



Implications of the Financial Crisis for Financial Sector Policies

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Financial crisis...crisis of confidence in policies

- Response to the crisis – extensive liquidity, guarantees, bail outs that involve governments taking large ownership stakes etc. – has shaken confidence in the very blueprint of financial sector policies.
- Are mainstream policies dead?

But...the confusion arises because

- The crisis does not simply reflect a failure of free markets, but also failure of regulatory practices and
- There are tensions between short term and long term responses to a systemic crisis

Policies employed to contain a crisis- often in a haste to reestablish confidence and with inadequate consideration of long-term costs – should not be interpreted as permanent deviations from well-established policy positions.

Questions for policymakers

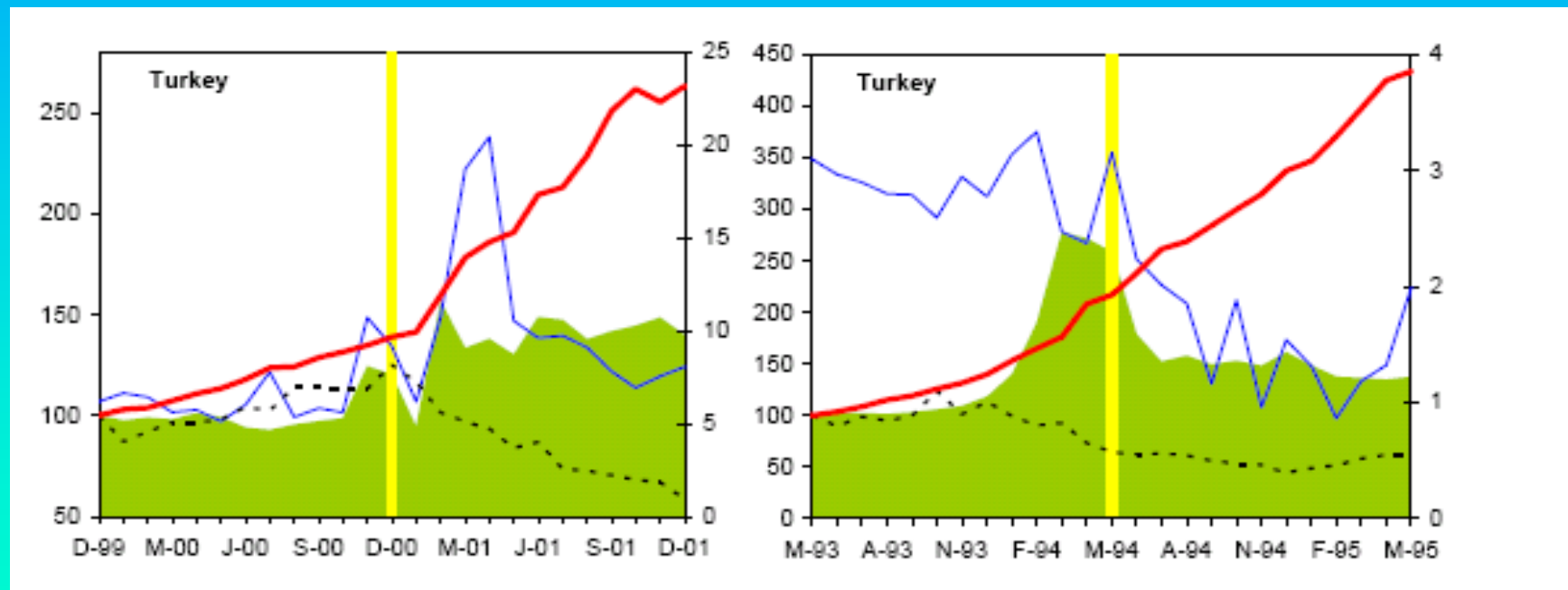
- Crisis containment: Role of liquidity support and blanket guarantees
- Crisis resolution: Role of governments in bail-out and owning financial institutions
- Recovery: How to encourage the banks to lend again
- Crisis prevention: Should governments regulate finance much more aggressively given the failures in market discipline?

Containing the crisis..

- “containment” requires quick restoration of confidence
- central banks need to lend quickly to avoid a liquidity crisis that will undermine sound institutions
- But long term goals should not be discarded because bailouts are likely to lead to more future crises
- unlimited liquidity/guarantees during crises does not speed recovery...to the contrary it is associated with greater output loss and higher fiscal costs

Impact of blanket guarantees

Turkey (May 1994, December 2000)



so instead of unlimited liquidity/ blanket guarantees

- distinguish between deeply insolvent banks vs. those that are solvent enough to be salvageable
- Information problems?
 - Identify and remedy gaps in information well in advance, demand improvements
 - Banks can stay open during inspections– but large transactions can be subject to clawback
 - Crisis preparedness also helps; establish and regularly test a well-publicized benchmark plan for dealing with crises (war games).

How to resolve the crisis

- Need to deal with widespread undercapitalization and insolvencies
- Recapitalization process often leaves governments as owners/temporary caretakers
- This in itself is not unusual and should not be taken as endorsement of government ownership – research suggests governments do not make good bankers

Government involvement

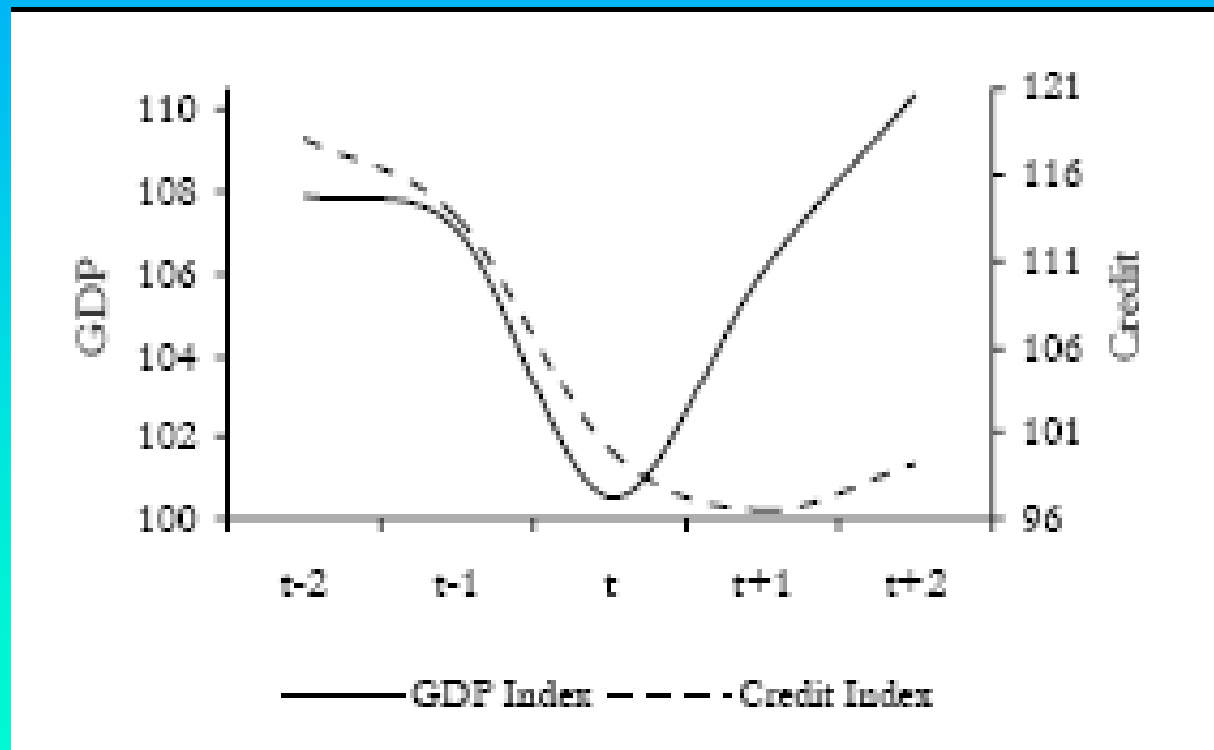
- Should be designed to
 - protect the interests of taxpayers
 - impose losses on responsible parties
 - use the private sector to identify winners and losers (for eg. by insisting that at least some share of new capital comes from the private sector; bad bank-good bank solutions)
- An exit plan for the public sector is a must
 - ideally after resolution the banks will be well-capitalized and in private hands

Encouraging recovery?

- Dealing with the credit crunch: research shows that output recovery almost always precedes credit recovery
- Output often recovers because of revival of demand, it is not supply driven. Even then credit growth remains depressed for a while
- Quick/indiscriminate recapitalization in the hopes that banks will start lending again may be misguided and may backfire

Recovery in Emerging Markets

Demirguc-Kunt Detragiache and Gupta (2005) and Calvo, Izquierdo, and Tanzi(2006)



Preventing Crises?

- Finance is risky business – regulation and supervision cannot eliminate crises, but make them less frequent and less costly.
- Clearly something went wrong...regulators were not able to exert oversight when it was needed.
- Crisis challenged the Basel framework in important ways (flaws with external ratings, accuracy of internal risk models, lack of disclosure and transparency...)
- Many reform proposals...better incentives, countercyclical regulation

Reform Proposals

- **Macro-prudential** regulation – aimed at reducing vulnerability of the whole *system* -- rather than that of individual financial institutions
 - Extra requirements for *systemic* institutions (large / interconnected)
- **Dynamic oversight** - design rules/ mechanisms so that regulators start asking tough questions and enforce rules when markets become overly exuberant.

Devil is in the details..

- What tools for large/interconnected institutions?
 - Additional capital / liquidity requirements
 - Colleges of regulators
- What tools to dampen boom/bust cycles?
 - Countercyclical provisions, leverage ratios, loan-to-value, capital –can be designed to move inversely with the business cycle
 - Adjustment based on credit growth rates or other macro indicator (e.g., GDP)
- Big challenges for regulators
 - Added complexity and informational burden – how can we tell we are in a bubble?
 - Do incentives really allow tightening in the boom? – political economy issues
 - Rules rather than discretionary adjustments

Regulatory governance

- Independence and accountability are important, and so are improved incentives
 - Better crisis preparedness (adopting and testing crisis resolution plans)would help avoid short-termism, use market signals to track risk
 - Estimate and publicize safety net subsidies for systemic institutions to focus attention on systemic stability and establish political accountability
 - Revise remuneration schemes for senior regulatory officials that include deferred compensation funds to lengthen decisionmaking horizons

Moving forward

- Policies are not dead but more work is necessary
- Despite their fragility, financial systems underpin economic development
- The challenge of financial sector policies is to align private incentives with public interest without taxing or subsidizing private risk-taking
- Public ownership or too aggressive regulation would simply hamper financial development and growth
- But striking this balance is becoming increasingly complex in an integrated and globalized financial system