

Conference on
South Asian Financial Systems at a Crossroad:
Promoting Stability and Growth
Gulmohar Hall, India Habitat Centre, Lodi Road, New Delhi
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(3rd ICRIER – InWent Annual Conference)

Background

Several generations of financial market reforms in South Asia have resulted in extended prudential regulations, an improved soundness of financial systems, in particular the banking system, and in an increased diversification of risks. But financial sector reforms also resulted in a rising openness and integration of South Asian financial markets into the global economy which has increased their exposure to spill-over and contagion from global shocks. After years of continued high growth, the vibrant economies of South Asia are now confronted with a slow-down of exports and industrial production. In contrast to advanced countries, in South Asia there is contagion from the real sector through a slump in exports and remittances to the financial sector which then in turn has second round effects on the real sector through the confidence channel. Although exposure to toxic assets is very low, all South Asian financial markets – credit, money, equity, bond and forex - have come under pressure in the second half of 2008 resulting in a rise in interest rate and bond spreads, steep stock market corrections, and a strong volatility of prices, in particular exchange rates.

Policy makers, central bankers and supervisory authorities have made endeavours both to stabilize South Asian financial systems and to enable their economies to return to a sustainable growth path. Thereby, they face the challenge to provide sufficient liquidity and to prevent a credit crunch while avoiding too much regulatory forbearance which might threaten the soundness of financial institutions in the future. On the other hand, the international financial crisis could also be perceived as a chance insofar as it has already given rise to far-reaching reform proposals regarding rules, regulation and governance of the international financial architecture. In addition, the financial crisis could induce financial sector reforms in the future which would improve regulatory surveillance in South Asia and at the same time enable national and regional financial systems to operate more adequately as a shock absorbers.

Conference Concept

The conference will analyse key issues in the South Asian financial market such as the national and global financial architecture including rules, infrastructure, and governance. Against this backdrop, the conference seeks to bring together central bankers, policy makers and financial practitioners from the region with selected representatives from international organizations and academia for a dialogue on four related sets of questions. First, what are the strengths and flaws in current financial systems and how would a new approach of judicious liberalization with more effective regulation facilitate growth with stability? Second, which institutional and regulatory infrastructure is conducive to improve regulatory surveillance and to strengthen cohesion of the financial system? Third, how could monetary policy best deal with the impacts of the global financial crisis on credit crunch, volatile exchange rates and growth? And fourth, how could the pre-crisis flaws of the international financial architecture be overcome?

To address these questions, the conference will be organised around three substantive sessions and a high level panel discussion, as below.

Session 1: The Future of Financial Sector Reforms

On first sight it does not seem an appropriate timing to envisage future financial sector reforms in the course of the current global financial turmoil; policy makers, central banks and regulators are striving to provide financial institutions with sufficient liquidity and to keep up credit flows to the real sector. But the global financial crisis can also be taken as the crucial test which part of the financial sector reforms in the past have stood firm to financial innovations and rapid de-leveraging and should therefore developed further; and which part of former financial sector reforms have proved to be inadequate and thus have to be adjusted. On the other hand, one of the current major reform projects in South Asian countries is the implementation of Basel II which encourages pro-cyclical risk taking and thereby tends to accentuate boom-bust cycles. Moreover, only recently the Indian Commission on Financial Sector Reforms has presented a comprehensive report, in which it advocates a shift in paradigm towards an increased liberalization in combination with more effective regulation in contrast to the rather calibrated approach applied by policy makers and the RBI. Thus, this session would try to address the following important questions:

1. What are the strengths and flaws in current financial architecture in South Asian countries?
2. What lessons for future financial sector reforms can be drawn by the global financial crisis?
3. How can regulators challenge the pro-cyclical risk taking behaviour of banks to a greater extent?

Session 2: Strengthening Regulatory Surveillance

On average South Asian banking systems are financially sound and well capitalised. In contrast to European financial institutions only very few South Asian banks are directly exposed to so-called toxic assets on the US mortgage market. Thus, existing regulatory surveillance seems to have served South Asian countries well. Meanwhile, several G20 countries are increasingly calling for an extension of regulators' mandate beyond micro prudential supervision of individual institutions which has proved to be insufficient. They are advocating the adoption of a macro prudential approach with which regulators should be able to identify and mitigate potential systemic threats rather earlier. Besides expanding the mandate, recommendations focus on better cooperation and increased coordination between regulators both on a national and regional level to enhance consistence and prevent regulatory arbitrage. With the Financial Sector Oversight Agency (Report of the Committee on Financial Sector Reforms appointed by the Indian Planning Commission) and the European Systemic Risk Council (de Larosière Commission appointed by the European Commission) recent proposals support an integrated regulatory structure under an apex umbrella institution in contrast to the prevailing governance system with several specialized regulatory bodies. In this context, the following questions appear to be of particular relevance:

1. Is there an optimal regulatory structure to promote financial stability?
2. How could regulatory arbitrage be prevented?
3. What role could the envisaged (regional) regulatory colleges play for managing systemic risks and contagion?

Session 3: Monetary Policy against the Backdrop of the Global Financial Crisis

In the current situation monetary policy in South Asian countries faces several dilemma. Net capital imports are declining due to the increasing of spreads and the drying up of international liquidity as a result of higher EME risk perception. On the other hand plummeting exports together with the slow-down in the inflow of remittances increase the current account deficit. Conventional wisdom would recommend a rise in interest rates to attract foreign funding of the deficit. However, such a monetary policy stance would tend to aggravate the credit crunch and finally erode bank solvency. Therefore several central banks practise quantitative easing complemented by reverse sterilization and increased public foreign indebtedness to provide sufficient domestic and foreign liquidity and to dampen devaluation of the exchange rate. However, injecting liquidity into the financial system might induce higher capital exports and if

the situation is lasting, foreign exchange reserves might be rapidly deployed and exchange rates finally depreciated. Moreover, if domestic financial markets are flooded with liquidity now, there is a risk of inflating a new bubble when the economy is going to restart in the future. The session would attempt to answer the following key questions:

1. Which monetary policy is most suitable to moderate credit crunch?
2. What policy instruments are available beyond a low or zero-interest rate policy?
3. How can interventions in the foreign exchange market ease the impacts of the crisis?
4. How could asset price bubbles be prevented in the next upswing?

High Level Panel Discussion: The Future of the International Financial Architecture

The three major flaws of the international financial architecture before the crisis were the lack of international coordination, the limited scope of regulatory regimes and the deficient legitimacy of the IFIs. A common feature of the multiple international initiatives in the course of the crisis is the trend to broaden the membership towards stakeholders from emerging market economies and developing countries which relates in particular to the G20 and Financial Stability Board. Together with the UN Financial Reform Commission and UNCTAD Taskforce on Systemic Issues and Economic Cooperation these initiatives put forward a broad range of concurrent proposals, in particular regarding closer international cooperation in terms of crisis resolution, the empowerment of central banks to promote financial stability and enhanced cross-border regulatory and supervisory coordination to detect and mitigate systemic risk. However, there are still key issues, e.g. the pro-cyclicality of banking regulation or the lack of regulation on hedge funds and credit agencies which further need to be addressed; moreover, the discussion on the reform of international financial institutions in terms of voice and ownership is rather controversial. In this context, the following questions appear to be of particular relevance:

1. Which are the most urgent policy measures to overcome the pre-crisis flaws of the international financial architecture?
2. How could international cooperation between supervisory authorities and regulators be improved?
3. What reform measures are most needed to restore legitimacy and policy scope of the IFIs?