DIIS POLICY BRIEF

Governance in the Global Economy

Beyond 'light touch' regulation of finance

November 2009

The leaders of the G20 countries declared at their summit in Pittsburgh that the initiatives they have taken over the course of the last year to repair their financial systems have been successful. The truth is that very little progress has been made. This DIIS policy brief outlines a systematic and consistent approach to financial regulation which may ensure that financial crises in the future will be significantly fewer and milder than they have been in the past two decades.

G20 FAIL TO ADDRESS KEY MECHANISMS UNDERLYING CURRENT CRISIS

In their statement after the Pittsburgh summit, the G20 Leaders proposed "to launch a framework that lays out the policies and the way we act together to generate strong, sustainable and balanced global growth". Further, the statement proposed "to make sure our regulatory system for banks and other financial firms reins in the excesses that led to the financial crisis". But will the suggested measures – raising capital standards, implementing international standards for remuneration, improving over-the-counter derivatives markets and instituting more controls over large financial firms – be sufficient to prevent a new financial crisis and economic crisis in the near future? Unfortunately, there is little reason to believe so, for the suggested measures do not address the key mechanisms underlying the current crisis.

CONSIDER BOTH FINANCIAL SECTOR AND REAL ECONOMY

The recommendations in this DIIS Policy Brief derive from two key premises. Firstly, instability is a structural feature of finance and hence, in the absence of effective macroeconomic policies and financial regulation, finance will destabilize the global economy at regular intervals. Second, any approach aiming to enhance the stability and resilience of the international financial system and the global economy more generally that is partial – as opposed to systemic, consistent and comprehensive – will be in-effective. Comprehensive regulation should proceed along two main dimensions: on one hand, a set of macroeconomic policies that contribute to containing the financial sector and dampening its cyclical effects on the real economy and, on the other, a set of financial regulations that harness finance to the needs of the real economy.

POLICY RECOMMENDATIONS

- revision of monetary policies, to focus on containing capital market-inflation rather than targeting consumer-price inflation alone
- macroprudential regulation of the financial sector, aiming to address systemic risk and dampen cycles of credit expansion and credit contraction
- reshaping core incentives in the financial sector, and introducing public assessment and approval of new financial products
- fiscal policies that change relative incentives from short-term speculation to long-term productive investment

MONETARY POLICIES AGAINST CAPITAL MARKET INFLATION

Most observers agree that a key contributing factor to the global financial crisis was a very loose monetary policy by the US Federal Reserve from the early 2000s onwards. Keeping interest rates very low in this period facilitated an excessive credit boom in the US and beyond. The times when Central Banks have their eyes narrowly focused on consumer price inflation, disregarding inflation in capital markets, ought to be over now. Monetary authorities should closely monitor and target capital market inflation as well as aim to reduce volatility in financial markets more generally. Capital market inflation can, as we have seen, be hugely detrimental to the real economy and financial volatility comes with large costs, even in the absence of full-scale financial crisis.

The Central Bank should be given the objective of a maximum rate of inflation, not just for consumer prices, but for the purchasing power of money in terms of goods, services and assets, in other words. It could fulfill simultaneously a smoothing of the economic cycles and the prevention of speculative bubbles by the coordination of two instruments: interest rate policy and moves in the research ratios of banks. For instance, facing an acceleration of asset prices not justified by a clear rise of real rates of return, in the context of low consumer-price inflation, the Central Bank could choose to increase the reserve ratio of banks to sterilize excess liquidity that could otherwise trigger an asset bubble. This would need to be coordinated with new principles for macroprudential regulation.

MACROPRUDENTIAL FINANCIAL REGULATION

In the early 2000s, the Bank of International Settlements (BIS) pointed out the need for macroprudential regulation and the present crisis certainly has shown that microprudential regulations alone are insufficient to prevent a severe systemic crisis. Nevertheless, few realize that the currently prevailing approach to financial regulation does little to contain systemic risk. It must be addressed not just in rhetoric but also in terms of concrete regulatory measures.

Counter-cyclical capital adequacy requirements

Capital adequacy requirements (CARs) may be revised to serve the purpose of moderating the economic cycle. Often the debate on CARs is framed as a matter of limiting leverage rather than as a matter of moderating the cycle. This, in turn, leads to proposals to simply raise CARs. Raising them is necessary but not sufficient, how-ever. CARs must be revised in a manner that makes them counter-cyclical as opposed to pro-cyclical. This means that CARs need to be specified in a manner that

Photo: Scanpix. Mario Tama (AFP / Getty Images North America).

moderates excessive lending in the boom and automatically makes built-up reserves available during busts. This measure would moderate the economic cycle by dampening the credit expansion in the boom, as well as the subsequent credit contraction during the bust, in other words. Charles Goodhart and Avinash Persaud have proposed a simple framework by which CARs are raised by a ratio linked to the growth of the value of bank assets. By this mechanism, capital adequacy requirements for a given bank would be raised automatically by, say, 0.5 per cent for each 1 per cent excess growth in the value of the bank's assets. If a bank was to grow its assets at a rate of 20 per cent above its allowance – in the context of a booming economy – its minimum capital adequacy requirement would rise from, say, 8 % to 18 %.

COMPREHENSIVE AND DIVERSIFIED REGULATION OF FINANCIAL INSTITUTIONS

The extent of deleveraging is hugely important to the severity of a financial crisis and to the degree of damage done to the non-financial sectors of the economy. Regulation should hence prevent excessive leverage not only in banks but also in non-bank financial institutions, which in recent years have often carried much higher levels of leverage than commercial banks. Saying that all financial institutions – rather than only banks – should be subject to regulation does not imply, however, that all financial institutions should be regulated in the same manner. Because diversity in investment behaviour is crucial for systemic liquidity, any expansion of financial regulation to encompass all financial institutions must be accompanied by a diversification of regulation. This will entail a break with the current tendency to encourage the adoption of more or less identical risk management models for all financial institutions. Financial regulation should be diversified so as to encourage diversity in the investment behaviour of different types of financial institutions, reflecting their very different risk capacities and time-horizons. The more short-run and long-term investors behave differently, the shorter market disruptions will be.

A new generation of risk assessment models should be developed which correct current shortcomings, by explicitly taking into account crucial issues such as the relatively high frequency of extreme events, the endogeneity of bubbles, and the possible freezing of financial markets and credit access. The financial sector should not be entitled to build this new generation of risk-management models independently: public certification of risk management models needs to be undertaken, for each of the different types of financial institutions. Overall, the regulatory ambition should be to encourage adoption of counter-cyclical risk management systems, rather than the currently universally adopted short-term, pro-cyclical risk-management models.

REGULATING FINANCIAL INNOVATION

Public assessment and approval of financial products and trading

Over the course of the past two decades, the financial sector has produced a wave of financial innovations, which was a key factor contributing to the global financial crisis. In other domains (e.g., medicines, transport, etc.), public authorities have designed rules and procedures to prohibit innovations that have significant negative externalities. In the domain of finance, it took nearly two centuries to design and implement regulations to prevent the bank runs that once threatened the foundation market economies: the resilience of monetary systems. Mutatis mutandis, the task of public authorities is to invent rules preventing the collapse of modern financial systems as a result of unexpected feedbacks from potentially dangerous innovations, such as securitization allied with complex derivatives. Thus, all new financial innovations, by all types of financial institutions, should be subject to ex ante certification by public authorities. In line with this logic, off-balance sheet transactions should be prohibited and all financial trading should be required to take place on publicly regulated exchanges or clearing houses.

Reshaping incentives in financial institutions

A key element of an effective regulation of financial institutions must be a reform of remuneration for all finance market participants according to ex-post, medium-term economic performance rather than market values of assets. Sellers of mortgage credit, for instance, should be paid according to reimbursement flows, thus taking into account the risk of default. Similarly, use of stock options as a means of remuneration should be abandoned because they tend to promote excessive risk-taking and may lead investment practices astray from the objective of improving medium- to long-term performance. At a general level, remuneration practices that reward ex-post medium-term economic performance can be expected to lead to much greater moderation of credit creation. Revising remuneration practices according to this principle will be more effective than the much-debated proposal to merely cap banker's remuneration without addressing the core issue: the need to redesign the incentive system so as to internalize the risk, as opposed to transferring it to less informed actors.

FISCAL POLICIES FOR PRODUCTIVE FINANCIAL FLOWS

In the current enthusiasm for 'Keynesian' policy, the emphasis is almost exclusively on expansionary fiscal policy, i.e. the use of large public spending packages to stimulate the recovery of the economy. Few experts dare to remember that Keynes devoted much attention to the issue of damp-ening the destabilising effects of international finan-

cial speculation. A very small tax on capital flows (0.05 %) – as advocated recently by P. Steinbrück, former German Finance Minister, as well as by Lord Turner, Chairman of the British Financial Services Authority and Gordon Brown, UK Prime Minister – would serve two crucial purposes. First, a tax on capital flows would shift the relative incentives from short-term speculation to long-term productive investment. This is absolutely critical given the current emphasis on creating long-term sustainable growth. Second, the regressive taxation, or 'socialism-for-the-rich', implied by the massive government bail-outs of financial institutions in recent years is deeply problematic for a number of reasons. Some mechanism ensuring that, in the medium to long-term, the financial sector is not subsidized by taxpayers is indispensable. A tax on capital flows would serve the dual purpose of financing bail-outs and shifting incentives towards productive investment well.

INTERNATIONAL COORDINATION

To address the potential problem of regulatory arbitrage, international coordination of these policies and regulations is essential. The IMF should be mandated to monitor and sanction against regulatory arbitrage as an integral part of expanded multilateral surveillance activities. Countering regulatory arbitrage should, needless to say, be a key objective of annual Article IV consultations with member countries.

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