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REGULATION OF FINANCE AND FINANCIAL STABILITY AND ITS SIGNIFICANT ASPECTS

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Abstract: The article covers the important points about regulation of finance and financial stability in the world economy and its basic aspects. Moreover, special factors that influence economy are noted.

Keywords: social domain, economy functions, efficient financial system, asymmetric, credit ceilings, credit ceilings, banking sector, deposit insurance.

INTRODUCTION

An economy is an area of the production, distribution and trade, as well as consumption of goods and services. In general, it is defined as a social domain that emphasize the practices, discourses, and material expressions associated with the production, use, and management of scarce resources. A given economy is a set of processes that involves its culture, values, education, technological evolution, history, social organization, political structure, legal systems, and natural resources as main factors. These factors give context, content, and set the conditions and parameters in which an economy functions. In other words, the economic domain is a social domain of interrelated human practices and transactions that does not stand alone.

The preceding discussion has shown that stability is an essential attribute of an efficient financial system. After many episodes of turmoil in financial markets in both developing and developed countries, there now appears to exist a consensus on the need for prudential regulations in order to attain stability. The theory of finance suggests that because information is imperfect and asymmetric (the borrower knows more about his investment than the lender) and contracts are incomplete (lenders cannot control all aspects of the borrower's behaviour), banks implement their own quantity rationing by imposing credit ceilings, and restrict deposit and loan rates in order to avoid excessive risk-taking.

Since higher interest rates tend to reduce the average quality of loans through adverse selection (lending to high-risk borrowers willing to pay high interest rates) and moral hazard (inducing "good" borrowers to invest in riskier projects), the expected rate of return net of default will decline once the loan rate has reached a certain level. This implies that even in the absence of prudential regulations, there will be limits to price competition and risk-taking in the banking sector. However, self-restraint cannot always be relied on to prevent financial instability, particularly in developing countries. Banks tend to engage in speculative financing and excessive risk-taking provided that failure does not have serious consequences for their shareholders and managers. This happens when they can easily acquire deposit insurance, enjoy implicit or explicit guarantees for bail-out and have easy access to the lender-of-last resort facility, and when sanctions and penalties for failing bank managers are inadequate. This is often the case in developing countries where governments are often all too ready to rescue banks in trouble. The moral hazard that results is made worse by the existence of deposit insurance schemes designed to give protection to depositors and attract funds into banks. Banks often have to pay very little for the insurance coverage while having all the incentives to raise deposit rates to mobilize funds to invest in highreturn, high-risk, and often speculative projects. Furthermore, in developing countries large non-finandal corporations are often able to exert strong influence over banks, causing bank lending to be concentrated on a small number of firms, at the cost of increasing their own vulnerability. Corporate distress borrowing and Ponzi financing tend to be much more common in developing countries, and these become particularly visible and problematic during episodes of financial .liberalization. The intense competition that banks in many developing countries face from unregulated financial markets can also lead to higher interest rates and greater risk-taking.

Evidence from both developed and developing countries shows that a judicious combination of effective prudential and protective regulations is necessary to prevent financial instability. In many developing countries, however, regulations restricting excessive risk-taking and/or covering such risks are absent. In some countries government restrictions on lending to a single firm and the acquisition of real estate or shares in non-financial corporations are strict but not implemented. Legal provisions against bad assets are either absent or ignored, and capital requirements are inadequate, non-existent or unimplemented. There is widespread non-compliance even with legal reserve requirements, not always because they are especially high, but because the monetary authorities are unable to impose sufficient penalties. However, prudential regulations, while necessary, may not always be sufficient to prevent financial instability. With the freeing of deposit rates, considerable competition can build up between the newly deregulated and unregulated financial sectors, giving rise to sharp increases in deposit rates, thereby raising the loan rates and deteriorating the quality of bank assets as high-yield, high-risk lending replaces safer but lower-yielding portfolios. It is not always possible to check this process through prudential regulations on the asset side of banks' balance sheets. Pressures can develop to allow banks to enter into new lines of business in order to restore their profitability and viability in the face of higher deposit cost. Such pressures will often find favour with the liberalist view underlying interest rate deregulation, and hence result in the relaxation of constraints on types of bank lending and investment. The experience of the United States in the 1980s illustrates how easily such a process can develop. As the Fed moved away from targeting interest rates to monetarism in order to reduce inflation and the Regulation Q ceilings on deposit rates were lifted, banks with long-term portfolios with fixed interest rates (particularly mutual savings banks and Savings and Loan Associations, S&Ls) experienced serious difficulties. Considerable pressure developed for the introduction of legislation to attract deposits to these institutions (e.g. raising deposit insurance limits) and to allow them to invest in high-yield, high-risk assets. Thus, these institutions, and subsequently commercial banks, increasingly financed consumer and credit card loans, high-yield non-investment grade (junk) bonds, leverage buy-outs, real estate acquisition, and development and construction loans. A large amount of debt was accumulated by households and firms while banks acquired high-risk assets. This process ended with the collapse of the S&Ls with an estimated cost of about $200 billion, and was replaced by the debt-deflation process already mentioned. Stricter capital adequacy requirements of the type recently introduced by BIS (UNCTAD, 1992, part two, Annex I) could have helped to slow down this process but would probably not have prevented it. As there was simultaneously a speculative bubble in the stock-market, banks would have had no difficulty in raising capital on very favourable terms to cover their high-risk investment, but would have remained exposed to risks on both sides of their balance sheets. Indeed, this is exactly what happened in Japan where banks can account as capital almost half of accrued but unrealized capital gains on equities and use them to offset potential loan losses. As the stock-market was rising rapidly in the 1980s, banks counted on these gains instead of setting aside reserves against potential losses on high-risk, property-related lending. The subsequent decline in stock prices, together with the fall in property prices, thus created difficulties for banks from both sides of their balance sheets. There are also other instances of boom and bust where rapid expansion of some banks through high-risk, high-return lending increased their stock prices sharply and allowed them to raise capital at costs lower than the prudent banks. "In such cases neither public scrutiny of bank balance sheets, nor capital ratios would have prevented the propagation of the crisis". In short, competition among financial institutions can easily result in escalation of interest rates and/or excessive risk-taking either because prudential capital requirements become ineffective or pressures build up to relax controls over bank asset portfolios. Such risks are greater in developing countries. This, together with the fact that stability of interest rates and asset prices is essential for an efficient financial system, constitutes a strong case in favour of controlling interest rates as well as bank lending.

An effective way of doing this is to impose statutory ceilings on deposit and/or loan rates. Such ceilings were widely used in industrial countries until recent years. In Japan, for instance, interest rate regulations played a crucial role as a "policy-based framework established throughout the high growth period" (Kato et al., 1993, p. 122), and have not yet been abolished totally. Again, the recent legislation in the United States regarding the depository institutions (the Federal Deposit Insurance Corporation Improvement Act of 1991, Jones and King, 1992) stipulates mandatory restrictions on deposit interest rates for undercapitalized banks in the context of capitalbased policy of prompt corrective action. Since undercapitalization is widespread among banks in developing countries, the scope for the application of such restrictions must be much greater. Regulation of short-term interest rates through intervention in interbank markets is also essential for attaining greater financial stability and preventing frequent bank failures, particularly when there is considerable maturity mismatching between banks' assets and liabilities. Under such conditions, large swings in interest rates can create serious dilemmas for banks. If banks respond to an unexpected increase in market interest rates by raising deposit rates, their profits can be sharply reduced and their solvency threatened. If they do not, or if they are prevented from doing so by deposit ceilings, they may suffer a considerable deposit drain.

Banks can respond to increased swings in short-term rates with variable-rate loans or by shortening the maturities of their assets, as they have indeed done in many countries, but when done on a laige enough scale this simply transfers the interest rate risk onto the borrower and replaces it with greater credit risk. It should be kept in mind that control over interest rates through ceilings and intervention does not eliminate the need for certain types of prudential regulations to reduce financial fragility, i.e. vulnerability to default in the corporate and household sectors (Minsky, 1982, 1986; Davis, 1993). This is particularly true in developing countries where the level of economic activity is much more variable. When activity is buoyant, banks tend to lend increasingly against assets which carry considerable capital risk, including not only illiquid assets such as property but also securities; they also expand consumer credits and invest directly in securities and property. But when the expansion comes to an end and incomes and asset prices start to fall, the quality of bank assets can deteriorate rapidly, and even set off a debt-deflation process and credit crunch. Reducing the fragility of the financial system thus calls for prudential regulations designed to prevent excessive investment and lending with considerable capital risk arising from their susceptibility to changes in the pace of economic activity.

In conclusion, it should be noted that efficiency of the financial system crucially depends on the way it is organized, because that influences the nature and the degree of risk, uncertainty and instability. On the other hand, the experience of industrial countries shows that there is no single way of organizing finance. Consequently, an important issue in financial reform in developing (and Eastern European) countries is what types of financial institutions and markets need to be promoted.

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