XXII. Issues in Financial Regulation: Efficiency, Stability, Information

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1. INTRODUCTION

Economic analysis suggests that regulation is justified and wanted when market mechanisms reveal shortcomings. Design and control of the financial industry and markets can be both explained and warranted along these lines.

The credit and monetary system is characterised by fundamental externalities, notably insofar as it affects overall economic welfare. The workings of monetary policy on the one hand, and, on the other, price stability, the efficient inter-temporal allocation of resources, sectoral resource transfers, and economic growth, all depend upon the correct functioning of the financial system.

Asymmetric information is an important feature of the financial sector, with opposite types of problems encountered, in principle, in the banking and in the insurance industries. On this count too, “failures” in the working of the market manifest themselves: both sources of market failure can be seen as instances of missing markets.

A third source of welfare-loss is related to market power. In this respect, among the many possible causes of market failure, non-competitive behaviour of existing firms with significant oligopoly power appears to be the most relevant one in financial markets. Lack of competitive pressures implies allocative as well as productive and dynamic inefficiencies.

The very functioning of financial markets requires therefore regulation, which should however be designed in the light of market deficiencies, and with a view to preventing them, or, at least, to warding off their negative effects, insofar as possible. In this framework, the process of regulatory design should be also steadily updated to reflect changes in relevant economic forces. Technological advance, modifications in savings patterns and modes, adaptations in instruments and techniques of monetary policy, market size..., are all factors which impinge upon failures in financial markets, and hence on the optimal design of regulation.

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In practice, instead, traditional divisions within the financial markets, often inherited from the 1920s and the 1930s, had ossified regulatory frameworks over a nearly fifty-year span. The Great Depression – which was at the time interpreted as a major endogenous market failure, related to and compounded by the close links between industry and finance – set off a flood tide of regulation, retreat, and disintegration of the national financial markets. This led notably in many countries to strict separation of functions and activities in the financial markets which implied a decline in contestability. In turn, this went hand in hand with an increase in oligopoly forces in financial markets. In some countries dominated by strong statist pressures, regulation of the financial sector took the extreme form of nationalization.

The regulatory process came thus to be flawed by a fundamental confusion of cause and effect. As is now abundantly clear, the Great Depression was the result of basic failures of monetary and fiscal policies of the major countries in a beggar-thy-neighbour context, not to specific failures of the financial system.

In the 1970s and in the 1980s fundamental economic forces set in motion a long overdue process of financial deregulation, first in the international markets, then domestically in all major countries, albeit to different extents and in different degrees, in part as a consequence of the profound diversity in inherited control systems.

However, it soon became clear that deregulation had to be accompanied by re-regulation. Because of the very nature of the financial system, the two processes should be seen as complementary. Rapid growth and diversification of financial transactions, technological change, new market dimensions, securitization and financial innovation proper, all required new approaches to "market design". Innovative regulation was – and is – required to create efficient market structures. Operative rules on intermediaries; methods, techniques and transparency of brokerage, dealing and settlement in securities and money markets; rules of conduct and definition of standard products and qualities in markets for financial futures, options and swaps: all these are instances which require specific, innovative and mutually consistent regulatory frameworks.

This paper is an attempt to put such processes of de- and re-regulation into an economic perspective, within the context of globalization of financial markets, with a view to improving both their efficiency and their stability. Section 2 offers an analytical assessment of regulation in financial markets, while Section 3 contains a brief overview of recent developments in Europe, Japan and the United States. Section 4 draws some general conclusions.

The emphasis will be on an internationally co-ordinated approach towards financial regulation leading to contestable markets, reducing information