Corporate Governance of the World's Financial System: Extend the Financial Regulation Franchise to Emerging Economies

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The Quality of the Developed World's Financial System and Global Imbalances

There is a conventional view that global imbalances—in which developed countries, in particular the United States, are the net borrowers and emerging markets, in particular China, are net lenders—are a symptom of inefficiency in the world financial system, a potential cause of financial crises, and therefore need to be corrected through government or multilateral interventions.

However, many economists argue that the global imbalances per se are not a symptom of inefficiency.[1] The argument in a nutshell is as follows: let us consider the case of two countries—a developed country (for example, the United States) and an emerging economy (for example, China). For the purpose of this analysis, there are two key features of the emerging economy. First, there are more risks that firms and households are exposed to in the emerging market economy. The shocks to the firms and households in such an economy are typically larger. Higher uncertainty and volatility at the level of the households and firms translate into a desire to save more for precautionary purposes. Second, emerging capital and financial markets are much shallower than developed capital markets. Importantly, there are few, if any, domestic long-term assets and relatively few domestic safe shorter-term assets in which to channel these large precautionary savings. It is natural then that emerging economies would invest in the financial assets in developed economies. In other words, a key "export" of an economy with a developed financial market to emerging market consumers is the depth and sophistication of its financial system.[2]

Consider an example of Russia. In the last 10 years, Russia became a significantly larger economy that is also more integrated and reliant on the global financial system. Its income depends on a volatile and risky stream of revenues from commodities. Despite impressive development in the recent years, Russia's financial markets are rudimentary and do not offer long-term assets to households and firms. Nor can they can adequately hedge their long-term and short-term risks. It is not surprising that foreign assets are a popular means of savings and insurance for Russians; the only viable alternative is real estate, which is by definition illiquid and cannot hedge most of the risks. Households in Russia hold a large amount of foreign currency in dollars and euros. The government and private sector in Russia invest in long-term foreign assets that are not provided by local financial markets. As we argued above, the ability of markets in the developed countries to provide high quality assets superior to those in other countries can explain why developing countries accumulate foreign assets. In other words, developed countries' financial systems export the services of financial assets to countries that need them but cannot produce them. The availability of these foreign assets is important from the welfare point of view as it provides the necessary insurance and financial intermediation that are not available through the domestic financial system. It is not surprising that the largest foreign reserves are held by developing countries, such as China and Russia.

Importantly, even small differences in the deepness of financial markets can generate very large "imbalances".[3] The quality of the financial system in the developed world is a key determinant of the flow of funds and the prices for U.S. assets. The

very fact that U.S. dollar assets are still in high demand even after several bankruptcies and near-bankruptcies of major financial institutions as well as an unprecedented peace-time expansion of government debt implies that the U.S. financial system and the dollar are still superior to competitors. But further deterioration of the financial system may destroy the "superior and unique" U.S. export—the long-term dollar-denominated assets. On the contrary, if the U.S. manages to improve, even if marginally, its financial regulation and macroeconomic policy, then global imbalances will be "aggravated"—the inflow of capital to the U.S. will grow with the respective current account deficit in the U.S. and current account surplus in China.

Should we be worried about such a development? Probably not. The crisis did not happen because of global imbalances per se. The crisis happened because investors in Western financial institutions overestimated the quality of these institutions. Therefore, the major task now is to improve the regulation of Western financial markets and institutions. The good news is that the global imbalances provide at least a partial solution to this problem.

Emerging Economies as Key Stakeholders in the Developed World's Financial System

The two major determinants of the West's comparative advantage in financial intermediation and financial asset creation are good economic policy and high quality of financial regulation. While there is now at least a beginning of a "peer review" process for macroeconomic policy with the Mutual Assessment Process[4], there is much less international coordination in financial regulation. We believe that the world should not miss an important opportunity here.

Who can monitor the quality of the developed countries' financial systems? It is crucial to involve the largest non-OECD economies in the debate on financial regulation and in the design and subsequent enforcement of a new system of regulating global financial markets and institutions. The global financial system strongly benefits from extending a regulatory and oversight franchise to these countries. Even though the vast majority of the global financial institutions are in the West, the new financial system should incorporate the interests of emerging markets. The standard reason for this is promotion of global welfare. Indeed, the cross-border externalities of the West's financial system on other countries should be internalized. In the post-crisis world, the large emerging economies will remain important providers of capital to the OECD markets. These economies will continue to grow faster than the G-7 countries and will feel the constraints of the underdeveloped financial system and the lack of safe and credible investment instruments. As the crisis re-confirmed the importance of reserves and stabilization funds, emerging market countries will also resume building up their sovereign funds. Conservative finance ministers in countries, such as Russia, Chile and China, who argued for keeping higher reserves, are now viewed as heroes and will likely wield even greater influence in the aftermath of the crisis.

As large investors in the G-7 financial system, the developing countries will have a stake in enforcing investor protection in a broad sense and therefore improving the quality of regulation. This is similar to the main principle of corporate governance: providers of finance should have a say on how their resources are used.

But there is also another reason. Including emerging markets in regulating OECD financial markets is not only fair and good for developing countries, it is also good for investors in OECD countries. The interests of the developing countries that lack their own financial institutions are aligned with those of all investors in the OECD financial markets. Hence, if emerging markets are given the effective participation in the design and enforcement of new regulation, they can effectively promote investor interests. This is especially important given that investors are not organized and are usually underrepresented in the debate. Thus, developing countries can help resolve a collective action problem.

Yet another important advantage of extending the financial regulation franchise to developing countries follows from their incentives to take into account not only the benefits of stricter financial regulation but also its costs. Being major stakeholders in the Western financial system, they are interested not only in preventing crises and bankruptcies of individual institutions but also in the long-term performance of assets. Therefore, it is in their interest not to throw away the baby with the bathwater; emerging markets have very strong incentives to preserve the global financial system's ability to innovate. The voters in the developed countries are looking for a culprit for the financial crisis, which may create a temptation for the policymakers to over-regulate. On the other hand, those developing countries, whose financial systems lag behind, are important beneficiaries of financial innovation. For many of those countries, the stakes in promoting efficient financial intermediation and economic growth are much higher than the stakes in the developed countries; it is an issue of political survival. While the OECD democracies can afford a slower growth rate, for many emerging markets, a growth slowdown also implies significant threats to political and social stability.

References

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Endnotes

[1] See Caballero, Farhi, and Gourinchas (2008) and Mendoza, Quadrini, and Rios-Rull (2007)

[2] Blanchard and Milesi-Ferreti (2011) describe this situation as a "distortion" which developing countries should be willing to correct. Certainly, all countries are interested in developing a world-class financial system. However, it is unrealistic to expect that the major emerging markets will be able to catch up with the West in terms of the quality of financial institutions. Also, as we argue below, even a small gap in efficiency of financial systems results in large imbalances. The other important consideration is that some countries may just have a substantial comparative advantage in financial intermediation (e.g. due to the Anglo-Saxon origin of the legal system). This comparative advantage may determine these countries' long-term export orientation in exporting financial services. This is similar to the fact that resource-rich countries export resources and tropical countries export tropical agricultural products. Such a comparative advantage is not carved in stone. For example, the U.S. is "resource-rich" and has the most advanced technology in the oil and gas sector, being the largest producer of natural gas and one of the largest oil producers in the world, but it has no *comparative* advantage in these industries anymore. But it is difficult to imagine that the developing countries' financial systems will close the gap with Western ones in any foreseeable future.

[3] See Mendoza, Quadrini, and Rios-Rull (2007)

[4] In this article, we focus on financial regulation. But the macroeconomic policy in the G7 countries is certainly a major concern. The unprecedented rise in the government expenditures during the crisis has resulted to an increase in debt that may prove unsustainable. This is no longer a domestic policy issue. As shown in Doepke and Schneider (2006), foreigners hold a large amount of the U.S. government debt and increased U.S. inflation constitutes a substantial tax on them. An increase in inflation redistributes wealth from the foreigners to the young, middle class households who hold mortgages. Politicians faced with an increased debt may be tempted to inflate instead of taking more unpopular measures such as decreasing government spending. The developing countries with their large reserves will lose the most from irresponsible macroeconomic policies in the West.