Chapter 4

Regulatory Responses to the International Boom-Bust Cycle

"The efficiency gains from financial market integration are counter-balanced by the negative effects of growth volatility. This prompts the question: what is a financial system for?"

The boom-bust cycle within countries is mirrored in the boom-bust cycle of cross-border capital flows to emerging economies. We know that credit cycles in the OECD have contributed to international volatility of capital flows, which was transmitted to instability in domestic financial sectors, and have seriously undermined growth in developing countries, particularly during severe and frequent currency and banking crises. Though financial crisis in developing countries have a very long history, they have become more frequent and more severe in the last decades, following a period of intense liberalisation of the domestic financial sector and of capital accounts worldwide. We do not make this observation as an argument in favour of financial market repression, but to better balance the cost-benefit assessment of liberalisation. Though pro-cyclicality is endemic in financial markets, inappropriate regulation and deregulation of these markets seriously accentuates its effects.

Regulatory Spillovers and Economic Development

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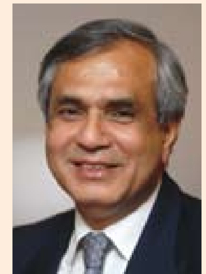
At the time of the Asian financial crisis in 1997-98, Asian central bankers and finance ministers were given a strong dressing down by the financial gurus in OECD economies on the serious policy mistake of not bringing their financial sectors in line with those of advanced economies. The limited integration of their financial sectors with global markets, lack of capital account convertibility and continuation of administrative controls in these economies was seen as sign of backwardness and lack of sophistication in macroeconomic management. I still recall being told by financial sector fundamentalists, just after the massive capital flight had brought the Indonesian economy to near bankruptcy, that building up foreign exchange reserves was simply wasteful and foolish because they are not really needed if policymakers got macroeconomic management right. With complete exchange and interest rate flexibility, it was argued, reserves are simply not required! Those were the high days of the Washington Consensus where regulators saw any form of government control as unnecessary and dysfunctional and firmly believed that the markets and market



players can self-regulate while maximising returns. Now of course we know differently. One of the central lessons of the current financial crisis is that 'one cap certainly does not fit all' and especially not in the case of the financial sector.

The crisis has shown that there is hardly any case for a level playing field and uniform rules and operational principles for all economies irrespective of their level of financial sector development or their regulatory capacities. To many of us in Asia this had become reasonably clear even at the time of the financial crisis by observing the relative success of apparently unorthodox policy approaches adopted by the Hong Kong Monetary Authority in defeating attempts at breaking the peg or those adopted by Malaysia in preventing a run on the Ringgit by freezing the exchange rate and bringing in extensive capital controls. The Indian and Chinese success in weathering both the financial crisis while maintaining relatively strong capital controls and large segments of the banking sector in public ownership also points to the effectiveness of tailoring financial sector policies and regulatory regimes in sync with ground conditions and not with a view to earning brownie points from advanced economy theologians.

The second important lesson in my view is to make sure that the development of the financial sector and the extent of liberalisation and integration with the global economy should not run far ahead of the rest of the economy as it tends to happen in emerging economies who fall in the trap of equating the emergence of a sparkling financial district to modernisation of the overall economy. As a result, in many emerging economies, the financial sector quite often begins to look like an enclave that acts in tandem with global financial sectors rather than serve the needs of the domestic economy. This exacerbates the dualistic economic structure by attracting the human talent and leaving the real economy bereft of managerial resources. Therefore, it is important that the design and development of the financial sector is tailored to the actual needs of the individual emerging economy. This will of course imply the existence of a number of 'unlevel playing fields' especially if host country regulations are enforced as this report argues should be the case. This is required to prevent emerging economies from unnecessarily suffering the contagion from episodes that originate in the advanced economies and also allows them the degrees of freedom required to ensure that their financial sector grows organically with the rest of the economy.

The last three decades have made developing countries, particularly those more integrated into world markets, swing at the rhythm of highly pro-cyclical external financing, with very negative effects on their growth and development. Of particular concern is that the current global crisis, which originated in OECD countries, has led to a far larger decline of net private capital flows to developing countries (estimated by the Institute of International Finance at around 8 percent of emerging countries' GDP) than that caused in previous crises originating in developing countries.

Financial volatility has a direct impact on the balance of payments and domestic financial markets, and, through these avenues, on domestic economic activity and other macroeconomic variables. Furthermore, in the face of strong swings of private capital markets, developing countries lose the 'policy space' to adopt autonomous counter-cyclical macroeconomic policies. The unfortunate outcome of this dynamics is that 'twin' external and domestic financial crises became far more frequent.

The major task of a development-friendly international financial architecture, and particularly for regulatory reform both nationally and internationally, is to try to curb the pro-cyclical and volatile nature of financial markets and to mitigate the pro-cyclical effects of financial markets, thus opening 'policy space' for counter-cyclical macroeconomic policies in the developing world. This would also help avoid costly financial crises. It would also help

developing countries combat volatility generated by foreign financial institutions acting irresponsibly under home country regulation.

Boom-bust cycles reflect investor herding and associated contagion – of both optimism and pessimism. Volatility in developing countries is often associated with shifting appetite for risk of investors in developed countries. In particular, the 'search for yield' characteristic of low interest rate environments in developed economies generates incentives for credit creation, carry trade, and leverage that is often associated with the pumping up of asset bubbles in emerging economies and elsewhere.

A booming private sector tends to influence the public sector, through a number of ways, to support the boom and to refrain from counter-cyclical macroeconomic policies. Thus, unstable external financing distorts incentives that both private agents and authorities face throughout the business cycle, inducing pro-cyclical behaviour from economic agents and policymakers. The costs of such financial volatility in the developing world are very high. There is now overwhelming evidence that pro-cyclical financial markets and macroeconomic policies have increased growth volatility and have discouraged growth in the developing world. The efficiency gains from financial market integration are counter-balanced by the negative effects of growth volatility. This prompts the question: what is a financial system for?

Research by Eichengreen and others has suggested that over the past twenty-five years the incomes of developing countries had been 25 percent lower than they would otherwise be were it not for currency and banking crises. Others have estimated even higher average annual costs of crises. According to some estimates, Indonesia experienced larger falls in output and incomes during the 1990s Asian crisis than the United States during the Great Depression. The costs, in terms of lost output, of the current crisis, in both developed and many developing countries will be extremely large. Credit cycles contribute in a major way to international volatility of capital flows, reflected in domestic financial sector and macroeconomic boom-bust behaviour. This has very severe consequences for development.

What can developing countries do? The first instinct has been to call on home country regulators of international banks to chasten the cycle of feast and famine. However regulatory action there has tended to amplify the cycle not cut it. In booms, national regulators in the home countries tend to act like national champions of their local banks, afraid to reduce the international competitiveness of their banks by restraining their international activities even where there are systemic dangers in the host countries. Indeed, home country regulators tend to support the push of their banks abroad, arguing that developing country host regulators are being too protective of their financial systems and should apply common standards that the large international banks are more equipped to meet. In the subsequent crash, tax payers are angry at bailing out a bank that has been lending to foreigners and consequently home country regulators tend to exert less forbearance on international lending than local lending.

The best protection for developing countries from the feast and famine of cross-border capital flows is not to rely on the concern of home country regulators, especially where the home is a large developed country and the host is a smaller developing country, but to rely on host country regulation. On macro-prudential grounds, the host country regulator may require all lending activity to be carried out by locally regulated subsidiaries. It can impose higher capital requirements on lending when there is an above average growth of credit and where it can detect systemic risk, such as a crowding of investment in small sectors or a large build-up of foreign currency funding of local assets. Where host country authorities identify risks to domestic financial stability, borrowing outside the locally regulated sector could be made illegal and any charge on local assets by unregulated external lenders unenforceable. This is not to say that the home country regulator should not work with the host country regulator on these issues. Facilitating this process should be one of the objectives of multilateral regulatory bodies such as the Financial Stability Board. We return to the host-home country debate in later Chapters.