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Regulatory Change at Risk

A variety of factors, mediated by the power of finance, are working to abort the needed changes in the regulation of finance

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If Kenneth Rogoff and Carmen Reinhart are to be believed, policy makers have learnt little from the experience of financial crises over the last eight centuries. The same frailties, deriving from overexuberance and overleveraging, have surfaced time and time again, with surprisingly similar outcomes: banking crises, sovereign defaults, protracted downturns and a painfully long period of adjustment.

The financial collapse during the Great Depression in the 1930s laid the foundations of the post-war regulatory structure that erected a firewall between tightly-regulated deposits-based banking that had access to liquidity buffers from central banks, and relatively lightly-regulated investment banking dependent on capital markets without liquidity backstops, through the Glass-Steagall Act.

The growing sophistication of the financial sector, and the 'irrational exuberance' deriving from the Great Moderation, gradually eroded the regulatory structure. Systemically-significant financial activity migrated out of the regulated deposits-based banking system. Financial institutions became too big and interconnected to be allowed to fail, facilitated by the repeal of the Glass-Steagall Act and the rise of universal banking. Despite repeated warnings from history, leverage was once again permitted to build up. Central banks lost sight of the fact that financial stability was the original mandate on which they were founded. They now focused almost entirely on output and inflation, targeting the business cycle while neglecting the credit cycle.

Reminiscent of the regulatory transformation in the wake of the Great Depression, the monumental collapse of the western financial system is leading to a fundamental reform of financial regulation under the watchful eyes of the G20. But will this time be any different?

Reforms agreed to so far, especially with regard to the new Basel-III capital and liquidity standards, are impressive. But Basel-III is still micro-regulatory and focused on deposits-based banks. The retention of risk-weights and mark-to-market mechanisms may leave it still too pro-cyclical to control build-up of leverage in the absence of a robust unweighted leverage ratio. The shadow banking system, which vastly increased the money multiplier, and lay at the heart of the recent crisis, can only be reined in through macroprudential regulation that would widen the perimeter of regulation. This has still to be done. Stronger regulation without widening the perimeter is likely to strengthen shadow



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banking. There are signs that this might, indeed, be happening.

Effective enforcement, supervision, harmonisation and monitoring have yet to begin. Cracks are also appearing in the global consensus on compensation practices, accounting standards, reining in rating agencies, financial transactions taxes, regulating Global Systemically-Important Financial Institutions (G-Sifis) and the implementation of the new Basel-III capital standards. With the collapse of major financial institutions, remaining Sifis have become even more systemically-important.

The rise of banking and joint stock companies was to facilitate tapping into individual savings for large, productive brick-and-mortar projects that accelerated growth, and, hence, per-capita incomes, that had crept ahead at snail's pace ever since the Neolithic Revolution and right up to the Industrial Revolution.

If banking intermediated savings for the real sector, returns in the financial sector should be linked to productivity growth and returns in the real sector. But the financial sector generated returns far in excess of the real sector that enabled bankers to get outsized emoluments compared to real sector managers. This was possible because the banking sector, at some point, started intermediating for the financial sector itself, which became the engine of growth in advanced countries, as real sector activity started migrating to more productive emerging economies.

High returns were possible in the financial sector through leveraged investment in financial assets, which, through a combination of loose monetary policy over an

extended period and the money multiplier effect of leveraging in the shadow-banking system, vastly inflated asset prices. Profits were booked not through actual trades that cleared the market, but on book profits calculated on index-based valuations on thin OTC trades. Since these returns were not based on productivity growth in the real sector, this was a bubble waiting to burst. These outsized profits, it turned out, were not — and could not be — funded out of returns in the real economy but eventually out of taxpayer money.

Prior to the financial crisis, financial markets in developed countries were seen as models for developing countries. The ground reality, however, was that big emerging markets such as China were able to sustain high levels of growth despite less developed financial markets, and alongside a good measure of 'financial repression', that may have directed rising household savings into investment in the real economy. This repression also gave governments access to resources that enabled them to make the large investments required in physical and social infrastructure. Developed countries, on the other hand, have seen savings, investment and growth in the real sector decline since 1980s, coinciding with the ascendancy of the financial sector in their economies. Today's advanced countries too experienced sustained and steady growth when their banking sector was not as completely divorced from the real sector as now, when their banking sector was akin to that in India and China today.

In developing countries like India, financial markets were regulated like public utilities on the unstated premise that there

must be some underlying real sector exposure to justify financial activity. There are limits on borrowing for consumption, unless the level of borrowing can be sustained by discounting incomes from labour, or profits from productive activities in the real sector, opposed to a speculative discounting of book profits from inflated asset prices that can vanish overnight. Central banks in developing countries fixed one eye on financial stability and always had an element of macroprudential regulation.

Stringent regulation, however, comes with a cost, as it is a proxy for tax that raises the cost of capital, notwithstanding large capital inflows. Emerging markets, therefore, turned to the western model of light-touch regulation as a long-term objective to deepen financial markets to lower the cost of capital. The priorities in emerging markets, like India, before the crisis, were not regulatory but developmental, with the aim of deepening and developing new markets to sustain high rates of growth in the real economy. Financial inclusion, high cost of capital, long-term funding instruments for infrastructure, development of liquid bond markets to improve monetary policy transmission, financialisation of savings invested in physical assets such as gold so that they could be leveraged for productive investment, among others, were financial sector priorities in India before the crisis. Nothing has happened in Indian financial markets that warrant changing these priorities.

So, where do we go from here, now that the G20 is trying to harmonise financial regulation across major jurisdictions, which includes both developing and developed countries, to reduce regulatory arbitrage and moral hazards in the emerging financial landscape? Clearly, returning to the financial repression of the past is not an option, but neither is a return to largely self-regulated and self-correcting financial markets. Historical experience indicates the existence of some kind of financial sector Kuznets Curve, where there is a close association between financial deepening and growth, but up to a point, beyond which risks multiply while growth and welfare benefits become ambivalent, as the financial sector begins to feed on itself rather than on the real economy. So, if this time is to be different, a fundamental philosophical shift is needed in the rules informing the regulatory framework of the financial sector. However, given the strength and reach of the financial sector lobby, including the 'group think' in, and intellectual capture of, financial institutions and centres, things may eventually turn out no different this time.

(The author is a civil servant. Views are personal)