Regulatory reforms among G20

In the face of the impending global financial meltdown a year ago, world leaders found clarity: financial regulatory frameworks needed to be overhauled.

Indeed, there was "incredible consensus" among G20 nations to enact much needed reforms, says Rakesh Mohan, former deputy governor of the Reserve Bank of India. "At the peak of the crisis, it was very clear, there was consensus, there was intention, there were willing efforts."

But the political will of the international community to implement regulatory reforms is weakening, as global economies and financial markets have recovered faster than expected, says Mohan, speaking at the INSEAD Leadership Summit in Asia.

Fan Gang, a fellow panelist at the summit and a member of the monetary policy committee of China's central bank, believes new regulations are needed to improve transparency regarding the risks of financial products.

"From the perspective of China, the only hope is to have more regulation, not only on the financial side but also on the fiscal side of the economy, and then we can hope to have a more stable dollar and a more stable financial system in the world."

Mohan, who left India's central bank about six months ago, believes that the prevailing worldview of financial markets being efficient and therefore self-regulating makes it "very difficult" for regulators at central banks to act. Claiming that there have been the largest outbreaks of financial crises in the last three decades, he questions why people still believe in 'efficient markets' despite evidence to the contrary.

"I don't perceive a great deal of change in the academic thinking of financial markets. Until that happens, it's very difficult for politicians, regulators, for decision makers to go against the grain of current thinking."

On his part, Fan takes issue with the US for allegedly telling other countries that they had experienced financial crises because their markets were not efficient and that they had too much regulation.

Fan says it was only thanks to the US dollar's position as the global reserve currency that Washington did not experience any major balance of payment-related financial crisis in the past despite its trade deficits, as it was free to print as much money as it needed.

"We (China) are expected to be cautious and we save too much and we lend to America, so that's the problem," Fan said, to laughter from the audience.

Another speaker, Ilian Mihov, professor of economics at INSEAD, believes the global financial crisis will result in people thinking about regulations from a “dynamic point of view,” as well as about systemic risks. Mihov also says people will realise the importance of using interest rates to prick asset bubbles, besides the use of fiscal policies. In addition, key institutions such as central banks should monitor the growth of bubbles in areas like the housing market and the banking sector.

Mihov also calls for the development of a policy framework to address systemic risks. He adds that the current regulations adopt a microeconomic perspective, when a macroeconomic perspective is also needed to “connect all the dots.”

Mohan agrees, saying there’s a widespread consensus for the need to monitor financial institutions collectively, instead of the traditional focus on individual institutions.

Asked whether the current financial regulations suffice, Mohan says: “They clearly do not.” Mohan, who was involved in drafting G20 regulations, says he believes that all systemically important financial institutions should be regulated equally, but the challenge lies in identifying such institutions. He adds that although there is consensus among the G20 countries for the need to increase capital ratio requirements for financial institutions and to lower leverage, trying to enforce these requirements could force financial institutions to divest assets, which could have negative ramifications for market confidence.

Mohan also notes that not a single Asian or Latin American country’s financial sector was in trouble in the wake of the current global financial crisis, saying that these countries had learned from the lessons of their own financial crises. Indeed, the US, UK and Europe could learn from emerging economies about prudent financial regulation and the use of monetary policy.

Reflecting on India’s experience, Mohan says the country’s government faced unrelenting criticism prior to the global financial crisis that its regulation of the domestic financial sector was “standing in the way of growth” despite low inflation, firm economic growth and high credit growth. The criticism, says Mohan, only abated upon the outbreak of the crisis.

Mohan credits the joint oversight of the domestic financial institutions by India’s central bank and the monetary authority in averting a potential financial crisis. For instance, when Indian regulators saw that housing prices and home financing were growing rapidly by 40-50 per cent a year, they used “prudential regulatory methods to curb that growth so that we didn’t have to use the sledge hammer of monetary policy.”