

## **José de Gregorio: What does society expect from the financial sector?**

Panel discussion remarks by Mr José de Gregorio, Universidad de Chile and former Governor of the Central Bank of Chile following the Per Jacobsson Lecture by Dr YV Reddy, 24 June 2012, Basel, Switzerland.

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I would like to thank the BIS for the invitation to participate in this panel, which makes us look at financial markets from a new perspective.

As policymakers, we are used to talking about how the financial system must operate in order to fulfill its goals without threatening financial stability or imposing costs at the aggregate level. In recent years, the discussion has focused on how to avoid excessive procyclicality, contagion, moral hazard, and other important policy concerns.

As economists, we have been trying to explain the misbehavior of financial systems, and we are still searching for answers. Although we may have some ideas, the policy implications are not straightforward, but the answers cannot wait. Policy design needs answers as soon as possible, and delays may cause well intentioned policies to be poorly implemented.

But what society really demands from financial systems is quite difficult to define. Society is a collection of actors, with different interests and different needs. People want access to the financial system at fair conditions. Therefore it is useful to think of society as everyone who is not related directly to the financial industry or policymaking.

Starting from here, we can say that society is demanding *safer and fairer* financial systems. The view that financial markets were big casinos, where the betting was done with other people's money and gamblers walked away unpunished, is quite common around the world. Public opinion has been dominated by that sentiment, which has also affected policymaking.

### **On financial development**

Let me start by stressing that financial intermediation is good, and with the backlash from the crisis it should be repeated that a well functioning financial system is key to prosperity. It promotes economic growth by channeling investment funds from savers to borrowers (Levine, 2006). It is central to promoting entrepreneurship and to facilitating investment, including human capital accumulation. It provides financing to households in order to smooth consumption, and provides insurance. It provides safe and cheap means of payment. The difficulties faced by households and firms in many emerging market economies due to underdeveloped financial institutions and markets should be a clear reminder of this positive role. But financial depth may also be a source of great problems. As in many situations, more is not always better.

There is plenty of research concluding that economies with deep financial systems grow more. However, studying this issue in Latin America many years ago I came to the conclusion that in Latin America growth during the eighties was lower in countries with more developed financial systems, since the collapse of their economies during the debt crisis was larger (De Gregorio and Guidotti, 1995). Indeed, it was Carlos Diaz-Alejandro, by the mid-eighties, who eloquently said "good-bye financial repression, hello financial crash" (Diaz-Alejandro, 1985). Some recent research also points in the same direction, as reviewed in Dr. Reddy's lecture – beyond a certain level, financial depth has marginal contributions to growth (Arcand et al., 2012; Cecchetti and Kharroubi, 2012).

In Chile we had a great financial crisis in the early eighties which led to an overhaul of financial regulation. The country followed the prudent route, allowing only activities that could be handled appropriately by financial intermediaries, but above all that could be understood

and monitored well by market participants and financial regulators. Since the country was emerging from a deep financial crisis, the macro view of the financial system and its regulation were a central part of the design.

But this seems not to have been the case in advanced economies.

The global financial crisis has revealed the perils of financial deepening. It has shown that advanced economies are not different. This is not new in emerging markets, but is something less common and more dramatic in advanced economies. Long ago we learned that when an economic downturn comes with a financial crisis the costs are extremely high.

### **What went wrong?**

It is important to recall that the crisis had its origins in a noble cause: providing housing to low-income families. This was perhaps the response to rising income inequality, as emphasized by Rajan (2010), and the lack of other policies to correct this problem in a fast and efficient way. Ironically, the crisis affected more intensely precisely those that were supposed to benefit from “financial inclusion.”

There are many other cases in which well intentioned developments are implemented through weak policies. Take the case of interest rate ceilings. In order to promote fairness, many countries introduce limits on the interest rate on loans. This policy attempts principally to protect people with disadvantages and allow them to participate in the financial system. If this ceiling is set low enough, it may end up generating exclusion rather than lower financial costs for households, who may end up paying much higher interest rates in informal credit markets.

This is not the place to analyze all the causes and culprits of the crisis, but it is worth discussing certain aspects that are frequently singled out by the general public.

First and foremost, the crisis was caused by the irresponsible behavior of the financial industry. The structure of incentives was unsuitable. It led to excessive risk-taking without proper risk management. Compensation was heavily biased towards deal-making, regardless of the quality of the deals. Commissions and fees were a very important component of the compensation scheme. In the end, all that mattered was granting credit indiscriminately, maximizing packaging and selling securities, etc. This was at the foundation of the originate-and-distribute model of financial services, and served to increase leverage to unsustainable levels. We know that linking compensation to productivity is efficient, but the devil is in the details.

Second, the regulation-making process, as very well discussed in Dr. Reddy’s lecture, was also distorted by comprehensive capture by the financial industry. As he explains, this was not only capture of the regulators, but also capture of public policy relating to the financial system. With a little bit of moral hazard, which is exacerbated by regulatory and policy capture, the result was the creation of a very vulnerable financial system.

Finally, there was indifference in policy circles. None of us saw it coming, at least not with the intensity with which it arrived, which still persists. Indeed, it was difficult for those of us from emerging markets to think that this could happen in the advanced world. Whenever we had raised a concern we had been told that “these are developed countries,” as an argument that “this time is different”. There were, of course, calls for prudence, in particular from this institution, but we never thought that the consequences would be so dramatic. Markets should provide enough discipline to balance risk and return, but that was not exactly the case. The market functioned poorly. In addition, we had a sense of security given the “decoupling” that took place in the 2000s, in part due to good macroeconomic management, and which became a recoupling by mid-2008 (Dooley and Hutchison, 2009; Korinek et al., 2010).

It is easy to put the blame on the behavior of the financial industry, but the policy implications are not straightforward. But from the three points I have raised – misbehavior of market participants, comprehensive capture, and policymakers' indifference – there are three simple conclusions: we need tight regulation, transparency and disclosure of conflicts of interest, and permanent monitoring of financial stability.

### **What else may go wrong?**

Financial systems in emerging markets escaped from the crisis due to some extent to prudent regulation, built on a history of recurrent crises. But perhaps it was also due to the fact that we are somewhat slow to adapt to financial innovation. Indeed, many issues, such as the use of derivatives by the banking industry, were being discussed in emerging markets on the eve of the crisis. Of course, we are much more aware of the risks of financial innovation. It is particularly important to understand innovations – something that I think very few understood before the crisis. A simple rule for policymaking is that if you cannot understand what is really being proposed and you do not see the benefits, it is better steer clear. We used this simple dictum at the Central Bank of Chile.

Not everything is bright in emerging markets. There are many challenges. One issue that has not been a problem so far, but presents potential risks, is the role of public banks. Some research has shown that in Latin America public banks are less procyclical than private banks (Micco and Panizza, 2006), but this could be for good or bad reasons. If public banks are prudent and avoid jumping on the bandwagon of optimism during the upturn this is good – they may even soften credit constraints during the downturn. However, public banks may also be an instrument to pay back supporters of politicians, and certainly this is unfair and inefficient. Public banks may also be subject to capture by the electoral cycle (Micco et al., 2007), or used as an instrument to implement industrial policy. Given the lack of other instruments, providing credit for selected economic activities may be a way to promote specific sectors. There are certainly better tools for promoting specific sectors, especially from efficiency, fiscal, transparency and accountability points of view.

An issue that has been on the agenda in most countries is financial consumer protection. This is, of course, a welcome development, and is a clear demand from society. Transparency in financial charges and the nature of the contracts, the ability to change across financial agents, assigning clear responsibilities in this area to regulators, and improving financial literacy are among the issues being discussed. It is important, however, for consumer protection to form an integral part of the regulatory infrastructure in order to avoid inconsistencies among agencies and risks to depositors and overall financial stability in the name of protecting consumers. Consumer protection also has a high risk of being captured by the political cycle. This could be specially damaging in the financial system – and therefore every effort should be made to make the institutions safeguarding financial consumers autonomous and technical.

For macroeconomists and financial economists, today it is difficult to focus on something other than the European crisis. The health of the global economy depends on a good resolution to this crisis. However, we cannot forget the duty of building a *safer and fairer* financial system. Today we have the opportunity to tackle this task, but we also have to avoid shortcuts that may end up rebuilding a weaker financial system.

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