The Crisis and Beyond: Financial Sector Policies

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Financial crisis…crisis of confidence in policies

- The global crisis and the response to the crisis – extensive liquidity, guarantees, bail outs that involve governments taking large ownership stakes etc. – has shaken confidence in the very blueprint of financial and macro policies.

- Are mainstream policies dead?

Debating conventional wisdom

- The role of the State
- Approach towards Regulation and Supervision
- Competition Policy
- Costs/benefits of Financial Integration
- Access vs. Stability

=> Important research agenda; but policies don’t wait for research hence there are risks of drawing the wrong lessons

Role of the state

- Before the crisis –
  - a recognition of changing role of the state;
  - an accepted move towards private sector-led financial development;
  - significant progress with bank privatization all around the world.
- Crisis –
  - Dealing with wide-spread insolvencies led to government recapitalization and state ownership in the West;
  - trying to off-set the credit crunch all countries around the world tried to ensure continuous flow of credit relying on development banks and public banks.

Role of the state

- Hence after the crisis –
  - a change in sentiment, appreciation for public institutions;
  - halting of the privatization programs;
  - more sympathy for pro-active policy interventions of all sorts.

- But is this the right lesson?

Role of the state

- Recapitalization process often leaves governments as owners/temporary caretakers
- This in itself is not unusual and should not be taken as endorsement of government ownership – research suggests governments do not make good bankers
- Government involvement should be designed to protect the interests of taxpayers, impose losses on responsible parties, use the private sector to identify winners and losers (for eg. by insisting that at least some share of new capital comes from the private sector)
- An exit plan for the public sector is a must, ideally after resolution the banks will be well-capitalized and in private hands

Role of the state

- As far as the credit recovery goes, it is true public institutions increased lending during the downturn (for ex. Brazil's development banks, China's banking system) – but so did countries with no public banks.
- There are significant doubts about the quality of the loans made during the down-turn and the long run implications
- Benefits of government ownership not clear during the crisis either

Regulatory Reform ?

- Before the crisis –
  - Lax regulations; over-confidence in ability of financial markets to self-correct or regulate; lack of attention to incentives.
- After the crisis –
  - Skepticism regarding market discipline; calls for government intervention and tighter regulatory and supervisory standards.

Regulatory Reform ?

- Clearly something went wrong…regulators were not able to exert oversight when it was needed.
- Finance is risky business – regulation and supervision cannot eliminate crises, but make them less frequent and less costly.
- Crisis challenged the Basel framework in important ways (flaws with external ratings, accuracy of internal risk models, lack of disclosure and transparency...)
- Many reform proposals…stricter capital regulation, better incentives, countercyclical regulation

Regulatory Reform ?

- Many reform proposals…consensus being forged around
  - Strengthened capital standards – leverage ratio, reliance on stricter forms of capital (common equity, Tier 1)
  - Countercyclical buffer (only in effect when there is “excess credit growth.”)
  - An emphasis on macro-prudential risks (even stricter regulations for systemically important institutions?)

Regulatory Reform ?

- But, regulation still emphasizes “risk-adjusted” capital which leads to manipulation, regulatory arbitrage.
- Countercyclical regulation good in theory: Design rules/mechanisms so that regulators start asking tough questions and enforce rules when markets become overly exuberant.
- But..in practice
  - It is difficult to tell when we are in a bubble
  - There will be significant opposition to policies that may dampen expansion…would the regulator have the clout?
- Not enough emphasis on incentives, regulatory governance

Competition Policy

- Trade-offs between competition and stability?
- Has banking systems become too concentrated? TBTF policies and incentive distortions
- Too-big-to-fail = too-big-to-exist? Too many to fail…
  - anti-trust, breaking up large institutions, capital regulation, taxation…

How to prevent banks from becoming systemic?

- Size limits? But size may imply efficiency, diversification…
- Activity limits? hard to distinguish propriety trading from legitimate risk-reducing hedging
- Additional risk buffers – capital, contingent capital, convertible debt..
- Remove explicit deposit insurance for systemically large institutions
- Make them easier to fail – living will; shelf bankruptcy

Pros/Cons of Financial Liberalization

- Crisis has renewed doubts about the merits of financial liberalization.
  - it is well-known that globalization makes economies more vulnerable to crises
  - but the key is better understanding the potential trade-offs between longer term development goals and this vulnerability
  - and if and how countries can enjoy the benefits while minimizing the risks

Pros/Cons of Financial Liberalization

- Renewed interest in capital controls? How to deal with inflows/outflows?
  - Initially following the crisis there has been a decline in capital flows (and rising costs) in all regions – mostly in high income; followed by middle income; less so by low income (due to their more limited integration)
  - Among developing regions, European countries (ECA) suffered the greatest declines, followed by Middle East/North Africa (MENA) and Sub-Saharan Africa (SSA)
  - But there is heterogeneity across countries…after the crisis with low interest rates/depressed growth in the developed world, some are already experiencing large inflows.

Pros/Cons of Financial Liberalization

- Two broad types of controls with different roles:
  - Crisis containment: controls on outflows to prevent disorderly investor retreat (avoid run on reserves, prevent exchange rate collapse…)
  - Crisis prevention: controls on inflows to stop ‘hot money’ from coming in (prevent appreciation, bubbles, financial system risk-taking …)

Pros/Cons of Financial Liberalization

- Controls on **outflows** aim to buy time to ‘set things straight’
  - Not helpful to prevent currency crashes: huge anticipated return differentials dwarf cost of controls
  - A side-effect is the discouragement of future inflows
  - Perhaps temporary respite if authorities possess strong enforcement capacity – but risk that controls end up replacing needed adjustments
- Controls on **inflows** popular since the 1990s to navigate inflow booms
  - Aim to deter short-term inflows – quick to flow out
  - May help weather ‘normal’ ups and downs of flows, but not major global shocks that make *all* investors run

Pros/Cons of Financial Liberalization

- Do controls work? Many studies but no consensus on the effects of inflow or outflow controls
  - Very hard to build the counterfactual ‘no controls’ case: many other things happen along with controls
  - Some temporary effects (e.g., onshore/offshore market segmentation), that tend to wear out as investors find loopholes – faster in financially-developed economies
  - Need for constant (and costly) updating and monitoring
  - Comprehensive controls more likely to be effective -- but they deter both ‘bad’ and ‘good’ flows (trade, FDI)
  - Cost of controls mostly borne by small investors / firms

Pros/Cons of Financial Liberalization

- Renewed concerns about foreign banks?
  - Foreign bank entry was promoted throughout the 1990s as part of globalization.
  - Most of the literature on foreign banks is positive, suggestion they affect efficiency, competition, stability and access positively when the underlying institutions are favorable.
  - But most of the studies on the issue of stability have focused on cases where crisis started in the host as opposed to parent countries. Was the recent crisis different? What was the impact on the extent of crisis, decline of credit, recovery etc.?

Access vs. Stability

- Recent global financial crisis also exposed an important tension between access and stability

- Were we wrong to emphasize access in the light of what happened?

Access vs. Stability

- No. But…
  - access needs to be sustainable access, and expanding it should not be pursued at the expense of stability.
  - Fannie Mae and Freddie Mac increased availability of mortgages to borrowers with questionable ability to repay; Subsequent relaxing of the standards, the increase in home prices due to a larger pool of “qualified” borrowers, and their eventual default in large numbers during the downturn, all added to the severity of the crisis.
- important lesson of the recent crisis => irresponsible expansion of access can be very costly

Access vs. Stability

- We also need to remember that for poor households, credit is not the only – or in many cases, the principal- financial service they need.
- It is true that provision of financial services to the poor often requires subsidies. But subsidizing access to credit is tricky business and may backfire in unexpected ways, and subsidies may be better spent on savings and payment systems which are necessary for participation in a modern market economy.
- Access to formal payment and savings services can approach universality as economies develop. However, not everyone will – or should- qualify for credit.

Access vs. Stability

- All this should not take away from the important goal of broadening financial access, just that we need to be careful in how we do this.
- Not all government action is equally effective and some policies, as we have seen, can be counterproductive.
- Government policies should focus on:
  - building financial institutions; enabling financial infrastructure and encourage adoption of new technologies; encouraging competition, and establishing sound prudential regulation to provide the private sector with appropriate incentive structures and broaden access.
- Despite the lessons of the recent crisis, these days there is a renewed interest in direct interventions
  - be it through subsidies or credit guarantees (or even ownership of financial institutions). Scope for direct government action is more limited than believed

Moving forward

- More research/policy work necessary to draw the right lessons from the crisis
- Despite their fragility, financial systems underpin economic development
- The challenge of financial sector policies is to align private incentives with public interest without taxing or subsidizing private risk-taking
- Public ownership or too aggressive regulation would simply hamper financial development and growth
- But striking this balance is becoming increasingly complex in an integrated and globalized financial system