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Financial Crisis and Financial Intermediation: Asking Different Questions

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The financial sector, which once was hailed as the driver of growth, brought about a global crisis in finance and the real economy in 2008. Reforms are needed in the financial sector and also in the ways that we think about the financial sector in the context of the ultimate objectives of economic and social well-being.

Rather than asking the same questions that were asked before the crisis and getting the same answers, we need to ask a different set of questions or put the same questions differently. This chapter examines India's experience with regulation of the financial sector.

Financial-sector reforms need to minimize the chances of future catastrophes and yet maintain as many as possible of the social benefits of the financial sector. Is there merit in considering, more seriously than is the case now, the experiences of other countries with the crisis? The financial crisis originated in some countries with great intensity, but its intensity in the financial sector varied among countries. One question is whether it is appropriate to universalize the causes of crisis on the basis of the most affected countries (such as the United States) or whether it would be better to analyze the variations in the intensity of the financial crisis in different countries (say, Canada, Australia, China, or India). In November 2007, the *Economist* identified India, Hungary, and Turkey as the most vulnerable economies among the emerging-market economies, but in two of the three countries its prediction proved to be wrong. Was the framework for assessment of vulnerability wrong? Similarly, inflation targeting helped in obtaining credibility for policies and thus price stability. But in many countries, price stability was maintained without inflation targeting. The question is whether countries that achieved credibility through inflation targeting can now give up the

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instrumentality of inflation targeting, retain a focus on price stability, and acquire operational flexibility to maintain some output and financial stability.

How should the reform agenda of the financial sector be linked to other policies? Precautionary steps may be taken in the regulation of the financial sector to reduce the risks that may emanate from other policies. The regulatory framework for the financial sector in India consciously built precautionary approaches to mitigate the ill effects of high fiscal deficits and large government borrowing programs. These measures were not exactly countercyclical but were in some ways macroprudential.

Although globally agreed-on standards of financial regulation would ensure coordination among national regulations as needed in a globalized world of finance, should there be emphasis on allowing for diversity in financial regulation among different countries? In the decade before the crisis of 2008, a globally binding model of best practices would have been the model practiced in London or New York. If that model had been adopted universally, China, India, and much of Asia in general would not have been leading the recovery. No one has a monopoly on universal wisdom on financial regulation. So how do we ensure diversity in financial regulation among countries in the future?

Whose Fault? Markets or the Government?

We formerly assumed that the failures of markets can be made up by the strengths of regulation, but the crisis has shown that market failures and regulatory failures reinforce each other. In the interactions between the market and government, governments can make up for market failures, they can interact with their strengths to synergize for the overall benefit, or they can reinforce each other's failures. The appropriate question may be how can we ensure that markets and regulations interface with each other to maximize social benefits and not collude or allow one to be captured or dominated by the other. Institutions like Fannie Mae and Freddie Mac in the United States were instruments of public policy, but they conducted their business no differently from their private-sector counterparts in terms of lobbying and tinkering with accounting standards. At the same time, public-sector banks in some other countries have been prudent and risk averse.

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What accounts for differences in the economic behavior of instruments of public policy in different countries? Should public governance be different from the private sector in regard to values, checks and balances, incentives, and security of employment? Should those factors influence the relative roles of government and the market?

The Social Value of the Financial Sector?

The social value of the financial sector can be assessed in terms of its direct relevance (as a service to the average person in providing financial services) and its indirect relevance (through its resource mobilization and allocation, including managing risks and rewards).

The provision of financial services should be treated as public utility services and subject to regulation accordingly. A distinction in actual operations between the provision of financial services and intermediation is difficult, but it is necessary for a good design of public policy. The well-known Volcker rule attempts this.

Broadly, financial services may be defined as those that a common person would want from the financial sector and more generally are of direct social value. For example, people need the safe custody of cash and access to their cash when needed (the withdrawal of cash from automatic teller machines ensures equity in the quality of service). Second, citizens need one extremely safe instrument in which their savings can be kept for a rainy day. Third, the payment system should enable transfers of money between people in different locations with minimum inconvenience as well as cost. Fourth, resources need to be provided to smooth consumption when incomes are uneven over a period while the bulk of consumption is more stable (this requires access to credit facilities, but finance for the common person is often equated with personal credit to them). Finally, people participate in financial transactions as incidental to their normal lives, and the default option indicated by public policy should take account of these needs and not leave it to financial markets and regimes of contracts (between the financial intermediary and the everyday consumer) that are often among unequals. Have these social demands on the financial sector been assessed in regard to quality, coverage, or cost? Postcrisis, there are references to financial inclusion, but are there global standards or benchmarks for the purpose?

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The social value of the financial sector is brought about indirectly in terms of the productive use of capital. Savers and investors have different risk and reward appetites and time horizons. It might be useful to explore empirical evidence in regard to having the financial sector enhance its role in mobilizing savings and allocating resources efficiently. Cross-country experiences seem to indicate that savings have been low in some of the countries where the financial sector is highly developed. Savings have been moderate or high in some countries where the banking system rather than the nonbanking system in the financial sector is dominant. What is the empirical evidence on the link between the level of saving, the efficient use of savings, and the level of development or nature of the financial sector?

In terms of cross-country flows, the empirical evidence shows that financial-sector development brought about a flow of resources to finance more consumption rather than savings in the developed financial sector. In most countries where the financial sector was highly developed, inequalities seem to have increased. What is the empirical cross-country evidence on developments in the financial sector and their implications for growth as well as equity? It appears that an optimal level and an optimal quality of financial-sector intermediation and sophistication seem to enable growth with stability but anything above these levels has not added fundamentally to society. In other words, are there an optimal level and complexity of the financial sector that optimize its social value?

How Active Should Regulation and Supervision Be?

If there are an optimal level and an optimal complexity of financial markets, which may be dynamic, then there may be a need to rebalance the regulatory regimes, with increasing regulation in some cases and decreasing regulation in others. In some countries, especially emerging-market economies, some deregulation of the financial sector may be needed to enable it to facilitate growth, but the extent of deregulation needs to take account of global experiences and local circumstances.

It is often argued that one reason for the crisis is that regulatory skills were not able to cope with market innovations. In the case of innovations, where should the benefit of the doubt rest—with the market or the regulator? For example, the safety of a drug has to be proved by the producer before it can be marketed, and for most other commodities,

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producers must pay a penalty if the product sold proves to be toxic. Where does a financial innovation lie within these two categories? One approach, adopted by the Reserve Bank of India (RBI), is that if the innovation's benefits do not convince the regulator of its safety, then it will not be permitted or permitted only with conditions (such as placing the burden of ensuring the proper criteria of the customer on the seller of the financial product).

After the crisis, several considerations appear to warrant a greater role for discretion than for rules. Countercyclical policies would involve assessment of structural and cyclical components. Such an assessment has subjective elements, and differentiation between the two is complex in emerging-market economies. The identification of systemically important institutions may warrant judgment. A financial intermediary that is not big may be a dominant player in a particular critical segment of financial market and thereby turn out to be systemically important. The issue in regulation and supervision is often one of effectiveness and not mere intensity. Effectiveness can be enhanced by a combination of early warning signals, preventive corrective actions, a graded escalating scale of effective penalties, and a wide range of instruments, to be applied with discretion. The actions of the regulator against the regulated cannot be based only on the transgression by an intermediary in individual instances or on technical compliance with a specific regulation. The regulator also must have an overall comfort with the conduct of business by a financial intermediary, consistent with the spirit of regulations. How extensive and how intensive should regulation be in normal circumstances, and how much additional discretion should be provided for meeting extraordinary circumstances?

Finally, the traditional debate between rules versus discretion in regulation may have to be restated. The new questions may be, how flexible should rules be, and what constraints should be imposed on discretion?

How to Design Financial Institutions?

Some financial institutions—say, in the United States and the United Kingdom—have been said to be too big to fail. At the same time, however, there can be financial institutions that are too big to save (examples can be found in Iceland). Other institutions that are important for a sector of the real economy or a segment of the financial markets

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may be not too big but too important or too critical to fail. There may also be financial institutions that are too powerful to regulate, owing to compulsions of domestic political economy or diplomatic considerations. When there are a few globally systemically important financial intermediaries that operate out of and with the strong governmental support of globally significant countries, they become too powerful to regulate. The situation is worse when the infrastructure, such as a few rating agencies and business news agencies, are also too important to fail. Can we influence the conduct of business by such entities by focusing regulations on standards of ownership and governance in relevant institutions? Will recognizing systemically important institutions and imposing higher capital requirements reduce or enhance the appetites of too powerful institutions for excessive risk? Should such institutions be stopped from emerging or existing?

How to Mitigate the Effects of Crisis?

Moral-hazard considerations compel large elements of constructive ambiguity in any strategy to mitigate the effects of crisis. It is possible to differentiate between a bailout of institutions and a bailout of their management and shareholders. Should we differentiate between the institutions whose continuity is critical to mitigating the effects of crisis and the managers and shareholders of these institutions that should be held responsible for the crisis? The power to dismiss executives, supersede the board of directors to replace management, and mandate the sale of shareholdings could be part of the package of unconventional measures that can mitigate the effects of crisis with minimum danger of moral hazard. In one case in India, a bank approached the Reserve Bank of India for liquidity support with full collateral, but liquidity was suspected of being denied to the bank by market participants owing to its questionable investments. The RBI made support conditional on the departure of the chief executive.

How Limited Is Our Understanding?

The cross-border activities of financial institutions are a big black box. The cross-border exposures have been a major source of collapse of

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many financial intermediaries in the crisis. In fact, much of the U.S. Federal Reserve's bailout packages helped resolve cross-border issues. Many financial institutions outside the United States faced a crisis because of overseas wholesale funding or lending. The nature of the regulation of many cross-border activities of financial intermediaries is unclear. Is it possible that the cross-border activities of financial institutions directly or indirectly contribute to undermining public policy in regard to regulations, taxes, and occasionally legality? How does volatility affect capital flows that are carried out by the cross-border activities of the financial sector on the real sector?

As it evolves, when does a financial sector stop playing the role of enabling the growth of the real economy and start injecting negative impulses into the real economy? When does the financial sector create wealth or value, and when does it divert wealth to itself from others? Further, should the real economy keep adjusting to the financial economy even when the latter is volatile for a prolonged period or deviates significantly owing to extraneous considerations? What are the differences between financial markets and nonfinancial markets? How do the two interact to enable enhancement of social value, create wealth, or divert wealth from many to a few? What kind of interaction occurs between banking and nonbanking sectors and between real and financial transactions in the financial sector?

Conflict-of-interest rules in the financial sector are often applied similarly in the public sector or regulator and in the private sector. There are advantages of coordination and also threats of conflicts of interests when there is an expanded mandate for regulators. Recent experience with crisis has shown that in public institutions, the benefits of coordination can prevail over the risks of conflicts of interest. In private institutions, despite the firewalls that were promised, the ill effects of conflicts of interests have prevailed. Should we change our regulatory structures relating to the coordination of conflict-of-interest rules in the public sector as distinct from the profit-driven private sector?

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Leading Economists Reassess Economic Policy

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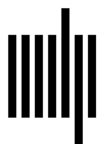

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