

THE FUTURE OF FINANCIAL REGULATION

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What's at Stake

The recent global financial turmoil has brought into sharp relief the need to rethink many aspects of financial market regulation. There is clearly a need to redesign regulatory structures for increasingly complex financial systems and to increase transparency in the operation of specific markets and financial institutions.

These issues are a high priority for industrial countries as they try to put their financial systems back on their feet and prevent further collapses. But the need is equally pressing for emerging markets, even though financial systems in most of them have not been ravaged to the same extent. For these economies, the challenge is to rethink the financial development paradigm and the right lessons they should take from the crisis.

Let us review the five big considerations that national governments face as they survey the newly altered financial landscape and consider how to harness its potential while managing the risks it entails.

What Should Be Done

1. How to deal with the increasing complexity of financial institutions and markets?

The financial landscape has changed in important ways that will ultimately not be reversed even by the crisis. Even if some of the more exotic securities and deriva-

tives products implicated in the crisis disappear forever, financial institutions in virtually every country now have a broad reach, both domestically and across national borders. Regulating these institutions as unified entities may make more sense than regulating specific parts of each of them.

The reality, however, is that the best-conceived regulation has its limits. Recognizing that reality, rather than maintaining the illusion that that the goal is to achieve a perfect regulatory system, may actually yield a more creative approach in terms of thinking about what is necessary to make market discipline work better and augment formal regulation. One lesson from the crisis in the U.S. is that implicit government involvement (in the government-sponsored enterprises such as Fannie Mae and Freddie Mac, for instance) and tight regulation of just part of the financial system can make matters much worse as this combination can distort the forces of market discipline.

2. How to strike a balance between financial innovation and management of systemic risks?

The broad concept of financial innovation has gotten tarred with the same brush applied to the exotic instruments that precipitated the crisis (in tandem with regulatory negligence and outright fraud). But the reality is that some innovations have improved the efficacy of financial intermediation and are here to stay. For instance, currency derivatives are essential for hedging



foreign exchange risk in open economies. Similarly, commodity derivatives can smooth income fluctuations for agricultural producers. This is not to say that such products are without their risks. But the role of the government should not be to block these markets but rather to foster them and bring them out into the open, where they can be regulated more effectively. Blocking the development of products for which there is a real demand simply drives them underground. Over-the-counter derivatives contracts, such as OTC currency derivatives, are harder to regulate and can in many circumstances be much riskier than exchange-traded products.

The key challenge for regulation is how to encourage and manage beneficial financial innovation without stifling it. It would be optimal to create some regulatory space for innovations, but the problem is that innovation that gets too far ahead of regulation can generate risks of its own. Recent events suggest the need for caution; while this is reasonable, it is worth keeping in mind that translating caution into regulatory overbearance that kills innovation has its own costs. Striking the right balance is the problem, and not an easy one to solve.

3. Should governments rethink the notion of promoting financial development?

There is an important difference between basic financial development and financial innovation in the form of exotic derivatives products. In many emerging market economies, the challenge is to develop markets that will allow for efficient financial intermediation of savings (both domestic and foreign) into productive investment. For economies such as China and India, this not only means strengthening their banking systems but also fostering a broader range of markets, including corporate bond markets and exchange-traded currency derivatives.

Moreover, for these economies there is still the key imperative of financial inclusion—bringing into the ambit of the formal financial system a large swath of the population that currently has no access. This is essential to give much of the population (particularly in rural areas) access to credit to promote entrepreneurship; saving instruments; and instruments to manage risk. Simple innovations such as creating exchanges for trading warehouse receipts electronically can also provide a huge boost in terms of agricultural finance. Financial inclusion is relevant in rapidly-growing economies not just for financial stability but also for socioeconomic stability (by providing opportunities for the economically underprivileged).

4. Where do macroeconomic policies fit in to this discussion about financial markets?

There is in fact a deep connection between financial markets and macroeconomic policies. The absence of a good financial system makes the transmission of monetary policy a lot less efficient and can therefore complicate its conduct. It is equally true that stable macroeconomic policies are a key building block for financial reforms. Using banks as a conduit for redistribution or as a device for financing large government budget deficits crimps financial development and reforms, and has large hidden costs that are ultimately borne by depositors and taxpayers. Here again, the challenge for emerging economies is to figure out how to move simultaneously on both fronts—better macro policies and financial reforms—in a mutually-reinforcing way.

5. Is there a role for global coordination of financial regulatory policies?

This sounds like a good idea but it is far from obvious that it is desirable, let alone feasible. There are certainly regulatory challenges posed by institutions that span multiple countries and could easily engage in regulatory arbitrage. Nevertheless, the logic of trying to de-



velop common regulatory standards across countries is not clear. Instead, what would be more productive is to use forums such as the IMF and the Financial Stability Forum to develop common principles for regulation, based on different countries' experiences and expertise, and then leave it to each country to apply those principles in a manner that takes account of domestic circumstances.

An important priority is to use a forum such as the IMF to coordinate and maintain oversight of macroeconomic policies in different countries. There are huge negative externalities to the global economy from misguided policies in systemically important countries. Even consensual behavior among big economies such as China and the U.S. has to be analyzed and understood in the context of the global implications of their policies. Recent events show that innocent bystanders can get caught up in the whirlpools created by such consensual behavior, especially as financial globalization has created tight linkages among countries and international spillovers have become larger and more rapid.

The IMF ought to be the institution that maintains global oversight of both macroeconomic and financial policies, but for this it should have some teeth—leverage over its member countries—rather than just hope that moral suasion will work. To be an effective institution, it needs capital and, more importantly, legitimacy—it has to be seen as an even-handed advisor and arbiter, rather than just as a tool of the U.S. and other advanced economies. Creative solutions will be needed to solve the twin problems and break the logjam that currently exists in these dimensions.

The Bottom Line

These are difficult times with many challenging issues on the table. While there are no easy answers to the complex questions posed in this note, framing the is-

ues in the right way is half the battle. The Global Financial Summit is a good opportunity to get started.

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