The Evolution of Financial Regulation: Sufficient Change to Avoid Systemic Crises?

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Lausanne, Switzerland
19 September 2017

Financial stability and the role of regulation

- Financial instability can lead to economic crises
- Financial instability can aggravate economic crises
- Instability arises from market failures that regulation can offset
- But regulation has costs as well as benefits
- Implying market failures might be better addressed at source

Regulation – necessary but not sufficient?

- Economic history shows recurrent crises under a variety of regulatory and monetary regimes
- Economies can be hard hit even with a stable financial sector
- Excessive credit creation can lead to inflation or deflation (via cycles of "boom and bust")
- Current global crisis had its roots in deregulation and "too easy" monetary policy"
- Both regulatory and monetary policies were
- based on "false beliefs"

The role of AME banks prior to the crisis

- Demographics, the "fall of the wall" and global disinflation
- Fiat money in advanced market economies (AMEs)
- Inadequate policy resistance to banking excesses
- Made worse by the spread of "shadow banking"
- All contributed to "imbalances" in AME's and crisis in 2007
- Spreading to emerging market economies (EMEs) via semi fixed exchange rates
- And the policy makers all failed to see it coming

Leaving many AME financial sector problems unadressed post crisis

- Crisis management and crisis prevention but no crisis resolution?
- The urgency of this varies across regions
- Why the delay? Japanese versus Nordic approaches
- Also, who will pay for debt reduction – creditors or taxpayers?
- The particular problems of European banks and the future of the euro zone

Post crisis regulatory reforms – good news

- More and better capital and liquidity for banks
- Greater attention being paid to the “shadow banking system” and to the insurance industry
- Increased focus on systemic risks arising from size, interconnections and concentration
- Greater efforts to reduce “procyclicality”
- And agreements reached at the global level

Post crisis regulatory reforms – not good news

- Reform challenge greater due to crisis management
- Analytical foundations of reform measures questioned
- Implementation challenges credibility of whole exercise
- Lobbying and innovation could circumvent reforms
- As always "The Law of Unintended Consequences"

The need for more radical thinking about regulation?

- Implications of treating the financial system as a "complex adaptive system"?
- Should countercyclical monetary and regulatory policies be more closely integrated?
- Should capital requirements be both much higher and much simpler?
- How to encourage self and market discipline?
- Should the basic structure of the system be altered?

Need to embrace "complexity"?

- Analytical shortcomings of economic models
- The domestic economy as a complex adaptive system
- The global economy as a complex system of complex systems
- Fundamental lessons suggested for policymakers
- The need for a "paradigm shift"

And why it has not and will not happen

- Still just muddling though rather than thinking big thoughts
- Paradigm shifts in normal times
- The retreat into “false beliefs”
- Cast the blame on others, both domestically and internationally

Need better integration of monetary and regulatory policies?

- Concerns to maintain agency "independence"
- Better integration in the "boom" phase
- Better integration in the "bust" phase; brake and accelerator?
- Can macro-prudential policies allow "lower for longer"?

Need higher and simpler capital requirements?

- Current "risk-weighted" requirements have no analytical foundation
- Banks have gamed requirements for decades
- Simple leverage ratios as an alternative?
- Need to deal with transitional problems

Need more reliance on self and market discipline

- Regulation only one of three Basel Pillars
- How might self-discipline be encouraged?
- How might market discipline be encouraged?
- Are more detailed and transparent policies always desirable?

Need for more radical structural change

- Lessons from other complex systems
- Roll back consolidation, globalisation and securitisation?
- Introduce “narrow money” along with FINTECH
- And abolish financial safety nets and regulation

Concluding thoughts

- Future systemic crises are still possible
- Every geographical region has economic and/or financial sector problems
- In an interconnected world, problems anywhere become problems everywhere
- Economic and financial stress also interact
- And serious economic problems will have social and political implications

  - GOOD LUCK–YOU MIGHT JUST NEED IT