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## Capital flows and regulatory arbitrage



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**EVENTS** earlier in the year in Australia show the extent to which cross-border capital flows can arbitrage regulatory hurdles. It appears that in an effort to rein in a burgeoning housing bubble, the Australian central bank, the Reserve Bank of Australia (RBA) has placed caps on bank lending to real estate developers.



PROF DR OBIYATHULLA  
ISMATH BACHA

The policy, aimed largely at curbing purchases of Australian homes by foreigners through domestic borrowing, initially was effective. In addition to foreign speculators, domestic housing developers too were hit hard.

Such regulation would have essentially taken the wind out of a domestic housing bubble, had it not been for foreign hedge funds and private equity. Given free capital flows, these foreign entities, which are really shadow banks, stepped in to provide the needed funding, obviously at higher interest rates.

At that point of time, the foreign lenders appeared to be making huge profits from the large interest spreads. For both the foreign lenders and the foreign speculators of Australian property, the ability to sidestep the regulation appeared to be a win-win.

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The obvious loser is the RBA. Not only has its initiative to curb the housing bubble been rendered ineffective, its policy has given rise to profitable regulatory arbitrage. Interest rates on home financing, which were at about 6% prior to the RBA policy, are now being funded at 12%. A highly profitable 6% spread to the foreign capital providers.

Thus, despite the fact that the underlying project risk is in no way any different post-regulation, the foreign shadow banks are earning equity-like returns from low-risk home financing.

This episode amply illustrates the limits of regulation and policymaking in a globalised world with free capital flows. For central banks in particular, domestic monetary policy becomes less effective if not impotent. And it arises from the classic “trilemma” in international finance, which argues that domestic monetary policy independence is not possible in the face of free capital flows and/or fixed exchange rates.

While Australia certainly does not have fixed exchange rates, nor is the regulatory change above one of broad monetary policy, but a targeted attempt at curbing excesses within a sector, it nevertheless has resulted in regulation giving rise to arbitrage opportunity. Arbitrage opportunity arises whenever regulation tries to create artificial barriers.

As implied by the “trilemma”, an independent rate decision even for a specific sector is not possible with free capital flows. While domestic banks are subject to RBA requirements, foreign hedge funds are not.

In the absence of capital controls, there is nothing to prevent them from stepping in to fill a vacuum created by regulation. The RBA may be the most obvious loser but there is more. Domestic banks that could not benefit from the enlarged spreads are losers too. So, too, the Australian family looking to purchase a home of their own.

### **Lessons for Emerging Islamic Economies**

There are important lessons from the Australian episode for policymakers, particularly of emerging Islamic economies.

The first and obvious lesson is the fact that in the globalised world that we now live in, regulation that seeks to distort or puts up barriers can be arbitrated away. Aside from eroding policy effectiveness, the outcomes may be diametrically opposite to what was intended.

Second, policy options may not be as clear cut as they once were. The trade-offs are increasingly complex and their outcomes increasingly uncertain.

The third key lesson is that with the advances in information technology, financial borders have become highly porous. Money and capital can be moved across borders in so many ways. Regulation by way of licensing which by creating barriers increased the franchise values can now be arbitrated. Entire industries/sectors can be “uberised”.

While Muslim countries – Nigeria, Egypt and the like – with their massive political risks may not exactly see foreign capital inflows rushing in to arbitrage the many distortions within, they can still be taken advantage of. Where the profit potential is large and some of the risks can be hedged externally, speculative capital will seek out opportunities.

The fixed or quasi fixed-exchange rate regimes of these countries actually make the profit potential larger by way of the one way put options they provide. The exchange rate crises that such countries experience perennially are testimony to their vulnerability to speculative capital.

The solution lies not in capital controls which can be hugely distortionary, but in smart regulation that takes advantage of, rather than go against the grain of technological changes. Enlightened governments and clever policymakers should be able to see the writing on the wall.

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*Dr Obiyathulla Ismath Bacha is currently professor of finance at the Malaysia-based International Centre for Education in Islamic Finance. The views expressed are of the writer and do not necessarily reflect the stand of the newspaper's owners and editorial board.*