Improvements and Shortcomings of Financial Market Regulation after the Great Recession

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Structure

- What was planned?
- Theoretical background of existing regulation
- What should be the theoretical background of regulation?
- What should be the principles of regulation?

What was planned after the Crash 2007 / 2008

G20 Meeting Washington 2008

"We will make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanding trade in financial products and services" (G20, Declaration following the Washington meeting, November 2008:3).

G20 Meeting London 2009

“Financial markets will remain global and interconnected, while financial innovation will continue to play an important role to foster economic efficiency.” (G20 Meeting London, Enhancing sound regulation and strengthening transparency. Working Group 1, Final Report, March 25 2009: v)

What is the theoretical background of regulation?

- Financial markets are efficient

  -but even if financial markets are efficient they may not reflect fundamentals

- Rational expectations

  - but the expectations of economic agents are not identical with the equilibrium of economic models

What should be the theoretical background of regulation?

- Financial markets are endogenously unstable
  - Different agents have different expectations
  - Agents do not know fundamentals
  - Agents have a short-term time horizon
  - Herding is widespread
  - ……
  - Read: Robert Aliber and Charles Kindleberger, Manias, Panics and Crashes: A History of Financial Crises, Sixth Edition, 2011

- Flexible exchange rates and a global financial markets are a contradiction

- There is historical time

Paul Samuelson thought the neoclassical model makes an interesting assumption: In the neoclassical paradigm the world is "ergodic".

This excludes "how it the Bible does when it says: 'we go this way only once'." Samuelson, Paul A. "Nonoptimality of Money Holding under Laissez Faire." *The Canadian Journal of Economics / Revue Canadienne D'Economique*, vol. 2, no. 2, 1969, pp. 303–308. *JSTOR*, www.jstor.org/stable/133642.

- Risk models are misleading for regulation

What should be the principles of financial market regulation?

- A) Risk models
  - Risk models should not play any role in regulation
  - Why not going back to a standard approach without risk models?
  - The existing leverage ratio is not sufficient

- B) Currency mismatch
  - Financial market regulation should sharply reduce any currency mismatch – and reduce international capital flows
  - A reduction of financial integration is beneficial

(Dani Rodrik, The Globalisation Paradox, London 2011)

- C) The Shadow financial system has to be regulated in the same ways as the commercial banking system

or

- Cut all links between commercial banks and the shadow financial system
  - No ownership links
  - No credit links

- D) Reregulation of real estate market is desirable

  - The old Fannie Mae (Federal National Mortgage Association) was a good system
  - The high market share of German building associations was a good system

    (in 2014 45.% of Germans live in own flat / house)
  - Prevent foreign investment in the real estate sector - Denmark is a good model

    (Foreign investors or private persons not living in Denmark are not allowed to buy real estate)

“The Bank estimates that the global stock of leveraged loans has now reached an all-time high of US$ 3.4 trillion, equivalent to 11% of total advanced economy credit to non-financial corporates. The share of corporate debt owed by highly leveraged companies is now very close to or above pre-crisis levels in major advanced economies

We have also seen an increase in sales of complex products as investment banks try to boost their income in a challenging trading environment. And in some countries, retail lending conditions have loosened.”

"From a financial stability perspective, a key risk is that insurance companies and pension funds encounter higher losses in stressed markets and become forced sellers or bystanders rather than buyers, so amplifying market vulnerabilities."

“Other non-bank financial firms such as investment funds have also turned increasingly to less liquid and riskier investments. Investment fund flows now account for one third of total portfolio flows to emerging market economies (compared to one tenth before the crisis). Bank analysis suggests that non-banks now hold around 40% of the rapidly growing global leveraged loan market. More than US$ 30 trillion of global assets are now held in open-ended funds that offer short-term redemptions while investing in longer-dated and potentially illiquid assets.”

Speech by Sir Jon Cunliffe, Bank of Engand

Deputy Governor Financial Stability, Member of the Monetary Policy Committee, Member of the Financial Policy Committee and Member of the Prudential Regulation Committee Society of Professional Economists Annual Conference, London, 14 October 2019 https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/financial-stability-and-low-for-long-speech-by-jon-cunliffe.pdf?la=en&hash=D8721FC53A74F611335548FB350264BD2AEC0C2B

- The Bank of England has issued a stark warning over the rapid growth in lending to indebted companies around the world, drawing parallels with the US sub-prime mortgage market that triggered the 2008 financial crisis.

https://www.theguardian.com/business/2018/oct/17/bank-of-england-high-risk-lending-leveraged-loans

A word to China

- China is a socialist market economy
- China is on the way to socialism – I was told many times
- China should search for a own model of financial market regulation and globalisation – it could become the leader of the Global South

Thanks

Major results from work package 3

The following major policies has to be followed to create prosperous development

- Re-regulating and downsizing of the financial sector,
- Changing the logic of corporate governance away from shareholder value,
- Re-distribution of income (and wealth),
- Re-creation of international monetary and economic policy coordination,
- Re-orientation of macroeconomic policies towards stabilizing domestic demand at non-inflationary full employment levels.

What was done?

- Institutional changes concentrated almost entirely on the financial system (excluding international capital flows and exchange rates)
- Philosophy of reform
  - "We will make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanding trade in financial products and services." (G20 2008: 3)
  - "Financial markets will remain global and interconnected, while financial innovation will continue to play an important role to foster economic efficiency." (G20 2009: V)

- Major financial market reforms
  - Increased volume and quality of capital and liquidity holding of banks and reduced the role of risk models
  - Tried to tackle the Too-Big-to-Fail problem (last will of banks, plan not to save owners and creditors of banks again, build-up of a fund to help failed institutions)
  - Partly but not consequently cut the links between commercial banking and the shadow financial system (mainly in US)
  - Trading of derivatives as much as possible on organised exchanges
  - Binding rules of management remunerations
  - Creating more transparency

What was not done?

- No fundamental restructuring of the financial system
- No change in corporate governance
- No reform of the international financial and exchange rate system
- No re-regulation of labour market to establish a nominal wage anchor and reduce wage dispersion
- No change in income inequality
- No demand management to create full employment

Fundamental restructuring of financial system

- Strict separation between commercial banks and shadow financial institutions
  - no ownership relation, no credit relation and no proprietary trading of banks
  - This would lead to a radical shrinking of shadow institutions
- Strong instruments are needed to influence credit allocation (for example curb credit to the real sector or consumption credit, support Green New Deal projects, etc.)
- Too big to fail: For example, financial institutions should be reduced to liabilities of 2 or 3 per cent of GDP in big countries
- Financing of the real estate sector should be especially regulated
- Derivative products have to simplified and approved by supervisors
- Securitisation has to be regulated and restricted
- Over the counter derivative trading has to be forbidden
- Offshore centres have to be pressured to follow international rules

Change in corporate governance

- Share buy back has to be generally forbidden
- Unfriendly takeovers have to made very difficult
- Distribution of profits to shareholders have to be limited, for example no dividends if the company makes losses.
- Payment schemes of management have to changed and top management salaries radically cut
- Different stakeholders, epically unions, should be able to influence management decisions
- Multinational companies should be
  - taxed on world level
  - exposed to anti-trust policy
  - exposed to transparency

A reformed international monetary order

- The present international financial system is characterised by unstable international capital flows, exchange rate volatility, currency competition and periodically unstainable current account imbalances
- Overall a regulated globalisation and no hyper-inflation should be the guideline for reforms (Dani Rodrik)
- Needed is an exchange rate system with more stable exchange rates and limited current account imbalances – a new type of Bretton Woods system
- International capital controls are a precondition for more stability of capital flows and exchange rates
- Part of international capital flow do not serve a positive purpose – for example short-term speculative flows and part of portfolio flows
- Currency mismatch especially in developing countries has to be avoided

Re-regulation of labour markets

- The nominal wage level is important for the stability of the inflation rate
- Wage norm: the nominal wage level should increase according to trend productivity growth and target inflation rate of the central bank
- Wage dispersion has to be reduced
- A re-regulation of labour market and strengthening of trade unions and employers' association is needed to achieve these goals

Make societies again more equal

- High income inequality leads
  - to a lack of aggregate demand and the danger if stagnation
  - to a lack of spending for education (the poor cannot afford investment in education, increasing criminality, incoherent dysfunctional societies, etc.
- Income inequality has to be reduced by
  - Reducing wage dispersion
  - Reducing the power of financial markets (reducing the profit mark-up)
  - Government redistribution policies

Macroeconomic demand management for full-employment

- Income distribution has to be changed to create sufficient consumption demand out of income
- Investment demand has to be stabilised and regulated in proportion of other demand elements
  - Big state owned enterprise sector in the area of public goods and public utilities
  - Green New Deal could stimulate investment and sustainability
  - Development banks to stimulate socially preferable investment in different areas (real estate, new energies, etc.)
- No big current account imbalances should be allowed – no export driven accumulation models
- International coordination of demand management should be tried to achieved