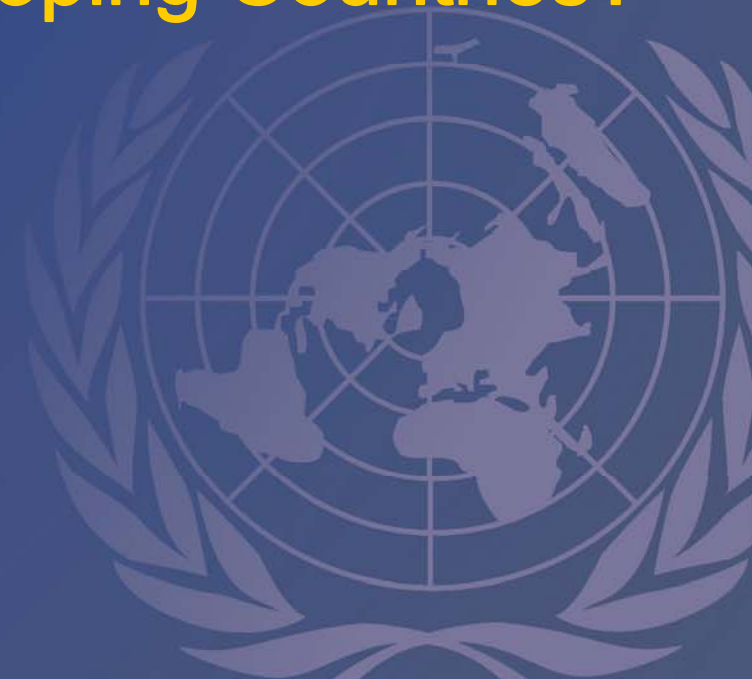




Rethinking International and Domestic Financial Regulation: What Works Best for Developing Countries?

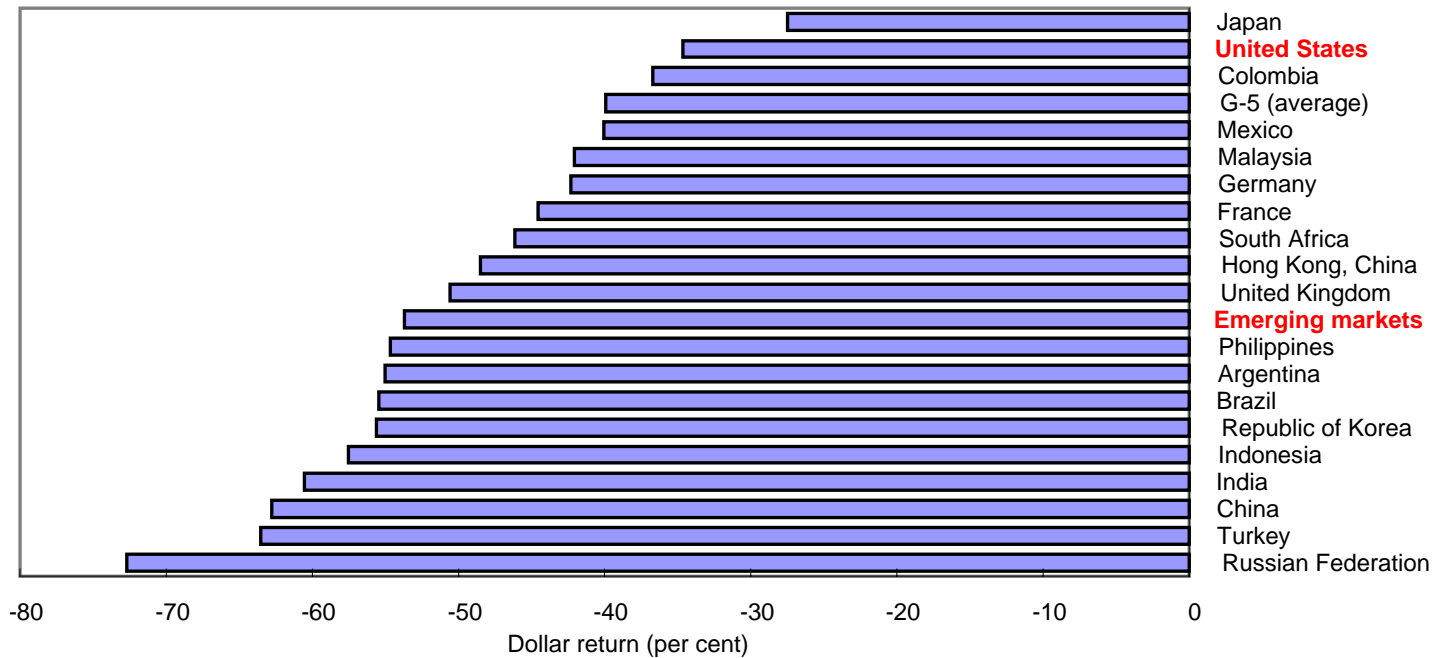
Policy Responses to Unfettered Finance
Geneva, June 8-9, 2009





The Myth of Decoupling

Figure 2.4
EQUITY MARKET DOLLAR RETURNS, 2008

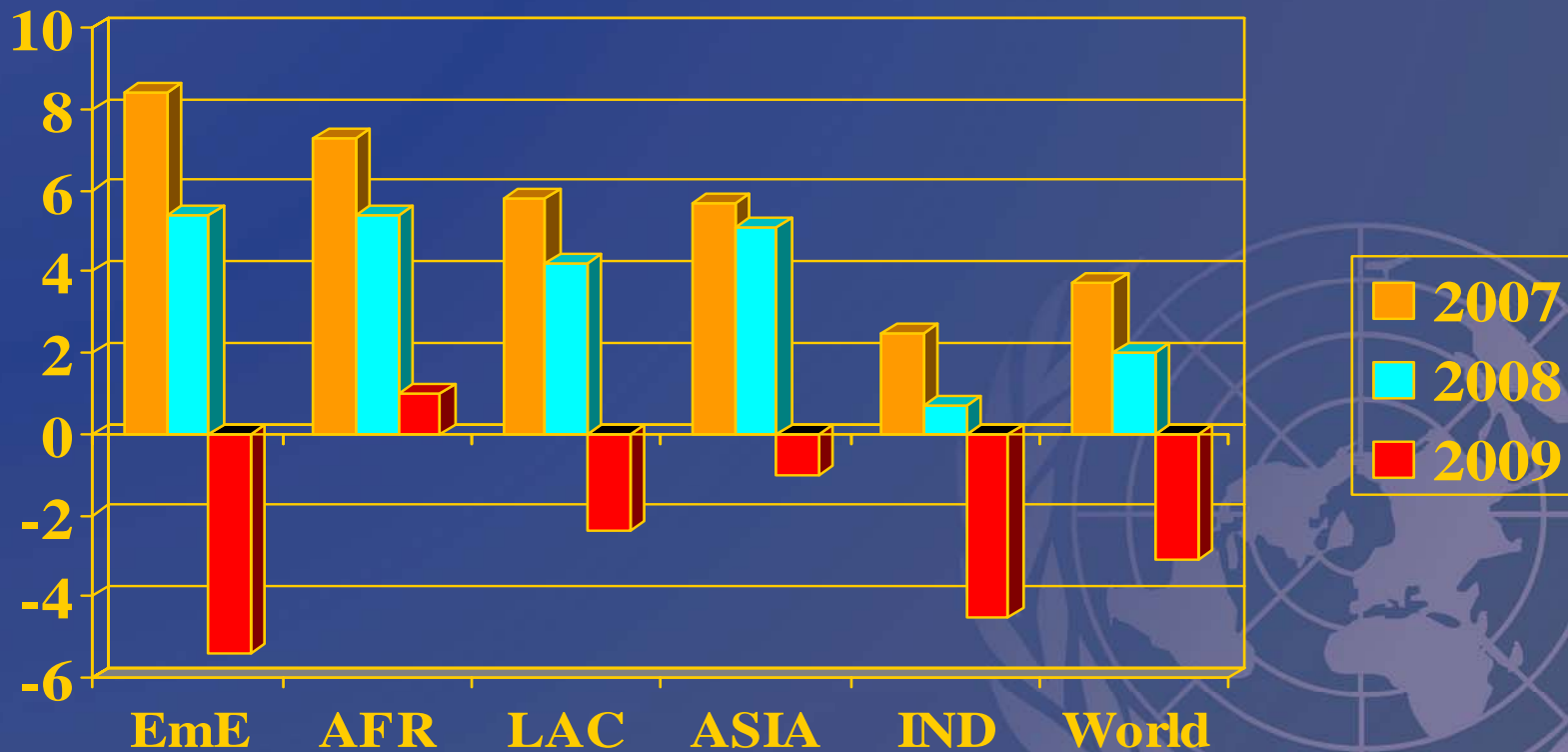


Source: UNCTAD secretariat calculations, based on stocks and markets data from Thomson Datastream.



The Myth of Decoupling

GDP Growth





A Crisis Foretold

Proximate cause:

- We built too many houses

What really went wrong:

- Inexistent global monetary system
- Weak regulatory regime
 - Global imbalances fed many bubbles

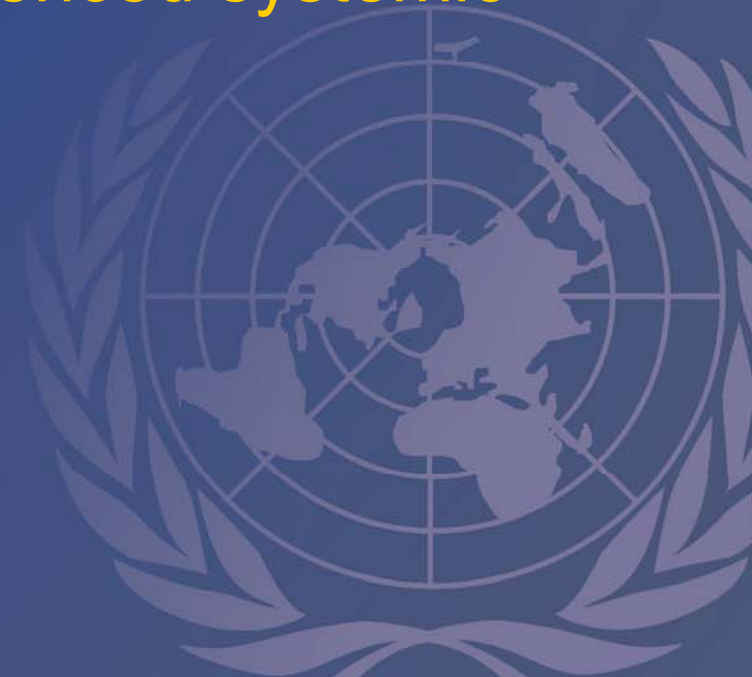
Fighting the last crisis?

- Bad idea if each crisis is different from the previous
- But are they different?
- Avoid regulatory cycles
 - Learn from “near misses”





- A recent UNCTAD report suggests that uncertainty associated with the subprime crisis generated a sudden unwinding of speculative position in many markets
- The Report highlights three specific areas in which global markets experienced systemic failure:
 - Financial markets
 - Commodities markets
 - Currency markets





Responses:

– Firefighting:

- Inflation is *not* the main risk right now
 - Expansionary policies are necessary
- More coordination in conducting such expansionary policies
 - Countries that have more space to adopt expansionary policies should do more
- Avoid procyclical policies in developing countries by providing the necessary financial resources





Responses:

- Long term issues (but to be tackled now):
 - Rethink financial regulation
 - Both domestic and international
 - Build a coherent monetary system aimed at avoiding competitive depreciations
 - Multilateral code of conduct
 - Build a system for the stabilization of commodity prices





7+1 Lessons for Financial Regulators





1 Focus on the Right Definition of Financial Efficiency

- Five possible definitions (Tobin, 1984)
 - Information arbitrage efficiency
 - Fundamental valuation efficiency
 - Full insurance efficiency
 - Transactional efficiency
 - Functional or social efficiency
 - From the point of view of a regulator, social efficiency should be the only relevant definition of efficiency
 - Several financial products can yield large private returns but have no social return
- Key objective of regulatory reform:
 - Do not stunt financial innovation but weed out financial instruments which increase risk but have no social return





Large Private Returns, But Where Are the Social Returns?

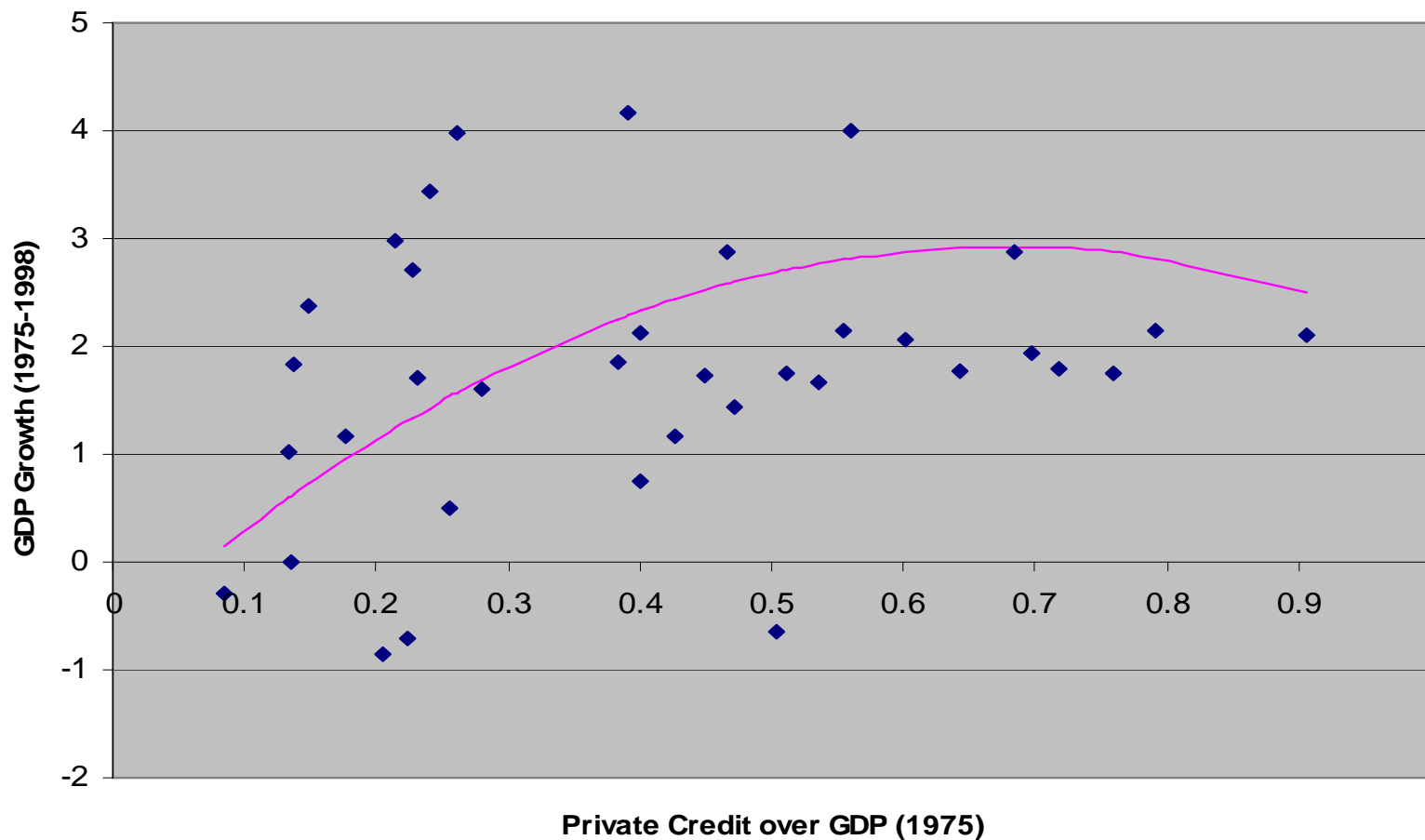
- In 1983, the US financial sector generated 5 per cent of the nation's GDP and accounted for 7.5 per cent of total corporate profits.
- In 2006, the US financial sector generated 8 percent of GDP and accounted for 40 per cent of total corporate profits.
- In the meantime, the US financial sector had to be bailed out 3 times in three decades
 - Tobin (1984) “There must be something wrong with an incentive structure which leads the brightest and most talented graduates to engage in financial activities remote from the production of goods and services”
 - Rodrik (2008) “What are some of the ways in which financial innovation has made our lives measurably and unambiguously better”



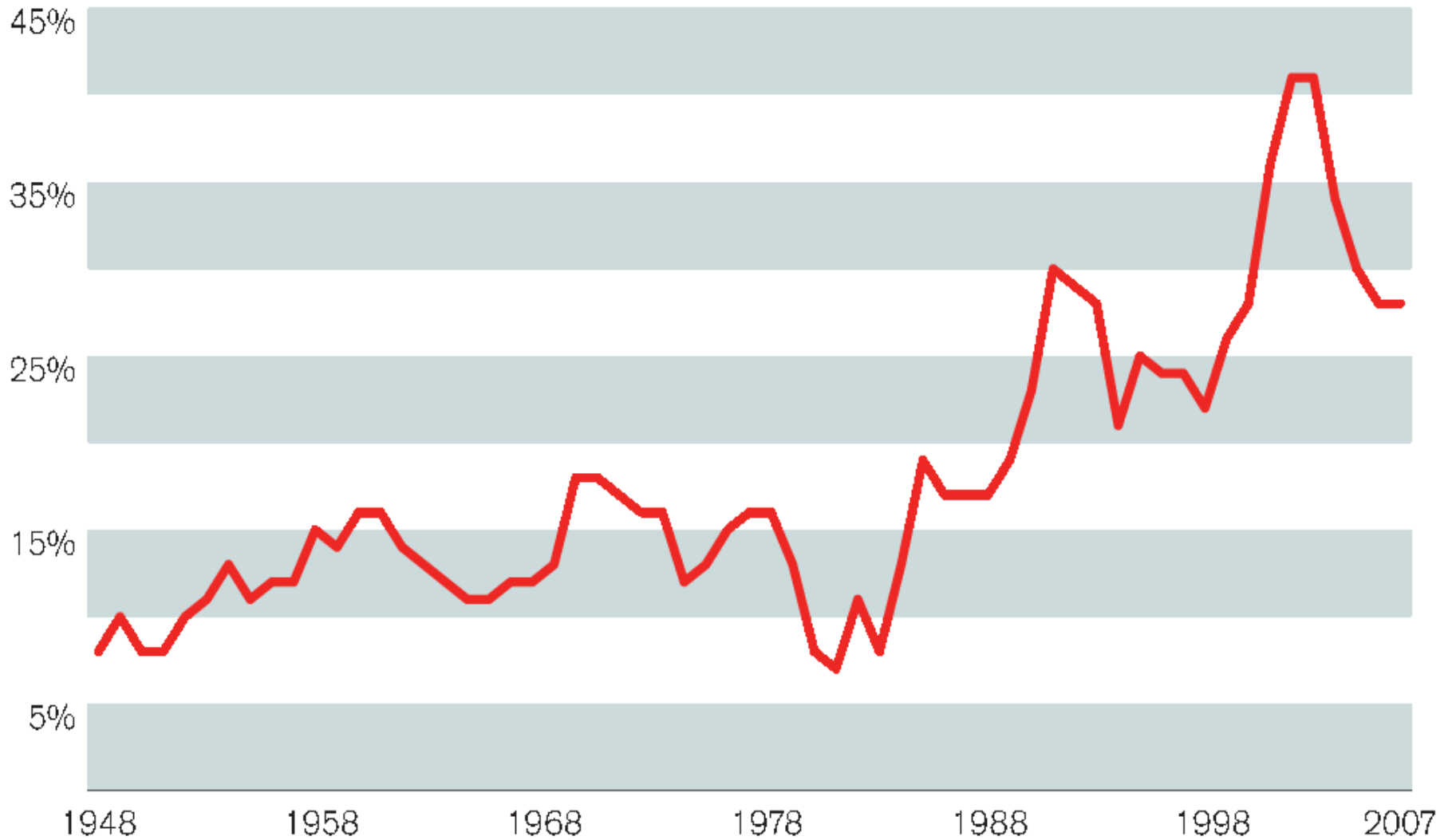


There can be too much finance

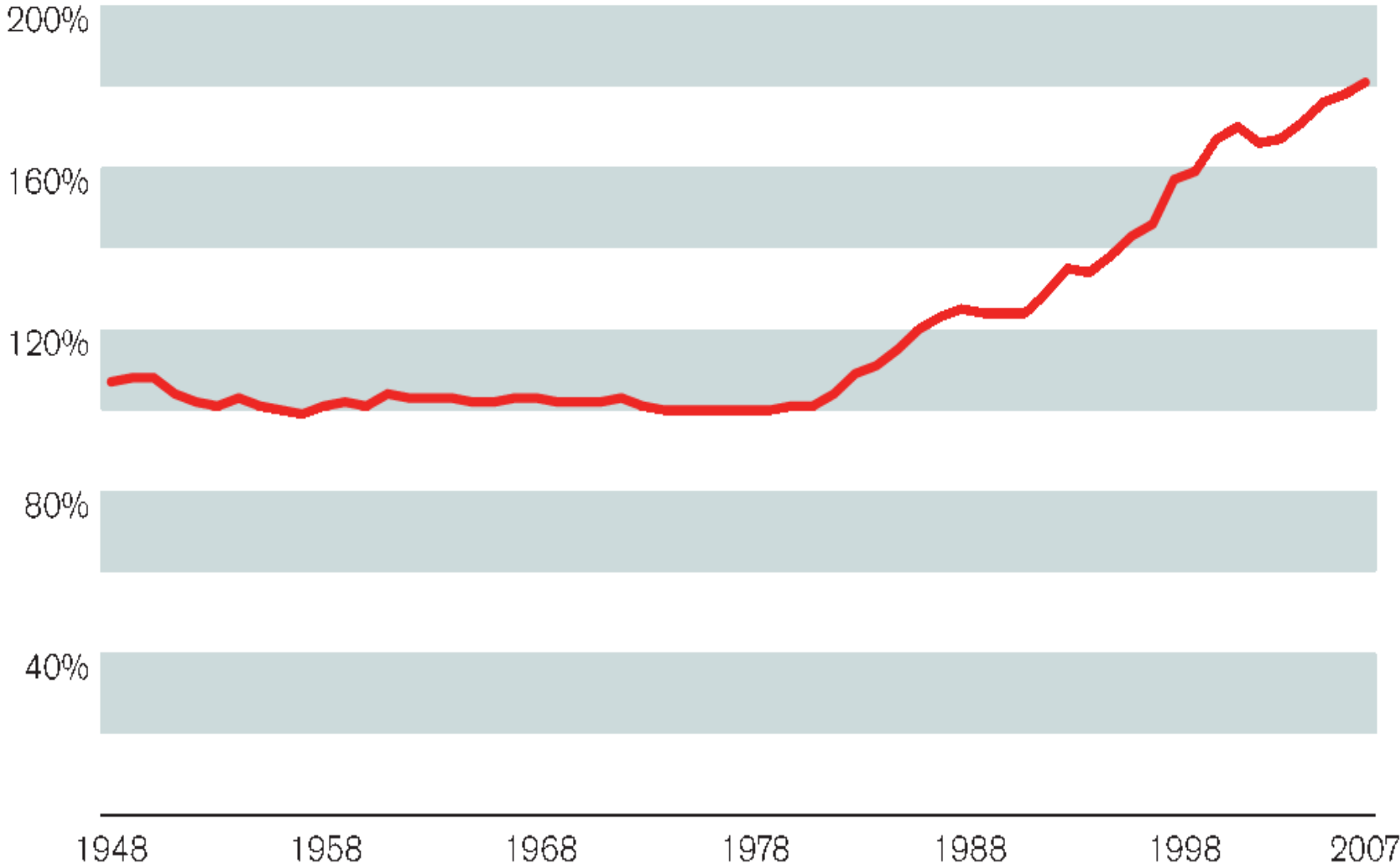
Figure 1: Financial Development and GDP Growth



FINANCIAL-INDUSTRY PROFITS AS A SHARE OF U.S. BUSINESS PROFITS



PAY PER WORKER IN THE FINANCIAL SECTOR AS A PERCENTAGE OF AVERAGE U.S. COMPENSATION

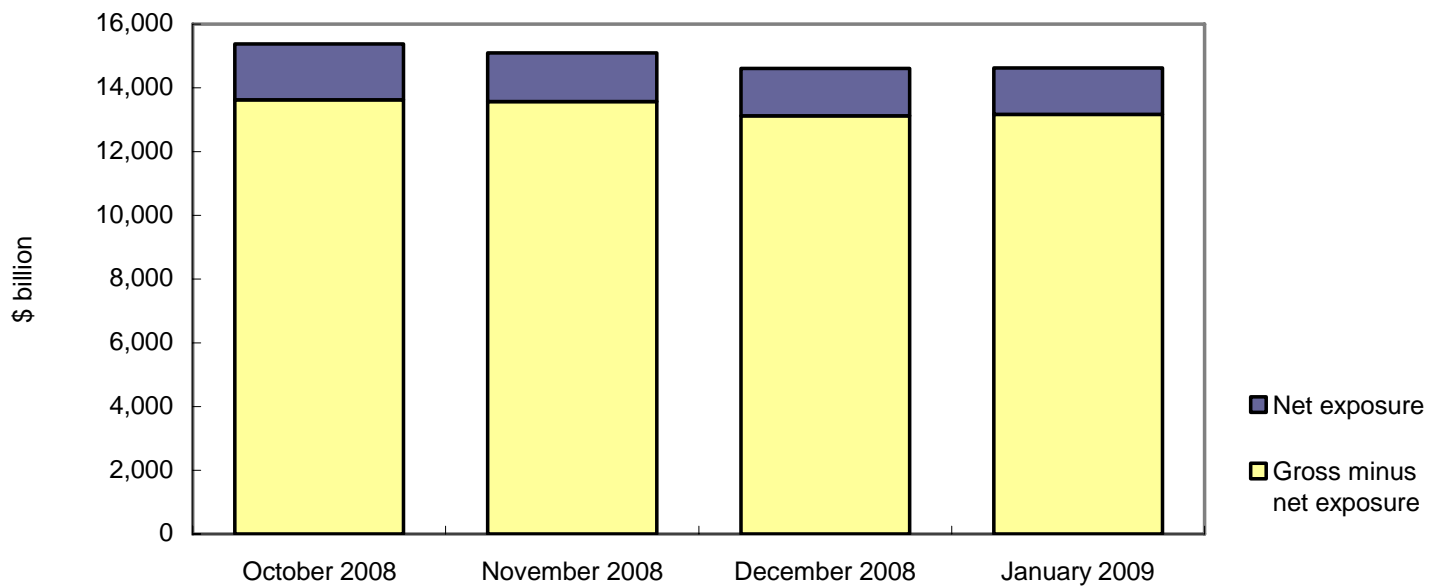


Source: Johnson (2009)



Pure Gambling

Figure 2.3
OUTSTANDING CREDIT DEFAULT SWAPS, GROSS AND NET NOTIONAL AMOUNT



Source: UNCTAD secretariat calculations, based on data from the Depository Trust and Clearing Corporation.



2 Market-Based Regulation Does Not Always Work

- There are flaws with the assumption that markets know best and regulators should not try to second guess them
 - Regulation is necessary because markets sometimes do not work.
 - How can one avoid market failures by using the same evaluation instruments used by market participants?
 - Market-based risk indicators (such as high-yield spreads or implicit volatility) tend to be low at the peak of the credit cycle, exactly when risk is high





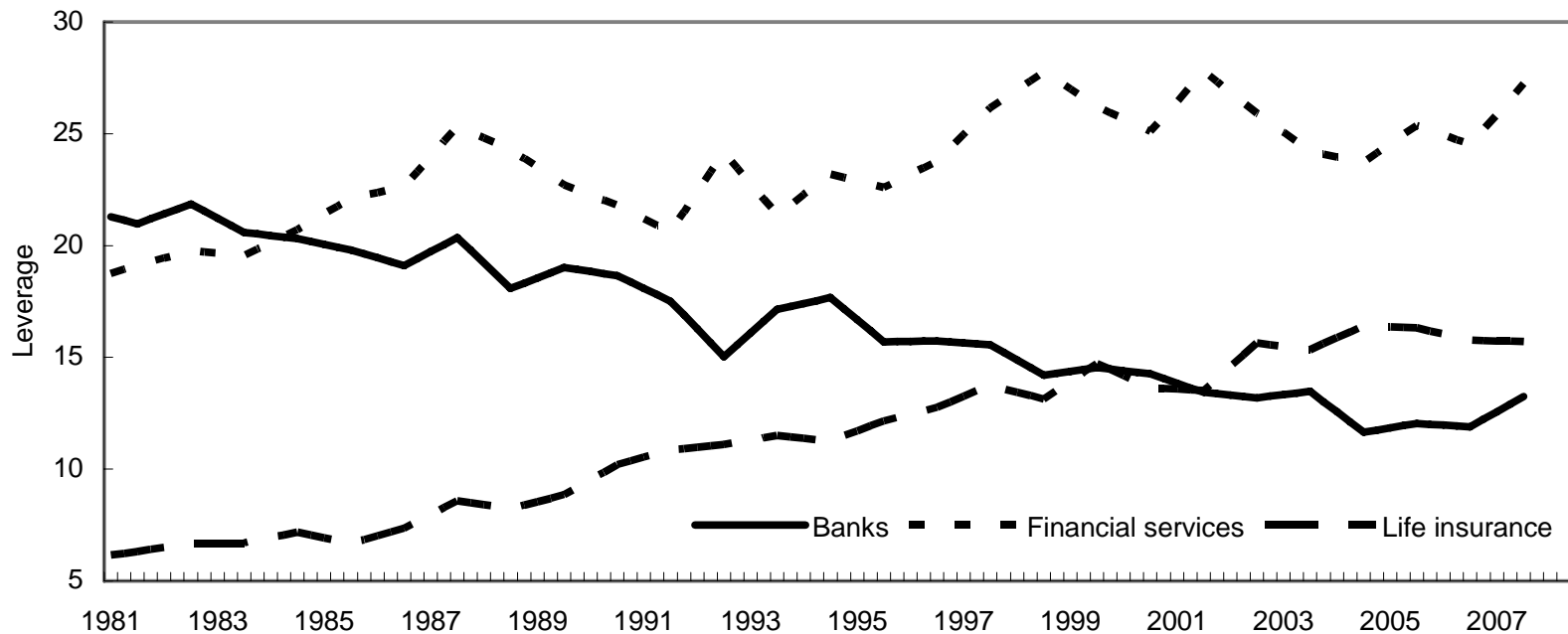
3 Guaranteeing the Safety of Individual Banks Is Not Enough

- This is a fallacy of composition because actions that are good and prudent for individual institutions may have negative systemic implications
 - Problems with mark-to-market accounting
 - Problem with ratings
 - *Macroprudential* regulation needs to complement microprudential regulation
 - It can work like a system of automatic stabilizers which is also good for political economy reasons
- 



4 Avoid Regulatory Arbitrage

Figure 2.1
LEVERAGE OF TOP-10 UNITED STATES FINANCIAL FIRMS BY SECTOR



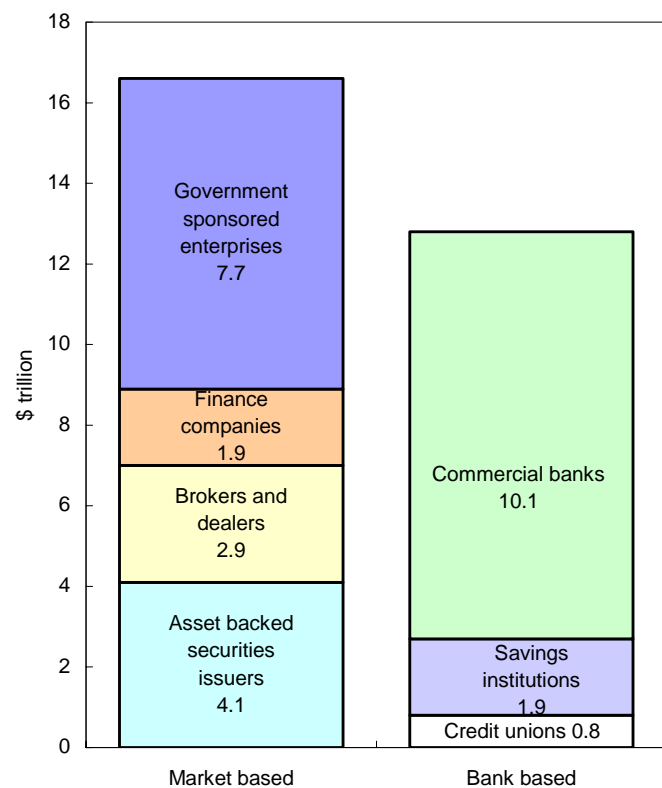
Source: UNCTAD secretariat calculations, based on balance sheet data from Thomson Datastream.

Note: Leverage ratio measured as share of shareholders equity over total assets. Data refer to 4 quarter moving average.



4 Avoid Regulatory Arbitrage

Figure 2.2
THE SHADOW BANKING SYSTEM, 2007, Q2

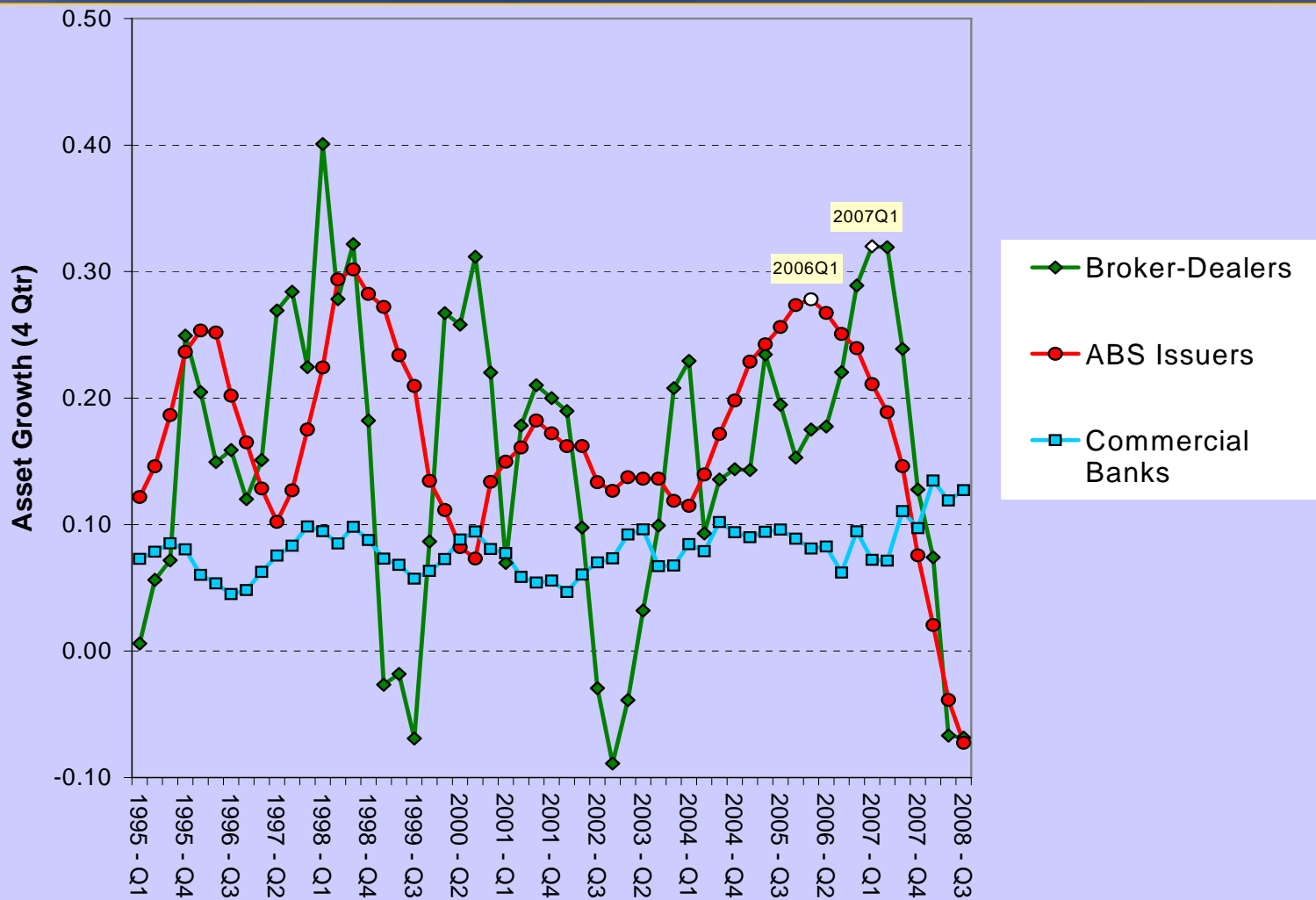


Source: Shin (2009).

- Each institution can be a source of systemic risk
- Providers of financial products should be supervised on the basis of the risk they produce
 - If an investment banks issues insurance contracts like CDS, it should be supervised like an insurance company
 - If an insurance company is involved into maturity transformation, it should be regulated like bank



4 Avoid Regulatory Arbitrage





5 International Cooperation

- Data sharing
 - No data on cross-border exposure among banks and derivative products
 - Need to develop a system for evaluating cross-border systemic risk
- Need to agree on regulatory responsibility for banks and other financial institutions with an international presence
- Avoid races to the bottom
- But no common regulatory system
 - Increase the participation of developing countries in standard-setting bodies and agencies in charge of guaranteeing international financial stability





6 Adjust Incentives in The Financial Industry

- Pay structure
- Credit rating agencies





7 Lessons for Developing Countries

- Protect yourself
 - Avoid appreciations
 - Accumulate reserves
 - But they are never enough
 - Avoid currency and maturity mismatches
 - Remember that *it may be* true that an open capital account can deliver the goods with a well-regulated financial system
 - But who has a well-regulated financial system?





7 Lessons for Developing Countries

- Developing countries are often characterized by a non-competitive financial system in which banks make good profits by paying low interest on deposits and charging high interest rates on loans, which they only extend to super-safe borrowers
- Financial development is good
 - But it can also increase vulnerabilities because it alters the incentives structure of the various players within the financial system (Rajan, 2005)
 - Developing country regulators should develop their financial sectors gradually to avoid boom and bust cycles





7 Lessons for Developing Countries

- There is no one-size fits all financial regulatory system
 - We now realize that good financial regulation is very difficult to implement.
 - Thus, there may be a trade off between financial sophistication and stability
 - Countries with more ability to regulate and that are better prepared to absorb shocks may want to adopt a more aggressive process of liberalization
 - Other countries may want to be more cautious
 - The right approach is the one of Deng Xiaoping





+1 The role of state-owned banks

- Two views
 - *The scarcity of capital was such that no banking system could conceivably succeed in attracting funds. . . Supply of capital for the needs of industrialization required the compulsory machinery of the government*
 - Gerschenkron (1962)
 - *Whatever its original objectives, state ownership tends to stunt financial sector development, thereby contributing to slower growth*
 - The World Bank (2001)





+1 The role of state-owned banks

- What do the data say?
 - The World Bank is right
 - La Porta, Lopez de Silanes, and Shleifer (2002)
 - It is impossible to say about growth and financial development
 - Levy Yeyati, Micco, and Panizza (2006); Rodrik (2004)
 - But public banks can help stabilizing the economy during periods of crisis...
 - Micco and Panizza (2006)
 - ..and increase the efficiency of the banking system in low income countries
 - Detragiache, Tressel, and Gupta (2008)
- Gerschenkron might be right, after all





+1 The role of state-owned banks

- Governance is key
 - Some countries have excellent state-owned banks
 - Some countries have bad state-owned banks
 - Some have both types
- A clear objective function is also necessary to avoid Sisyphus's syndrome
- But remember, in bad times all banks are state-owned





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