The Formation of a Single Legal Space as a Prerequisite for Overcoming Systemic Risk

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Abstract

This article examines the concept of systemic risk, its fundamental origins and the dangers of systemic risk in a given state in relation to other countries of the world. Methods for minimizing systemic risks in the contemporary world are looked at, with special attention given to the idea of constructing a single legal framework to address systemic risk. The problem of 'soft law', along with its pros and cons, is discussed and a parallel is drawn with the European legislation in the field of norms standardization. This article discusses transition economics as a source of systemic risk. Data from the Russian Federation and EU countries are given as examples. The main findings stress the need to adapt international standards to national legislation, and emphasize the need for forecasting, the creation of countercyclical capital buffers, the need to combine the use of macro-prudential approaches with monetary policy, and the necessity to regulate institutional structure. It should also be noted, that all government policy, especially monetary, fiscal, and macro-and micro-prudential (supplemented by specific supervision), should be a part of a permanent system of macro-financial stability, created to predict financial crises. The economic crisis has shown that financial stability cannot be guaranteed by each country independently. This is necessary, but not sufficient. The strong economic interdependence of countries in the framework of globalization cannot be excluded from the equation.

Keywords: systemic risk, concentration of risks, soft law, standardization of legislation, countercyclical policy

1. Introduction

In today's geopolitical situation, all countries are, to some extent, susceptible to systemic risk. It is inherent in all economies, and it cannot be ruled out entirely. Globalization does not generate separate political, economic or social risks, but creates systemic risks (Goldin, 2012). The growing interdependence of nations and peoples is also evident, along with the ever increasing role of supranational institutions, which often dictate the rules of conduct for national institutions. Insofar as transition economies are characterized by relatively volatile markets, they are sources of systemic risk, which can be transferred to countries with developed economies. Therefore, it is of the utmost importance to find methods for minimizing systemic risk. Taking the economic relations between Russia (an example of a transition economy) and Germany and Latvia as an example of the close links in the global economy, we see: the trade turnover between Russia and Germany amounted to about 76.5 billion euros in 2013, Russia exported goods to the sum of 36 billion euros and imported German goods to the sum of 40.5 billion euros (vestifinance.ru, 2014). If Latvia refused to trade with Russia, the Latvian economy could fall by 10-15 per cent (Reuters, 2014).

Systemic risk is the risk that one party fails to fulfill their obligations, or the risk of disruptions to the functionality of the system, which may result in the failure of other participants in the system to meet their obligations on time (Official Academic, 2007). Systemic risk stems from the concentration of various types of risks, forming possible losses, the size of which potentially threatens the financial stability of the whole, or parts of, the market (Basel Committee, 2011). Sources of systemic risk can be differentiated by the type of risk, the financial product, the groups of financial institutions, and the regional concentration of systemic risk. In the "Global Risks 2014" report (WEForum, 2014), issued after the World Economic Forum, 31 global risks were analyzed in order to identify the most significant risks in terms of systemic risk. In this paper, we propose to
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The three main sources of systemic risk (geopolitical, social and economic risks) which leads to higher inflation, involves substantial risk for domestic producers, and risks the devaluation of macroeconomic risks. We can observe a significant weakening in the national currencies of emerging markets, violations of rates in the national economy and the negative effects of financial factors may also lead to depreciation in countries with transitive economies. Emerging markets are characterized by these trends. The struggle for resources and territory, leads to geopolitical instability, and currency social risk is connected to economic risk. The threat posed by conflicts of interest of industrialized and developing countries, and the standardization of norms, and the need to adapt international standards adopted by national legislation. In this context, Solvency II is of considerable interest as a common European project in the restructuring of insurance regulations. The project is designed to standardize approaches to the regulation of the insurance market, and implement IFRS and Basel III (part of the so-called "soft law"). These international standards have both their advantages and disadvantages; however, their disadvantages can be eliminated through the adaptation of standards to the national characteristics of any given economy. For example, according to experts, the introduction of Basel III standards in Russia would increase the banks’ responsibility in risk management, which would improve the credit ratings of organizations, which in turn would help reduce the cost of financing the funding base of national banks (Ackerman, 2014). The global economic crisis has intensified the property gap within the population. Along with the ever decreasing number of members of the middle class, this clearly indicates the possibility of social unrest in the near future and evidently illustrates the social risk. According to the research presented in the ‘Global Risks 2014’ report (WEForum, 2014), this will be the main risk in 2014. For example, unemployment increases the likelihood of social unrest. A new record for the number of registered jobseekers in France was documented, with a rise at the end of February 2014 reaching 3,350,000 (Landre, 2014). In Spain, 55.5% of all unemployed persons are less than 25 years of age. In all 17 regions of Spain, the unemployment rate is no lower than 17%, with some of the most noteworthy among them being Andalusia (34.94%), the Canary Islands (32.55%) and Extremadura (32.14%) (Le Monde, 2014). Therefore, social risk is connected to economic risk. The threat posed by conflicts of interest of industrialized and developing countries, and the struggle for resources and territory, leads to geopolitical instability, and currency depreciation in countries with transitive economies. Emerging markets are characterized by these trends. Violations of rates in the national economy and the negative effects of financial factors may also lead to macroeconomic risks. We can observe a significant weakening in the national currencies of emerging markets, which leads to higher inflation, involves substantial risk for domestic producers, and risks the devaluation of macroeconomic projects. Thus, the three main sources of systemic risk (geopolitical, social and economic risks) are interconnected.

It is also important to note the possible methods of reducing systemic risk, based on macroeconomic theory. The terms of countercyclical policy (a policy that deals with systemic risks which may occur) state that capital and
liquidity buffers should be above the average level for an extended period of time, which implies the creation and maintenance of the buffer during the cycle. Finally, it should be recognized that other macro-prudential policy tools can be used to limit or prevent the emergence of macroeconomic and financial imbalances. For example, in Asia, reserves have long been part of the arsenal for combating such imbalances. Undeniably, better regulation is necessary, but even with the new macro-prudential approach it may not be enough to prevent the build-up of systemic risk. As a result, monetary policy should play a supporting role. Fiscal policy can also be designed to promote financial stability, as it has financial resources of enormous proportions which the public sector can call upon in periods of stress.

4. Discussion

There are various approaches to the reduction of systemic risk, but this article is aimed at extensively considering the problem of transparency of economic activity, the creation of a unified legal space, and the standardization of the norms of law. As noted above, economic risk can be reduced by increasing the transparency of economic activity. Consequently, considerable attention is drawn to Solvency II as a project for the European reform of insurance supervision, designed to standardize approaches to the regulation of the insurance market. The project is characterized by relatively stringent requirements for capital, and corporate governance. This approach has been implemented into a number of emerging markets. Some experts believe that it is indisputably necessary to synchronize the regulation of the Russian and European insurance markets [News Insurance Agency, 2013]; however, some experts have a critical opinion of Solvency II: “Complicated models […] can be abused for involved decision making which may be dangerous” (Vanduffel, 2008). The implementation of IFRS in Russia is increasing the transparency of company reports which, on the one hand, minimizes systemic risk and increases the reliability of insurance companies; however, on the other hand, can increase tariffs and force small players out of the market. It is also important to consider the ‘Scenarios for the Russian Federation’ report (WEForum, 2013), published after the World Economic Forum in January 2013. This paper focuses on the three main problems of the Russian Federation: the global energy picture, weak institutions, and social cohesion. These problems are common to all countries with economies in transition, but it is important to focus on the problem of weak institutional framework in more detail. It is widely believed that Russia's economic success stems from important institutional reforms after the collapse of the Soviet Union and the development of a more liberal economy (Chadee & Rojas, 2013). Here we take purchasing power parity as an example for purposes of comparison; Russia and Brazil had approximately equal GDP per capita in 2000 (approximately 7,600 U.S. dollars), compared with China and India, whose GDPs were in the region of 2,000 U.S. dollars. By 2011, their GDPs were as follows: Russia - 17,600 USD; Brazil - 12,300 U.S. dollars; China - 9,200 U.S. dollars, and India - 3,900 U.S. dollars (Chadee & Rojas, 2013). Nevertheless, Russia is still characterized by weak institutions, an insufficient level of regulatory framework, and weak activity of regulatory bodies. It is partly for this reason, that countries with transition economies are characterized by much higher levels of corruption than other countries. This fact significantly complicates business activity, which in turn leads to an increased ‘off-the-books’ economy, and reduces tax revenues to all levels of the budget. The formation of a single legal space and the standardization of legislation will help solve the problem of weak institutions. In this context, it is necessary to consider the problem known as "soft law". A striking example is the standards and principles that determine the Basel Committee on Banking Supervision, which bears several informal characteristics. They recommend best practices and this is exactly how soft law works; it brings together professionals in their field. In comparison, International Law is too formal, and does not allow it to quickly adapt to the rapidly changing situation. In addition, soft law necessitates soft compliance. Nevertheless, some features of the process of soft law should be noted:

1. It leads to the cancellation of conventional legislative procedures.
2. The exclusion of parliaments is general practice.
3. The content is often not sufficiently clear.
4. Contents may be incompatible with current legislation.
5. It may be inaccessible and not transparent, with opportunities for public involvement being insignificant.

Also, an important phenomenon in the application of soft law is that the views of small countries are not considered in the decision-making process. Konrad Hummler described soft law as the law of the strongest (Mather, 2010). Some authors believe that the organization of the European Union was designed to solve this problem, but in practice it has only exacerbated the situation - in any given vote, only the views of the largest member-countries are considered. Therefore, countries are now obliged to adopt Basel standards as national laws. Central banks in developing countries are actively bringing into force some elements of Basel II and Basel III, which is already partially displacing Russian banking legislation. At the same time, despite the fact that the
Majority believe that the unification of legislation reduces risks, some authors believe the contrary. For example, in the article, "The Evolution of the Basel framework concept for the regulation of bank capital" (Prakash, 2008), published in 2008, it is noted that systemic risks lie in global standardization. It should also be noted, that Stefano Micossi, in his article "A viable alternative to Basel III prudential rules", says that Basel III’s "new rules are more complex, opaque and open to manipulation" (Micossi, 2013). Thus, it should be noted, that there is a need to adapt international standards to national legislation. Russian experts believe that the introduction of Basel III norms in Russia and work within a single legal system are having a positive impact on competitiveness (Ivanovsky, 2014). However, despite criticism of the legislation standardization process, it helps to address systemic risk in the economy, as a result of the harmonization of numerous processes. It should be noted that from 1 January 2014, the EU adopted uniform rules for banks, the first to apply to all EU banks. The SEPA system (Single Euro Payments Area) has been in place since February 2014. The system’s main objective is to increase the efficiency of intra-European payments and the conversion of fragmented national markets into a whole; it is designed to replace most national payment systems. This is one more step towards the harmonization of the legal space, which is designed to minimize systemic risks in the EU.

5. Conclusion

This article considered the main sources of systemic risk, and identified both key risks and methods for minimizing them. Although there are still many open questions, we would like to stress that significant progress has been made in the international coordination of the regulation system. Future studies may be directed at the study of management structure and information flow in the regulation of systemic risk. Another interesting area that could be considered in future research concerns the analysis of economic coordination between countries in the context of globalization. Our research shows that systemic risk can be reduced by increasing the transparency of economic activity, and addressing the issue of weak institutions. This problem could be solved by forming a single legal space and standardizing legislation. It is necessary to put special emphasis on the need to adapt accepted international standards for national legislation. In addition, we would like to emphasize the necessity of combining macro-prudential approaches and monetary policy, as well as the need to regulate institutional structure. All government policies, especially monetary, fiscal, and macro- and micro-prudential policies (accompanied by the appropriate regulation), should be part of a permanent system for macro-financial stability, created to preempt financial excesses. In order for this system to be effective, attention should be given to institutional structure and international coordination. Insofar as responsibility for financial stability is widely distributed, to achieve this goal, it is important to have control over various instruments of policy. Therefore, institutional framework should be based on clear authority and responsibility. It must rely on close collaboration between central banks and regulatory authorities, both at home and abroad.

References


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