Financial Development Policy:

A Post-Crisis View from a Latin Perspective

Financial Globalization: Shifting Balances

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Outline

- The Latin American pre-crisis consensus
- Lessons from the global financial crisis
- Some implications for Latin America

Based on:

De la Torre, Augusto and Alain Ize (2010). “Regulatory Reform: Integrating Paradigms,” *International Finance,* Vol. 13, Issue 1.

De la Torre, Augusto and Alain Ize (2010), “Whither Financial Development: A Post-Crisis View from a Latin American Perspective,” Mimeo

The road to financial development: Pre-crisis consensus in Latin America

- Pre-crisis consensus – a response to the “financial repression” of the 70s and 80s and the recurrent crises of the 80s and 90s

- The pillars of the consensus
  - *Macro stability* ➔ financial stability ➔ financial development
  - *Let markets breath!* – including through int’l financial market integration
    - Main role of the state: to strengthen the enabling environment
    - Promotion of market discipline
      - Capital (skin in the game)
      - Transparency and accounting/auditing standards; rating agencies
      - Strict limits on access to the safety net
  - Convergence towards the *Basel-inspired prudential agenda*
    - Focused on idiosyncratic risks; ignored systemic risk
  - More recently: emphasis on *broadening financial access*
    - Micro-finance revolution
    - Repositioning of specialized development banks

The crisis questioned the pillars of the consensus

- *Macro stability* – can promote unsustainable financial development!
- *Let markets breath* – market discipline failed miserably
  - Information and sophistication proved insufficient for markets to self-regulate
- *Basel prudential agenda* – needs major rethinking
  - Price history is not enough – from normal distributions to black swans and fat tails
  - The soundness of the parts does not imply the soundness of the whole
  - Dividing and diversifying idiosyncratic risk does not necessarily reduce systemic risk
- *Broadening financial access* – can increase systemic risk exposure
  - The developmental role of the state may conflict with its systemic stability role

The crisis brought into the open new market failures

- The interaction between macro stability and market laissez-faire triggered *new market failures* with perverse dynamics
  - *Second generation asymmetric information failures*
  - *Collective cognition failures* (“mood swings”)
  - *Collective action failures* (gaps between the private and social good)

- Details in De la Torre and Ize (2010)

Asymmetric information failures

- Better and cheaper information (together with macro stability), instead of reducing information asymmetry frictions, increased them
  - Multiplication of new agents and products that exacerbated frictions at virtually all nodes of the chain (Aschcraft & Schuerman, 2008)
  - Most popular crisis explanation (Calomiris, 2008; Caprio et al, 2008)

- Under the cover of opacity, agents with little or no “skin in the game” took advantage of the less informed
  - Fee for service, passing on the risk from hand to hand
  - Each link in the chain contaminated by informational asymmetries
    - Debtors, originators, packagers, banks, rating agencies, insurers, asset managers, shareholders, investors…
  - Cheaper/easier to vote with your feet than to monitor diligently
  - Standards erosion, negligence, excessive risk taking, fraud
  - Dynamics exacerbated by perception that the state will be there at the end of the day

Cognitive cognition failures

- Macro stability, innovations, and the illusion of “scientific” risk management exacerbated collective cognition failures
  - In the tradition of Keynes, Minsky, Kindleberger, Shiller
  - Optimism and exuberance boosted the bubble
    - Lower volatility reduced the VaRs and fed the feeling that “this time is different”
  - Fear of the unknown, pessimism and panic boosted the downward spiral
    - One dissonance was enough (i.e., CBX swaps vs. rating agencies)

- Cognitive constraints
  - Poor information – constant updating of perceptions
  - Fallibility of cognition – biased perceptions
    - The systemic implications of innovation were not well understood

Collective action failures

- Macro stability and the reduction of transaction costs…
  - …promoted a process of market completion motivated by private interests…
  - …in a context of growing interconnectedness, and network and scale effects…
  - …triggering rising gaps between the private and social good
- Collective action failures
  - Coordination problems
    - “Keep dancing until the music stops” (Charles Prince)
  - “Free riding”
    - Lending-short-and-running free-riding on market information and liquidity (public goods) is preferable to lending long and monitoring based on costly-to-obtain private information
    - The safety net exacerbates free-riding incentives
  - Un-internalized externalities
    - Market frictions inhibit internalizing the social benefits of liquidity and the social costs of deleveraging through “fire sales”
- Dynamic regulatory arbitrage
  - “Shadow banking” was boosted by the larger gap between private and social interests outside the perimeter of prudential regulation

Some implications for Latin America

- In the future, systemic risk will originate less in domestic macro imbalances and more in external shocks and endogenous perverse dynamics

- The basic pillars of consensus should continue to hold but will need to be complemented with a smarter of the state in mitigating the new market failures
  - Second-generation asymmetric information failures (asset management, mortgage financing)
  - Unexpected impacts of financial innovations (forex derivatives, Sofoles financing)
  - Asymmetric market completion (credit cards)

- Many of the reform priorities in LAC are the same as those for the rest of the world but need some adaptation to local conditions
  - Prudential norms to help internalize externalities
  - Redefinition of the perimeter to help prevent dynamic regulatory arbitrage
  - Better control and monitoring of complex financial innovations
  - More systemic and holistic supervision – diachronic and synchronic

Going macro-prudential: even more important?

- For LAC, macro prudential tools are even more relevant because monetary policy is more over-burdened
- Concerns for growth of excess exchange rate volatility further restrict the room for monetary policy
  - Macro prudential instruments can both limit systemic risk and take some of the burden off of monetary policy
  - Good fiscal policy is a necessary complement
- However, a significant degree of exchange rate flexibility is needed to enhance prudential policy independence
  - Otherwise, the impact of macro and micro regulatory adjustments will be diluted through cross-border regulatory arbitrage

Revisiting some dimensions of financial globalization?

- The better quality of LAC’s insertion into world capital markets has provided an appreciable degree of protection during the last crisis
  - Net creditor position in debt contracts, net debtor position in equity contracts
  - Reduction of currency mismatches and exchange rate flexibility

- However, financial globalization will be a growing source of:
  - Inter-connectedness (externalities and new agency problems)
  - Innovations, capital flows, and shifts in risk apetite (cognition shocks)

- LAC will need to intensify its agenda for reform to mitigate the associated systemic risks
  - Should LAC add Chilean-type capital controls to its standard set of policy tools?
  - Should subsidiaries of foreign banks be ring-fenced from pressures of their parents?
  - Can the regional regulatory framework deviate to any significant extent from the one to be defined globally?

Revisiting role of the state in financial development?

- Development banks (DBs): can its counter-cyclical role in crisis times be strengthened without competing with private banks in normal times?
  - Counter-cyclical role of DBs requires a knowledge of sectors and customers to mitigate asymmetric information problems
  - Avoiding competition under normal times should ease access to information and the distribution channels of private banks in times of crisis
  - In normal times, DBs should focus on catalytic functions and the expansion of the credit frontier – to help complete markets and capture positive externalities

- Tax and subsidy policy: should it be used more actively to promote the sustainable development of financial markets?
  - In principle, the growing gaps between the private and social good could justify a more active tax and subsidy policy
    - Examples: a Pigovian tax to internalize externalities; tax exemptions to promote capital markets development; investment subsidies or credit guarantees to promote access
  - However, risks of doing more harm than good are high and the Latin American record is not particularly encouraging…

Thank you!