Emerging markets and the emergence of new economic paradigms

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The world is changing fast and we regulators must understand what is going on and act accordingly. I want to refer to two main topics: the new status of Emerging markets and the intellectual challenges we regulators are confronted with as a consequence of this crisis.

Emerging markets are no longer a homogeneous small and underdeveloped group of countries. Today Emerging markets provide the world with the most serious hope of economic recovery. From China and India passing through Brazil, South Africa and Korea up to Chile Malaysia and Peru, among several other jurisdictions world growth will rest on the potentials of these economies.

Emerging markets do also “emerge” as partners in which developed countries may find interesting and valuables standards and practices. Just two examples of countries I know better.

In Chile we never had originators of securitized bonds not retaining the junior portion. This created a double positive effect: originators were keen to finance good credits and were extremely interested in maximizing the efficiency of the repayment process.

In Brazil, financial institutions can only offer registered products so in practice almost all OTC derivative contracts are registered in one of two central entities, one being the depositary and the second one the central counterparty at BMF Bovespa.

Brazil and Norway are unique cases of this desirable situation.

I am being unfair as there are several other examples in Emerging Markets that I should also mention, but time doesn’t allow it.

At the IOSCO Emerging Markets Committee we are seeking best practices in Emerging Markets that could serve us to foster this important segment but that could also serve as inspiration for our

developed markets friends. We are currently working in a Task Force on Securitization in Emerging Markets, headed by SEBI from India and CNBV of Mexico and in partnership with the International Monetary Fund in order to identify best practices.

We also hope to start soon another task force on OTC derivative markets in Emerging Economies.

Let me now turn to my second point: the conceptual framework underlying our regulatory landscape.

The starting point is simple: the crisis arose in the most performing world financial centres, those with ex ante better standards and with the most sophisticated actors, public and private.

In my view this has two readings.

One reading comes from practice. Simply put: we need to improve implementation of our own principles. There are good principles out there, but not all of them are properly implemented. We need to identify them but most of all, we need to understand why implementation has been weak in some cases.

The second reading comes from theory. From a conceptual viewpoint, our regulatory approach has various roots but owes much to the Efficient Market Hypothesis. The current crisis has put under discussion those theories but in particular this one.

A simple formulation of Fama's Efficient Market Hypothesis could be the following: provided that there is enough and timely information, traders will not miss the opportunity to make a gain if they are allowed to.

Let's get slightly into two details.

The first detail is "provided that there is enough and timely information". We securities regulators are permanently looking after more transparency. We believe information is necessary for markets to work properly. But, what do we mean by enough information? Is it "enough information" the one contained in prospectuses of hundreds of pages? Is it enough the output of extremely complex models? Is it enough the innumerable quantity of notes to financial statements under IFRS? This crisis suggests that eventually not. We now know that most of that information nobody read it and eventually only few people could understand.

In practice despite hundreds of Gigabytes of information, investors did not take into account all relevant information.

The second condition has to do with the former hero, “the trader”. We think of the trader as the one rational agent that using all relevant information would take “optimal decisions”. There is too much evidence that this was not the case.

Olivier Blanchard, Chief Economist of the IMF, said that investors replicated the price pattern of the last couple of years to forecast the behaviour of real estate prices for the next couple of years. (IMF, 2009)

Ben Bernanke, Chairman of the Federal Reserve, testifying before Congress on September 23, 2008 said that “The troubles at Lehman had been well known for some time, and investors clearly recognized- as evidenced by the high cost of insuring Lehman’s debt in the market for CDS- that the failure of the firm was a significant possibility. Thus we judged that investors and counterparties had had time to take precautionary measures” (Caballero and Kurlat, 2009)

Rationality will be more properly understood after this crisis and regulation should learn from this. How bounded or limited is the economic agent's rationality?

We know recognize that

- successful traders have an exaggerated good opinion of themselves such that they believe they can beat the market, a belief that in itself contradicts the Efficient Market Hypothesis
- people tend to stick to prior beliefs, even if new information contradicts it
- independent directors may be subservient,
- etc...

I suggest that beyond the rationality argument, there are two other elements we must consider:

1) Corporate governance. Most "traders" are not individuals but legal entities, firms that have a strategy and structures of control and surveillance. We have discussed about compensation, but for the subject is far more complex. How do boards work? Which incentives they face? Why don't

they want to hear bad news and prepare for facing risks? Does it help to have a strong majority shareholder?

2) Competition. We need to take a closer look at how competition takes place in financial markets. Competition induces innovation, but innovation quickly spreads across the financial sector. So we end up in a situation with significant herd behaviour. The outcome of this is the following: behaving well, namely being prudent in terms of risk taking may not be a dominant strategy when all other participants play risky bets. This vicious circle must be handled through regulatory action.

Therefore, the world has changed and we regulators face an enormous task ahead. The Emerging Markets Committee that I have the honour to Chair and their member countries are actively participating in the various instances within and outside IOSCO.

We need to understand what has happened in the world's most sophisticated financial centres. We are ready to collaborate in that process contributing with our experience of previous crisis and the good practices that several of our fellow emerging markets have developed in the last successful years.

Finally, I would like to share with you some findings of our last survey on the financial crisis in emerging markets that we started developing one year ago. In the last survey there some issues that need attention from our side:

First, it appears that while macroeconomic risks have receded, financial risks have increased. In particular, emerging market regulators appear to be concerned about the illiquidity in several markets, the repatriation of foreign capital and withdrawal of lines of credit.

Second, all stakeholders must be aware that several jurisdictions have reported that there are emerging political risks.

Third, and to some extent in contradiction to the last points, it appears as if Emerging market regulators were starting to look the world closer to the "business as usual approach", namely, one in which systemic risk is not relevant. The FSB has asked all regulators to consider systemic risks in our daily work and IOSCO is giving to this issue a prominent role for the future.

We have made enormous progress in the last months to avoid a worse situation, but the challenges ahead are huge. Playing

different roles, both regulators and private sector participants have an enormous responsibility to continue building a new regulatory framework that helps us minimizing the likelihood of repeating this crisis.