

# 1

---

## *Introduction and Overview*

MASAHIRO KAWAI AND ESWAR S. PRASAD

The global financial crisis has led to a sweeping reevaluation of frameworks for financial market regulation and macroeconomic policies. Some progress has been made on strengthening these frameworks, both at the national and international levels, but numerous challenges lie ahead in terms of developing an analytical framework to guide these changes in a manner that promotes financial stability. This book provides a stock-taking exercise for these issues and evaluates recent developments from an emerging markets perspective.

The main objective of this book is to develop analytical frameworks and policy prescriptions for emerging markets for balancing the goals of financial development and broader financial inclusion, with the imperative of strengthening macroeconomic and financial stability in these economies. The book starts with two chapters that provide an overview of the global regulatory landscape and discusses these from the perspective of Asian emerging markets. The next set of chapters discusses how to promote financial development and inclusion in these emerging markets in a manner that takes account of regulatory concerns and constraints. The third set of chapters evaluates different approaches to strengthening macroeconomic frameworks in a manner that promotes financial stability. Finally, the book turns to issues related to cross-border regulatory coordination, which are becoming increasingly important as financial institutions operate freely across national borders and as capital flows serve as a channel for the rapid international transmission of financial shocks.

## Part I. The Evolving Global Regulatory Landscape: Implications for Emerging Markets

Chapter 2, by Viral Acharya, is titled “The Dodd-Frank Act and Basel III: Intentions, Unintended Consequences, and Lessons for Emerging Markets.” This chapter attempts to explain the changes to financial sector reforms under the Dodd-Frank Act in the United States and Basel III requirements globally, their unintended consequences, and the risks to fast-growing nations such as India from the adjustment by the global financial sector to these changes. The chapter also provides some broader lessons for India concerning financial sector reforms, government involvement in the financial sector, possible macroprudential safeguards against spillover risks from the global economy, and finally, management of government debt and fiscal conditions.

Acharya argues that the Dodd-Frank Act has a number of shortcomings. These include lack of adequate attention to the distortive role played by government guarantees to the financial sector, an ill-conceived resolution authority that is likely to contribute to substantial uncertainty at the time of the next crisis, and inadequate regulation of shadow banking. Turning to Basel III, Acharya argues that, like its predecessors, it is fundamentally flawed as a way of designing macroprudential regulation of the financial sector. He argues that the Basel capital requirements employ static risk weights, fail to recognize that risk weights alter the incentives of the financial sector exposed to different asset classes, ignore correlated or concentrated exposures of the financial sector to apparently safe asset classes, and do not employ direct firm-level or asset-level leverage restrictions. He acknowledges that Dodd-Frank has several redeeming features, including requirements of stress-test-based macroprudential regulation and explicit investigation of systemic risk in designating some financial firms as systemically important.

Acharya contends that emerging markets like India should resist the call for a blind adherence to Basel III and persist with the approach adopted by the Reserve Bank of India, including asset-level leverage restrictions and a dynamic sector risk-weight adjustment approach. Indeed, these asset-level and dynamic approaches, which are popular in India and some other Asian countries, would be useful for the Basel Committee and other Western regulators to consider in future financial reforms. The author makes the case for the following financial sector reforms in India:

—Institute a fee for government guarantees to the banking sector (especially the explicitly guaranteed, state-owned sector).

—Undertake a fully macroprudential view of its financial sector regulation (covering not just banks but also shadow banks).

—Strive for a consensus among fast-growing emerging markets as well as in the G-20 for principles guiding systemic risk containment in the financial sector, which in turn can limit global spillover risks (such as the eurozone debt crisis).

—Manage the government debt level and fiscal deficit in a countercyclical manner, while also deepening credit and fixed-income markets.

The chapter by Yoshinori Shimizu, titled “Global Financial Regulations and the Asian Financial System: Lessons from the Financial Crisis,” draws three lessons from the global financial crisis and proposes some directions for global regulatory reform. The three lessons identified in the chapter are as follows. First, the regulatory system that existed at the time of the crisis was hopelessly outdated, with weak capital requirements, lack of transparency, and an unregulated shadow banking system. Second, liquidity assurance is the key to avoiding financial crises. Adequate liquidity is difficult to measure using standard metrics, especially as the concept of adequacy hinges on the relative importance of different funding sources for the banking system, which is specific to each country. Third, global regulations will need more freedom and flexibility to deal with complex financial institutions that operate in different segments of the financial system and also across national borders.

The chapter notes that previous capital regulations created incentives for regulatory arbitrage that resulted in the financial crisis. The new regulations proposed under Basel III will not by themselves prevent a recurrence of financial crises. The chapter proposes the use of a “market-valued capital ratio” as a better measure of a bank’s soundness, a ratio that should be carefully monitored by supervisory authorities. This ratio, which is easily observable, is given by the total market valuation of a bank divided by its total assets.

The chapter offers three proposals for regulatory improvements in the context of Asian emerging markets. These would achieve both financial stability and stable economic growth through regulations that reflect the unique characteristics of individual countries. The emphasis would be on macroprudential regulation and supervision suited to the circumstances of the financial markets of individual jurisdictions. Regulations should be reviewed and reassessed periodically to better address the procyclicality problem.

## **Part II. Promoting Financial Development and Inclusion**

The next set of chapters focuses on the financial development agenda for Asian emerging markets and attempts to come to grips with the difficult balance between maintaining financial stability and allowing innovation and development in financial markets.

Cyn-Young Park’s chapter, titled “The Asian Financial System: Development and Challenges,” reviews the development agenda for Asian financial systems in the face of a rapidly changing global financial landscape in the aftermath of the financial crisis and the worldwide recession that ensued. The chapter goes on to explain the salient features of the region’s financial sector developments, discusses the sector’s challenges for balanced and inclusive growth in Asia, examines

approaches to financial development for diversity and stability, and concludes with some policy implications.

The author contends that there are two important reform priorities across the Asian region that provide a framework within which financial sector policies need to be determined. The first is an overriding interest of economic growth and development in the context of financial stability. The second is the drive to create inclusive growth to support social stability and equity. The chapter argues that special attention needs to be paid to not only the balance between growth and stability but also the balance between financial innovation and regulation.

The author then makes the case that the experience of the global financial crisis underscores an unfinished financial sector reform agenda. Following the crisis, and the G-20 responses to it, significant reforms have been put in place aimed at building a stronger, more globally consistent, supervisory and regulatory framework for the financial sector. Despite the critical nature of these reforms for the future of the global financial landscape, their focus has been rather exclusively on strengthening global regulatory guidelines such as the Basel III standards, filling regulatory gaps, and broadening the regulatory perimeter.

There is an urgent need to establish effective and collaborative implementation mechanisms at the national level, reinforcing global efforts at revamping the financial architecture to avoid a repeat of the crisis. However, such reform efforts should not overlook the enormous development challenges faced by the region's low- and middle-income countries and the different conditions that they face in terms of financial sector and market development, regulatory capacity, availability and flow of information, and financial openness.

The chapter by Francisco Ceballos, Tatiana Didier, and Sergio L. Schmukler, titled "Financial Globalization in Emerging Countries: Diversification versus Offshoring," presents some basic stylized facts on where emerging economies, and Latin America in particular, stand on financial development. It documents the major trends since the early 1990s comparing Asia, Eastern Europe, and Latin America among themselves and with advanced countries and shows that the financial systems of emerging economies have become more complex and more diversified.

According to the author, domestic financial systems in emerging market economies are becoming less bank based, with equity and bond markets playing a more important role. Moreover, institutional investors are gaining ground in channeling domestic savings, thus increasing the availability of funds for investment in capital markets. Several emerging market economies have also started to reduce currency and maturity mismatches. Despite these developments, many emerging countries still lag behind the progress attained by advanced economies, and there is no convergence between the financial systems of these two groups of economies. Furthermore, in many emerging markets a few large financial institutions continue to capture most of the domestic savings. In the case of Latin America, despite the many efforts on reforming the macroeconomic and

financial sectors, financial development has not taken place as fast as previously envisioned, trailing behind several emerging economies, most notably those in Asia. The expectation of a broad market-based financial system with dispersed ownership has yet to materialize.

Despite all the improvements, he argues that many emerging economies are financially still relatively underdeveloped. In fact, the countries that have developed the most in recent years are the advanced economies. Therefore, the gap between developed and developing economies regarding financial development has, if anything, widened. This disparity has increased in most parts of the financial system. As a result, the financial sectors of emerging economies are expected to continue to expand in the years to come. Eventually, emerging economies will need to catch up, develop their financial systems, and take more risk, in the process of becoming more like developed nations. The challenge is in doing so without undermining financial stability. Clarity about the rules that policymakers are adopting will help in this regard. Macroprudential policies that limit expansions constitute a clear example. It will be difficult to distinguish between potentially dangerous financial booms and innovation-fueled expansions in financial markets, for the same reasons that it has been difficult to spot bubbles in the financial systems of many developed countries.

### **Part III. Strengthening Macroeconomic Frameworks**

The three chapters in this part, written by prominent central bank officials who have been at the front lines of both practical policymaking and intellectual discussions about central banking, review how emerging markets can make their macroeconomic frameworks more resilient to external shocks and provide a strong foundation for financial stability.

Subir Gokarn's chapter, titled "Strengthening Macroeconomic Frameworks: The Indian Experience," seeks to explain how developing countries in Asia as a whole proved to be quite resilient to the global economic slowdown in the wake of the recent financial crisis that started in the United States. The author illustrates his points using India as an example. He contends that the impact of the crisis on the Indian economy came mainly through three channels: trade, finance, and confidence, which in turn affected both the financial and the real sectors directly and indirectly, reflecting the interdependence and integration of the two sectors. The chapter notes the robust policy responses that kept India relatively protected from the aftershocks of the crisis.

The chapter goes on to discuss the emerging new consensus about monetary and regulatory frameworks, especially how monetary and financial stability policies can no longer be easily disentangled. The chapter discusses three areas in which a suitable balance will have to be struck. The first is financial stability versus innovation—how to maintain room for innovation and flexibility in finan-

cial markets without this threatening regulatory control and financial stability. The second is global versus domestic—how to strike a balance between policy responses to global and domestic shocks, which might sometimes call for different settings of policy instruments. The third is aggregate versus composite—how to adjust and calibrate different policies so that the right mix can be obtained—that for instance balances considerations of growth with price and financial stability. Getting the combination of monetary and fiscal policies right is another difficult but important challenge, particularly for an emerging market economy like India, with a high level of public debt and a monetary policy whose effectiveness is hindered by lack of fiscal discipline.

Kiyohiko G. Nishimura's chapter is titled "The Macroprudential Policy Framework from an Asian Perspective." This chapter takes up several key issues relating to macroeconomic policy frameworks, explicitly taking account of financial markets, or macroprudential policies, especially from an Asian perspective. It asks the following two questions: What methods should regulators and the central bank employ to detect an intolerable accumulation of risks in the financial system? And how should regulators maintain financial stability in the short run, while improving efficiency in credit intermediation functions to support long-term economic growth? The author seeks practical, best-practice answers to these questions, rather than optimum solutions based on a particular theory. One guiding principle is the need to effectively coordinate monetary and macroprudential policies. Another principle is ensuring that macroprudential policies don't create a false sense of security about the dangers posed by tail risks in the financial system.

Before attempting to answer some of these questions, the chapter reviews the evolution of the current financial crisis in the United States and Europe and of that in Japan two decades ago. Although much attention has been focused on financial excess as typified by excessive leveraging in financial institutions, the author emphasizes the importance of underlying changes in fundamentals, especially demographic factors such as population aging. The latter has particularly important implications for the future in Asia. The basic message of the chapter is that many of Asia's growing economies may face problems in the near future similar to those of developed countries, and it is thus of the utmost importance to implement appropriate macroprudential policies without delay.

Mehmet Yörükoğlu's chapter is titled "Emergence in the Postcrisis World: Widening Asymmetries between Advanced and Emerging Economies." According to the author, globalization, the rising openness of emerging market economies, and rapid technological changes will impact the global economic landscape even more strongly after the financial crisis. This has important effects and implications on macroeconomic policymaking in emerging economies. Increasing growth and inflation differentials between advanced and emerging economies under an environment of abundant liquidity and savings glut make inflation targeting insufficient to maintain price stability and financial stability together.

To achieve the job of maintaining price stability without accumulating financial instability risks, the inflation targeting framework should be supported by strong macroprudential and more disciplined fiscal policies. Many emerging economies, including Turkey, have started to use macroprudential tools more actively after the global financial crisis. This chapter discusses what macroeconomic policies are appropriate for emerging economies in the post-financial-crisis world, as globalization and emergence processes continue at an even faster pace, and offers some perspectives from the Turkish experience.

#### **Part IV. Developing a Sound Global Regulatory Architecture**

Rising financial integration through cross-border capital flows and banks that operate in multiple jurisdictions are creating new challenges for financial regulation and, ultimately, for financial stability. The two chapters in this part critically evaluate recent proposals for revamping the global regulatory architecture and offer some prescriptions for steps to cope with the challenges posed by rising financial globalization.

In a chapter titled “The Impact of Changes in the Global Financial Regulatory Landscape on Emerging Markets,” Tarisa Watanagase notes that large and complex financial institutions have become increasingly prominent and global in their operations. A framework for cross-border resolution needs global cooperation and consistent legal frameworks. She warns of a potential moral hazard problem if the resolution plan is not credible and argues that these institutions should be reduced in size to better serve the real economy.

The chapter notes that the supervisory capacity and approach, not just regulation, also need improvement and that risk-focused supervision is more important than just regulation. The chapter also warns of the risk of moral hazard due to a bad incentive structure if remuneration in the financial sector remains linked to short-term profitability. It stresses the use of macroprudential tools for financial stability purposes, which also contributes to individual bank soundness and the reduction of systemic risk: loan-to-value ratio, sectoral risk weight, and credit card holder requirements.

Many new requirements under Basel III, such as capital buffers for concentration risk and liquidity risk, do indeed help promote stability but cannot by themselves ensure financial stability. The chapter argues for the need to strengthen regional safety nets in Asia, which could include increasing the size of the Chiang Mai Initiative, expediting the process for liquidity support, and developing the ASEAN+3 network, which would reduce the need for individual countries to accumulate reserves. The chapter concludes that it is important to ensure resilience by using the right mix of monetary policies, fiscal policies, and macroprudential measures to guard against financial imbalances and maintain policy space.

Duncan Alford's chapter is titled "International Financial Reforms: Capital Standards, Resolution Regimes, and Supervisory Colleges and Their Effect on Emerging Markets." Since the fall of 2008—when the G-20 met in Washington, D.C., at the beginning of the financial crisis—the heads of state of the G-20 have proposed a flurry of reforms to the international financial system. This chapter focuses on three proposed reforms: the improved capital requirements intended to reduce the risk of bank failure (Basel III), the improved recovery and resolution regimes for global banks, and the development of supervisory colleges of cross-border financial institutions to improve supervisory cooperation and convergence.

The chapter then addresses the implications of these regulatory reforms for Asian emerging markets, arguing that a new concordat between home and host countries with respect to crisis management is needed. Supplanting the Basel Concordat that focuses on home-host supervisory coordination, this new concordat would set standards allowing for the resolution of cross-border banks. Under the new concordat, financial institutions would be able to enter a market only if effective resolution arrangements existed in both the home and host countries.

The chapter concludes that an international regime for the orderly winding up of insolvent banks is a necessary component for truly effective international regulation and supervisory coordination. Without such a regime, policymakers are left with two stark choices: failure of the financial institution, with the resulting economic disruption; or using taxpayer funds to recapitalize the financial institution.

## Conclusion

The major message of the volume can be summarized in the following way: Financial systems in emerging economies have developed and deepened over recent decades, but they still lag behind those of developed economies. In general, they have yet to reduce the presence of the state in financial markets (such as state-owned banks), create money markets that function well (including derivatives instruments), or diversify the modes of financial intermediation (for example by strengthening local-currency bond markets). Emerging economies need to encourage further financial opening and innovations to allow them to achieve convergence with developed economies. Thus, emerging economy financial systems can continue to develop and deepen so they resemble those in developed economies. At the same time, their policymakers need to enhance their financial market supervisory and regulatory capacity to avoid a buildup of financial imbalances—such as asset price bubbles—given that their economic growth will remain high and their financial sectors will expand rapidly.

Emerging economies must pursue a balancing act. They need to develop and deepen their financial sectors (which is vital for economic growth) while at the



same time maintaining financial stability (which is needed to sustain growth and social stability). They must try to promote financial opening and innovations (which are needed for dynamic growth) and encourage financial inclusion (which is vital for inclusive growth) while improving policy and institutional frameworks to supervise and regulate financial systems in an increasingly market-based and globalizing environment.

In this context, the central bank of a country needs to balance the objectives of supporting growth, price stability, and financial stability. This is a considerable challenge particularly when it does not have macroprudential policy tools. In this case, the central bank needs to work closely with supervisory and regulatory authorities who are in charge of macroprudential policies, in order to achieve macroeconomic and financial stability.

Emerging economies often face additional challenges of maintaining fiscal and debt sustainability and managing international capital flows. In the short term, an appropriate mix of monetary, fiscal, macroprudential policies, and, to the extent necessary, capital flow management measures is needed to maintain stable growth and price and financial stability. In the longer term, structural reforms are needed to strengthen market infrastructure for financial systems and improve corporate governance of both banks and bank borrowers so as to make the financial market more resilient to domestic and external shocks.

Emerging economies can be victims of volatile behavior by global large complex financial institutions (LCFIs). The international community needs to develop an international agreement on supervisory and resolution frameworks for LCFIs. Clearly defined coordination between home and host supervisory authorities will help to protect the financial stability of emerging economies that could be adversely affected by the failures of LCFIs operating in their jurisdictions. An agreement on resolving the problems caused by failed LCFIs would benefit all the economies concerned, particularly emerging economies.

Finally, at the regional level, there is a strong case for greater financial cooperation to promote regional financial stability. For example, the ASEAN+3 framework in Asia for regional macroeconomic and financial surveillance and financial safety nets can be further strengthened.