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Aspects of Regulatory Efficiency and Effectiveness

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Theoretical underpinnings

- One of the core issues in economics is the organisation of production and the allocation of the resulting output among consumers.
- To allocate capital across space & time requires contracts to link providers and users of capital.
- Without access to multiple investors, many production processes would be constrained to sub-optimal scales.
- Growth suffers when frictions hinder the flow of resources to the best possible uses.

What does the financial system do?

- The financial system helps to overcome these frictions in part by:
  - Producing information about potential investments & alternatives for allocating capital;
  - Monitoring investments to ensure adherence to the contracts consumers and investors hold;
  - Mobilising and pooling savings;
  - Enabling the trading, diversification, and management of risk; and
  - Facilitating the exchange of goods and services
- How efficiently it does so facilitates economic growth

The perfect market benchmark

- Economists embrace the theoretical construct of the ‘perfect’ capital market as a benchmark for optimal resource allocation
- In a perfect capital market:
  - Consumers and service providers make decisions that reflect all relevant information (i.e. there are no *information imperfections*);
  - Both consumers and service providers act as price takers (i.e. there is no *market power imbalance*);
  - Market prices reflect all costs, including to third parties (i.e. there are no *externalities*).

The *raison d'être* of regulatory intervention

- The perfect market example is useful in understanding real markets in the sense that any inefficiency that arises in actual market economies can be traced to a violation of at least one of its assumptions.
- In theory, if the financial system can function efficiently on its own, regulatory intervention may not be justified, at least not on purely economic terms
- In practice, one or more of the implied ‘market failures’ are often present in real market economies.

The existence of market failures

- When market failures exist, financial markets may not efficiently manage financial risk, may not allocate resources across space and time optimally, and may be subject to other weaknesses.
- There are real economic costs associated with the misallocation of resources.
- It is the existence of market failure and an assessment of the implications of said failure on economic activity that provides a *prima facie* case for some type of corrective measure.
- Various measures can be used to address market failures. Depending on the type of failure, they may include incentive mechanisms, competition policy, improving financial education, as well as direct regulatory intervention .

Prerequisites for financial system efficiency

- A preliminary step is to ask if the necessary infrastructure is in place:
  - Sound fiscal and macroeconomic policies & monetary controls
    - Support sustainable aggregate economic activity
    - Constrain major internal & external imbalances
  - Well-developed infrastructure for financial services
    - Reliable accounting, auditing, legal & judicial, and tax systems
  - In theory, if the financial system can function efficiently and stably when these pre-conditions are met, no further steps may be needed.
  - In practice, financial services have been susceptible to periodic problems of illiquidity, insolvency, and fraud.

Establishing proper policy objectives

- Ask next, what are we trying to achieve. The fundamental objective in correcting market failures is to achieve *efficient market outcomes*.
- If the problem is not correctly identified, it becomes difficult to specify proper corrective mechanisms.
- There is no one-to-one mapping between the objectives of financial policy and the mechanisms available to achieve them. There should be a clear understanding of the manner in which a full complement of alternative measures may further the desired objective, but only those measures that <u>directly target</u> the particular problem identified in the market failure analysis.

Mapping the objectives to actual policy choices

- Market failures have their origins in the characteristics of market participants, the products and services offered, and the structure of the market. Thus, these factors are important considerations in the regulatory decision making process.
- Policy makers must strike a balance between relying on competition and relying on regulation. Competition is necessary for an efficient market in financial services, but it is not sufficient. Competition (and market discipline) alone cannot resolve all of the market failures in financial services.
- Regulation is also not a sufficient requirement for the attainment of efficient economic outcomes, though it sometimes is necessary. Regulation can have significant effects on markets and, hence, on social welfare. For example, regulation that inhibits competition in markets that would otherwise be structurally competitive raises the cost of entry, and can result in lower output, higher prices for consumers, and less innovation.
- The ideal response requires a proper balance between addressing the market failure and allowing financial institutions and markets to perform efficiently the functions for which they were intended.