growing links between fiscal and financial sectors. The experience with managing the crisis in general, and the developments in Euro zone have brought to the attention of all policy makers the close links between the fiscal position, the financial sector and monetary policy in the context of not only financial stability but overall macro economic stability.

Central Banks in Developing Countries:

Central banks in developing countries may face some complex challenges unique to their conditions. Firstly, in regard to central banks in developing countries, a mandate for growth should be added

or emphasised, keeping in view the possible current excessive emphasis on maintaining stability as a response to the financial crisis specially in advanced economies.

Secondly, greater discretion and sectoral approach in regulation may be needed to supplement monetary policy in order to address simultaneously, the often significantly overlapping elements of structural and cyclical factors in any developing economy.

Thirdly, equity considerations have to be demonstrably brought into the picture in developing countries at this stage to convincingly take account of the lessons.

Issues:

The redefined role of central banks provokes consideration of several issues. How to recognise the business cycle, and how far should one proceed in leaving against the cycle to be effective but optimal? Will the widening mandate and emphasis on coordination, result in dilution of direction and possibly accountability? With large public debt in advanced economies, will rules of the game in conduct of monetary policy in regard to level of tolerable inflation and acceptable level of financial repression change? Will the governance arrangements change to reflect the broader social implications of

conduct of monetary policy, and indeed, financial sector as a whole? Would it imply representation for central banks in governance of other financial sectors and regulators? Will it imply representation of civil society in the governance? Will it change governor centric image of central banks?

Developing Countries in the Current Environment:

It is recognised that a collapse in the global financial markets was avoided in 2008 through concerted actions by several central banks and governments. In 2009, there was an effort to stimulate the economy through fiscal, monetary and some other measures by almost all countries. However, the responses to the stimulus and to the outcomes have been understandably varied. This situation in 2010 warranted the description of the state of the global economy as uneven recovery or multi speed recovery of the global economy. However, subsequently there were fears of possible double dip recession in some advanced economies, and the resilience of the recovery was in doubt. While the emerging market economies as a group recovered rapidly, there has been a stalling of growth and challenges arose in terms of inflation and possible overheating in many of their economies. By the last quarter of 2011, with the deepening of the crisis in Euro zone, there is a perception that the

global economy in a dangerous phase, which is characterized by simultaneous correction of internal and external imbalances in both advanced and developing economies.

A retrospect of developments since the eruption of the crisis would indicate that many of the fundamental problems that caused the crisis are yet to be resolved, though there is a better recognition of need for corrective actions. Macro economic imbalances are far from being redressed. The changes in financial regulation are still underway. The international monetary system and the global financial architecture are being improved at best, only marginally. The disconnect between the recovery in financial sector and the lackluster performance of real economy in advanced economies is in a way continuation of the disconnect between financial sector and real economy that has been witnessed so far. In these circumstances, it is clear that the global economy is in a somewhat dangerous phase, but the problems and prospects for different countries are varied, within this somewhat pessimistic and uncertain scenario.

In major advanced economies, there is considerable debate about the relative roles of fiscal and monetary policies. Often, recourse to monetary policies has been undertaken in view of lack of political support for fiscal measures. At an intellectual level also, there is considerable difference of opinion on appropriate policy responses for

the problems in advanced economies. There is a significant challenge for advanced economies to undertake short-term stimulus while assuring the financial markets that there is a credible plan for medium term fiscal consolidation in view of the huge public debt that has been incurred in managing the crisis. The political configuration in U.S.A., in Japan and a majority of Euro zone countries is not conducive to hard decisions with elections slated in a number of countries.

There are signs of overheating in some emerging market economies, while at the same time some of them are facing inflationary pressures. The developing economies may continue their resilience relative to advanced economies, though resilience is moderated by the developments in advanced economies. There have been several social and political movements, such as occupy Wall Street, and developments in Middle East which point to the fact that the financial crisis has not only evolved into an economic crisis, but is exhibiting signs of political crisis in many countries, and social unrest in a few countries. The socio-political indicators reinforce the somewhat pessimistic picture about the prospects for global economy in the short run.

Strengths of Developing World:

The developing and emerging market economies do exhibit significant strengths in this otherwise gloomy picture of global economy.

Firstly, in most countries, financial sector remains reasonably strong and resilient.

Secondly, there are very few countries which have problem of excessive leverage warranting deleveraging and consequent tensions.

Thirdly, medium to long terms fiscal position is reasonably strong in many countries, compared to the current position in many advanced economies.

Fourthly, in most of the major economies, the external sector continues to be strong, and forex reserves are, in most cases, comfortable.

Fifthly, there are few economies, particularly in Asia, which need significant internal rebalancing in favour of domestic demand from export demand and in favour of domestic consumption from investment, but there are other countries who may not be facing such a challenge in a significant manner.

Sixthly, demography is currently to the advantage of these countries since there is a large labour force currently in position, and the labour force is expected to increase significantly in future. Above all, in most, if not all countries, hope of a better future for the youth and the next generation seems to dominate, though there are tensions in regard to issues of emerging inequalities and persistent unfairness in governance. It is necessary to be conscious of the fact that despite the strengths and possible acceleration in economic growth, it is difficult to envisage bridging the gap between the standards of living in developing economies and the standards of living of advanced economies in any meaningful fashion. The strengths contribute to hope for better tomorrow, compared to yesterday.

Challenges to Developing World:

The developing and emerging market economies, however, face significant challenges, and most of these are emanating out of global factors which accentuate inherent infirmities of their economies. Firstly, volatility in commodity markets is likely to continue and, perhaps, intensify due to opposing factors. The possible slow down in advanced economies is likely to have a dampening affect on the commodity prices while the ample liquidity in financial sector could add to the increase in prices. Further, the elevated commodity prices

may be an advantage to several countries, but it could imply serious disadvantage to commodity importing countries, especially in the case of food and fuel.

Secondly, volatility in financial markets has to be managed in view of the highly uncertain monetary and financial conditions, and somewhat pessimistic economic prospects prevalent in advanced economies. There are significant policy uncertainties due to the magnitudes and complexities of rebalancing needed in these economies, since political economy considerations dominate such rebalancing.

Thirdly, the global economic uncertainties in conjunction with considerable liquidity may impart greater volatility to cross-border capital flows through financial markets, in particular emerging market economies. Further, in view of the fiscal strengths in advanced economies, there may be uncertainty in aid flows to some developing countries and there may also be a reduction in such official flows on capital account.

Fourthly, there is evidence of asset price booms and high growth in bank credit in some developing countries, while simultaneously there are signs of slow down in economic growth, making the policy responses extremely complex. These challenges have to be met in a

global environment where the growth in leading advanced economies is likely to be very subdued and uncertain.

Fifthly, in response to the global developments, some developing economies are embarking on a policy of shifting demand from external to domestic, but this process may pose some issues in the short run, in terms of imparting surplus capacity in some sectors, and capacity constraints in some others.

Finally, these challenges of developing economies have to be met keeping in view their inherent incapacity to borrow in own currency and inadequate comfort from the international monetary system and global financial architecture. However, lessons from the crisis in the recent decades have helped them to some extent in strengthening their macro economic position, fiscal position, and to some extent, external sector to be able to meet the challenges with greater confidence than before.

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