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Global Financial Governance—need for a new approach-A commentary

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In no other area have globalization and integration progressed in recent years more quickly and forcefully than in Finance. The world has witnessed an unprecedented exponential growth in cross-border asset flows and holdings by non-financial institutions and banks after the generalized removal of capital controls in the 1970s and 1980s. This has been more prominent among the industrialized countries than others. Among the emerging countries financial integration has been lower, though still significant, probably due to their less developed financial markets. The financial integration has peculiar characteristics and it differs from other economic activities because of the presence of greater information asymmetry between borrowers and lenders. Lenders put their money at risk without the benefit of the same information on the quality of the project and of the counterparts that borrowers enjoy. The more the information is asymmetric, the more the financial sector is inefficient and risky. Regulatory and supervisory policies have a major impact on the size and the nature of information asymmetries, e.g. disclosure requirements for securities, bank capital regulation etc. Such information asymmetries are more pronounced across the frontiers, since countries possess individual legal systems, regulatory arrangements, and social and moral habits that are relatively unfamiliar to the foreigners. However, financial integration is not always associated with information asymmetry. For large transnational financial & non-financial agglomerates the asymmetry of information is not a problem as they are able to gain local knowledge; rather, on the other hand, their presence improves market management practices in the host countries.

Some Salient Features of the Crisis

The financial crisis situation which occurred during 2007-09, had the characteristics of the previous episodes of the financial instability and also some of the characteristics specific to it. Seen from this angle, the crisis is not a new phenomenon but an acceleration of the existing trends. For example, views about the nature of the mortgage crisis are divided between those who stress its novel character and those who emphasize the many things it has in common with the earlier episodes of financial instability.

1 New Elements

What is new is quite evident. This crisis originated from unprecedented real estate & its securitisation. Traditionally the real estate finance had been carried out through relatively unsophisticated instruments maintaining a close link between the borrower (the household) and the financier (the banks). The loans used to remain in the bank's balance sheets as they are, based on fixed or floating interest rates. This could ensure ex-post monitoring of the borrowers. But in the new form of the business, these mortgages were packaged in sophisticated commercial instruments and derivatives and were dispersed widely throughout the country (the US) and across the globe. This resulted in rapid spread of the risk to far many institutions and far many countries. Because of the spread of the risk to many and better allocation, the system became more efficient and more resilient to shocks. In practice, this encouraged the banks & other financial institutions to expand their mortgages to cover even increasingly risky homeowners, using Special Investment Vehicles to escape the proportionate increase in their capital. Moreover, they tended to underestimate the risk of the loans made over to sub primes. This was because these mortgages had ready market for their quick securitization and passing over to other investors. These secondary player firms and banks were not aware of the quantum of the risks purchased by the originator

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firm or bank and they solely relied on the benevolent credit rating agencies.

2. Reminiscences of previous episodes

The financial crisis was preceded by a prolonged period of price escalation of assets: —stock and real estate witnessed continuous escalation of prices in the global markets for about a decade before the crisis in August 2007. The prices went beyond all reasonableness and this fuelled further speculation and consequent additional unrealistic increase in prices. No investor could bet against the trend in the market.

Another example of the precedent similarities was that the period of the price boom on the stock and real estate markets was preceded by expansionary monetary policy and fast growth of money and credit in both the developed and the developing countries (for most of 1990s and 2000s).

All these old and new features suggest an increase in the degree of interdependence of the international financial system. This system is now deeply embedded in the international markets and has become the irreversible future landscape of the global financial markets. This is evident from the fact that, as per the latest estimates, about 40% of the subprime mortgage segment in the US is ultimately borne by the investors in Europe and other parts of the world. In other words, to an increasing extent, the supervisory and regulatory environment of the originating country will affect the risk profile of the foreign investors.

A Critical Analysis of the Central Banks' Policies in Crisis

The crisis also had wide spread implications as far as the various Central Banks' Policies are concerned. As lenders of the last resort, the Central Banks are the first line of defence for financial stability in the crisis situation. With evolution of big financial conglomerates and complexity entering into their way of working like invention of newer financial instruments for trading, sophisticated derivatives and launch of SIVs, the need for the Central Banks to increase interaction among them has increased. The banks all over the globe have responded almost similarly to the crisis. They have broadened their policy by opening gates for accepting a wide range of collaterals and by dealing with a large number of banks and even non-bank counterparties. In doing so, the central banks have decided to accept more risk in its balance sheet. The mortgaged backed securities also became acceptable to the banks as collaterals in many countries. A generalized move towards broad central bank refinancing practices seems inevitable. This crisis has demonstrated that liquidity crunch can have its genesis anywhere in the world and the money markets can fail requiring state intervention.

Another issue is the need being felt to review the role of the central banks in targeting inflation directly. The crisis has demonstrated strongly that direct inflation targeting is not always the best possible policy. The central banks have to adopt a more elaborate framework, responding to money, credit and financial market indicators in a more systematic way.

1. The future of financial regulation

The recent global financial turmoil has brought into focus the need to rethink many aspects of the financial market regulation. There is clearly a need to redesign the regulatory structures for increasingly complex financial system in order to ensure greater transparency in the financial markets & institutions. These regulatory issues have a greater relevance for the developed economies as compared to the emerging economies as the former try to put their financial systems back on their feet and prevent further collapses. For the emerging economies the need is to rethink the financial development paradigm & right lessons they learn from the crisis.

(a) Dealing with the increasing complexities of financial markets

As discussed above, the financial landscape of the markets has undergone irreversible change becoming more complex and intertwined. Even if the financial instruments and derivatives found responsible for this crisis are abandoned, many other SIVs and complex derivatives will be invented. The financial institutions of every country have gained broad reach both domestically and across the border. Regulating these institutions as unified entities may make more sense than to regulate them individually. The reality is that even the best-conceived regulation has its limits. One important lesson from the crisis in the US is that instead of addressing only a handful of banking & non-banking institutions (such as government sponsored enterprises like Fannie Mae and Freddie Mac) and tight regulation of just a part of the financial system can worsen the situation as they will distort the market discipline.

(b) Striking a balance between financial innovation and financial risks

The concept of financial innovation got tarnished by the failure of those exotic instruments that

precipitated the crisis. In fact, on the contrary, it was a complete regulatory failure and outright fraud. But the fact is that many of the financial innovations have increased the efficiency of financial markets and are here to stay. For example, currency hedging is very important for shielding the firms from foreign exchange risk in open economies. Similarly, commodity derivatives actually protect the farmers against the fluctuating incomes from the agriculture produce. Of course, these derivatives also entail certain amount of risk. But this is no reason for any government to ban these instruments but it needs to foster them and effectively regulate them. The problem aggravates when the regulation can not keep pace with the innovations. When the innovations go far ahead of the regulations, they tend to entail greater risks. Hence, the success of regulation lies in its keeping pace with the financial innovations and effectiveness in their monitoring.

(c) Managing financial development with financial innovations

Financial development differs significantly from exotic financial derivatives. Financial development will entail developing such financial markets where the innovative financial intermediaries can be effectively dealt with and channelled into productive investment. This will involve fostering broader range of markets, including corporate bond markets and exchange traded currency derivatives. This is especially true for the countries which have lesser developed financial markets & emerging economies where the issue of 'Financial Inclusion' of the rural deprived population is offered opportunities in the markets promoting entrepreneurship, savings instruments, hedging facilities to manage risks etc.

2. Stabilizing the emerging economies

The emerging economies have already been impacted by the global slowdown. Notwithstanding the lack of up-to-date information on capital flows, the IMF recently estimated that the global portfolio to the emerging economies is retracting at an accelerated pace. The new debt flows to these countries have been reduced to half during the third quarter as compared to the second quarter. In commodity dependent countries like Latin America and Africa, the prices have struck the rock bottom due to greatly reduced consumption in countries like US and Japan. This has put pressure on the current account of these countries. Other non-commodity exports have also come down due to reduced demand in the US, Europe and Japan. The workers' remittances have reduced drastically.

In most of the emerging economies, the central banks target inflation and therefore the degrees of freedom in ensuring independence of the monetary policy get compromised, especially in cases where the credibility is low. Most of these economies suffered high rates of inflation during initial months since July,2008 till October,2008 (in India it being running in double digits). On contrast, in the US, till the end of the current fiscal year, the inflation rate is expected to be around 4% only, which is just 1% point higher than the year ago. Therefore, in many of the emerging countries, the policy space for manipulating the interest rates reduced drastically whereas in the US, the Fed Reserve could cut the interest rates by 350 basis points. In the emerging economies the fiscal policies behave procyclical i.e. during the boom period, the fiscal deficit increases and during recession, it decreases as the credit supplies dry up. This is because during the boom times they do not save enough. The IMF also reinforces the pro-cyclical pattern by advocating fiscal adjustment while extending credit in bad times. This does not help stimulate the economic activities or push the countries out of the economic recession sentiment. Therefore, there are no easy solutions to these problems of pro-cyclic fiscal pattern in the emerging economies. As far as the measures within the country are concerned, the reduction of interest rates is a viable option for increasing liquidity in the financial system. But this is fraught with risk of inflation shooting up and also devaluation of the home currency. Nevertheless, many countries have reduced their landing rates and have also taken other measures to increase liquidity in the system. However, the approach of the international agencies like IMF has been the same traditional way, extending short-term liquidity facility to countries that have the track record of "sound policies" and sustainable debt burdens. This will still lead to making available the credit to the countries which do not need it. What should be done is to ensure coordination of the central banks and lower the interest rates so that in future, the counter cyclical fiscal policies can be adopted. Also, there is a great need to develop regional and global markets where these countries can invest the large FOREX reserves, they have accumulated.

Reforming the aid mechanism

Today's crisis emphasizes two main lessons of finance. Financial markets penalize policy weaknesses and mistakes. For many emerging markets the foreign

finance has been a mixed blessing. On one hand it has permitted fast creation of the fixed capital while on the other hand, it has also been associated with crisis and development set-backs. However, most of the markets have chosen a safer strategy, with cautious opening of domestic capital markets and an emphasis on stability. Their development policy has emphasized modernisation and use of domestic savings and the pursuit of macroeconomic stability with low and stable inflation and exchange rates,

Poor countries have found it harder to resist external finance in the face of limited domestic resources and large needs. They are heavily reliant upon ODA in the form of grants or cheap credits to build infrastructure and provide needed education, health and other social services. But just like private capital, ODA is subject to sudden stops and starts. And just like private capital, volatility in ODA undermines its effectiveness as a tool to finance sustainable development and therefore, high return, but long gestation, projects are put off for fear that future funding might be hard to come by. Aid volatility is also linked to volatility in fiscal spending and volatility in real exchange rates. Multiyear financial programming mechanisms should become standard across all donors. And is best used when it supports long term development programs. That means that donors should be prepared to provide predictable indicative funding commitments for the duration of the programme.

The Heal

The Nobel laureate Edmund S. Phelps opines that undoubtedly some new regulations are required here and there. Yet, many observers have argued the lack of restraints on the banking industry was more a failure of the regulatory authorities to exercise their powers than it was an absence of regulatory authority to act. A new mindset is required, above all. A fundamental issue that regulatory discussions must confront, however, is what function society needs the banking industry to perform. Increasingly over the past two decades, the banks have tried to make money with mortgages, residential and commercial. As this has proved difficult, the banks will either have to shrink their supply of credit to the economy as a whole or else redirect some of their credit to the business sector. Unfortunately, the banks for the most part appear to have lost the expertise to make business loans and investments, which they once had in the fabulous years of investment banks such as Deutsche Bank and J.P. Morgan.

It seems likely that highly regulated banks are not the ideal sources of finance for business investment, particularly for innovative business investments. A natural source of finance for new start-up firms are the rich uncles, called “angel investors,” who know more about the start-up entrepreneur than a banker would be in a position to know. Another natural source of finance is the venture capitalists, who also have the entrepreneurial background to be able to mentor as well as finance the young firms. Some of the hedge funds are also doing creative work in financing various innovative projects.

Clearly it is not in society’s interests to regulate rich uncles, venture capitalists and hedge funds investing or lending to small or new businesses. If society makes the mistake of doing so, innovation will suffer. So will the rewards of work. And the supply of jobs.

Joseph E. Stiglitz on the downturn and the heal

To too great extent, there has been a race to the bottom in accordance with the myth that deregulation breeds innovation. Instead, the innovation was greatest when it came to getting around the regulations designed to ensure good information and a safe and sound financial system.

Financial markets are supposed to be a means to an end — a more prosperous and stable economy as a result of good allocation of resources and better management of risk. But instead, financial markets didn’t manage risk, they created it. They didn’t enable America’s families to manage the risk of volatile interest rates, and now millions are losing their homes. Furthermore, they misallocated hundreds of billions of dollars.

The Human Toll

The consequences of these mistakes will run into the trillions — not just the money that is being spent on the bailouts, but the shortfall between global economic potential growth and actual performance.

Beyond this, of course, is the human toll — families whose life dreams are destroyed as they lose their homes, their jobs, and their life savings. If we are to maintain global financial liberalization, with financial products moving easily across borders, we must be sure that these products are safe and that the financial institutions who are selling them can stand behind the products they create.

Financial market regulators, at both the national and international level, have failed. To a large extent, Basel II, the new framework of bank regulation, was

based on self-regulation, itself an oxymoron. Banks have shown that they are not up to the task of managing their own risk. But even if they had, there is the more fundamental problem of systemic risk.

The current global financial architecture hasn't been working well. But more than that, it is unfair, especially to the developing countries. They will be among the innocent victims of this global crisis that wears the "made in America" label. Even countries which have done everything right — those which have managed their economy with far better regulation and better macro-economic prudence than the US — will suffer as a result of America's mistakes. Worse, the International Monetary Fund has — at least in the past — demanded pro-cyclical policies (raising interest rates and taxes, lowering expenditures when an economy goes into a recession), while Europe and America do just the opposite. The result is that capital flees developing countries in times of crisis, reinforcing the vicious cycle.

Flawed governance structure

There is mounting evidence that the developing countries may require massive amounts of money, amounts that are beyond the capacity of the IMF. The sources of liquid funds are in Asia and the Middle East. But why should they turn their hard-earned money over to an institution with a failed track record; one which pushed the deregulatory policies that have gotten the world into the mess where are in now; one which continues to advocate the asymmetric policies which contribute to global instability; and one whose governance structure is so flawed?

Concluding remarks

Right now, the recession is the more immediate problem. If the inflation goes up, the reserves should be taken out as quickly as they were accumulated. This is a typical lender-of-last-resort situation. In my view, the central banks should pursue the agenda of making available liquidity in the market through various means e.g. decreasing interest rates, repo rate reduction, managing CRR, increasing government investment in major development and infrastructure projects etc. so that the requisite credit is available to the businesses and confidence gets rebuilt, which measures will stimulate the economies again. The regulatory structure that permitted these events to occur will have to be redesigned. The regulatory problem that needs to be solved is roughly this: The public needs a conveniently provided medium of exchange that is free of default risk or "bank runs." The best way to achieve this would be to have a competitive banking system with government-insured deposits.

But this can only work if the assets held by these banks are tightly regulated. If such equilibrium could be reached, it would still be possible for an institution outside this regulated system to offer deposits that are only slightly riskier but that also pay a higher return than deposits at the regulated banks. Some consumers and firms will find this attractive and switch their deposits. But if everyone does, the regulations will no longer protect anyone. The regulatory structure designed in the 1930s seemed to solve this problem for 60 years, but something else will be needed for the next 60. The exact nature of action to be taken will vary from country to country based on their peculiar characteristics of economy, the behaviour of the public and regulatory and legal system in place there, to regulate these spurious lenders. Already these measures are being taken by many central banks and the results of which will be tangibly available to assess their effectiveness after some time, say three to four months. The US stock markets have started to show some signs of recovery. There has not been any major failure of financial & non-financial institution since then. The other countries are also expected follow the suite in a period of six months. Nevertheless, the major lesson to be learnt is that the new regulations mechanisms that will be put in place after the present crisis should be constantly reviewed to prevent any such recurrence in future.

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