

Roundtable on
Global Financial Reform:
Successes, Failures and the Public Interest
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Influences of banking system regulation on growth and development

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What commercial banks do

- Commercial banks provide the main elements of a nation's payments system
 - Transfers bank to bank, domestic and overseas, bank to government, bank to cash
- Commercial banks provide much of the short-term credit needed to run big and small businesses and government
 - Financing business operations
 - Smoothing lumpy inflows or outflows
 - Small and medium firms do not have effective alternatives

How banks **create** money

Company X borrows \$100 to buy inputs

- Company signs loan contract, including collateral (bank assets increase \$100)
- Bank puts \$100 in Company X deposit account (bank liabilities increase \$100)
- \$5 of excess bank reserves now count as required reserves

Aspects of financial system oversight

- Licensing and regulation
- Deposit insurance
- Central bank credit
- Safe resolution of failed banks

What is/should be required of banks to get/keep a license

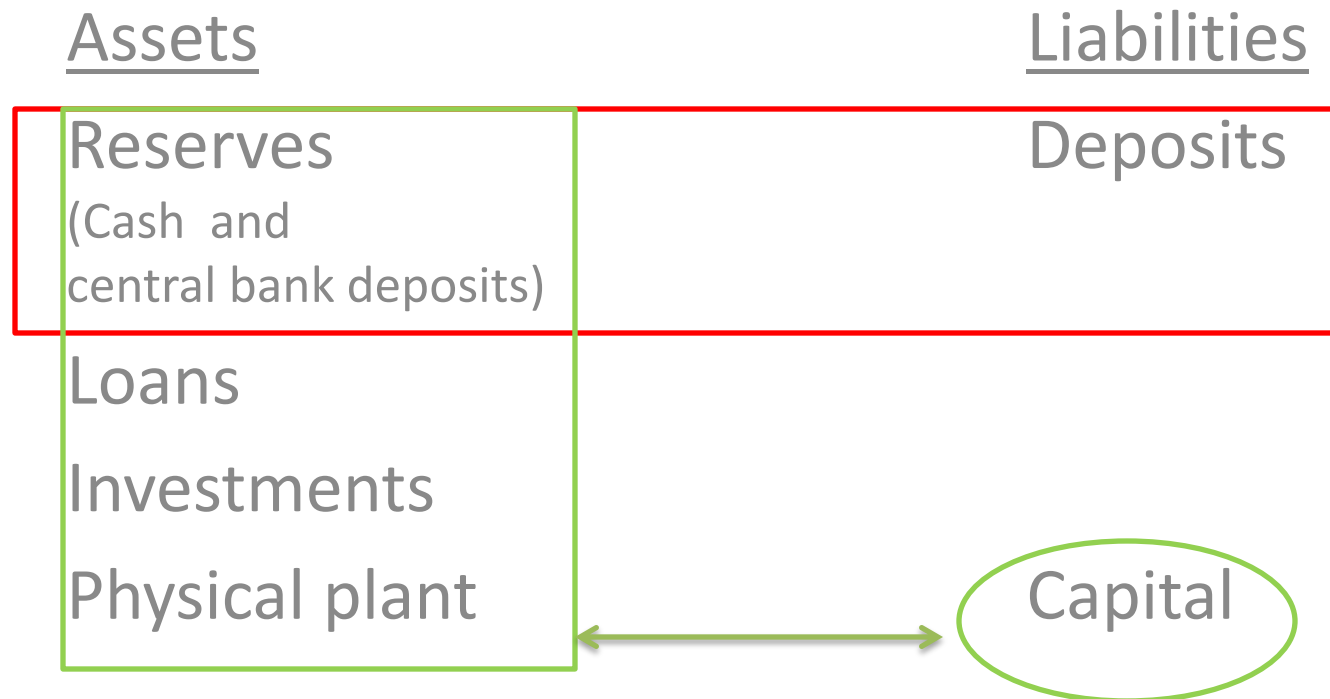
- Must maintain confidence of depositors
- Must maintain confidence of other banks in payments clearing system
- Special privilege of lending bank-created money
- Main source of funds is (should be) deposits

Therefore, require license to operate and agreement to abide by regulations in exchange for which get access to central bank credit and can buy deposit insurance policy

Regulating banks: two dimensions

- Required reserve ratios to cover expected deposit withdrawals and manage country's money supply
 - Makes countercyclical monetary policy possible
- Capital adequacy ratios to absorb potential reductions in value of banks' assets
 - Potential countercyclical effect (macroprudential)
 - Risk weights influences credit allocation

A bank's balance sheet



Various banking policies that seek to influence composition of investment

- Banks raise money relatively cheaply
- Monetary policy differential impact on more and less interest-sensitive industries
- Prohibiting racist heuristics in loan assessments
- Policies of “directed” lending
 - Pressure to buy and hold government debt
 - Outright instruction (former Korea model)
 - Priority sectors (India)
 - Target the poor & microentrepreneurs (Brazil)

Need for public monitoring

- By **legislature**
 - Central bank reports to legislature and its independent monitoring
- By **press**
 - Monitoring flow of banking activity
 - Investigative journalism
- By **civil society**
 - Lobbying legislatures
 - Commenting on proposed regulation
 - Campaigns for specific reforms

Doable?