

**Session 10: From Weathering the Crisis to  
Re-Building Prosperity: New Policy  
Perspectives**

**The Role of Financial  
Regulation**

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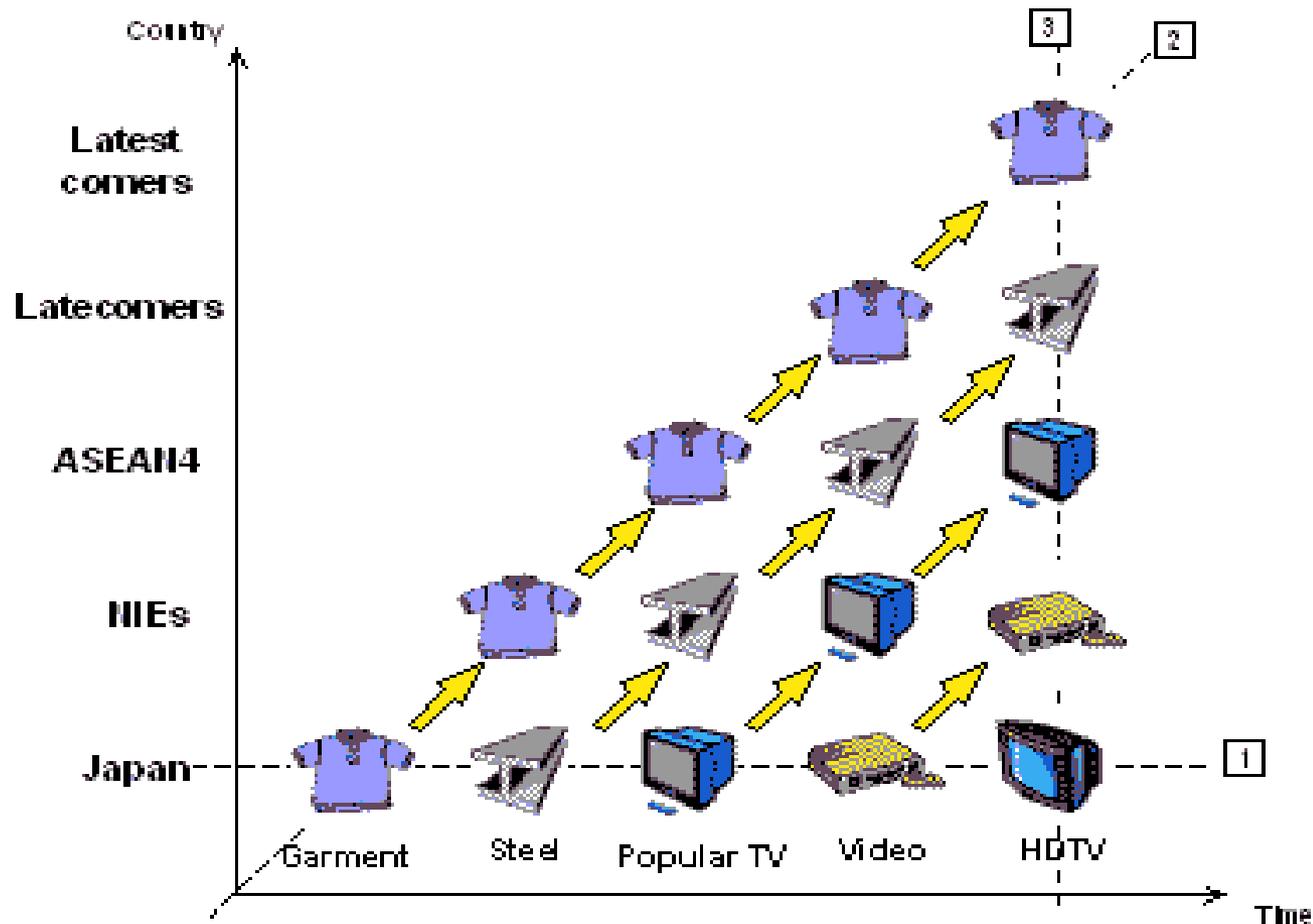
# Outline

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1. Rebuilding Prosperity & Lessons from the Crisis: Need for Financial Stability (FS)
2. Regulation is key for Financial Stability
3. FS, SIFIs and moral hazard?
4. FS, Global inter-connectedness with high liquidity?
5. Challenges ahead for FS
6. Conclusions

# 1. Global Real Integration (stylized)

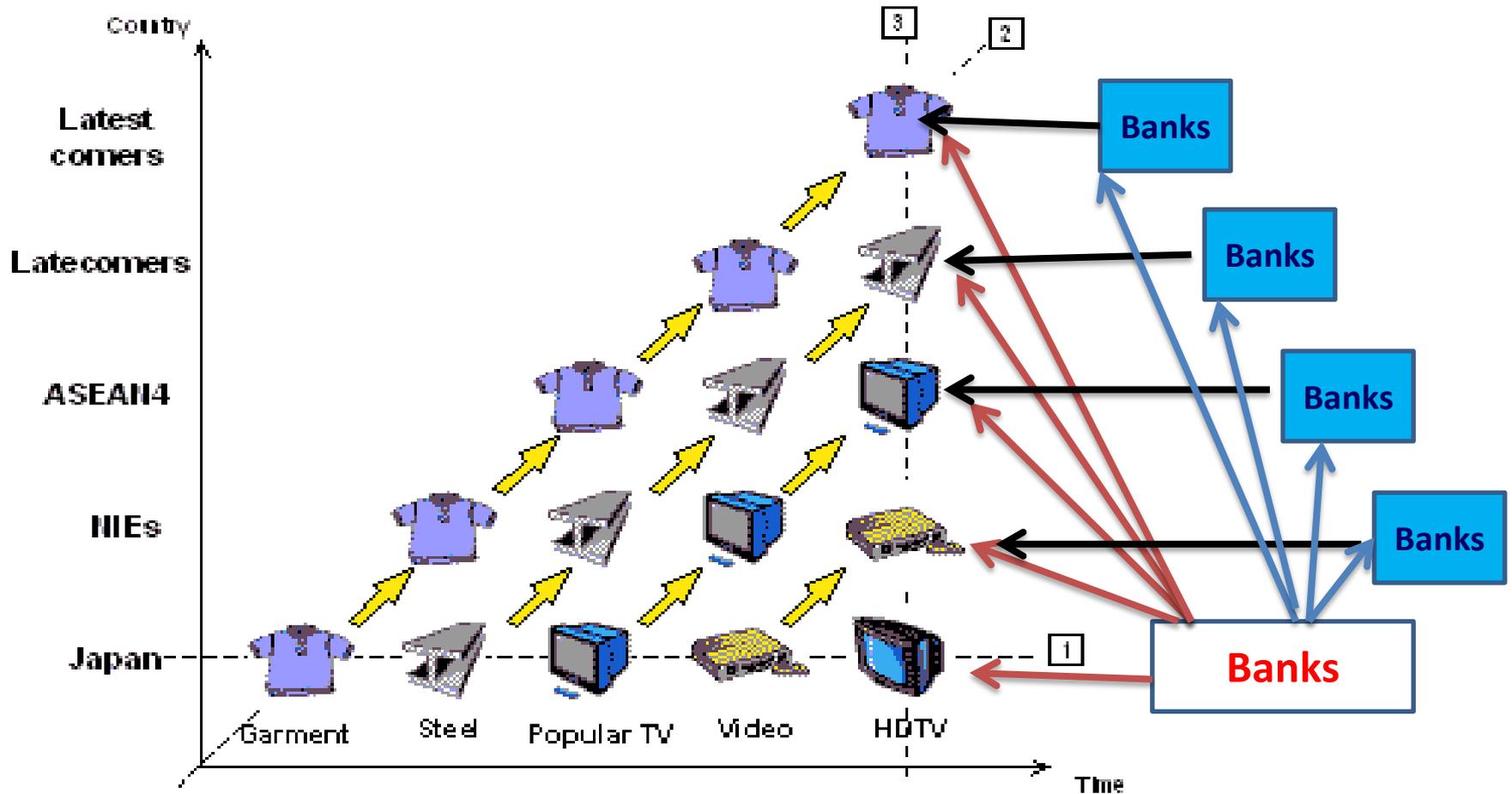
## Structural Transformation in East Asia



Source: J. Y. Lin, [2009] from Akamatsu [1960]

# 1. Global Financial Integration (stylized)

## Structural Transformation in East Asia



Source: J. Y. Lin, [2009] from Akamatsu [1960]

# 1. Global Financial Crisis, Lessons (1)

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- Numerous crises episodes last two decades with global disruptions involving financial sectors
- **Economic prosperity cannot occur without Financial Stability**
- Individually sound and stable financial institutions do not necessarily make a stable financial system → Microprudential (MiP) and Macroprudential (MaP) frameworks must be combined
  - MaP goals: Limit the risk of system wide financial distress; Maintain the provision of financial services; Reduce costs for the real economy (output loss)
  - Instruments (BIS-CGFS [2010]): RR, K req, LTV-DTI, provisions, etc

# 1. Global Financial Crisis, Lessons (2)

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- **Main issue: inherent pro-cyclicality of financial intermediation** v-a-v real economy business cycles; amplifying effect; positive and negative elements; how to “make it right”, “fine-tune”, get “synergies”? Short answer: avoid “excesses”
- **Regulation reduces excessive risk** through requirement of buffers → higher cost of capital → lowers excessive risk taking: (a) raising banks' K requirements; (b) using more reserve requirements; (c) increasing FX reserves
- **Regulation controls build-up of system wide risk:** (a) reducing excessive inter-linkages between FIs; (b) ensuring sound credit origination; (c) reducing excessive K inflows

## 2. Regulation is key to reach FS (1)

- **Complex task: fine-tune pro-cyclicality of financial sector.** Theory and practice of policy-making → several policy tools including Monetary Policy (MP), Fiscal Policy (FP); effects on activity known; effect on risk (and FS) less known
- **Ex: combining MP and MaPs to reduce excessive risk and increase FS is delicate.** Lean against asset-price cycles vs cleaning after? 2008 Crisis show social cost of “cleaning after” is too high but previous Booms show that separate fundamentals and “irrational exuberance” is very difficult. Then, questions: What level of risk? Is the true objective to “prevent” or to “reduce” the probability of crises?
- **Pragmatism: in complement with econ. cycle management policies, use Regulation (MaPs) to reduce excessive risk**

## 2. Regulation is key to reach FS (2)

- **More promising & Win-Win: strengthening financial regulation & infrastructure** (e.g., G20-FSB, Basel 3 agenda → cost & quantity of K, CC buffers, micro-incentives, strong supervision, local & cross-border resolution frameworks, etc.)
- **Regulation & multipliers:** smoothing financial accelerator, getting the “right” credit multiplier → reducing “excesses” (leverage, asset-credit growth,...)
- **Regulation & provisions:** provisioning for white swans (better be dynamic) and buffers for black swans
- **Regulation & information:** minimizing contagion (hedging obligation, identification of counterparties, registration in data repositories and CCPs clearing, etc.)

### 3. FS, SIFIs and moral hazard

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- SIFIs, especially global ones pose systemic risk for financial sector because of asset size, interconnectedness, cross-border activities. TBTF → moral hazard → excessive risk
  - SIFIs were at the heart of the 2008 crisis; SIFIs should be subject to closer supervision and specific regulatory requirements; should be resolvable
  - Can MiP and MaP set “right” size for SIFIs? (e.g., work of BCBS “equalizing” probability of failure and facilitating resolution processes across jurisdictions thru cost of K)
- Moral hazard can emerge without SIFIs, if success of MP & MiP-MaP policies “numb” incentives for prudent behavior

## 4. Global interconnectedness w high liquidity

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- Global interconnectedness of K markets in a situation of high liquidity create new challenges for MP and CBs exacerbating old impossible trinity
- Case for using MiP-MaP to avoid excessive credit growth in recipient countries, complementing MP action (and FP) to dampen aggregate demand pressure
- But: greater K movements into EMEs may continue after end of QEs; changes in relative country risk & lower home bias → portfolio composition shift toward EMEs, etc., and EMEs would need and benefit from LT foreign savings.

# 5. The Challenges Ahead for FS (1)

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- The G20 has agreed on a bold package for regulatory reform, under FSB construction
- The regulatory cost of implementing this package will be significant – but the cost of rescues (bail-outs) in times of crisis far outweigh them
- A long “phase-in” period for implementation of the financial reforms has been agreed the regulatory reform should not impact the recovery of the economy, despite claims to the contrary
- G20-FSB package will strengthen FS locally and globally

# 5. The Challenges Ahead for FS (2)

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- **The crisis is not over:**
  - Global recovery has weakened
  - Unemployment at high levels in advanced economies
  - Tensions remain in European sovereign markets
- **The main challenge for regulators today is to coordinate consistent implementation across all jurisdictions of regulatory reforms in a scenario full of uncertainties.**

## 6. Conclusions and Brazilian experience

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- Brazil has sailed well through the crisis so far, managing well massive inflow of foreign capital. Why?
  - Well-tested, strong, credible macroeconomic framework
  - Well regulated and solid financial system with flexibility to implement anti-crisis measures in a timely manner, including MaPs
- Financial regulation also supportive of inclusive economic development : removing obstacles to market efficiency (e.g. transparency of banking tariffs); reducing fixed costs of financial intermediation (e.g. through bank correspondents)

# 6. Conclusions & More General Questions

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- **Financial Stability needed for Sustainable Economic Prosperity** but controlling pro-cyclicality of financial sector is a very complex task
- **Financial Stability** → requires **Strong, Comprehensive Prudential Regulation**; and Prudential Regulation has national and global dimensions
- (Some) prevention (leaning, smoothing cycle) seems better than “mopping-up” after (cleaning after crises); **Prudential Regulation** strong candidate to perform this task and can be effective to foster financial stability and reduce excessive risk

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**Thank You**