Regional Monitoring of Capital Flows and Coordination of Financial Regulation: Stakes and Options for Asia

Michael G. Plummer,
Head, Development Division
OECD

Presented to the:

7th Research Meeting of the NIPFP DEA Research Program

31 August-1 September, 2010

New Dehli, India

Organization of Presentation

I. Regulation of Capital Flows and the New Finance
II. Improving the post-GEC Architecture
III. The Asian Financial Stability Dialogue in the post-GEC Era
IV. Conclusions

Main Points

- Capital flows are beneficial but associated externalities suggest need for careful monitoring and, at times, control
- The global economic crisis (GEC) demands improved systems of monitoring, regulation, and cooperation at all levels
- We make the case that an AFSD could be an important part of the post-GEC architecture by improving surveillance, sharing information, developing effective early warning systems, facilitating dialogue, and helping shepherd financial cooperation.

Final Introductory Notes:

- The paper mostly focuses on the microeconomics of the GEC, rather than the macro (though the macro comes in through surveillance issues).
- This paper was written while I was the Eni Professor of International Economics at the Johns Hopkins University, SAIS-Bologna. I have since (January 2010) moved over to the OECD as Head of the Development Division.
- Note: the views expressed in this presentation are mine alone and do not necessarily reflect those of the OECD or any other institution.

I. Regulation of Capital Flows and the New Finance

Capital Flows: Riding the Good Elephant

- Theory: let capital go where it is most productive
- Should be particularly advantageous to developing countries
- However, there exists an externality in terms of the potential economic and systemic risks to developing countries (Kawai and Takagi):
    - i. Creation of credit boom and real e appreciation
    - ii. “Double mismatch” and asset bubbles
    - iii. Threat of reversal (“financial pollution”)
- Necessary prudential role for government, monitoring needs to be careful, and, we argue, the government should hold a considerable regulatory stick.
- More important today as modern financial and institutions, including highly-leveraged financial institutions, increase the potential power of these capital flows.

Empirical Evidence on Capital Flows

- More experience in Latin America than Asia, but Asian Crisis suggested possible "generalization" of serious capital-flow externalities.
- Asian economies have developed more effective national frameworks for dealing with capital inflows (Adams 2008) but really untested (and some bad experiences, e.g., Thailand Dec. 2006). Through dialogue and information sharing, the proposed Asian Financial Stability Dialogue (AFSD), discussed later, could play a role here.
- Capital account liberalization and growth: mixed, but if control for institutions, positive (Klein 2005)

The New Finance and the GEC

- Sophistication of financial markets has increased exponentially
- However, we argue that regulatory and supervisory systems have failed to keep up, particularly in terms of risk valuation and early-warning systems
- We have a long list of “best practices” that ended in disaster (high-yield bonds, Enron, mark-to-market, risk management modelling)
- In the context of the GEC, subprime, MBSs, CDSs, and many dervatives were too complex to accurately gauge risks (and credit rating agencies did a poor job rating them...conflict of interest?).

New Finance, con'd

- Value at risk models performed poorly
- Surveillance has sometimes been poor (e.g., AIG, Madoff), in part due to highly-leverage financial institutions lying outside regulatory framework.
- Hedge funds (and other highly-leveraged financial institutions): useful role, but lack transparency (not major player in crisis but had its role...I am a bit surprised by Volker's June 2009 rejection of any sort of regulation). Geithner: short-selling during crises increasing stress; potential failure as in LTCM.
- Both these problems were evident in AIG case alone in the United States.

II. Improving the Post-GEC Architecture

Creating a Better Regulatory and Surveillance Framework

- We delineate several areas that need to be addressed in creating an effective post-GEC regime:

1. Need to improve information dissemintation and transparency
   a. Greater disclosure by financial institutions, including hedge funds and other highly-leveraged financial institutions

   b. Better assessment and analysis of risks inherent in structured products

   c. Improved financial stability analysis and early-warning systems (regular stress tests? Not easy, as displayed in the recent Eurozone example).

   d. Macro surveillance issues (but devil in details!)

   d. Greater transparency in OTC markets, esp. CDSs

Note: We argue that these areas are probably the most urgent in post-GEC

Better Regulatory and Surveillance Framework, con'd

2. Improved cross-border arrangements for financial regulations (e.g., avoid regulatory arbitrage, ground rules for crisis management...example: protecting home banks with int'l operations).
3. Greater attention to ex-rate issues in macro surveillance, e.g., carry trade, currency mismatches with excessive leverage, imbalances (Goldstein 2009).
4. Mechanisms to avoid pro-cyclical nature of finance (more risk during boom; retrench during crisis). Dynamic provisioning?
5. Too big to fail issue: tough but necessary! Still, not a magic bullet and, again, devil in details.

III. The Asian Financial Stability Dialogue in the post-GEC Era

Global or Regional Approaches to Cooperation?

- Key question: At which level should cooperation and coordination take place?
- In addressing the issues just listed, global level is theoretically optimal.
- The Financial Stability Board (FSB), established in the wake of the GEC (April 2009) as successor to Financial Stability Forum with expanded mandate and membership (including RBI), is addressing issues of general concern.
- For example, recent study (August 18, 2010) estimated possible effects of stricter capital and liquidity standards (finds very small short-run effects and positive long-run effects).
- The FSB has also considered moral hazard issues of systemically important financial institutions, “information gaps,” and reforming compensation structures.

The Case for Regional Approach

- Nevertheless, there are reasons why regional cooperation may de facto improve cooperation:

a. WTO versus RTAs
b. EU: Subsidiarity: initiatives at the most decentralized level
c. Externalities may be regional (disproportionate impact on region)
d. Easier to mobilize and focus policy at regional level.

The Need for the AFSD

- We argue at length in the paper that financial development needs to be a priority in Asia.
- Coupled with the problems inherent in the GEC, an AFSD, if structured correctly, could help promote development, reduce risks, anticipate problems, and facilitate pro-active solutions to emerging financial and other macro problems, including, e.g., rebalancing.
- Overlap with FSB? Yes, but this is strength, not weakness. AFSD will focus on priority issues to Asia. Besides, only a minority of Asian countries are formally in FSB, which has now become a large as well as diverse organization.
- We also make the case that deepening financial cooperation and coordination needs to part of the post-GEC architecture, and that the AFSD could play a facilitating role.

IV. Conclusions

Learning from the GEC

- The GEC continues to be an extremely traumatic experience, though thankfully the worst seems to be behind us (some signs of "double dip" but unlikely…most likely we will see an erratic but continued recovery).
- We need to learn from past mistakes—not just GEC, but even earlier crises—in creating a new, effective international financial architecture. We couldn't afford to let this happen "now", let alone "again".
- This will require major changes at all levels. But let's not fool ourselves; doing so will not be easy!

The Need for Asian Initiative

- Asia needs to take a more pro-active stance in molding this new architecture; stakes for the region are extremely high.
- We support the idea of a AFSD as a means of complementing existing processes in Asia (e.g., EMEAP, APEC FMP, ASEAN+3) and globally (FSB)
- We also argue that "real" regional integration in Asia needs to be complemented by greater financial cooperation and coodination; CMIM and ABF are baby steps in this direction. The AFSD would be a useful complement.