Miroslav Singer: Regulatory earthquake

Welcoming remarks by Mr Miroslav Singer, Governor of the Czech National Bank, at the Basel Consultative Group Workshop on the impacts of Basel III on emerging market and smaller economies, Czech National Bank, Prague, 26 August 2013.

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Dear participants of the Basel Consultative Group Workshop,

Ladies and gentlemen,

Let me warmly welcome you to the Czech National Bank, which is proud to host this workshop on the impacts of Basel III on emerging market and smaller economies.

I am very glad that my institution is involved in this workstream because I believe it is important for emerging economies not to be merely passive recipients of the regulatory "earthquake" in the banking industry which is spreading from advanced countries. Emerging economies should not and cannot blindly adopt new regulatory measures, as their financial markets have their own specific features. What is a priority for regulators in the most developed economies may not be a priority for regulators in emerging economies. On the other hand, the proposed measures within the Basel III framework may have unintended consequences for these countries, so it is worthwhile either to be prepared for them or to try to mitigate them if they are negative.

Let me start by underlining what I consider to be the two fundamental difficulties of the current regulatory push. The first one is of a general nature, while the second lies in differences in the relationship between the size of the financial sector and the size of the real economy in the most developed economies and the emerging ones.

As to the general difficulty, I strongly believe that the world is becoming more fundamentally uncertain. Alignment and coordination of regulatory tools and policies can only take us so far. There is no guarantee that rules and harmonisation will produce the right outcome, that the new rules will be significantly better than previous ones, or that in the fundamentally highly uncertain world the "right" set of rules exists at all. Therefore, it is surprising to me that we are so focused on the design of the, hopefully, right set of rules and often also on limiting the space for their diversification. After all, diversification is a tried and tested strategy for dealing with fundamental uncertainties. The push for harmonisation at the expense of space for diversification is leading individual sovereigns to take a different approach, namely, that of insulation and buffering. This itself is not such a bad thing. After all, taking as a benchmark the maritime world, in which the rules of shipbuilding are fundamentally clearer, more certain and more effective than the current rules of financial market regulation, big ships are constructed with watertight compartments to contain any flooding if the hull is breached. However, uncoordinated insulation hinders free trade in financial services and flows of financial assets, effectively harming the common markets for them. I believe that the marginal benefits of focusing more on space for coordinated diversification of approaches to regulation are now much higher than those of trying to find "the ultimately and finally correct set of rules" and imposing them on all countries.

As to the second difficulty, it seems to me that the much smaller size of the financial sector relative to the real economy in emerging or less developed economies has profound consequences for the optimal mix of regulatory rules – consequences that are neither acknowledged nor discussed. To develop this idea, let me stress that most measures dealing with the crises of financial institutions in the most developed economies were influenced by the fact that those institutions dwarfed the budget revenues of the relevant treasuries. Consequently, their wind-down – with government guarantees for most of their liabilities to agents in the real economy, such as household or corporate sector deposits – would have led immediately to a serious downgrade of the relevant sovereign debt. But this is not the

case with most developing and emerging economies and their financial institutions, whose size relative to the real economy, forex reserves or budget revenues is much smaller. Consequently, the optimal mix of the pace of financial sector growth and the risk of financial sector crises differs significantly, allowing for faster growth even with higher risks. In addition, while recognising that many developed economies see a need to downsize their financial sectors and/or institutions, this need is not shared in the emerging world and less developed countries. The different mix of regulatory rules – allowing for faster growth of the financial sector in countries where its relative size is lower, even at the expense of higher riskiness of the sector, would also be welfare enhancing. After all, generally faster growth of less developed economies resulting from faster growth of their service sectors – comprising also financial services – would foster growth of the most developed countries' export sectors and consequently overcome the slack caused by their need to restrict their financial sector growth rates. It is quiet fascinating how this observation – which in essence merely follows some of the basic logic of the Ricardian argument supporting free international trade – is being almost completely ignored in the current regulatory earthquake.

This earthquake is mostly due to the financial crisis, which spread swiftly to the world primarily from the US and later from the Eurozone. The emerging markets were hit as well, some of them very strongly, but by and large their financial sectors have shown stronger resilience than in many developed countries. This was also the case of my country – the Czech Republic – as we have had no bankruptcy of any more significant financial institution and consequently no state aid in the financial industry for many years now. However, this is no reason for complacency. The market economy has always developed in more or less deep cycles and it seems this will be the case in the future as well. It is our duty to assess the measures critically at present, as some of them may have adverse side effects and may in fact exacerbate potential crises.

Your contributions are concerned with emerging market and smaller economies, i.e. EMSEs. This group of countries is a rather heterogeneous one. Under this heading one can subsume China and countries from Southeast Asia as well as Latin America and the Caribbean, countries which were formerly centrally planned economies as well as small island economies with huge financial sectors. Some of the countries have their own currencies, some are members of currency unions and some, as is the case of the Czech Republic, are members of the European Union, which implies a tremendous amount of regulatory measures created to a large extent out of their control. Furthermore, it is obvious that jurisdictions within this group differ substantially and will continue to do so.

Despite all these differences, I think the emerging and smaller economies have some common features other than the already mentioned most profound difference of relatively smaller sizes of their financial sectors and institutions. For example:

- their financial markets are typically more volatile than those in advanced economies, and so is their GDP growth, which at the same time is higher on average than in advanced economies;
- these countries are also typically experiencing stronger credit growth, as their financial sectors are in the process of catch-up;
- they usually have lower credit ratings and shallower government bond markets, which in some cases implies a lack of high quality liquid assets, a lack of adequate collateral etc. Saying that, I must stress that this difference does not apply to some; my country is a testimony to this;
- the countries face a whole range of home-host issues, as many globally significant financial institutions operate branches or subsidiaries in those countries.

These are just examples of features which could possibly interact with the Basel III framework in emerging economies in a way that was not originally intended. As I see from the topics covered by your workstream, you touch on all these aspects, so there is a chance

that the paper that will emerge out of your contributions and out of the discussions you will have today will be useful for regulators in EMSEs and for the Basel Committee on Banking Supervision as well. Hopefully, today's workshop will help you with this.

Ladies and gentlemen, I hope that some of my more general comments on the deficiencies of the current regulatory "push" have not ruined your motivation for this meeting. I wish you every success in your work.