Financial sector regulation and macroeconomic policy

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The Bank for International Settlement (BIS), the Centre for Advanced Financial Research and Learning (CAFRAL), and the Reserve Bank of India (RBI) need to be complimented not only for the excellent logistics, but also the outstanding background papers that have been prepared for the conference. I had in fact prepared a draft for delivery today, but discarded it after listening to the stimulating presentations made by Governor Subbarao and Jaime Caruana, and to the discussions that followed. I, therefore, decided to revise my presentation in order to supplement the proceedings of yesterday by posing a series of questions and exploring some possible answers.

The theme for the Conference is very valuable and path breaking since it raises fundamental issues contextually and is also forward looking. Contextually the subject covered in the Conference provides necessary correctives to the pre-occupation in the current debates on financial regulation relating it with the issue of maintaining financial stability as a response to the global financial crisis. It is also forward looking in the sense that it recognises the possible contributions that the developing and emerging market economies, particularly Asia, could make to the evolving debate on the subject, in view of their potentially enhanced role in the global economy in future. Fundamentally, it is of great significance, because the title of the Conference recognises the main purpose of public policy relating to the financial sector, viz, ensuring growth with stability while addressing the issues of (social) equity. The trade-off between growth and stability, and their inter-linkages have been recognised as being inherent in financial regulation, but equity considerations have come to the fore in global debates in the very recent past, mainly as a consequence of the adverse impact of the crisis on welfare of large segments of population. This Conference, in a way, recognises the instrumentalist view of the role of the financial sector in public policy and asserts its primary goals as growth, stability and equity. By sponsoring this conference, the BIS is also rightly projecting itself as a truly global institution, for which Jaime Caruana and Philip Turner deserve full credit. Governor Subbarao and Usha Thorat are simultaneously placing India as an active participant in the journey towards a better global financial system in the interest of global economy as a whole.

A world in crisis or post-crisis world?

Jamie Caruana made a profound statement in a casual manner when he said in his speech: “I especially appreciate the optimism in the title’s reference to the post-crisis world. Such optimism is more apparent here in Asia than in Europe”. It is generally agreed that a possible collapse in the financial sector was avoided in 2008. There has also been some recovery in the global economy. Hence, many analysts tend to describe the current situation as a post-crisis world. There are others who argue that we are still living through the crisis, and hence it is premature to proceed on the basis that the phase of crisis management is behind us.

It is undeniable that the crisis in the financial sector has been significantly moderated, but the process of correction of the excesses of the past, especially high leverage in some advanced economies, is far from complete. In a sense, therefore, there are risks to the financial sector, though it may not be a continuing crisis situation. However, in the process of managing the financial crisis, a fiscal crisis has ensued, since excess leverage has been shifted from the balance sheets of private financial sector to the public/government sector. In particular, the current situation, in the euro area and potentially in the United States and the United

Kingdom, evidently represents a continuation or a spillover of the crisis from the financial sector. It is also clear that unemployment continues to be high in many of the advanced economies. There is a stalling of growth and employment generation in developing and emerging economies too. In a way, therefore, the fallout of the financial crisis and the consequent strain on government finances has been the economic crisis afflicting many parts of the world. Economic activity appears to be far from normal. Furthermore, in managing this combination of financial, fiscal and economic crises, another crisis situation has surfaced at the political level. As part of a political deal to manage the crisis, for instance, two Prime Ministers (of Greece and Italy) had to make way for the appointment of technocrats. Managing the political economy at a national level as a fallout of global financial crisis means facing unprecedented challenges, be it in the United States or China or India. In addition, there is widespread pressure on social cohesion in several countries. This is illustrated by spontaneous mass movements, both in advanced economies such as the United Kingdom and the euro area, and in developing economies such as parts of Asia and the Arab world. Perhaps there is more to come ahead of us due to further spill over into several social segments. These developments are in some ways a reflection of a broader rebalancing on several fronts that has been triggered by the crisis in the financial sector.

In brief, therefore, the financial crisis may be over if viewed from a narrow perspective, but from broader and longer-term perspectives, we are still living through the crisis. One important lesson from these developments is that in the conduct of macro policy, it is difficult to define the boundaries of the financial, fiscal, and monetary environments, and they cannot be treated in silos, particularly under extraordinary circumstances involving rebalancing on several fronts.

Re-regulating or rebalancing the financial sector

It may be useful to distinguish between re-regulation and the rebalancing of regulatory structures and policy regimes as a result of the broader lessons from the crisis so far. Excessive deregulation was one of the causes of the global financial crisis, but it was not a global phenomenon. Excessive deregulation of the financial sector was generally confined to the United States, the United Kingdom and other European countries. The standards of regulation even in advanced economies have not been uniform as the contrasting examples of Canada or Australia with the United States or the euro area would illustrate. It is true that excessive deregulation was a key feature of systemically important economies which had severe negative consequences for the global economy. But that does not mean that contagion itself is due to globally pervasive excessive deregulation of the financial sector. It would therefore, be unrealistic to generalise that public policy should attempt re-regulation in all jurisdictions. Moreover, several incidents that have come to light indicate considerable regulatory forbearance in the systemically important countries, that was disproportionate to the inherent weaknesses in their financial systems. It can be argued that in some cases, the issue was more of ineffective supervision than of excessive deregulation. Better supervision does not mean more regulation but striking the right balance between regulation and supervision.

Empirical studies comparing developments in Canada and the United States may shed some light in this regard. Both have close trade integration; both have open capital accounts; and both have floating exchange rates. Yet the financial sector in Canada has not been as vulnerable as in the United States. Part of the reason may lie in the macroeconomic policy environment which is instructive, but a large part may have something to do with the nature and quality of regulation and supervision.

In many developing economies, neither shadow banking nor toxic financial derivatives have been prevalent: so re-regulation may not be warranted. Many emerging market economies may not need large-scale capital infusions in banks or changes in incentives that are now being advocated for advanced economies. But they may have certain symptoms of what may be broadly described as repression in the financial sector. The current debate often addresses the correctives needed for what may be described as excessive financialisation; but it does not specifically address the issues of managing development of the financial sector in economies that may be far from such excesses. More important, the linkages between the macroeconomic environment and the financial sector may be somewhat different in countries with under-developed financial sectors than in those with overleveraged financial sectors. Perhaps it would be appropriate for the developing countries to consider the paths of development of their financial sectors to reach the optimal level, keeping in view the lessons from the global financial crisis.

In brief, therefore, the major thrust of regulation of the financial sector may be in terms of defining the perimeter and the substance of regulation. The lessons we have learnt about the framework for financial sector regulation that is appropriate to each country point to the rebalancing of existing regulatory systems. Hence, with the task ahead being ideally described as rebalancing, some re-regulation of the financial sector may be appropriate in many advanced economies. In the effort of rebalancing in each country, the global perspectives gained from the crisis become particularly relevant in view of the contagion that was experienced.

Optimal level of financialisation

Governor Subbarao in his address indicated that a developed financial sector would serve the interests of the real sector, but that does not mean that more of the financial sector would always lead to better outcomes. He made two profound statements, and they are closely related: “Is there such a thing as a ‘socially optimal’ size for the financial sector?”, and “It is the real sector that must drive the financial sector, not the other way round”. While it may be difficult to define what is optimal, we have experienced excessive financialisation that could damage the real sector. We must strive to understand this phenomenon. Excessive financialisation is generally taken to mean excessive leverage or excessive expansion of credit through leverage, or excessive recourse to exotic derivatives. But excessive financialisation has several additional aspects that are relevant for economic analysis and policy.

First, there has been significant financialisation of commodity markets. It happened both by virtue of deregulation of the commodity markets and by virtue of the excessive liquidity that happened to be readily available. This phenomenon has arguably resulted in excessive volatility in commodity markets. In standard economic analysis, the price of a commodity is determined by the law of supply and demand. In the case of excessive financialisation, commodities become an asset class, and hence the price is determined not only by demand and supply of the commodity in the real sector but also by the demand and supply for the commodity as a financial asset. A persistent disconnect between the spot prices of commodities and the underlying demand and supply conditions – that is mainly caused by the conditions in financial markets – is evidence of financialisation of commodity markets. Persistent volatility in commodity prices, due more to commodities as an asset class than to trading could imply avoidable costs in the process of price discovery and possible distortions in the market. The correctives in public policy in regard to excessive financialisation of commodity markets extend beyond the scope of regulation of financial sector.

Secondly, there has been significant financialisation of household budgets, particularly in advanced economies. The changes in demand for houses or scooters or cars are often dependent on credit conditions, rather than on the standard assumptions about income and price elasticities of demand. Even the expected cash flows, including in particular social security, are determined by the market value of the pension funds and other sources of social security over people's lifetimes. Not only current consumption, but also the future streams of income derived from savings are determined by the conditions of the financial market.

Thirdly, there has been financialisation of corporates. Corporates are exposed to financial markets not only through their underlying operations of producing and selling, but also through their treasury operations. Many corporations derive incomes from their treasury operations, often totally unrelated to their main business activity, and they may take significant risks on this account. Their treasury operations are not necessarily restricted to the jurisdiction of a single country, especially when they have cross-border operations. Many large corporations have built up large cash surpluses in recent years as they held back investments in the real economy. The cross-border treasury operations of corporates often fall outside the scope of regulation of the financial sector, and the impact of this phenomenon on the effectiveness of macroeconomic policy is unclear.

Fourthly, there has been excessive financialisation of the financial sector itself in many advanced economies. In other words, incentives in the form of commissions related to transactions led to multiple layers of transactions. Some innovations were like mirrors of reality; as the mirrors multiplied, the distortion of the original object became all the greater. Further, complexity was injected in regard to some of these innovations to circumvent the regulatory prescriptions on transparency or on capital adequacy, or to mislead the counterparty. The comparisons of the growth of the financial sector as a percentage of GDP, the growth of profits of financial institutions as a percentage of profits of all the corporates engaged in economic activity, the remuneration of managers in the financial sector relative to others, and the share of shadow banking systems as well as derivatives in the total activity of the financial sector, would be useful indicators of the extent of financialisation of the financial sector. Analysis of the indicators of excessive financialisation with reference to the record of economic growth and stability in the countries may be useful. The analysis could encompass advanced economies such as Canada, the United States, Sweden, Norway, Japan, Australia, and emerging market economies in Asia, in particular China and India, and Latin America. In brief, empirical evidence may be a good pointer to the excessive financialisation, and thus throw some light, at least in broader terms, on the optimal level of financialisation for each country.

Composition of financial sector, growth and stability

Governor Subbarao, who has earlier expressed himself against making banking too boring, elaborated on the issue when he said: "Is making banking boring a necessary and sufficient solution to preventing the excesses of the pre-crisis period? And what will be the cost of making banking boring?" This issue can be restated in broader terms as one of optimal composition of financial sector. It is not only the level of financialisation of an economy, but also the nature and composition of the sector that may be relevant for growth and stability. East Asia had displayed significant growth, and faced a major episode of instability in recent decades. As a result of the crisis, it changed its policies relating to financial sector. Malaysia followed one distinct model of crisis management and the others another model. Both helped Asia to come out of the crisis stronger. In the recent decades, Latin America had displayed lower growth rates than East Asia, but witnessed far higher instability than east Asia. Latin American economies are characterised by impressively liberalised financial sectors. East Asia, on the other hand, displays a strong presence of traditional banking and, in particular, a lower market share of foreign banks. China has displayed remarkable growth and impressive stability in the recent decades, and is characterised by a financial sector dominated by state ownership, significantly regulated and highly directed (by public policy). India also represents a high growth economy with stability and a financial sector which, as in the case of China, is dominated by traditional banking and by state-owned financial institutions. Similarly, it is possible to identify several advanced economies with varying levels of growth and record of stability, emanating among other things from differing patterns of financialisation.

The diverse growth and stability experiences of different countries with quite different financial sector structures would therefore require enquiry into five related factors, viz:

(i) the macroeconomic environment in which the financial sector operates;

(ii) the share of the financial sector in total economic activity;

(iii) the composition of the financial sector in terms of banking, non banking, derivatives etc;

(iv) the framework of financial sector regulation; and

(v) the quality of supervision of the sector.

There may well be instances of over-regulation, but under-governance. Regulation and supervision can play a role in influencing the composition and the quality of the financial sector. Hence, analysis of the trade-offs between growth, stability and regulation may include considerations of the composition and quality of the financial sector – which encompasses both the conduct of the markets and the conduct of regulation, including supervision.

It is also possible that there is excessive financialisation in one segment of the economy, say the financial sector, and there may be several segments of real sector (such as agriculture and SMEs) or regions or sections of the population that are under-served by financial sector. The initiatives in regard to financial inclusion by the G20 resolutions represent the recognition of the possible dualism in the growth of the financial sector. Cross-country comparisons of the composition, coverage and penetration of the financial sector and its links with growth, stability and equity, may be valuable for understanding the desirable composition of the financial sector appropriate to each country.

Coupling or decoupling of developing and emerging market economies

There was a reference in the discussions to the validity of the decoupling hypothesis in view of the experience with the global financial crisis. It is useful to consider the evolution of this debate. Before the global financial crisis erupted, the benefits of global integration and possible downsides were highlighted. In the initial stages of the global uncertainties in 2007-08, there was a hypothesis that the developing and emerging market economies are significantly decoupled from one another despite the global integration that had taken place. The hope was that their economies would grow in a way that could compensate for loss of momentum in economic activity in the crisis-hit advanced economies. Subsequently, as a result of the contagion observed in the global economy in 2008-09, the hypothesis of contagion and coupling overtook the hypothesis of decoupling. In 2010 and 2011, with impressive recovery in the emerging economies, the decoupling hypothesis again took centre stage. More recently, the picture has been far more confusing, and in any case, a significant divergence between the emerging and developed economies in economic performance in terms of parameters such as unemployment, growth and inflation, is being observed. It is very clear that the economies are in many ways coupled; but much depends on the structure of a national economy, and the nature of its integration with the rest of the global economy. At a conceptual level, the debate reflects both the incomplete global integration of economies and the continued importance of public policy at the national level. The issue of the financial sector is more complex because externalities are more pervasive than in the goods sector. Thus, it may be useful to explore the importance of differentiating between the financial and goods sectors in assessing coupling and decoupling. The main link between international trade in goods and international finance is trade finance. The margins for the financial sector are low in trade finance, and so are the risks. The immediate impact of any disruption in the financial sector from the advanced to developing economies occurred through trade finance. A second level of contagion is through financial flows, and this happens on account of the gross capital flows in the short run and not over an extended period. Sentiment and herd behaviour influence gross capital flows, and this is, perhaps, an important source of coupling. A third level of contagion is through the demand and supply of goods and services that determine current account balance. This is influenced by the trade linkages. For example, the impact of the global financial crisis on China was more through trade and sentiment, than through financial flows. It may be useful to analyse the coupling and decoupling in terms of the nature of contagion through different, but related channels.

An important policy issue would be the need to identify global regulatory regimes that immunise global trade finance from the vagaries of volatile financial markets. It may be useful to explore the possibility of treating trade-finance as one similar to payment system and retail banking in a country; this would argue for ring-fencing this activity from investment banking and other riskier cross-border financial activities.

Globalised financial markets and competitive efficiency

The current policy initiatives at the global level on the financial sector basically assume that global financial markets are good for achieving efficiency and stability in all countries, provided they are well regulated at the national level with a global perspective in view. The thrust of global initiatives is to provide for the harmonisation of national regulations, by prescribing minimum standards of regulation for all countries, and coordination between national regulators especially on matters relating to cross-border presence and systemically important financial institutions. Further, the financial sector and its regulation should be put in the context of the macroeconomic conditions in the country, and its functioning is subjected to what may be described as basic infrastructure for global financial markets to function efficiently in the country. It is useful to explore the state of infrastructure for global financial markets in assessing the scope for efficiency in global finance through market mechanisms.

First, the international monetary system has generally been described as a non-system. The US dollar is the dominant reserve currency. The supply of this currency is determined by the Federal Reserve, which is statutorily mandated to make such supplies available to serve the interests of the United States. If the interests of the United States coincide with that of the global system, there may be no serious problems, but that may not necessarily be the case. There have been no globally agreed rules to govern the supply of this dominant international reserve currency since the fall of the Bretton Woods system. There is no serious alternative to this currency, and thus there is no market discipline in ensuring efficiency and appropriate supply to meet the demand. There is recognition that it is a non-system, and there is a search for finding a solution to this problem. The option of a currency of another country that could replace the US dollar as the dominant international reserve currency will not solve the basic problem of the present system, namely, "my (domestic) currency, but your (global) problem". It is possible to argue that several reserve currencies could be encouraged, but there is no system that could possibly achieve this. The SDR (Special Drawing Rights), which is a unit of accounting based on a basket of currencies, is currently being advocated. However, this may provide the benefit of diversification, but will not solve the problem of the possible inconsistency between the national goals of certain countries and the interests of global economies. In brief, global financial markets suffer from a monetary non-system.

Secondly, globalised finance would require a lender of last resort to address problems of sudden illiquidity. Such a lender of last resort should ideally have capacity to create or destroy money. More importantly, such an institution should be able to take some solvency risk since a lender of last resort has to make judgements about solvency. There is no institution in global finance to undertake this responsibility. The IMF is some sort of a lender of last resort, but its infirmities in terms of governance, ideology, trust and reputation are recognised and under discussion. There are still no mechanisms for the orderly restructuring of sovereign debt in cases of default or potential default. The implicit assumption of the absence of credit risk in regard to sovereign debt creates a huge incentive for the financial sector to be less than a responsible lender. It is difficult to conceive efficient global markets in a system that does not have a credible monetary system and is without an effective lender of last resort.

Thirdly, the existing infrastructure for global financial markets comprises, *inter alia,* credit rating activity dominated by two entities; the accounting functions are dominated by four entities; and the dissemination of information by two news agencies. Their infirmities are also well known. The issue is whether such an infrastructure contributes to the comfort of efficiency in global financial markets.

Fourthly, it may be useful to draw a distinction between multinational banks which have subsidiaries or branches in different countries (but predominantly operate in domestic markets) and international banks which specialise in cross-border financial activities, especially influencing capital account flows, both short-term and long-term. International banks are able to operate across financial markets in different countries with significant divergence in fiscal regimes as well as regulatory regimes. They may be involved in financial flows of suspect legality in one country, though not in both countries. Because of these operations, international banks enjoy a significant influence over the political economy in several countries.

Under these circumstances, two fundamental issues arise. The first is the validity of the assumption that global financial markets have an inherent tendency to be efficient and to self-correct. The second is the compatibility of autonomy in macroeconomic policies and the autonomy of financial sector regulation at the national level with the globalisation of finance. In brief, the globalisation of finance in the context of serious market imperfections and the absence of globally enforceable rules could, by virtue of the close linkages of finance with other macro policies at the national level, limit the space available for national authorities to conduct effective macro-policies.

Financial and real sectors

Jamie Caruana has described the interactions between the financial and real sectors in a very clear-cut fashion. The analysis is essentially in the context of the cyclical nature of financial activity being reinforced by its relationship with the real sector, and the cyclical nature is equally applicable to both the borrower and the lender. From a developing country perspective, some interesting issues arise. First, the major problem for developing countries relates to the financing of the structural transformation of the economy. The critical issue is whether the deregulated financial sector is reasonably efficient in the allocation of resources for structural transformation. In many advanced economies, such structural transformation was not necessarily financed through developed financial markets. It is possible to hold that the financial markets have a tendency to focus too much on the short-term outlook, and this may drive the political economy, and also macro-policy, towards a similar time horizon. This may lower household savings.

Secondly, to the extent that the real and the financial sectors interact with each other on several fronts, the issue of synchronisation between the development of factor markets and goods markets in relation to the development of financial markets would become critical. It is possible to argue that the financial sector may exacerbate the market distortions in the real economy due to the existence of structural rigidities. A deregulated financial sector may take advantage of structural rigidities rather than inducing their corrections. This would raise the issue of sequencing and harmonising of reforms and deregulation in the real and financial sectors.

Thirdly, Jaime Caruana has brought to attention an important aspect of external flows in the relationship between real and financial sector, “An important feature of cross-border credit flows is that they tend to exacerbate domestic credit cycles”. Since the financial markets of emerging and developing economies are not large, even modest levels of cross-border credit flows by global standards could have enormous influence on the domestic credit cycles. In this situation, the requisite policy tools both in macroeconomic terms and in terms of regulation of the financial sector may have to be multi-dimensional and have to be reasonably effective. In this light, a combination of macro-policies, prudential regulation and capital controls may be warranted. Such a management of the capital account would involve differentiation by residential status of an entity, or by denomination of currency.

Fourthly, I agree with Jaime Caruana when he says, “Sovereigns must now earn back their reputation as practically risk-free borrowers. And as history has taught us, sovereign solvency is a precondition for the central bank’s success in dealing with threats to monetary and financial stability”. The critical issues for many emerging and developing economies are that credit rating agencies heavily influence the view on sovereign solvency. The current global financial architecture as already explained shows that the odds are loaded heavily against developing and emerging market economies, though some advanced economies have been facing issues in this regard, in the recent past. In these circumstances, there is an additional burden on the part of policy makers in developing countries to assure sovereign solvency.

Fiscal and financial sector linkages

Jaime Caruana has referred to the two-way influences and said: “There is a clear and present danger of malign feedback from banks to sovereigns and from sovereigns to banks”. It may be interesting to recall that the two-way influence has often been benign: the government provided reinforcement of trust to the banks, and the banks ensured success of the government’s borrowing programmes. This cozy arrangement between the government and the banking sector worked smoothly, as long as both of them operated within the confines of a sovereign entity. This is no longer the case. In any case, the global financial crisis has brought about what may be termed the significant fiscalisation of the financial sector and the noticeable financialisation of fiscal policy.

First, traditional deposit insurance itself provided some sort of subsidy in as much as it has never been a commercially viable proposition. The recent extraordinary market interventions by monetary authorities have taken the characteristic of providing fiscal support to financial sector. The bail-out by the fiscal sector signifies a more direct subsidy to financial institutions. In some cases, capital has been injected by the government into banks, and in a few cases, banks have been nationalised. In managing the crisis and the subsequent exit policies, the boundaries between monetary and fiscal policies became unclear, and quasi-fiscal costs are not easy to compute. At the same time, there are on-going discussions in regard to the financing of direct and indirect fiscal support that had to be extended to the financial sector. This includes considering a financial sector transactions tax, including a Tobin Tax. However, there is significant opposition to these measures by national governments on the ground that the financial sector would move to other jurisdictions.

Jaime Caruana’s observations on the sovereign as ultimate risk bearer are specifically relevant for economies which do not happen to be fiscally strong but desire to deregulate the financial sector in the belief that such measures would be benign. Jaime Caruana said, “In effect, the sovereign becomes a deus ex machina, the supernatural intervention that resolves some ancient Greek tragedies”. The problem arises when the sovereign’s capacity for supernatural intervention is constrained by globalisation which may be beneficial in many respects, but could undermine the capacity of the sovereign to tackle a crisis in the financial sector. Thus, the financialisation of fiscal policy occurs because the conduct of fiscal policy is itself dominated by the consideration of the view of the global financial markets on the sovereign's solvency and its capacity to support a financial sector in distress. The phenomenon of fiscal policies being significantly constrained by views of the financial markets is being witnessed by advanced economies. In brief, the supernatural intervention by the sovereign through fiscal measures is subject to the blessings of the credit rating agencies on the state of their solvency. This state of affairs is bound to have a bearing on the conduct of both regulation of financial sector and macroeconomic policies.

Financial sector and macroeconomic policies

It is recognised that the regulation of the financial sector should serve the broader goals of human endeavour, namely, growth, stability and equity. Public policy in general and macroeconomic policy in particular share similar objectives. Markets are considered to be efficient when subjected to appropriate regulation, and thus are ideal means of achieving these goals. Both macroeconomic policy and regulation of the financial sector have to ensure that there is an appropriate balance between the State and the market, between fiscal and financial, and between the financial and real sectors. Accountable governance arrangements are available only at a national level, and both the regulation of the financial sector and macroeconomic policy are conducted at national levels. Under these circumstances, an appropriate space for public policy at a national level in regard to both financial sector and macroeconomic policy broadly defined is essential. Public policy has to guard itself against the erosion of such policy space. Simply stated, the extent and nature of sovereignty of a sovereign in a globalised economy with globalised finance is critical in designing and implementing coordination between regulation of the financial sector and macroeconomic policies.