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Economics as a Social Science: Financial Regulation After The Crisis

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One of the most striking developments of the late 20th century was the explosion in the volume, speed and complexity of international financial transactions, and the resulting breakdown of effective regulatory control over the global financial system. The speed with which this process has gone into reverse since the onset of the financial crisis has been equally striking.

Transactions in the global foreign exchange market, once confined to financing trade flows, peaked at around $4 trillion per day in mid-2008. At that pace, two days of foreign exchange trading would be sufficient to finance an entire year's trade flows. The growth of private credit reached an annualised rate of $10 trillion at the same time.

The market collapsed in the crisis of late 2008. According to the International Monetary Fund (2009), private sector credit growth fell by 90 per cent, and *'Emerging bond markets virtually shut down for a period of time in the fourth quarter'*.

Although rescue measures by governments have restored credit flows, the system remains weak and unstable. The challenge facing governments and regulators will be to construct a new financial system and a regulatory architecture strong enough to prevent a recurrence of the bubble and meltdown that has largely destroyed the existing unregulated system.

The essential features of a system of financial regulation to support market stability and prevent another meltdown are:

- Linking and integrating national financial systems to produce a sustainable international financial architecture
- Decoupling exchange rates from the vicissitudes of financial markets - the Tobin Tax
- Guaranteeing and regulating the banks
- Regulating innovation

- An effective ratings system

A new financial architecture

The idea of a 'global financial architecture' is both misleading and unattainable. The keystone for any financial architecture is the institution that acts as lender of last resort for others. This function is, and is likely to remain, one undertaken by national governments and their central banks. It follows that there can be no global financial architecture. Rather national systems of financial regulation must be linked and integrated to produce a sustainable international financial architecture.

To achieve this, there must be no 'offshore' financial system, outside the agreements that govern the international financial architecture, but nevertheless allowed to transact with institutions inside the system. This issue has already arisen in relation to international tax avoidance and evasion, and will arise in an even more acute form in relation to the Tobin tax, discussed below.

Fortunately, the OECD has already developed a strategy to address tax avoidance that will serve as a model for financial regulation. The Financial Stability Board, established as part of the response to the global financial crisis has already indicated that the tax haven model will be applied to 'regulatory havens' offering lax financial regulation. As with taxation, the process will undoubtedly be slow, but the mechanisms are in place to ensure that evasion of financial regulation through the use of offshore transactions can be prevented.

The Tobin tax

The long-advocated and long-resisted idea of a small tax on financial transactions, commonly called a Tobin tax, is the most promising option for ensuring that exchange rate movements reflect the economic fundamentals of trade and long-term capital flows, rather than the vicissitudes of financial markets.

A tax at a rate of 0.1 per cent would be insignificant in relation to the transaction costs associated with international trade or long-term investments. On the other hand, daily transactions of $3 trillion would yield revenue of $30 billion per day, or nearly $1 trillion per year. Since this amount exceeds the total profits of the financial sector (profits that are likely to be much smaller in future) an effective Tobin tax would imply a drastic reduction in the volume of short-term financial flows. It follows that the revenue from a Tobin tax, while

significant, would not be sufficient to replace the main existing sources of taxation, such as income tax.

The large literature on Tobin taxes has identified two significant problems with the simple proposal for a tax on international financial transactions.

First, it is possible to replicate spot transactions on foreign exchange markets with combinations of forward, futures and swap transactions. To make a Tobin tax effective, it would have to be applied to all financial transactions, including domestic transactions. During the bubble era, when the few remaining taxes on domestic financial transactions were being scrapped to facilitate the growth of the financial sector, this was seen as a fatal objection. It has become apparent, however, that the destabilising effects of explosive growth in the volume of financial transactions are much the same, whether the transactions are domestic or international.

The fact that a Tobin tax on international financial transactions would be integrated with taxes on domestic transactions suggests that, in all probability, revenue would be collected and retained by national governments. However, the suggestion that at least some of the revenue should be used to fund global projects, such as the international development goals of UNCTAD, remains worthy of consideration.

The second problem is that the tax would require global co-operation, since otherwise financial market activity would migrate to jurisdictions that did not apply the tax. Although this will remain a problem in the post-crisis world, it is likely to be much less severe than indicated by earlier discussions, because of the much smaller number of separate jurisdictions that would need to agree, following the emergence of the euro. It seems inevitable that most remaining European currencies, with the possible exception of the British pound, will disappear in the wake of the crisis, and that a Europe-wide regulatory system will emerge.

To address the problem of ‘offshore’ financial centres, such as Caribbean island states, is a Tobin tax on transactions among complying jurisdictions may have to be supplemented by a punitive tax, at a rate of, say 10 per cent, on transactions with non-compliant jurisdictions. This would effectively ensure that non-compliant jurisdictions were excluded from global financial markets, though the penalty would be modest as regards trade and long-term investment flows.

Regulating the Banks - Guarantees, regulation or narrow banking

The core of financial regulation is the existence of a (partial or total) guarantee that bank depositors who exercise ordinary prudence will not lose their money. Until October 2008, the guarantee system in Australia was carefully ambiguous. Governments and the Reserve Bank implicitly assured both the general public and wholesale lenders that our major banks are completely safe, while simultaneously denying that their liabilities were guaranteed. As was both predictable and predicted, the contradictions in this stance were exposed the first time the system faced a serious crisis. The result was the unlimited guarantee we have now.

We must now consider whether to maintain, modify or withdraw the guarantee. Whatever we do, the crucial issue that has not been faced so far is that publicly-guaranteed institutions require much closer regulation than is consistent with policies of financial deregulation.

So, there are three policy options available.

1. The first is the maintenance of the existing guarantee, and a comprehensive re-regulation of the system. This would not mean a return to the system that prevailed before the 1970s (no such return is ever possible), but it would require direct control over the allowable range of products, the setting of interest rates, fees and charges and the allocation of lending between sectors of the economy.

2. Current government rhetoric suggests the desire to return to something like the old system, with deposit guarantees being withdrawn once the crisis is over. But clearly, we cannot go back to the old ambiguity. If the guarantee is withdrawn, this will be a clear statement to depositors that they must make their own judgements about the safety of their money. It was in this context that the idea of a publicly-owned and publicly guaranteed savings bank was suggested.

3. The third option, in some ways a compromise, is that of narrow banking, in which publicly guaranteed banks stick to a tightly regulated range of well understood activities. This allows for a completely separate set of financial institutions, of which stock markets are the exemplar, where government guarantees are ruled out in advance. These would offer higher returns but no possibility of transferring risk to the public. This is my preferred option.

Narrow banking

Post-crisis financial regulation should begin with a clearly defined set of institutions (such as banks and insurance companies) offering a set of well-tested financial instruments with explicit public guarantees for clients, and a public guarantee of solvency, with nationalisation as a last-resort option. Financial innovations must be treated with caution, and allowed only on the basis of a clear understanding of their effects on systemic risk.

In this context, it is crucial to maintain sharp boundaries between publicly guaranteed institutions and unprotected financial institutions such as hedge funds, finance companies, stockbroking firms and mutual funds. Institutions in the latter category must not be allowed to present a threat of systemic failure that might precipitate a public sector rescue, whether direct (as in the recent crisis) or indirect (as in the 1998 bailout of Long Term Capital Management). A number of measures are required to ensure this:

- Ownership links between protected and unprotected financial institutions must be absolutely prohibited, to avoid the risk that failure of an unregulated subsidiary will necessitate a rescue of the parent, or that an unregulated parent could seek to expose a bank subsidiary to excessive risk. Long before the current crisis, these dangers were illustrated by Australian experience with bank-owned finance companies, most notably the rescue, by the Reserve Bank, of the Bank of Adelaide in the 1970s.

- Banks should not market unregulated financial products such as share investments and hedge funds.

- The provision of bank credit to unregulated financial enterprises should be limited to levels that ensure that even large-scale failure in this sector cannot threaten the solvency of the regulated system.

In the resulting system of ‘narrow banking’, the financial sector would become, in effect, an infrastructure service, like electricity or telecommunications. While the provision of financial services might be undertaken by either public or private enterprises, governments would accept a clear responsibility for the stability of the financial infrastructure.

Financial innovation

The prevailing rule has been to allow, and indeed encourage, financial innovations unless they can be shown to represent a threat to financial stability. With an unlimited public guarantee for the liabilities of large financial institutions, this rule is a guaranteed, and proven, recipe for disaster, offering huge rewards to any innovation that increases both risks (ultimately borne by the public) and returns (captured by the innovators). There must be a reversal of the burden of proof in relation to financial innovation.

The process of financial innovation, involving either the creation of new financial instruments or the design of new financial strategies for firms (often termed ‘financial engineering’) was a central feature of the era of market liberalism. The growth of finance has been almost unstoppable. Seemingly major financial crises like the stock market crash of 1987 or the NASDAQ crash of 2000 stimulated the development of yet more innovative responses. Even the exposure of spectacular fraud at the Enron Corporation, which had been nominated by Fortune magazine as 'America's most innovative' for six years in succession, did little to dent faith in the desirability of innovation.

It is now clear that unrestricted financial innovation played a major role in the advent of financial crisis, by facilitating the growth of unsound lending and by undermining systems of regulation. There is an inherent inconsistency between unrestricted financial innovation and a regulatory system aimed at preventing the failure of financial systems or at insuring market participants against such failures. Guarantees create ‘moral hazard’ by allowing financial institutions to capture the benefits of risky investments, while shifting some or all of the losses to government-backed insurance pools.

Moral hazard can only be offset by the design of regulatory mechanisms that discourage excessive risk-taking. But, as the literature on mechanism design has shown, the effectiveness of such mechanisms depends on the existence of stable relationships between the observable variables that are the subject of regulation and the risk allocation that generates them. Financial innovation changes the relationship. In the presence of moral

hazard, therefore, there is an incentive to introduce innovations that increase the underlying level of risk while leaving regulatory measures of risk unchanged.

It follows that the only sustainable approach to financial innovation is one in which proposed innovations are introduced only after the implementation of necessary changes to regulatory requirements and risk measures. If reliable risk measures cannot be computed, the associated innovations should not be permitted.

A public ratings system: capital adequacy, transparency and risk assessment

Another important regulatory adjustment will be the end of the system by which prudential regulation has been, in effect, outsourced to ratings agencies such as Standard & Poor's and Moody's. Agency ratings have been enshrined in regulation, for example through official investment guidelines that require regulated entities to invest in assets with a high rating (AAA in some cases, investment grade in others) or provide those responsible for making bad investment decisions with a 'safe harbour' against claims of negligence if the assets in question carried a high rating. For these purposes at least, an international, publicly-backed non-profit system of assessing and rating investments is required.

Conclusion

The temptation to put off until calmer times questions about our financial vulnerability has proved irresistible so far. Looking at the current global scene, however, it seems unlikely that economic calm will return any time soon. A careful examination of the vulnerabilities in our financial system is an urgent task for Australia and the world