Principles for Reform

In designing new policies for the financial sector, old-fashioned ideas are important

William Poole

THE financial crisis has caused widespread reevaluation of public policy toward the financial sector and financial regulation. Many reform plans have been proposed, but little has been settled. Political pressure on legislatures in many countries around the world is substantial, portending a collision between industry lobbying and popular conceptions, including misperceptions, of the nature of needed reforms.

Reform issues facing developing economies may seem different from those confronting advanced economies, but they are fundamentally the same. Policymakers in developing countries must maintain a vision of the financial sector they desire to foster, to avoid policies today that will make it difficult to achieve that vision. Too often policies viewed as short-term expedients create vested interests that are difficult to dismantle. The issue is particularly serious when it comes to regulatory constraints, which shape and distort the structure of financial services industries. Protected segments fight to retain their advantages, and regulatory agencies fight to retain influence. In general, there is a long record of establishing government agencies, but the record of their dismantling is woefully short.

It is also essential to have a vision of the financial structure of the future, because finance is inherently competitive around the globe, making it difficult and costly to prevent domestic nonfinancial firms from obtaining financial services abroad. Therefore, nurturing a domestic financial services industry requires attention to international competition, and that means attention to the characteristics of the most sophisticated types of financial services. Financial and nonfinancial industries face the same issues: a developing economy that aims to join the advanced economy club must be open to practices and technologies that raise productivity and income.

The financial crisis in the United States and Europe demonstrates that the financial system was defective and cannot be the basis of the financial vision for developing economies. What follows is my view of the core principles that ought to guide thinking about how to direct public policies toward financial services industries in all types of economies. I will speak loosely of central bank powers and regulators' powers, with the understanding that institutional arrangements differ from one country to another.

Price-level stability

The most important goal of a central bank should be maintenance of reasonable stability of the economy's general level of prices. Price-level stability aids economic development and helps maintain domestic and international confidence in an economy. Domestic markets, especially capital markets, function more efficiently when prices are stable.

A central bank that is successful in maintaining price stability will gain prestige and influence. Moreover—a point often neglected—when a central bank maintains price stability, it is in a position to pursue countercyclical monetary policy that will help stabilize employment at a high level.

Payments are paramount

No economy can function without a reliable mechanism for making and receiving payments. Neglecting the old-fashioned monetary functions of banks is a recipe for disaster. A commercial bank is simultaneously a monetary firm, accepting and transferring deposits, and a credit firm, making and administering loans. When the credit activities of banks create the potential for insolvency, their monetary functions are seriously impaired.

There are two defenses against the risk of bank insolvency. The first, and most important, is a *requirement that commercial banks maintain a large capital cushion* in exchange for the benefits of a bank charter. The recent financial crisis demonstrates that traditional standards of bank capital were not adequate. Banks should be required to maintain minimum equity capital of 10 percent of assets. In addition, 10 percent of total liabilities should be in the form of subordinated long-term debt, which the bank may convert into equity on maturity (sometimes called "contingent capital").

A stiff capital requirement serves several purposes. It maintains market confidence in the solvency of the banking system, imposes substantial market discipline over the activities of banks, and provides a large cushion to protect taxpayers from the risk being called on to bail out failing banks.

The second defense against bank insolvency is *regulatory oversight*. Banking systems generally enjoy government-provided deposit insurance. Oversight is necessary to protect the deposit insurance fund. Banking authorities should be charged with the single function of maintaining safety and soundness of banks. Banks should not be used to provide government-directed development finance. Strong banks are central to the development process, but their credit activities should be motivated by private-market considerations.

There are dangers to using banks as development agencies. One is that banks will be pressured into making loans that are not safe. A second is that government-directed bank credit activities are off budget. A government that wants to encourage development lending should do so transparently through government credit agencies whose resources are provided through the usual legislative process. Alternatively, governments can choose to subsidize private development firms. Because of the critical importance of banking stability, banks should not be a directed part of development finance.

The poison of excessive leverage

The primary cause of the current financial crisis was excessive leverage, especially in the banking system. In the context of U.S. experience over the past decade, it is interesting to compare the dot-com stock bust early in the decade with the subprime mortgage bust that started in 2007. Both episodes were characterized by a mania for risky assets that wound up visiting large losses on investors; however, only the subprime bust resulted in a financial crisis. Common stock was held largely in unleveraged accounts—in individual and mutual fund portfolios. Subprime mortgages and the securities issued against them were held in highly leveraged accounts in commercial and investment banks and some hedge funds.

Despite the poison of excessive leverage, tax systems generally subsidize debt by making interest a deductible business expense but not dividends on equity. Public policies that subsidize leverage make no sense. Individual and business income tax systems should phase out deductibility of interest and reduce tax rates to compensate, so that the reform is revenue neutral.

Regulatory discretion

Most regulators, most of the time, believe they can function more effectively if they have broader powers. That view needs to be challenged.

Every official in a democratic society functions under political constraints. A central bank governor, for example, knows that the position does not carry unlimited power, no matter how broad the statutory authority. At issue is always which actions can be pursued in the current political environment. Equally important, clear thinking about financial structure calls for consideration of the powers a central bank should *not* want to exercise, but might feel compelled to use if such power is contained in the controlling legislation.

For example, should a central bank buy obligations of private firms and local governments? If the answer is, as I believe it should be, that the central bank should not provide such loans, then it should not have the power to do so. Loans to entities other than banks should be the responsibility of the elected government. Emergency authority should be narrowly drawn, perhaps requiring formal assent from the prime minister or president to ensure that central bank resources are not misused. The issue is not that central banks will routinely misuse their lending powers but that political authorities will misuse central bank powers. Requiring political assent increases the transparency of central bank lending to nonbanks and places responsibility for such loans with political authorities, where it belongs.

Central bank lending ultimately depends on the power to create money; exercising that power wisely is necessary to maintain the purchasing power of the currency. Central bank independence from day-to-day political control is the best protection from inflationary finance. This is why a narrow definition of central bank powers and responsibilities is essential.

It is helpful to think through in advance which powers agencies need and should have. Arguing for extremely broad and vague power in the name of flexibility can be, I fear, a result of the failure to think issues through clearly. Every scholar knows how valuable the teaching experience is in sharpening ideas. Every regulator should be asking questions of this kind: If X happens, what should my agency do? What powers are needed? If Y happens, will those same powers be subject to abuse through the political process?

Over time, senior leadership in every agency changes. How confident can we be that future leaders will exercise broad authority wisely? When contemplating legislative changes, a good rule is to presume that future leaders will not have the same competence and motives they have today. Controlling legislation should constrain rather than enable future leaders, which is the only way to provide markets reasonable assurance of sound policies.

Old-fashioned, but important

The financial crisis demonstrates the continuing importance of some old-fashioned ideas. Because a banking crisis creates a general economic crisis, the laws and regulations that govern the financial sector must above all maintain stability in the commercial banking sector. Banks must focus on relatively low-risk lending and maintain substantial capital. The powers of regulatory agencies must be carefully designed; excessive power invites political misuse and creates market uncertainty about authorities' actions.

There must be much more effort to change the incentives for financial firms. Changing tax laws to encourage less leverage and larger capital requirements for banks will lead to a more stable financial system. Although financial crises have been a staple of market economies for centuries, we know enough about their causes to design policies to make such instabilities much less common in the future. ■

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