The King Kong Mistake and How To Avoid It

Improving the Regulatory Response to 2008 GFC

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The King Kong Mistake
Suppose a bunch of apes wanted to design the Super-Ape

- Apes are big, strong, and hairy...
- So, the Super-Ape committee might naturally think that the super-ape is:
  - Bigger!
  - Stronger!
  - Hairier!
- In other words, King Kong
But we know that this strategy ends badly…
In reality, we are the super-apes…and not because we are bigger, stronger, and hairier than regular apes.
The King Kong Mistake

- If one’s approach to a problem fails, the King Kong Mistake is to assume that the optimal solution is to do A LOT MORE of whatever it was that one was doing before;
Designing Super-Basel in Response to the GFC
The Regulatory Response to the GFC

- The Basel II system was built upon bank capital, supervision, and liquidity requirements;
- This system failed spectacularly in the 2008 GFC, leading to…
- Super-Basel (Basel III)
  - More capital;
  - More intense supervision;
  - More liquidity;
  - MacroPru;
- Is it going to work?
Capital and Liquidity

- The historical evidence shows that higher capital requirements do not reduce the probability of a financial crisis;

- Higher capital may reduce the impact of a crisis, but sensible Lender of Last Resort policies could probably have the same effect;
  - We have made a great deal of progress at thinking through what a sensible approach to LoLR should be;
  - Sensible LoLR policies can also deal with liquidity problems.
Financial Crises and Capital Ratios in the US

“Supervisors will need to focus on the big issues. Analysing bank balance sheets and businesses. Applying judgement. To my mind a great bank supervisor is forensic; is capable of substituting their judgement for those of management; but is wise enough to do so only when necessary; and has the personality to conduct the regulatory relationship without unnecessary conflict”…[guess the next sentence]

Supervision: Can it be done?

- The next sentence should be (but wasn’t):
  - “And so Supervision is an impossible task”.

- There are very few empirical studies of Supervision, but basically the point of Supervision is to turn the financial sector into a giant conglomerate with the central bank/regulator acting as Head Office;
  - In Industrial Organisation, the study of conglomerates focuses upon the phenomenon of the “Conglomerate Discount” because it is basically impossible to get Head Office to intervene only when it makes sense;

- Barth, Caprio, and Levine (2008) find that the more powerful is a country’s bank supervisor, the worse the financial system performs;
  - Barth, Caprio, and Levine, *Till Angels Govern*

- Eisenbach, Lucca, and Townsend (2016) argue that it is hard to tell if Supervision is effective due to endogeneity issues;
  - “The Economics of Bank Supervision”, NBER WP 22201
Supervision

- So, the IO evidence shows suggests that there are strong theoretical reasons to believe that Supervision faces severe problems;
- The cross-sectional evidence suggests that, in practice, Supervision does not accomplish its goals;
- The only bright spot is: “Supervision might work, it is just really hard to tell one way or the other”
Basel III, the King Kong Mistake, and what to do instead

• Basel III is the King Kong version of Basel II
  - It is hard to be optimistic about the probability that it thrives when set loose on the streets of Lower Manhattan (or the City of London, etc. etc.)

• What can we do instead?
  - Lost City Slicker: Farmer, how do I get to Little Rock?
  - Farmer: Stranger, you can’t get there from here.

• So, maybe we should start somewhere else.
MacroConduct Policy
Market discipline saved the world in 2008

- Dealing with the 2008 GFC pushed the regulatory system to the limit;
- If the GFC happened in 2010 instead of 2008 (after building for an additional 2 years), it would have been quite a challenge to keep the financial system functioning;
- We avoided this catastrophe because the market (not supervisors or regulators) stopped the bubble in time for the heroic crisis management efforts by central banks, regulators, and governments to save the day;
- So, maybe we should think about getting financial markets to work better.
Macro-Conduct Policy

• The financial market quality plays a central role in determining the overall level of economic performance (stability and growth);

• Financial regulation can play a key role in bringing about financial markets that work well;

• **MacroConduct Policy**: Strategically regulating financial markets so as to get them to work well;
  
  • There is no (or, at least, *there does not need not to be*) a growth/stability trade-off;

  • MacroConduct policy can reduce the immediate risk to financial stability (crisis risk) and also the long-run risk to financial stability produced by low growth;
Can it work?

- Let us examine the US evidence:
  - Do poorly working financial markets increase crisis risk and reduce growth?
  - Can regulators affect financial market quality?
    - Analysis based on research I am doing with Dimitri Tsomocos (Oxford) and Akshay Kotak (Oxford);
Fundamental Opacity (Subtracting Out Market and Time Series Effects)

Market Quality

Pre-SEC

SEC

Post-SEC

Year

Better

Worse
Credit booms, market quality, and crises: Non-Parametric Test

When markets work well, credit booms do not cause crises

Prob of No Crisis: 1.2%

Credit Data: Jorda, Schularick and Taylor Macrohistory Database
Crisis Probability and Market Quality: Non-Parametric Test

• In times of poor market quality (1840 to 1935, 1996 to 2016), the probability of a crisis is: 7% per year;
  - 115 Years, 8 Major Crises

• If the Probability of a Crisis remained at 7% during the 1945 to 1995 period of high market quality, then the probability of **not** observing a major crisis between 1945 and 2006 equals 1.2%;
  - If we have returned to a high crisis probability era, then the probability of observing at least on crisis between 1996 and 2016 is: 76%

• Conclusion:
  - The probability of a crisis does decreases as market quality increases;
  - We are back in a high crisis probability regime.
Market Quality and TFP Growth

TFP = 5.27 - 1.6 \times \text{Credit Growth} - 61.6^* \times \text{Opacity}

R^2: 9.6%

A "*" indicates statistical significance at the 1% level

TFP Data: John Fernald's webpage at the San Francisco Fed
Market Quality and TFP Growth

• Opacity has a strongly negative and highly statistically significant effect upon TFP growth;
  
  - Credit growth does not (in the US case) have a statistically significant effect;

• The decline in market quality over the post-war period does an excellent job of explaining the path of US TFP growth;
Improving the Regulatory Response to the GFC
Should we really bet the entire global financial system on Basel?

- Another financial crisis would be an economic, political, and social catastrophe for the Western World;

- The evidence suggest that dealing with financial crisis risk by putting all of our chips on Basel is not very prudent;
  - Will next time really be different?

- MacroConduct policy will not adversely affect the Basel approach, and it just might work;

- So, experimenting with MacroConduct Policy (in a small way) in addition to pursuing the standard approach is a low cost/high reward gamble that is worth a roll of the dice (I think);

- No pressure, but…
1 or 2 more crises and...