

# Comments on Borio and Drehman's "Operational Framework for Financial Stability"

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# Contribution of this paper

- Comprehensive review and critique of policies to avoid financial instability
  - Analytical frameworks
  - Measurement issues
  - Prudential policies and institutions

# Contribution of this paper (cont.)

- Conclusion: The right approach should consider
  - Forward looking indicators
  - Complex inter-linkages: Endogenous cycles
  - Macroprudential (rather than microprudential)

# A question of emphasis...

- Most of the literature stresses ***market failures***
- For developing countries, ***government failure*** is at least as important

# 1. Imbalanced regulation:

## *Financial Innovation*

- Financial innovation tends to occur in unregulated sectors/products
- Why? A “transfer” effect:
  - When standard financial sector is overregulated, innovation will occur elsewhere
- A different perspective on the current crisis?
  - The claim is that “lack of regulation” is the culprit
  - But, regulation may be forcing innovation to the margins, where it takes riskier forms

## 2. Wrong regulation

- Regulation that forces financial institutions to take overly risky positions
- For example,
  - Directed credit to “preferred sectors”
  - Holdings of government bonds: Argentinean pension funds – 55% of their portfolios

# 3. Wrong incentives

- Bail-outs and rescue operations
  - U.S. and developed countries now?
- Implicit insurance
  - Fixed-exchange rate regimes: Brazil up to 1998 and Argentina up to 2000
- Nationalizations
  - Argentinean pension funds – back to public mismanagement
  - Reaction: 24% drop in stock market in two days

# Conclusion

- Yes, markets may fail and lead to crises,
  - particularly financial markets: complex, systemic interlinkages
- However, specially, in developing countries crises are many times induced and promoted by governments:
  - *Healer, heal thyself!*
- Implication: ***monitor government also***