Managing Monetary and Regulatory Policy in the Post Crisis World

Shamshad Akhtar*
Mansoor Dailami**

This paper offers some reflections on the challenges that monetary authorities in emerging economies face in navigating the still very difficult economic conditions that the Great Recession of 2008–09 has left in its wake. More than two years have passed since Lehman Brothers sought bankruptcy protection in the United States, ushering in the worst global financial crisis of the postwar era. While global financial markets have broadly stabilized since March 2010 and growth has resumed in virtually all countries around the world. The situation stabilized supported by the extraordinary measures taken by national authorities and the international community, however much remains to be done to place the world economy on a path of sustainable growth and financial stability.

A large portion of the heavy lifting has and needs to be done by advanced countries, particularly in reconciling the short-term need to boost aggregate demand with the longer-term need to create a sustainable fiscal environment. But emerging market economies will not be insulated from the fallout of sovereign credit crisis in Europe or from further easing of monetary policy in the United States. In today’s globalized financial environment, restoring balance to the world economy is a shared responsibility that requires better coordination of macroeconomic policy stances to address the existing imbalances, while recognizing the underlying transformative changes in the balance of global growth and finance.

This paper begins with a brief, forward-looking assessment of the state of the world economy. This will set the context for discussing the challenges of formulating monetary policy in emerging economies, where domestic financial and macroeconomic stability are structurally linked to external developments such as the stance of monetary policy in the core financial markets, global liquidity, and the global business cycle. One implication of this structuralist perspective is the recognition that greater global integration reduces national autonomy in managing macroeconomic policy, particularly monetary policy. This topic has been the

* Regional Vice President, Middle East and North Africa, World Bank, and former governor, State Bank of Pakistan; sakhtar@worldbank.org ; ** Lead Economist, World Bank; mdailami@worldbank.org
subject of intense policy and academic debate and research going back to the pioneering open macroeconomy model of Robert Mundell and Marcus Fleming, which argues that countries can attain only two of the following three goals: free capital mobility, fixed exchange rates, and monetary policy autonomy. As many developing countries have moved to liberalize capital movements over the past two decades, they have adopted greater exchange rate flexibility as a way of addressing this “impossible trinity.” The pay-off of greater exchange rate flexibility has been the ability to rely on domestic interest rate policy in order to cope with the extraordinarily difficult global economic conditions of recent years, and many countries lowered their interest rates to ease the recessionary impacts of the crisis. With the economic recovery picking up steam and domestic inflationary pressures building up in several emerging economies, including Brazil, China, India, and Malaysia, these economies have, since March 2010, moved to a tightening phase, although some paused in recent weeks as uncertainty about the global economic outlook has begun to mount, while others resorted to more tightening.

The other important implication of the structural dependence of emerging economies on global developments is best seen in the context of the international banking industry – specifically, the rapid growth of the industry in the 1990s and 2000s, its role in generating pronounced credit cycles in emerging economies, its ongoing consolidation, and how it may respond to new regulatory changes being formulated and implemented in the core financial markets. Given the pre-crisis dynamics of a global credit boom that developed in an environment of low inflation, widening global financial imbalances and steady growth, there is now an active debate on how best to assess systemic financial risks while they are building up and whether monetary policy that is oriented toward price stability can by itself deliver financial and macroeconomic stability in today’s globalized financial environment. Thus, the paper will conclude with a discussion of the role of international policy coordination in areas of financial regulation, cross-border bank lending, and formulating monetary policy.

Global context
In the realm of immediate concerns, the divergent growth prospects of developed and developing countries are resulting in a decoupling of monetary policy between emerging market and mature economies. As major central banks renew their quantitative easing efforts and continue to keep interest rates extremely low, central banks in emerging market are increasingly moving into a tightening phase in response to heightened inflationary pressures (Figure 1). In high-income countries, the recovery that started in the second half of 2009 and gained momentum in the early part of 2010 remains fragile, despite considerable
monetary easing and fiscal stimulus. Our latest projections indicate that high-income countries will grow by 2.3 percent in 2010, well below the 6.2 percent projected for developing countries. For the global economy as a whole, GDP is projected to expand by about 3.3 percent this year and to remain in this vicinity through 2012. Growth in South Asia in 2010 is expected to be in the order of 7.5 percent, with India growing at a high rate of 8.2 percent, and Pakistan at 3.1 percent (World Bank, 2010).

Figure 1. Nominal Central Bank Policy Rates in Developed and EM Countries*

* Average of major advanced (US, UK, Japan, Euro area) and emerging market (Brazil, China, India, Russia, S Korea, Turkey) countries' weighted average using 2005 GDP

Just as in the years preceding the crisis, developing countries are expected to account for almost one-half of global growth in the several years ahead. Emerging markets now serving as an engine of global growth marks a significant point of inflection in global economic relations. For much of the postwar era, developing countries formulated macroeconomic policy, established economic linkages, and conducted diplomacy with an eye toward the growth dynamism and prospects of advanced countries. Global dynamics is now changing. More than a third of foreign direct investment in developing countries now originates in other developing countries. The weight of developing countries in global trade has grown even faster, rising from 20 percent in 1995 to an estimated 30 percent in 2010. This shift in global economic dynamics will pose new challenges to
developing countries. This along with experience gained during recent crisis, forces developing countries to reassess opportunities in South-South trade and investment ties, and to reorient policy accordingly.

One important implication of the current global growth and monetary scenario has been a strong rebound in foreign private capital flows to emerging economies, particularly countries with strong fundamentals and potential for further currency appreciation. With policy rates in advanced countries expected to remain low for some time, the medium-term prospects for capital flows to emerging market economies remain strong, supported by both technical and long-term fundamentals of demographic change, and growth potential. Investors seem to be operating under the belief that improved fundamentals in emerging economies are of a structural nature, and as such are positioning themselves to capitalize on that shift. The benchmark JPMorgan EMBI Global, for example, a widely used indicator of emerging market sovereign credit risk – narrowed by more than 610 basis points since its peak on October 24, 2008 and as of January, 2010 hovered at around 273 basis points (Figure 2). The key beneficiaries of this renewed increase in capital flows to emerging markets are likely to be countries with relatively well developed local capital markets, sound macroeconomic policy management, and favorable growth prospects: China, India, Brazil, Chile, Turkey, and Indonesia.

Figure 2. Emerging Markets Sovereign Spreads (2000-2010)
Managing capital flows remains an urgent policy challenge
Since the early 1990s, developing countries have experienced three waves of large influxes of foreign private capital.\(^1\) Two of these episodes ended in major crises, the second of which is ongoing, raising concerns that rapid flows could lead to asset bubbles and expose their financial markets to sudden reversals of flows. In each case, the thrust of policy responses adopted to counter the impacts of dramatic increases in capital inflows has been large-scale foreign exchange intervention and reserve accumulation, though some countries have relied on capital controls. The counterpart to this accumulation of foreign exchange reserves is intervention by central banks in foreign exchange markets. In practice, central banks accumulate foreign exchange reserves by purchasing part of their inward flows of foreign currency from private and public entities, paying for them with a mix of local currency and public debt. Thus, large scale reserve accumulation would most likely have expansionary domestic monetary and credit implications.

To the extent that central banks manage to sterilize the impact of their foreign exchange intervention through open market operations by issuing public debt, they undertake a reallocation of currency risk associated with capital flows from the private to public sector and expand their own balance sheets. In the absence of sterilization operations through open market operations and other administrative measures, the consequence would be an expansion in domestic monetary aggregates and inflationary pressures. At the present, with U.S. monetary authorities undertaking a second round of post-financial crisis quantitative easing, a rapid expansion in global liquidity in the near term seems likely (Figure 3). Global liquidity could in turn, amplify global credit expansion, as was the case during the boom years of 2003 until the onset of the crisis (Figure 4).

As developing countries become more deeply integrated into the world economy, designing and building a sound regime of foreign economic policy that recognizes both the opportunities and risks of global integration remains an urgent challenge. Roughly half of developing countries are now operating under a floating exchange rate regime, while many now have open capital accounts. Crafting macroeconomic policy in this environment of semi-open capital accounts and semi-floating exchange rates is, understandably, a difficult task. But two areas should be given priority. First, the complex web of capital controls and exchange rate restrictions remaining in many countries must be simplified and gradually eased. This process

\(^{1}\)A large body of theoretical and empirical research in recent years has attempted to identify the confluence of global financial market conditions and specific developing-country characteristics that could have led to a recurrence of that sequence (World Bank, 2007; Calvo et al., 1996; Dailami, 2000; Dailami and Haque, 2001; Edwards, 2001; Chinn and Ito, 2002; Kletzer and Spiegel, 2004).
should be carried out in line with improvements in macroeconomic policies and the development of local capital markets and should take into account the need for maintaining, or even strengthening, curbs on short-term debt inflows while easing restrictions on outflows. Second, authorities must build a prudential system of risk management robust enough to respond to the needs of a more flexible exchange rates and more open capital accounts.

Figure 3. Global Dollar Liquidity (1959-2010)

Figure 4. Global bank credit expansion

As developing countries become more deeply integrated into the world economy, designing and building a sound regime of foreign economic policy that recognizes
both the opportunities and risks of global integration remains an urgent challenge. Roughly half of developing countries are now operating under a floating exchange rate regime, while many now have open capital accounts. Crafting macroeconomic policy in this environment of semi-open capital accounts and semi-floating exchange rates is, understandably, a difficult task. But two areas should be given priority. First, the complex web of capital controls and exchange rate restrictions remaining in many countries must be simplified and gradually eased. This process should be carried out in line with improvements in macroeconomic policies and the development of local capital markets and should take into account the need for maintaining, or even strengthening, curbs on short-term debt inflows while easing restrictions on outflows. Second, authorities must build a prudential system of risk management robust enough to respond to the needs of a more flexible exchange rates and more open capital accounts.

One important outcome of the most recent G20 meeting in Seoul in November 2010 was a consensus that emerging markets facing a surge in capital inflows be able to implement macro-prudential measures to guard against potential asset price bubbles and destabilizing swings in their exchange rates. While countries pledged to seek to refrain from competitive devaluations of their currencies as a response to rapid capital inflows, the G20 meanwhile has tasked international regulators with reporting on best practices for responding to increasing capital inflows to emerging markets.

**Monetary policy challenges**

Developing countries today face a set of challenges in steering a course of monetary policy that is supportive of the domestic goals of sustainable growth, price stability, and external balance, while being mindful of the implications of a changing global economic and financial landscape on the other. In general, these multiple challenges fall into three categories – institutional design, policy tools to assess and track the macroeconomy on a timely basis, and macroprudential regulation to identify and address emerging systemic financial risks with spillover potentials to the real economy.

**Greater exchange rate flexibility has enabled reliance on interest rate policy to respond to changing economic conditions:**

Successful implementation of monetary policy in any country requires a solid institutional framework with key elements including an appropriate exchange rate regime, appropriate policy targets to anchor market expectations, and a monetary transmission mechanism consistent with the country’s stage of capital market development and openness to foreign capital flows. Under an inflation targeting regime, the central bank typically has direct influence on overnight interbank
lending rates, which indirectly influences interest rates across the entire term structure. The ability to use policy rates to influence monetary conditions came in handy during the crisis, particularly after onset of the acute phase in September 2008. During this period the thrust of monetary policy in major emerging economies was one of loosening through both interest rate policy and administrative measures. Central banks cut their key policy rates by as much as 300-500 basis points over the September 2008 to end-2009 period in a number of emerging market economies across regions including Brazil, India, Indonesia, Korea, and South Africa (Table 1). In some countries, such as Turkey, the decline in policy rates over the period was even steeper, falling as much as 1025 basis points, to 6.5 percent by year-end 2009.

Table 1. Central bank policy rates during, preceding and following the global financial crisis percent per annum

<table>
<thead>
<tr>
<th></th>
<th>Pre-financial crisis</th>
<th>Early phase of financial crisis</th>
<th>Onset of acute phase of financial crisis</th>
<th>Post-financial crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dec-05</td>
<td>Dec-06</td>
<td>Sep-08</td>
<td>Dec-08</td>
</tr>
<tr>
<td>Brazil</td>
<td>18.00</td>
<td>13.25</td>
<td>11.25</td>
<td>13.75</td>
</tr>
<tr>
<td>China</td>
<td>5.58</td>
<td>6.12</td>
<td>7.47</td>
<td>7.20</td>
</tr>
<tr>
<td>India</td>
<td>6.25</td>
<td>7.25</td>
<td>7.75</td>
<td>9.00</td>
</tr>
<tr>
<td>Indonesia</td>
<td>12.75</td>
<td>9.75</td>
<td>8.00</td>
<td>9.25</td>
</tr>
<tr>
<td>Korea</td>
<td>3.75</td>
<td>4.50</td>
<td>5.00</td>
<td>5.25</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3.00</td>
<td>3.50</td>
<td>3.50</td>
<td>3.50</td>
</tr>
<tr>
<td>Thailand</td>
<td>4.00</td>
<td>5.00</td>
<td>3.25</td>
<td>3.75</td>
</tr>
<tr>
<td>Russia</td>
<td>1.00</td>
<td>2.75</td>
<td>3.25</td>
<td>4.25</td>
</tr>
<tr>
<td>S. Africa</td>
<td>7.00</td>
<td>9.00</td>
<td>11.00</td>
<td>12.00</td>
</tr>
<tr>
<td>Turkey</td>
<td>13.50</td>
<td>17.50</td>
<td>15.75</td>
<td>16.75</td>
</tr>
</tbody>
</table>

Source: JP Morgan, Global Data Watch, various issues. All numbers are as of 15th of the month, except for Dec-2010.

Over most of the past year, and certainly since March 2010, as the recovery from crisis took firmer hold, the overall monetary policy stance has tightened, with central banks in these economies raising key policy rates in a number of these economies by some 50-200 basis points. The Reserve Bank of India, for example, has increased its key repo rate by 150 basis points to 6.25 percent in successive steps over the past year, and Brazil’s central bank has raised its key policy rate by 200 basis points. In China, where quantitative controls on credit expansion through changes in bank reserve requirements is the most often utilized monetary policy tool, the overall trend of tightening was also evident with recent rounds of interest rate adjustments reinforcing monetary tightening of last few months. And in October, the PBC raised its benchmark lending rate by 25 basis points, to 5.56 percent in October – the first such increase in nearly three years. With inflation rates having moderated across many emerging market economies and as uncertainty in the global economic outlook has increased again in the past several weeks, a wait-and-see attitude is generally prevailing in central banks in these
economies, and the recent trend of gradual monetary tightening is coming to a temporary halt.

*Changing policy approaches toward inflation targeting:* The conventional wisdom of monetary policy operation in the pre-crisis era was inflation targeting. By targeting inflation directly, rather than relying on intermediate instruments such as the growth rate of money aggregates or the level of the exchange rate of an “anchor” currency, the authorities intended to achieve price stability along with more stable macroeconomic conditions and sustained growth. By the middle of this decade, a large number of developing countries in Asia, Europe, and Latin America had moved to adopt inflation targeting, following the lead of high-income economies such as those of Australia, Canada, New Zealand, Sweden, and the United Kingdom. In seeking to achieving their inflation target, whether publicly announced or not, central banks typically adjust their policy rates to influence more directly short-term money market conditions through which monetary policy would be transmitted to term lending rates.

The early evaluation of inflation targeting was positive, with empirical research (IMF, 2005; Levin et al., 2004; Prasad, 2010) establishing that inflation targeting had, by and large, succeeded in delivering price stability. Inflation targeting had served to anchor inflation expectations, at least in the more benign environment of the late 1990s and early 2000s, when inflationary pressures in the global economy were kept in check by a number of supply side factors, including the closer integration of low-cost countries such as China, India, and the high productivity dividend of the information technology industry. This early, generally positive assessment of the effectiveness of inflation targeting underwent a reevaluation, however, as the 2008-09 crisis brought home that price stability does not always guarantee financial stability and financial crisis can occur even in the presence of low and stable inflation rates (White, 2006). While still in dispute, the prevailing view among economic policy makers has been to shift the amplify focus of monetary policy by extending it beyond the conventional focus on price stability to a broader aim of seeking to stabilize asset or credit markets when signs of an emerging bubble manifest. This is probably one of the most important policy lessons emerging from the financial crisis of the past few years.

2 Prior to the global financial crisis, the majority view was that the central bank should not assume responsibility for correcting financial imbalances (Bernanke and Gertler, 2001; Svensson, 2002; Goodfriend, 2007). Given recent experience, however, the opinion seems now to be shifting in favor of preemptive central bank action, as best articulated by “. . .The crisis of the past two years has prompted many of us to reexamine the widely held view that monetary policy should respond to asset prices only to the extent that they influence the anticipated trajectories of inflation and unemployment,” (Yellen, 2009).
Greater attention should be paid to the interactions between the real economy and financial markets:

As the global financial crisis has brought home so dramatically, price stability is not a sufficient guarantee for financial stability and this has prompted a lively debate within the international policy community about whether central banks should target asset prices in conducting monetary policy. A large body of theoretical and empirical research attempting to delineate global financial market conditions and specific developing country characteristics that could lead to episodes of speculative capital flows, excessive domestic credit creation, and asset bubbles has also evolved in recent years. This evidence and debate will have important implications for monetary policy conduct in emerging economies.

Development of appropriate tools and instruments to facilitate timely policy adjustment in response to changing domestic and external conditions is also a precondition for successful monetary policy formulation and implementation. A key requirement here is the quantitative modeling of the interactions between financial market developments and the real economy. To a large extent, macroeconomic crisis in emerging economies (with the exception of some) has, over the past three decades, been caused by or associated with financial market crises of some sort. Real-world data shows that shocks in financial markets can have dramatic, persistent effects on the functioning of the real economy. Weakening balance sheets at banks, for example, can lead to a rationing of credit, which can hamper the growth of real investment and economic activity, which in turn can lead to a further deterioration of banks’ balance sheets and further accumulation of nonperforming loans. Indeed, the recent global financial crisis demonstrated how dramatically and how rapidly instability in financial markets can feed through the real side in a negative feedback loop, even in countries with relatively well developed financial markets and institutions.

Macroprudential policy must be an integral part of stabilization efforts:
The realization that even advanced countries are vulnerable to episodes of systemic risk of a system-wide financial turmoil has brought about renewed interest in the theory and practice of macro prudential policy in both academic and policy circles. Beginning with the broadly accepted definition of systemic risk as “a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential for serious negative consequences for the real economy” (according to the Committee on the Global Financial System), there is much work underway in the international community and academia to articulate a practical approach to formulating macroprudential policy. In general, that work has two major aims: (a) strengthening the financial system’s resilience to business cycle downturns and other aggregate economic
shocks; and (b) actively limiting the buildup of financial risks and their spillover effects on the real economy. From this perspective, macroprudential regulation is distinct from micro prudential regulation, the latter of which focuses on the health of individual financial institutions through capital and liquidity standards and other supervisory arrangements. Designing a regulatory structure that encompasses appropriate elements of both macro and micro prudential regulation remains a major challenge for many central banks in emerging market economies.

Developing a proper mix of macro and micro prudential regulation requires a reexamination of existing frameworks, bearing in mind three important characteristics of emerging market banking systems. These are vulnerability to excessive credit expansion, particularly more so to selected sectors in particular to real estate sector and also to maturity and currency mismatches as the underlying financial system is developing; the role of non-bank financial institutions; and the presence of foreign banks.

*Developing financial systems are particularly vulnerable to excessive credit expansion:*
Where rapid credit expansion accompanies or follows deregulation of the national financial system, nonperforming loans tend to increase sharply and lead to insolvency problems; particularly where banks’ credit evaluation and overall regulatory and supervisory capacity are weak. As evident in a series of regional financial crises over the past few decades, excessive credit expansion that is accompanied by asset-liability currency mismatches, can further jeopardize the stability of developing financial systems and render them dangerously vulnerable to speculative capital flow reversals. This proved to be one of the core weaknesses of corporate sectors and financial systems in East Asia, which had accumulated high levels of dollar-denominated debt in the run-up to that region’s financial crisis in 1997-98, and it was a central factor in the vulnerability of several East European and Central Asian economies during the global financial crisis that followed a period of excessive credit growth worldwide. Unanticipated local currency devaluations can damage balance sheets and greatly increase the cost of servicing debt where significant amounts have been borrowed by banks and nonbank companies in non-local currency terms.

*Role of non-bank financial institutions often lag banks – in national regulatory responses and level of institutional development:*
In a number of these national financial systems, as regulation of banks has tightened, the non bank sectors has been small and/or the regulations developed for the nonbank financial institutions have been relatively lax or not appropriately revised to respond to the expansion of these institutions in size, diversity, and the
The available national regulatory capacity has often been challenged and strained in keeping pace with rapid growth and innovation in local financial markets and instruments. In a number of other emerging market financial systems, particularly in low and lower-middle income countries, the challenges are of a different nature, whereby banks tend to dominate and local institutional investor bases are relatively underdeveloped, impeding the development of well-functioning local capital markets and the overall effectiveness of financial intermediation.

The increasing presence of foreign banks has important implications for macroeconomic management and financial stability in developing countries:

For many developing countries, international banks now provide the primary gateway through which corporations, sovereigns, and banks transfer funds abroad, borrow on short and medium terms, and conduct foreign exchange and derivatives operations. Foreign claims on developing-country residents held by major international banks reporting to the Bank for International Settlements (the most comprehensive measure of international banking activity in developing countries) stood at $3.1 trillion as of March 2010, accounting for 10 percent of global foreign claims. At the same time, the past three years have been tremendously challenging for the international banking industry, testing its capacity not only to recover from the worst crises of the postwar era, but also to adapt to the new reality of tougher regulation, more competition, and heightened expectations of accountability and adherence to sound banking practices.

The question of how foreign bank presence affects the transmission of monetary policy in emerging market economies has attracted considerable research attention and policy debate (World Bank, 2009). The debate has evolved around two opposing views: first, that higher foreign bank presence strengthens transmission because it enhances financial sector efficiency and depth; and second, that foreign banks are less responsive to domestic monetary policy impulses because they have access to a large pool of external funds beyond the control of the monetary authority. As central banks emphasize the market orientation of their monetary policy through open-market operations and the liberalization of domestic interest rates, one key mechanism of monetary policy transmission is the link between the lending rate and the short-term money-market rate, with the latter more directly subject to the central bank’s influence. Research undertaken by World Bank (2009) is consistent with the view that foreign banks are less sensitive than domestic banks to domestic monetary conditions due to their ability to access international capital markets. But the policy and regulatory responses need to be carefully evaluated, bearing in mind the differences across developing countries in terms of monetary framework (inflation targeting), exchange rate regime,
regulatory and supervision capability, regional integration, and the level of financial sector development. Specific policy measures warranting attention in countries with high foreign bank presence should include various measures for reining in foreign banks, including limits on their lending activities.

As underscored at the recent G20 meeting, in a world in which financial institutions frequently operate globally, effective monitoring and oversight of the financial system can be achieved only through coordinated efforts of financial market regulators across national borders. Lax regulations – and often, lax enforcement of regulations – in one country or region make it more difficult for other countries to enforce more stringent standards, and can lead to regulatory arbitrage. Because national regulators have privileged access to information on financial institutions operating within their borders, they should retain primary responsibility for supervision, though with the recognition that greater international cooperation in information sharing and regulatory standards is needed to make national regulators more effective.

As one initial step in this direction, the top 20 or so “global systemically important financial institutions” (GSIFIS) are to be identified by the senior international financial market regulators that make up the Financial Stability Board over the next year. Banks on this list will be made subject to tighter supervision and will be required to prepare a “living will” that would facilitate a dismantling in the event of bank failure. Following this, regulators will identify a list of the next largest banks in their home markets (those that would be considered systemically important on a national basis) and, importantly, review how to extend tighter supervision to a broader group of financial institutions, including so-called shadow banks.

The role of international financial institutions
With the global economy on a sub-par growth trajectory and governments around the world – particularly in advanced countries – struggling under the strain of soaring fiscal deficits and debt, monetary policy must bear much of the burden of the global adjustment. For advanced countries, policy rates are at historically low levels, and monetary easing depends on the scale and scope of unconventional quantitative easing, in which central banks purchase government bonds or other assets. For countries in the emerging world that have already fully recouped their growth losses, normalization of monetary policy is the order of the day, along with simultaneously intervention in currency markets to dampen upward pressures on their currencies. This decoupling of the monetary policy stance between the developed and developing world is currently a major source of policy tension and conflict. Not addressing it could lead to trade protectionism and currency wars.
For the International Financial Institutions avoiding such a scenario should be given high priority. Seen from the contemporary perspective of globalized financial markets, however, national policy responses need to take account of their spillover effects across other countries and incorporate the interest of the international system as a whole.

*Fostering international financial stability through policy coordination:*

The policy debate on how to go about strengthening financial stability has a vital international component that should not be overlooked. In short, the 2008–09 global financial crises is a warning of how developments in what appeared to be a relatively small segment of the financial market in one country (in this instance, the U.S. subprime mortgage market) can have repercussions throughout advanced and developing countries. At the international level, development of a coherent, cross-border banking resolution mechanism that can guide both home and host country regulatory authorities in the event of a bank failure with cross-border exposures and funding remains an urgent task. Making meaningful progress on such issues will require a coherent approach to help ensure that financial activity does not gravitate to countries with the most lenient regulatory framework. Additionally, cooperation between regulatory authorities is needed to strengthen the international financial system as a whole.

In that context, the Basel III regime that was endorsed by G20 leaders in November is a step in the right direction, as it aims to discourage excessive risk taking in the banking industry and bolster banks’ ability to withstand periods of financial stress. Notably, Basel III raises the minimum common equity requirement from the current 2 percent of risk-weighted assets to 4.5 percent, while requiring banks to meet an additional 2.5 percent “capital conservation” buffer on top of the minimum capital requirement. But Basel III goes still further, introducing a second additional buffer, known as the “countercyclical buffer,” that increases the conservation buffer by a further 2.5 percentage points in a case where national authorities determine that credit growth has become so rapid that there is an excess accumulation of system-wide risk. In linking capital adequacy requirements to counter-cyclicality in this way, the new Basel III regime aims to draw on an important post-financial crisis lesson.

In the emerging markets there are two concerns being echoed: one, being the implications of the intricacies of Basel III and its high capital requirements on the flows and its costs to emerging markets; and two, the relevance (given some of the smaller markets concentrate on simple deposit and loan products) and ability of emerging market regulators to adopt and enforce such regulatory framework. A number of emerging markets argue whether it makes sense for them to be more
highly capitalized and liquid on grounds that their institutions and systems face more volatile operating environment. These debates matter as emerging markets and advanced countries financial structure, business focus and risk appetites vary considerable. Rather than moving mechanically to regulatory ratcheting, a proper approach entails analyzing the specific risks facing national jurisdictions and adopting regulations which subscribe to the regulatory principles and adopting simpler measures which deter overleveraging relative to core capital, deter excessive or non transparent risks associated with off-balance sheet transaction or in subsidiaries, adopt simpler and appropriate liquidity rules and stringent rules of loan losses recognition and dynamic provisioning which is consistent with the structure and capacities of banking systems.

References


Dailami, Mansoor and Nadeem Al Haque (2001). “Which Macroeconomic Policies are Sound?”. In W. Mahmud (Ed.), *Adjustment and Beyond: the Reform Experience in South Asia* (pp. 89-108), New York: Palgrave.


