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REVIEWING THE GLOBAL EXPERIENCE WITH ECONOMIC REGULATION -A forward looking perspective

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Toward a 21st Century Regulatory System

Your Excellencies,
Ladies and Gentlemen.

I am delighted to present this address on behalf of Mr Ajay Chhibber, Assistant Secretary General and Assistant Administrator UNDP, who sends his regrets as he unfortunately, could not be here himself.

I quote:

It is a great honor to be invited to speak to you today on a subject which will shape the future of economic progress in the 21st century. I will focus my brief remarks on two broad issues:

First, some thinking on the changing role of the state and regulation with the global financial crisis and the looming issues of climate change – the ultimate market failure. These new regulatory systems must be embedded in national regulation but with clear guidelines of basic international regulatory standards in a globalised world. Second, I will try and offer some thoughts on the role of competition versus regulation and issues around competitiveness. Let me take up these issues in sequence.

[1] Presented by Patrice COEUR-BIZOT, UN Resident Coordinator and UNDP Resident Representative, India

First, I think it needs to be recognised that the global financial crisis has brought the state roaring back, with large stimulus packages and overhaul of regulatory systems. It is to be welcomed – but only up to a point. Today, we need a smarter, more active state, not necessarily a bigger one.

In the decade before the crisis, the role of government was under attack almost everywhere. Alan Greenspan, the former chairman of the US Federal Reserve, expected the markets to self-regulate in their own interests. International institutions pushed for open capital accounts. Privatisation was promoted as the answer to the problems of the developing world.

In the post-colonial world, likewise, state-led development had become the accepted model. But the post-1980 period saw a reversal. Total government expenditure as a percentage of GDP declined in 43 developing countries – from 19.3 per cent in 1980 to 16.3 per cent in 1998. Asia experienced the most rapid decline – from 19.1 per cent in 1980 to 15.2 per cent in 1998. In spite of this, Asian countries succeeded in lifting millions out of poverty. Even in East Asia, crony capitalism, and not open capital accounts, was seen as the cause of the 1997-98 Asian financial crisis. This led to further cutbacks in public investment and social expenditure programmes.

So what is the appropriate role of the state after the financial crisis and what lessons can we draw on regulation? In the developed world, a permanent expansion is impossible, especially as ageing populations put further pressure on public finances. With almost half of GDP in state hands, it is not surprising that large stimulus packages helped stop the markets going over the edge. But with public debt in the developed world exceeding GDP, there is less scope for fiscal activism. If economies sink back into recession, further fiscal expansion could unnerve markets. In the long run, debt sustainability may require a fundamental review of the welfare state.

It is too early to predict the demise of the nation state. The state remains the ultimate protector of people's interests as markets overreach, on both the upswings and the downswings of capitalism. Self-regulation – à la 16th-century Scottish bankers – or a light-touch regulatory system cannot be the solution for the modern financial world. A coordinated, activist and sceptical regulatory system is needed.

The Group of 20 and more broadly the UN can play a bigger role. The pro-cyclical nature of regulation brought about by a number of factors; mark to market, ratings agencies prone to inflate ratings in good times, cash reserve ratios calculated to look better in good times were all factors that led to pro-cyclical regulation. Globalisation reduced perceptions of risk as no one regulator had a complete picture of balance sheets. Clever financial players were able to package risk in ways designed to avoid regulation.

In the post crisis scenario, the new important variable that is being sought to be addressed globally is the oversight of systemic risk. It is being acknowledged that institutional regulation alone is not sufficient in capturing and addressing systemic risks and it is imperative to have a mechanism to monitor and act upon the risks inherent in the interconnectedness across the financial system – a macro-prudential approach to regulation and supervision. It is now better appreciated that systemic risk is created endogenously rather than having exogenous origins beyond the remit of financial markets.

Basel prudential norms in terms of regulatory capital prescriptions and loan loss provisioning are widely considered as exacerbating the pro-cyclicality of bank credit. In India, prior to mid-1980s, cyclical movement in bank credit could not be traced. Since mid-1980s, upward/downward swings in bank credit are clearly observed to be associated with similar movements in GDP. One possible explanation for prominence of credit pro-cyclicality since late 1990s could be due to the fact that banks gained considerable freedom in business decisions moving away from the administered regime of the past.

Asian-style state-led capitalism has performed well during the crisis. With low public debt at around 40 per cent of GDP (India being an exception with much higher levels of debt), Asia has shown the world that future capitalist development depends on an activist state, but not necessarily a large one. Regulatory systems were more hands-on and in any case with much lower levels of financial liberalization put constraints on the ability of financial markets to take risk. The clean up of financial systems in the 1997 crisis in several countries in Asia was also a major factor in helping Asia avoid being hit very badly by this global crisis.

With global warming – the mother of all market failures – looming, the role of the state becomes more critical. Investment in green technologies and public infrastructure must be the priority. There is now a serious danger that the world's polluting industries will shift to the developing world with much weaker environment regulation. We need more globalized rules on environmental regulation which ensure that pollution will not be dumped on the developing world, but we must also ensure that there is flexibility and resources made available to developing countries through green energy mechanisms to adjust. More grant financing is also needed as we see that in Asia much of the new green financing have largely gone to China and India.

Most smaller developing countries do not have capacities to access such financing. Even so we have already seen this in the case of China which has lifted millions out of poverty but at a huge environmental cost with weak environmental regulation. Paying for the clean up is far more costly afterwards.

In India, economic growth is led by robust performance of the industrial sector. Impressive growth in manufacturing (9.4 per cent average over the past 17 years) is a reflection of growth trends including electronics, textiles, pharmaceuticals, and basic chemicals. These industries, belong to the "red category" of major polluting processes designated by the Central Pollution Control Board (CPCB), and have significant environmental consequences in terms of water effluents and/or air emissions and hazardous wastes. The economic boom has also led to an increase in investments and activities in the construction, mining, and iron and steel sectors. This, in turn, is causing a significant increase in brick making units, sponge iron plants and steel re-rolling mills that use highly polluting processes. The result is a visibly deteriorating environmental quality and highlighting the importance of stepping up efforts to manage the externalities of accelerated growth.

A second major issue I would like to briefly touch on is competition versus regulation and loss of competitiveness from over regulation.

Governments sometimes restrict competition in a wide range of sectors by inappropriate regulating markets for factors of production, such as labour, land and investment. They try to prevent abuses and correct market failures, but their efforts frequently have unintended consequences. For example, labour market regulations that protect jobs often constrain employment. Similarly, regulating land and property can slow growth by inhibiting capital investment and industrial consolidation. India is still suffering from some of this type of over-regulation: especially on labor regulation. This type of labor regulation ends up hurting rather than helping labor and reduces competitiveness. In India tight labor legislation has deterred manufacturing investment and has encouraged what is termed casual labor and has in fact hurt labor and employment. It is time for India to address these issues if it is to maintain more inclusive growth in the 21^{st} century.

In some countries, the biggest constraints on economic growth result from inappropriate and unevenly enforced regulations in naturally competitive manufacturing and service sectors. For example, to protect local industry and employment, governments create barriers such as import tariffs and restrictions on foreign direct investment. But protection of this kind insulates local companies from competition and so removes their incentive to provide better and cheaper goods and services to the society. We have seen removal of such protectionist policies the world over and even with the financial crisis we have not seen very visible return to protectionism so far. But there is scope for more – for example tariffs between south-south countries are still three times higher than tariffs between the south and the North.

To conclude, although regulations must continue to protect the countries' safety, health and environment, sometimes, those rules can get out of balance, placing unreasonable burdens on business—burdens that have stifled innovation and have had a chilling effect on growth and jobs. There is no manual for implementing market-supporting regulations. When regulators define rules of competition in areas such as predatory pricing and intellectual property, they must constantly strike a tricky balance.

Rules and standards to protect consumers must be sufficient, but not so costly as to discourage innovation and halt progress. Governments are too inclined to frame policy through trial and error, confusing economic goals with political and social ones. Although such experiments often reflect genuine choices about the type of market competition a society wishes to have, pressure from special interests for state intervention may not be benign and may completely undermine the economic rationale for regulation. Finally, crafting regulations that encourage rather than hinder competition and growth is increasingly tough at a time of accelerating technological change and economic uncertainty.

So to conclude let me say that a new 21st century regulatory system must be built on the principle that we are now facing issues which carry huge systemic risk globally whether it comes from the financial sector or whether it comes from climate change environmental issues or from issues of competitiveness. We live in the 21st century in a global commons and needs a global regulatory approach to address issues of market failure. At the same time we know that institutional regulatory structures must be national and local. We need then clearer global regulatory standards – mutually agreed - which are applied in national and local settings. “Think global but Act Local” applies as much to regulation as it does elsewhere. The role of the UN and the G-20 in helping shape such rules becomes critical.

Thank you very much and I know these and many other interesting issues will be intensely debated and discussed in the next two days. I have not discussed many important aspects of regulation such as its role in access, issues of corruption and transparency and the role of judicial activism and civil society in enforcing and monitoring regulation, but I am sure that the many experts in this room will speak on these subjects over the next few days. At the end I hope the conference will provide us with a clearer direction of a regulatory approach which will drive us forward towards a better world. I wish your conference great success and once again wish I were with you.

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