What Should Other Countries Learn from the U.S.'s Regulatory Response to the Crisis?

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As the recent global financial crisis originated in the U.S. financial sector, it is natural that the first regulatory response also came from the United States. The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Barack Obama in July 2010. The act set the tone for the other countries' plans to improve and increase regulation of the financial sector. Other countries are likely to follow the U.S. regulatory response for two reasons. First, as the U.S. is perceived as a stronghold of market economics, others countries' policymakers prefer to have regulation that is not laxer than regulation in the U.S. Second, as the previous deregulation efforts in the U.S. preceded the crisis, the other countries believe that deregulation may have been the root cause of the crisis. In this sense, the Dodd-Frank Act may be the single most important influence that the U.S. will export to the rest of the world as a consequence of the crisis. In what follows, we argue that while reform of financial regulation is certainly required, the world—and especially emerging markets—should also consider the cost of excessive financial regulation and the need for smarter rather than more extensive regulation.

Lessons from the Crisis

One of the most important lessons from the recent global financial crisis is that existing regulations created the wrong incentives for risk management in the financial sector. Financial institutions around the world took on excessive risks, both at microeconomic and macroeconomic levels. The former issue is related to moral hazard due to the socialization of losses while the latter is related to the possibility of contagion and the dangers to the financial system as a whole and consequently to the economy and to fiscal stability. These macroeconomic dangers that the financial sector posed were known but had never been taken seriously before the crisis as the leading financial institutions had never been so large and so systemically important.

As several of these institutions failed or nearly failed, they had to be saved and taxpayers in the U.S. and other developed countries witnessed a new phenomenon—the massive bailouts actually undermined the sustainability of public finances themselves and imposed a substantial debt burden on future generations. It is not surprising that voters around the world are now demanding stricter regulation of the financial sector to make sure this problem is not repeated. The ire to the financial sector as a cause of the crisis is exacerbated by what many perceive as excessive compensation for bankers and fund managers, increasing already skewed income distribution.

The Costs of Excessive Regulation

One potential solution to prevent possible future crises is to significantly curtail the ability of the financial sector to take on risks. The pendulum of financial regulation—which was most likely too lax before the crisis—is swinging back and has perhaps swung too far toward the side of overregulation in the current political climate.

What would be the consequences of a significant tightening of financial regulations? An important danger is that stricter rules governing the financial sector may, and likely will, decrease the ability of the financial system to innovate. Now, after the financial crisis and the ensuing Great Recession, the phrase "financial innovation" has such negative

connotations that it borders on obscenity. However, one should not forget the importance of financial markets and institutions to economic growth.

The deregulation and development of a much deeper and broader financial system in the U.S.–which resulted in the so-called financial revolution[1]–was crucial for financing new industries[2] like the revolution in information technology and telecommunications[3] that brought substantial increases in productivity both within and outside the United States. Financial development also brought tangible benefits to the developing countries. While many of these countries enjoyed fast economic growth, their financial systems lagged behind. However, these countries could provide their economies with financial intermediation services through the West's sophisticated financial system.

It is very difficult to evaluate the impact of such a comprehensive reform package as the Dodd-Frank Act. For more narrow regulatory changes, the estimates have been rather modest. For example, a recent OECD study entitled "The Macroeconomic Impact of Basel III" finds that stricter regulation of liquidity and capital of banks of Basel III will have a medium-term impact on GDP growth only of 0.05-0.15 percent of GDP per year.

But Basel III is nowhere near the Dodd–Frank Act in terms of its wide-reaching implications for the U.S. financial system. In this sense, one should look at more comprehensive regulations such as the Sarbanes-Oxley Act of 2002. As it turns out, even though Sarbanes-Oxley is a much more modest regulatory intervention than Dodd-Frank, its cost was quite substantial.

Sarbanes-Oxley was also a regulatory response to a crisis. Following a string of corporate and accounting scandals, the Sarbanes-Oxley Act significantly tightened regulation and standards for all U.S. public company boards, management and public accounting firms. On the one hand, the response from the regulators was much needed and well justified following the scandals and egregious corporate behavior at Enron and WorldCom. On the other hand, the act significantly increased the compliance costs for listing on U.S. exchanges. Luigi Zingales[4] argues that such compliance costs may be a significant factor for the U.S. losing its dominant positions on the IPO market for foreign listings. Zingales uses surveys of board members to show that the compliance costs for a relatively small listed company from the S&P Small Cap with an average capitalization of $750 million are equal to about $2 million. For large companies listed on the S&P 500 with average capitalizations of $24 billion, the compliance costs are close to $10 million. This research compares other potential explanations for the loss of competitiveness of the U.S. markets (as many companies preferred London and Hong Kong to New York), and concludes that the most likely cause is a significant tightening of compliance regulations.

The Main Trade-off in Financial Regulation

Policymakers understand that regulation which reduces risks and prevents crises also slows down economic development and growth. So they usually make regulatory choices resolving the trade-off between lower volatility and lower growth due to tighter regulation and lower risks on the one hand, and higher growth and higher volatility due to deregulation on the other hand.

Regulators prefer lower volatility because volatility brings social pain and also hurts long-term growth. The most important support based on empirical economic research for the proponents of financial regulations comes from the classical paper by Garey and Valerie Ramey, "Cross-Country Evidence on the Link between Volatility and Growth".[5] Their study examines 92 countries from 1960-1985 and shows that countries with higher volatility of growth have lower economic growth (controlling for country-specific growth correlations). Their analysis implies that one standard deviation of the volatility measure across countries translates into over half of a percentage point of annual per capita growth in the case of the 92 countries, and one-third of a percentage point of annual per capita growth in the case of the OECD countries. In oth-

er words, this research says: reducing volatility can significantly increase long-term economic growth. This would seem to be a perfect justification for increased financial regulation—as long as it helps to reduce volatility.

However, this argument may be misleading. One can argue that deregulation does result in higher risks, and higher risks are bad for growth; but, at the same time, the direct positive effect of deregulation on growth may be even higher. In this case, deregulation would actually pay off—even though it results in higher volatility.

This is the question addressed in a recent paper by Romain Ranciere, Aaron Tornell and Frank Westermann.[6] They start with a simple example—comparing the growth rates of India and Thailand between 1980 and 2001. India's growth was slow but steady; GDP per capita grew by almost 100 percent. Thailand's growth was much faster (almost 150 percent) but also included a serious economic crisis. Their estimates indicate that about a third of the growth difference between India and Thailand can be attributed to systemic risk taking. This of course does not imply that systemic financial crises are good for growth. Rather, deregulation of risk management may be beneficial to growth even despite the cost of occasional large crises.

The experience of just two countries is not sufficient to draw conclusions on the role of systemic risk in growth. The authors studied 83 countries over the period of 1960-2000. It turns out that the countries with a lower number of systemic crises grew significantly slower. The size of the effect was similar to that in the Ramey and Ramey study. If one would expand regulation so that there are three fewer crises for a typical country then it would grow on average slower by 0.3 percentage points a year. The effects are the strongest across the set of countries with weak institutions but functioning financial markets which encompass many of the emerging economies. In this sense, the reduction of systemic risk is the costliest for the emerging markets.

Crises and the View from Post-Socialist Countries

The finding that countries with a lower number of large crises grow significantly slower, at first, looks incredible as each crisis leads to a fall in GDP. Of course, nobody likes financial crises. On the other hand, only a cemetery has absolute stability. The research of Ranciere, Tornell, and Westermann shows that getting rid of systemic crises may actually come at a significant cost to long-term economic growth. Given the substantial potential for fast catch-up growth in the emerging markets, its benefits may well outweigh the costs of crises due to lax regulation.

This is where the economic history of Russia and of the other socialist countries provides an important lesson. The socialist economies were much more regulated than India, credit was centralized and financial markets were banned. It is no wonder that these economies had no crises. However, they lagged behind the West in terms of productivity growth and eventually went bankrupt in the late 1980s. Since then, market reforms resulted in the building of imperfect but functioning financial markets, integration into the global economy—with inevitable vulnerability to financial contagion and economic crises. However, the market reforms also provided the conditions for economic growth that allowed the closing of a substantial part of the gap with the OECD countries.

Financial Development and Volatility

Another important lesson from emerging markets is that financial development may help to mitigate the shocks brought on by financial crises. For most emerging markets whose economies are not diversified and depend on a single commodity or a single export market, the main problem during global economic crises is the sudden shock to the exchange rate. However, the economic impact of this shock depends on the level of financial development. In a recent paper, Aghion et al. (2009) show that exchange rate volatility has a strong negative effect on productivity growth only in

countries with low levels of financial development. While their data come from 83 countries in 1960-2000 and therefore do not cover the recent crisis, their results are in line with what we have seen in 2008-09 in the commodity exporting economies. These economies received a similar exchange rate shock in 2008 (when commodity prices went down by a factor of 2-3 times) but their GDP fall varied greatly. In Australia, the crisis resulted in a growth slowdown (from the long-term average of 3 percent to 1.4 percent), in Brazil, Chile, and Saudi Arabia there was flat growth or a fall but less than 1 percent, in Mexico GDP fell by 6 percent, and in Russia it fell by 8 percent (compared to 6 percent growth a year earlier). The output fall in Russia was certainly an implication of a few policy mistakes[7] but those mistakes were driven by the understanding that the financial system is too shallow to withstand a major exchange rate shock.

The main takeaway from the research by Aghion et al is the importance of financial development for mitigating the impact of crises. This argument is mostly relevant for the emerging markets. In the developed economies, where mature financial systems are already in place and where the economies are well-diversified so that large exchange rate shocks are unlikely, the regulators usually miss this additional cost of regulation—the slowdown of financial development.

Smarter Regulation, Not More Regulation

The arguments above imply that we need a functioning and effective financial system and for that we need functioning and effective regulations. This does not necessarily mean more regulation. The kind of regulation should provide incentives to take risks but at the same time rule out moral hazard where taxpayers bailout losses that arise due to excessive risk taking. Economists have long proposed specific regulations that can help solve these incentive issues.

First and foremost, regulations have to reduce informational asymmetries and enforce disclosure.[8] Second, regulators should promote financial literacy and financial education. Then, given that all the risks are disclosed and understood by customers and investors, the regulators should allow for financial innovation and for competition of business models.

The problem of course is that the logic above only works as long as there are no externalities. But the recent crisis has shown that it is very difficult to not bail out too-big-to-fail institutions. This means that regulation of the financial system should make sure that systemic institutions either do not arise or are regulated in a different way (through adding special resolution regimes for systemically important financial institutions).

The other source of externalities is the emergence of credit cycles: in a high-leverage economy, a bankruptcy of one institution may initiate a chain of fire sales and bankruptcies. If a leveraged institution is bankrupt, its creditors take losses and therefore have to sell some other assets. This in turn drives down asset prices (including prices of collateral) which results in losses of other institutions. In order to avoid this chain reaction, the regulators can use contingent capital, which has now become a tool of choice of macroprudential regulation. Contingent capital is a convertible security which is debt that is automatically converted to equity in case of a macroeconomic downturn.

All these and many other reasonable ideas have been included in the Dodd-Frank Act. It is certainly too early to judge whether these regulations are going to be implemented well. But certain elements of the Dodd-Frank Act may go too far—especially if we assume that the other elements, such as disclosure, resolution regimes and macroprudential regulations, work well. For example, the "Volcker rule"—which virtually reinstates the Glass-Steagall Act, separating commercial and investment banking—is likely to undermine the ability of U.S. banks to innovate and compete.

Should Emerging Markets Import Dodd-Frank?

So to what extent should the emerging markets follow the U.S.'s regulatory response to the crisis and

implement something like Dodd-Frank? On the one hand, there are all the reasons for emulating the U.S. regulation listed above. Also, it makes no sense to allow for "regulatory arbitrage". If regulation is laxer in some countries than in others then corporate mobility will render the tougher regulatory environment irrelevant. This issue already is and will certainly continue to be in the center of the G-8 and G-20 debate.

However, there are at least three reasons to be cautious. First, there is a risk of stifling the competition of regulatory regimes. If U.S. regulation is too tough or not as well designed as regulation in other countries, standardization of regulation may actually undermine the quality of regulation in the long run. For example, if after Sarbanes-Oxley, companies could escape the excessive burden of regulations and list in Hong Kong or London, global harmonization would leave no route to escape. If there are mistakes in Dodd-Frank, in a few years we may well be asking: why have the world's capital markets lost their competitive edge?

The second important reason for caution is that the emerging markets differ from the developed countries in their need for growth and for development of the financial system (the latter exactly because financial development helps mitigate the shocks caused by crises).

The third reason is also related to the fact that emerging markets are different. One should take into account the quality of regulators in the emerging markets, which is usually inferior to those in developed countries. In this sense, implementing sophisticated regulation in emerging markets is usually harder.

The latter argument implies the least common denominator in regulation. The emerging markets should only use those regulatory interventions that work in any context and that are easy to implement. The most obvious candidates for this list are transparency/disclosure and capital requirements (including contingent capital).

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Endnotes

[1] Rajan and Zingales (2002).
[2] Rajan and Zingales (1998).
[3] Shiller (2003).
[4] Zingales (2007).
[5] Ramey (1995).
[6] Ranciere, Tornell and Westermann (2008).
[7] See a detailed discussion in Guriev and Tsyvinski (2010).
[8] LaPorta et al. (2006).