ELSEVIER

The Journal of Socio-Economics 35 (2006) 48–71

The Journal of Socio-Economics

www.elsevier.com/locate/econbase

A new theory of financial regulation: Predicting, measuring and preventing financial crises

Carolyn Currie *

School of Finance and Economics, University of Technology, Sydney, Kuring-gai campus, P.O. Box 222, Lindfield, NSW 2070, Australia

Abstract

The frequency of financial crises in the last 20 years can be attributed to the lack of a comprehensive theory of financial regulation to guide policy makers. Existing theories fail to define the range of regulatory models, the causes of regulatory failure, and how to measure and prevent it. Faulty design of regulatory models, and the lack of ongoing performance monitoring incorporating early warning systems, is disrupting economic and social development. The new theory illustrates the necessity for a staged approach to liberalisation, which first assesses the capacity to conduct effective prudential supervision, before attempts are made to remove protective measures.
© 2005 Elsevier Inc. All rights reserved.

JEL classification: K200; N250; O160; P000

Keywords: Regulatory models; Economic systems; Development

1. Introduction

The failure of economies to deliver traditional goals of economic and social development, which in the extreme result in financial crises, has resulted in a rethink of the role of governments in regulating the financial system to better promote such goals and prevent such crises, both in advanced and emerging nations, and in economies which range from command to free market. These financial crises have become more frequent in the last 20 years according to Caprio and Klingebiel (1999/2003), who have identified 117 systemic banking crises (defined as the exhaustion of bank capital) occurring in 93 countries since the late 1970s. Lindgren et al. (1996), using a less stringent definition than that of Caprio and Klingebiel of zero or negative net worth of the entire banking system, concluding that 75% of IMF countries had significant

* Tel.: +61 2 95145450; fax: +61 2 95145515.
E-mail address: carolyn.currie@uts.edu.au.

1053-5357/$ – see front matter © 2005 Elsevier Inc. All rights reserved.
doi:10.1016/j.socec.2005.12.004

bank sector problem in the period 1980–1995, with 87 countries experiencing a currency crisis between 1975 and 1995.

Existing theories of regulation not only fail to define what constitutes a financial crisis, but also explain causes and prevention, as well as provide a basis for measuring severity and anticipating via an early warning system. In part this derives from failure of existing theories of regulation to put forward a cogent argument for the role of regulation of financial systems, to specify who are stakeholders and to define what outcomes are likely from incorrectly or correctly designed regulatory models. Existing theories of financial regulation fail to incorporate concepts of economic and social development which emphasise the importance of appropriately designing and tailoring regulatory models to the specific stage of growth of the underlying society and economy.

Assumptions as to the correct regulatory model are evident in ratings ascribed to nations. When categorising political risk as an input into country risk rating models, rating agencies put at the lowest end of the scale government controlled economies, while free enterprise economies are given the higher rating, without identifying the rationale for this assumption (Nagy, 1984). Even after the 1998 Asian crisis the "Washington Consensus"[1] continued to promote free market policies of privatisation, liberalisation of the financial system and removal of government controls as a panacea for emerging nations and financial crises, not recognising these as means not ends, and only capable of being effective if the economy has reached a certain stage of growth.

Defining regulatory change necessitates understanding the way financial systems can evolve (see Table 1). A taxonomy of regulatory models is a prerequisite as it outlines the diversity of permutations and combinations that can exist across financial systems, and hence how regulatory failure resulting in financial crises can occur by governments changing the regulatory model governing a financial system without a clear understanding of their own goals, the available economic resources and infrastructure, the legal system and quality of human capital necessary for compliance with regulatory standards, as well as limiting factors such as existing ownership structure and barriers to change all of the aforementioned factors.

This paper puts forward a theoretical basis for future research, which could use both case study methodology as well as test hypotheses based on aggregate data from emerging and advanced countries, providing a basis for the construction of a model which would permit cost effectiveness of different types of reform packages of financial systems to be measured. The theory relies on several key relationships, a taxonomy and a scale for measuring financial crises that then permits the prediction and measurement of regulatory failure and its corollary, regulatory success. The theory will provide the basis for testing the claim that the major ingredient for successful regulatory outcomes is the development of a monitoring system relying on a combination of the micro and macro measures used in this study, which permits feedback, and allows early warning and crisis management.

This paper is organised as follows. After defining regulatory failure (Section 2), it puts forward a new taxonomy of regulatory models for financial systems (Section 3). In Section 4 it expounds the elements of a new theory of Financial Regulation and the hypotheses and related empirical tests. This provides the basis for a second paper which will empirically test these hypotheses to determine if regulatory failure in an advanced nation derives from similar causes as in an emerging nation and determine if there is an optimum regulatory model which can be applied to an emerging nation. The final Section 5 discusses the new research paradigm which has its foundation in this new theory of Financial Regulation.

[1] This was first described by Williamson (1990), practiced by the IMF and criticised by Stiglitz (1998b).

Download English Version:

https://daneshyari.com/en/article/970569

Download Persian Version:

https://daneshyari.com/article/970569

Daneshyari.com