showCASE
No. 42 | 04.09.2017

CASE – Centrum Analiz Społeczno-Ekonomicznych
CASE – Center for Social and Economic Research

Overview: In this week's edition of showCASE, our analysts take a closer look at post-crisis financial regulations in an attempt to assess just how efficient they were in keeping risks in check without hindering growth.

Post-Financial Crisis Regulation Through a Critical Lens

By: Ellam Wawire Kulati, *CASE Analyst* and Christopher A. Hartwell, *President of CASE Management Board*

The 2007-2008 financial crisis appeared to expose a need for revised financial regulation in several areas, including capital and liquidity, derivatives, and consumer protection. This perception led to large numbers of rules and regulations formulated and enacted post-haste across the globe, reforms meant to be key in restoring the trust and confidence of the general public in the banking sector. Additionally, post-crisis financial regulation reform was largely meant to lead to international harmonization and coordination of financial regulations. However, as Stefan Ingves, Chairman of the Basel Committee on Banking Supervision recently noted, *"it is a good time to take a step back and ask how the different bits and pieces of the regulatory framework fit together."*

According to former Commissioner of the U.S. Securities and Exchange Commission Daniel M. Gallagher, harmonization of financial regulation appears to be the imposition of a one-size-fits-all regulatory standards on sovereign states. Pre-crisis U.S. and EU financial institutions had disparate regulations, he adds, but, in efforts to reduce friction between them, transatlantic efforts were made to find common ground with respect for national sovereignty. The aim of these efforts was for regulators to realize that despite having the same regulatory goals, different approaches were of different qualities. Part of the post-crisis regulations such as the Dodd-Frank Act have derailed this participative harmonization.

The "Dodd-Frank Wall Street Reform and Consumer Protection Act" was adopted in America in an attempt to address systemic risk and long-term sustainability in the US financial system after the crisis. Years after adoption, the act has been accused of spending scarce resources to implement provisions which did nothing to avert the crisis, while failing to fully carry out directives of the act that were responsive to the crisis. For example, improvement of the management of systemic risk is among the many aims of the Act. Before the crisis, financial institutions were regulated according to formal labels - banks, investment banks, insurance companies, *et al.* – and not to their actual actions. As such, large institutions could choose regulators that would offer the least restrictive supervision (it should be noted that institutions had a large number to choose from, as the financial sector in the US was already the most heavily-regulated sector of the economy). This "regulator roulette" resulted in ineffective supervision. The Fed, authorized by the Dodd-Frank Act, could now, in addition to regulating banks, supervise and regulate all financial firms whose failure could be hazardous to financial stability, regardless of form. Consequently, banks and non-bank financial institutions with substantial systemic influence now had to meet stricter capital and liquidity requirements, in order to withstand adverse economic conditions.

While an effect of these higher capital and liquidity requirements (reduced bank risk-taking incentives and providing a buffer against losses) may support growth, others (indirect bank lending) have been found to negatively impact the economy. Researchers at the Kennedy School of Government at Harvard University also discovered that the Dodd-Frank regulations are most onerous to the smaller entities, who rarely have teams of lawyers able to comply with the myriad of requirements. This same research found that the decline of community banks, for instance, can be attributed to the legislation.

Basel III, the third agreement by the Basel Committee on international banking supervision, also attempted to address the financial crisis. It aimed at improving financial shock absorption using liquidity coverage ratios, net stable funding ratios, establishment of liquidity risk management supervision principles, and monitoring metrics. Although it was a proponent of higher capital requirements akin to those of the Dodd-Frank Act, it also introduced countercyclical measures, where banks had to set aside more capital during credit expansion and vice versa. This regulation was also not without critics. Some research has shown that the regulation will result in increased borrowing costs for banks. Cosimano and Hakura, in their 2011 paper "*Bank Behaviour in Response to Basel III,*" find that a 1.3% increase in required equity-to-debt ratio will increase loan rates by 0.16% across the 100 largest banks in the world. It will also reduce loans from 4.6% in countries that experienced the crisis to 14.8% in those that did not experience it directly. Likewise, previous increases in equity requirements, such as those of Basel II regulations, led to the creation of shadow banking.

Worldwide changes in financial regulation, post-crisis, are meant to have reduced risk not only through increased capital requirement, but also through reduced leverage ratios and regular stress testing. Theory suggests that this should result in a decline in the measures of risk in the financial market. To this end, Natasha Sarin and Lawrence Summers of Harvard sought answers to the question, "Have big banks gotten safer?" They find that financial information provides little support for the view that these institutions are significantly safer than they were before the crisis, with some of the information pointing to increased risk. This is based on information on stock price volatility, options based estimates of future volatility, credit swaps, earning-price ratios, and preferred stock yields in major and midsized institutions in America together with major institutions in the world. Sarin and Summer's research does not support further regulation, citing the declines in franchise value due to the regulatory activity and the prospect of future regulation. Indeed, they show that further regulation, forcing a one-size-fits-all approach, could actually increase systemic risk.

In sum, the early results on the flurry of financial regulations enacted during and after the global financial crisis are not promising. Combined with the easy money of the past decade which has made another crisis more likely, policymakers should look at the drivers of financial crises more holistically. Unfortunately, we are not optimistic that this result will obtain.

This week: Budgetary revenues in 2017 will be larger by PLN 18.4 billion than anticipated in the budget bill, the Ministry of Finance announced on Tuesday. The improvement is a result of increased tax revenues and a favorable macroeconomic situation. According to the Ministry's estimates, the budgetary deficit will amount to PLN 32.9 billion, instead of the previously expected 59.3 billion.

GDP (Q2 2017)

4.4% y/y (est.)

Up from 4.2% in Q1

Inflation (July 2017)

1.7% y/y

Up from 1.5% in June

Unemployment (Jun 2017)

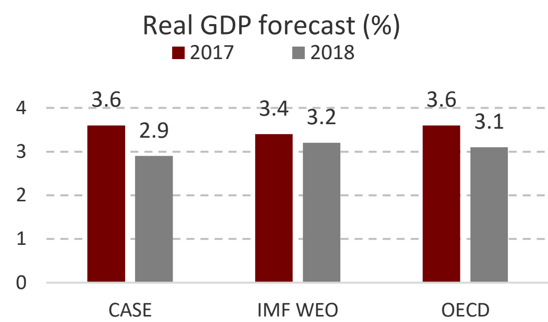
7.1%

Down from 7.4% in May

NBP Base rate

1.5%

From 2% Mar 2015



This week: According to Minister of Economic Development Maxim Oreshkin, the impact of sanctions imposed by the United States and the European Union is diminishing. Instead, Russia is strengthening the ties with Asian markets in a bid to reach growth of 2-2.1% this year. While trade with the United States is comparably small, China took over the European Union's role as Russia's major trading partner, said the Minister.

GDP (Q2 2017)

2.5% y/y

Up from 0.5% in Q1

Inflation (July 2017)

3.9% y/y

Down from 4.4% in June

Unemployment (July 2017)

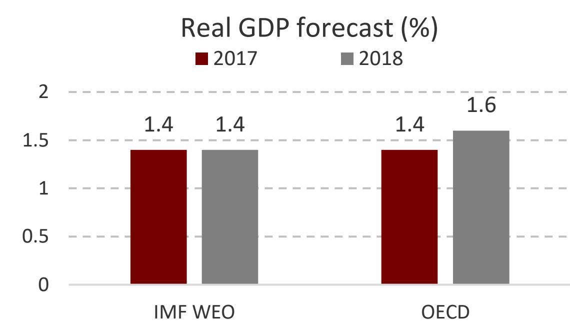
5.1%

Unchanged from June 2017

CBR Base rate

9 %

From 9.25%



This week: Two indices of the market research institute Gesellschaft für Konsumforschung (GfK) peaked in August. The GfK Consumer Climate Index reached its highest point since October 2001, and the GfK Income Expectation Index peaked at its highest point ever since its creation back in 1991. This upswing has been mainly led by the good situation in the labor market. Despite a decline in the economic outlook due to the Diesel emission scandal, GfK experts expect the German economy to grow in the long run.

GDP (Q2 2017)

2.1% y/y

Up from 2.0% in Q1

Inflation (Aug 2017)

1.8% y/y (est.)

Up from 1.5% in July

Unemployment (July 2017)

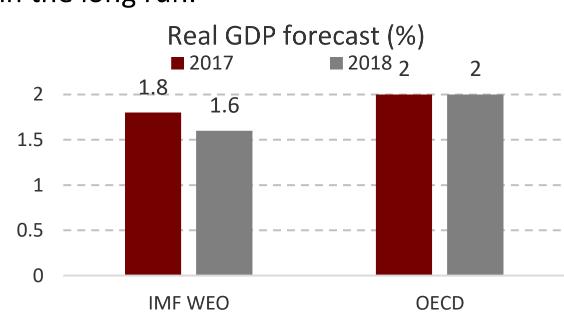
3.6%

Unchanged from June

ECB Deposit rate

-0.4%

From -0.3% Dec 2015



This week: The Association Agreement between Ukraine and the EU entered full force on September 1, which was around a fortnight after the 26th anniversary of Ukraine's statehood. Harmonization of the laws and standards of trade relations and economic development are scheduled to continue.

GDP (Q2 2017)

2.4% y/y

From 2.5% in Q1

Inflation (July 2017)

15.9% y/y

Up from 15.6% in June

Unemployment (Q1 2017)

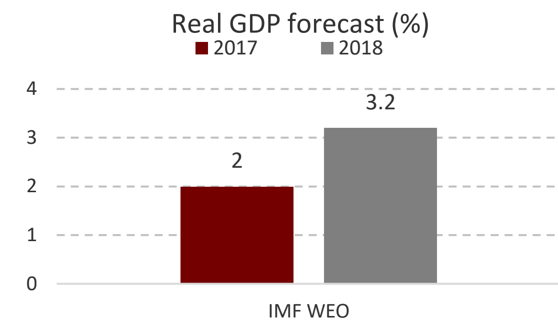
10.5%

Up from 10.0% in Q4

NBU Base rate

12.5%

From 13.0% in May



This week: Members of the Czech National Bank (CNB) see room to further raise the interest rate after becoming in August the first country in the EU to do so. The Bank's Vice Governor announced last week that a vote could take place at a Board Meeting as early as in September. The increase would constitute the first of the two rate hikes that the CNB forecasted to be implemented by the end of 2018.

GDP (Q2 2017)

4.5% y/y (est.)

Up from 3.0% in Q1 2017

Inflation (July 2017)

2.5% y/y

Up from 2.3% in June

Unemployment (Q2 2017)

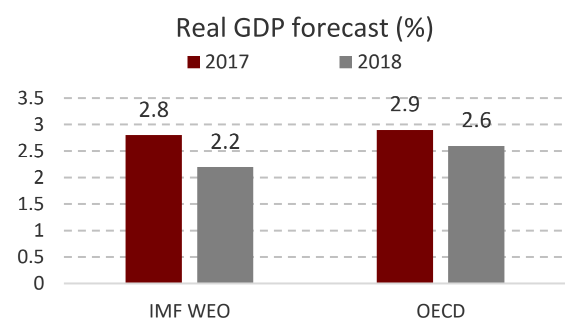
3.0% (est.)

Down from 3.4% in Q1

CNB Base rate

0.25%

From 0.05% (4 August 2017)



This week: Standard & Poor's revised up Hungary's long and short-term foreign and local currency sovereign credit ratings from stable to positive. This is a response to progress in the financial sector, acknowledgment of the Central Bank's effort to encourage lending, the expected stabilization of non-performing, loans and a recovery in the real estate prices.

GDP (Q1 2017)

4.2% y/y

Up from 1.6% in Q4

Inflation (July 2017)

2.1% y/y

Up from 1.9% in June

Unemployment (Q2 2017)

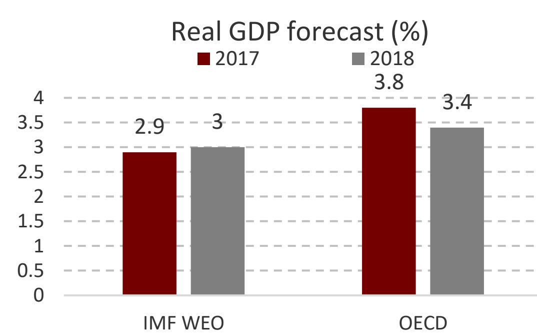
4.2%

Down from 4.3% in Q1

MNB Base rate

0.9%

From 1.05% May 2016



Other CASE products

CASE Center for Social and Economic Research

The weekly online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly.

Our weekly online CASE CPI

Monthly CASE forecasts for the Polish economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, and foreign trade, current account balance, and the CPI.

CASE economic forecasts for the Polish economy
(average % change on previous calendar year, unless otherwise indicated)

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
2017	3.6	3.9	2.9	3.8	1.9
2018	2.9	3.0	2.7	3.7	2.0
	Nominal monthly wages	**Merchandise exports (USD, bn)**	**Merchandise imports (USD, bn)**	**Merchandise trade balance (USD, bn)**	**CA balance (USD, bn)**
2017	4.7	201.6	201.8	-0.2	-4.7
2018	3.5	211.3	213.1	-1.8	-5.9

For more information on our weekly online CASE CPI, please visit: http://case-research.eu/en/online-case-cpi
To **subscribe** to our weekly showCASE newsletter, please visit: http://case-research.eu/en/showcase

Contributions: Krzysztof Głowacki, Katerina Hoskova, Katarzyna Mirecka, Aleksandra Polak, Katarzyna Sidło, Anne-Christin Winkler **Editor:** Katarzyna Sidło **Editor-in-chief:** Christopher Hartwell