International Conference on Reviewing the Global Experience with Economic Regulation – A Forward Looking Perspective

Inaugural Address

by

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Good evening distinguished ladies and gentlemen. It is an honour to address this gathering of international experts on competition and regulation. I am indeed happy that CIRC and CUTS are hosting this very timely event. I do hope that the deliberations of this conference will facilitate in the formulation of a forward looking agenda of economic regulation.

Until 1990-91, the Indian economy and more particularly the industrial and commercial sectors were subjected to a lot of controls. Competition laws had no place in such a scenario. In fact the MRTP Act had a different orientation. The major thrust of the new economic policy is to improve the productivity and efficiency of the system by injecting a greater element of competition. Hence, the need for competition laws and regulatory oversight to ensure that competitive conditions prevail in every market. Sectoral regulations are needed in those sectors where public policy considerations are dominant and where quasi monopolies emerge because of the nature of the products supplied. In the real world well functioning markets and cases of market failure co-exist. Unnecessary regulations of well functioning markets and the lack of such interventions in the case of

market failures are both associated with serious consequences. Broadly speaking, there are three objectives before regulation. These are: (1) promotion of investment, (2) protection of consumers to ensure that the services and products provided are at an appropriate quality and appropriate prices, and (3) attainment of efficiency in the production of goods and services. With a view to ensuring competition, the modern competition laws seek (a) to prohibit anticompetitive agreements such as cartels, (b) prohibit abuse of dominant position through unfair and discriminatory prices, and (c) regulate combinations such as merger and acquisitions.

While the regulator needs to intervene to overcome genuine problems in markets, it should also desist from overregulation. By regulating entry with a heavy hand, the regulator may restrict competition leading to overpricing and poor quality. For example, in the case of financial sector while prudential regulations including minimum capital requirement as well as 'fit and proper' criterion may be appropriate, they should not be stretched to such an extent that they inhibit entry of new institutions.

In any economic system, State can play many roles. One can identify three important roles: (1) as a producer of marketable goods and services, (2) as a 'regulator' of the system, and (3) as a supplier of "public goods" and "merit goods" like primary education and public health. While the role of the State as a producer of marketable goods and services is decreasing, its role as "regulator" is becoming increasingly important. The regulator comes into play in order to maintaining competitive conditions in a market and to ensure that everyone follows the basic rules of the game.

The need for expertise in the regulatory institutions has become obvious in the current international financial crisis. What stands out glaringly in the current episode is the

regulatory failure in the developed countries. The regulatory failure has been of two types:

(1) regulation was soft or almost absent in relation to certain segments of the financial markets, and

(2) there was an imperfect understanding of the nature of the derivative products.

In one sense, derivative products are a natural corollary of financial development. They meet a felt need. However, if the derivative products become too complex to discern where the risk lies, they become a source of concern. Rating agencies in the present episode were irresponsible in creating

a booming market in suspect derivative products. What is, however, important to understand is that there was a mismatch between financial innovation and the ability of regulators to monitor them. It is ironic that such a regulatory failure should have occurred at a time when intense discussions were being held in Basle and elsewhere to put in place a sound regulatory framework. Nevertheless, it is a pity that the regulators were not able to grasp fully the implications of the financial products which they approved implicitly. All these point to the need for building up appropriate expertise in the regulatory institutions. This is apart from the need to take a fresh look at the approach to

regulation. We need to draw appropriate lessons from the current international financial crisis. Too little regulation may encourage financial instability but too much of it can impede financial innovations which are badly needed. Regulatory oversight of innovations is necessary. But the regulatory perspective on innovation must not become too restrictive. In short, the policy makers must strike an appropriate balance between the need for financial innovations to sustain growth and the need for regulation to ensure stability. Financial innovations and regulations must go hand-in-hand in order to ensure growth with stability in real and financial sectors.

In principle, three broad institutional forms of regulation can be identified: (a) the regulatory authority is integrated into the normal government machinery, notably where it is a department of the ministry and controlled by the bureaucrats and minister, (b) the semi-independent agencies with some independence from the ministry but where decisions can still be overruled by the superior government authority, and (c) an independent agency where there is no right of appeal to a superior government authority, though there will a right of appeal to courts to ensure fairness and rationality in the decisions making process. It is indeed important that regulatory institutions move towards the third stage.

However, it is important to recognize the safeguards that need to be built into such a scheme. Regulators need to be careful to ensure that there is no "regulatory capture" either by political interests or other interest groups.

The regulation of individual sectors has to be consistent with the overall framework of maintaining competition. The existence of a large number of sectoral regulators together with competition authority may raise issues of overlap and friction. In general, it is best to leave the determination of competitive principles to competition authorities and for

sectoral regulators to focus on specific issues relating to their sectors.

Regulation must aim to achieve both effectiveness and efficiency. Effective regulation aims to achieve the social welfare goals set down by the government for the regulator. This can be ensured by regulation affecting (a) the structure of markets, and (b) conduct in markets through appropriate incentives and penalties. Efficient regulation, on the other hand, aims to achieve the social welfare goals at minimum economic costs. It remains a constant struggle for the

regulatory body to strike a balance between effectiveness and efficiency.

Regulation has thrown up many issues in the course of implementation. By now, there is a fairly rich historical experience. Best practices in this regard should be discussed and shared widely. I am quite sure that this conference will provide such an opportunity.