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

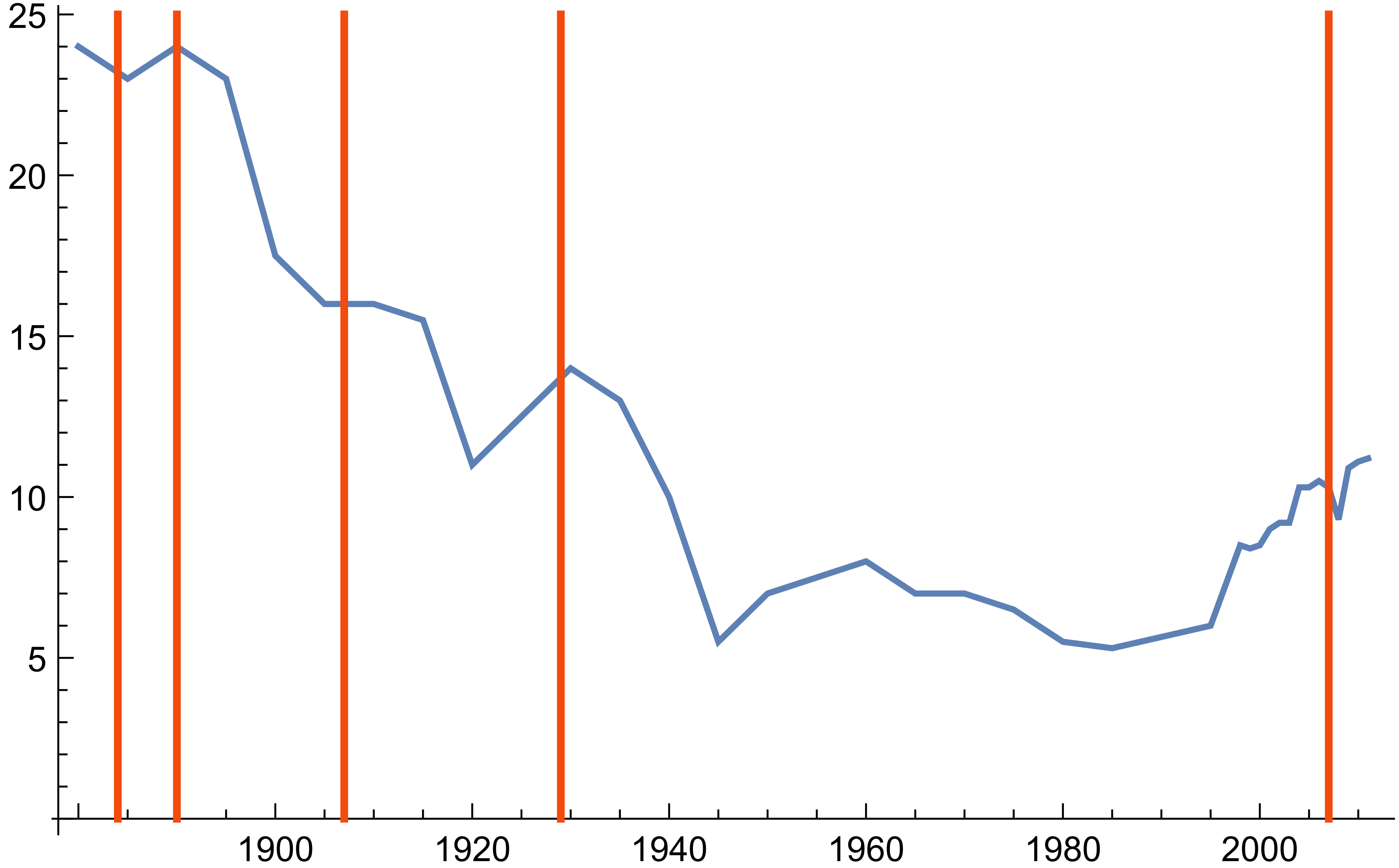
The Regulatory Response to the GFC

- 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;
    - IMF Global Financial Stability Report (2018), Chapt. 2
- 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;
    - Jorda, Richter, Schularick, and Taylor (2017), “Bank Capital Redux: Solvency, Liquidity, and Crisis”, NBER Working Paper 23287
- 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;
        - Reinhart and Reinhart, “The Crisis Next Time: What We Should Have Learned from 2008”, *Foreign Affairs* (Nov/Dec 2018)
    - Sensible LoLR policies can also deal with liquidity problems.

US Bank Capital Ratio



Financial Crises and Capital Ratios in the US

Source: 1880 – 1995, Berger, A, Herring, R and Szegö, G (1995); 1995 – 2014, St. Louis Fed

Supervision: The Job Requirement

"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]

Paul Tucker, Deputy Governor, Bank of England, "Macro and Microprudential Supervision", 29 June 2011

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;

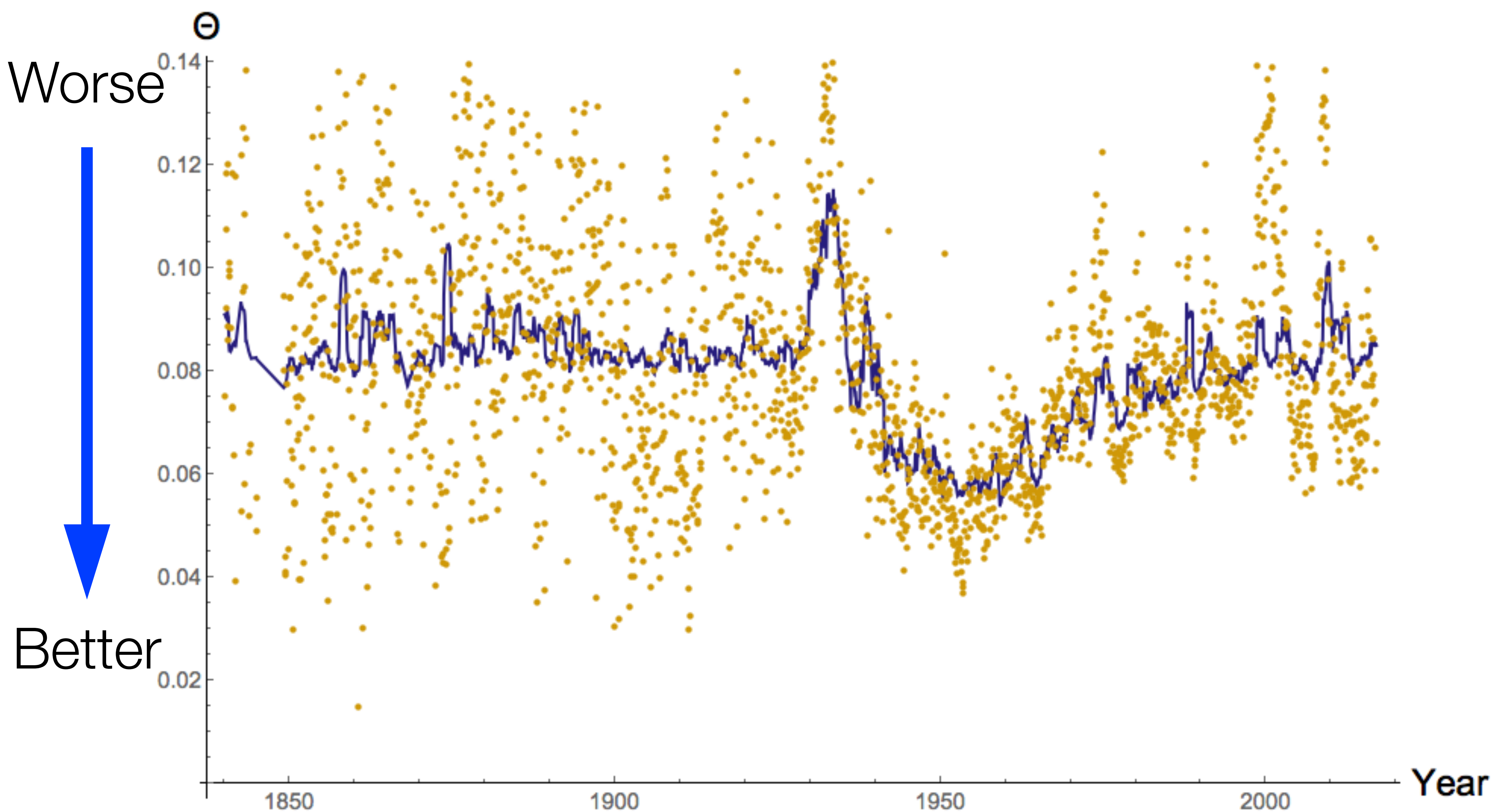
    - There is no (or, at least, *there does not need not to be*) a growth/stability trade-off;

    - 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;

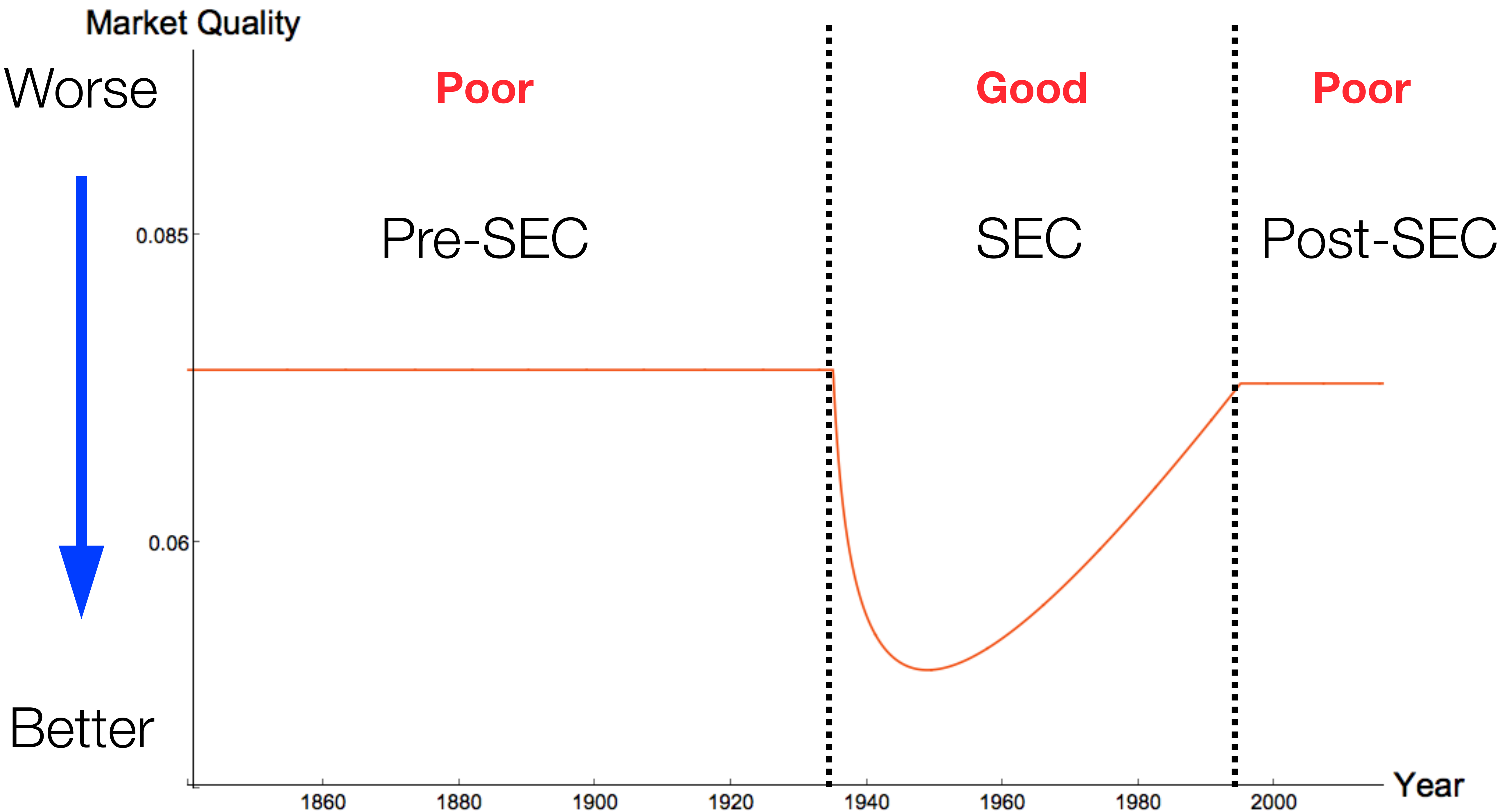
Can it work?

- 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);

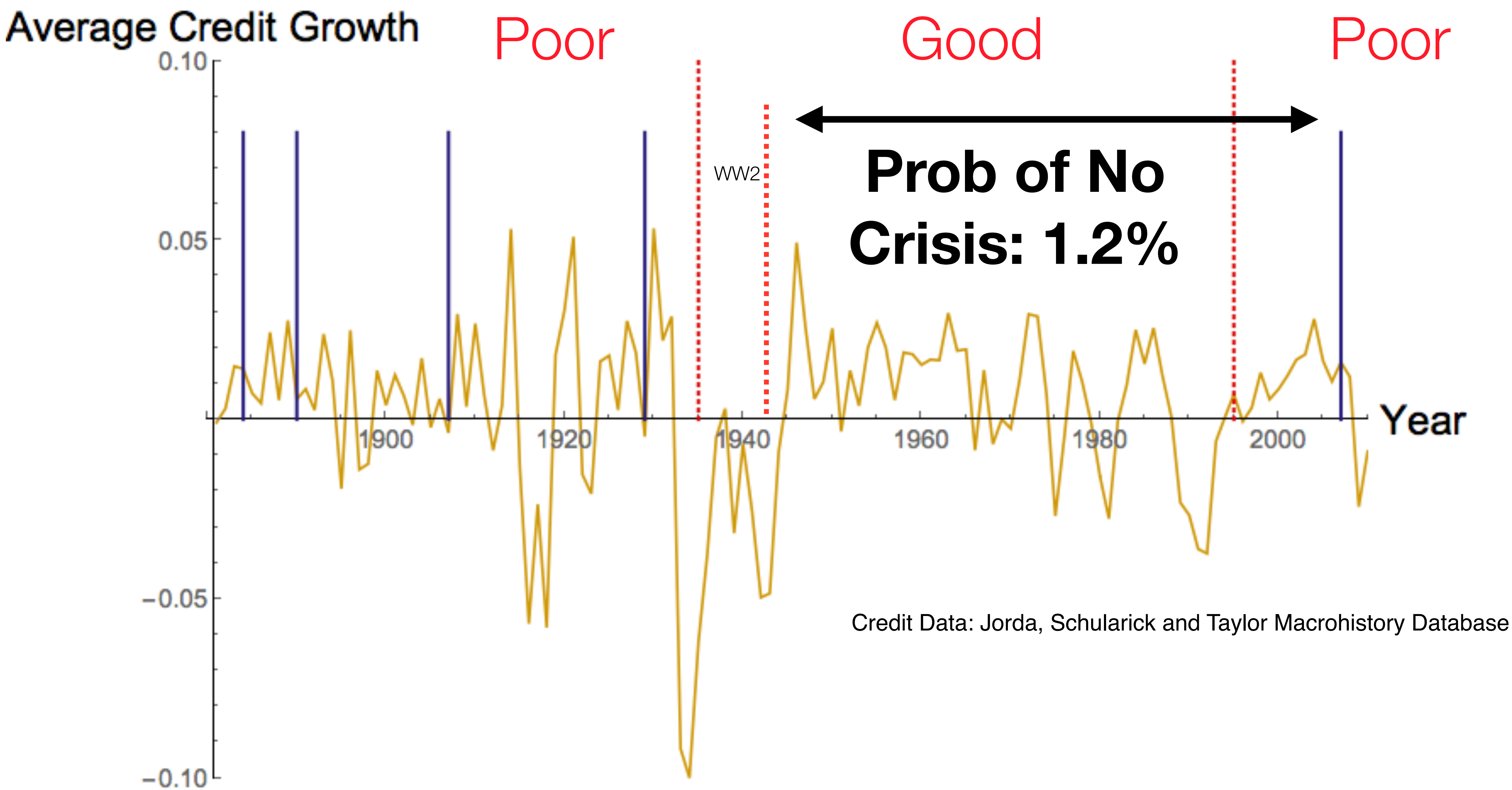
US Financial Market Effectiveness: 1840 - 2015



Fundamental Opacity (Subtracting Out Market and Time Series Effects)



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

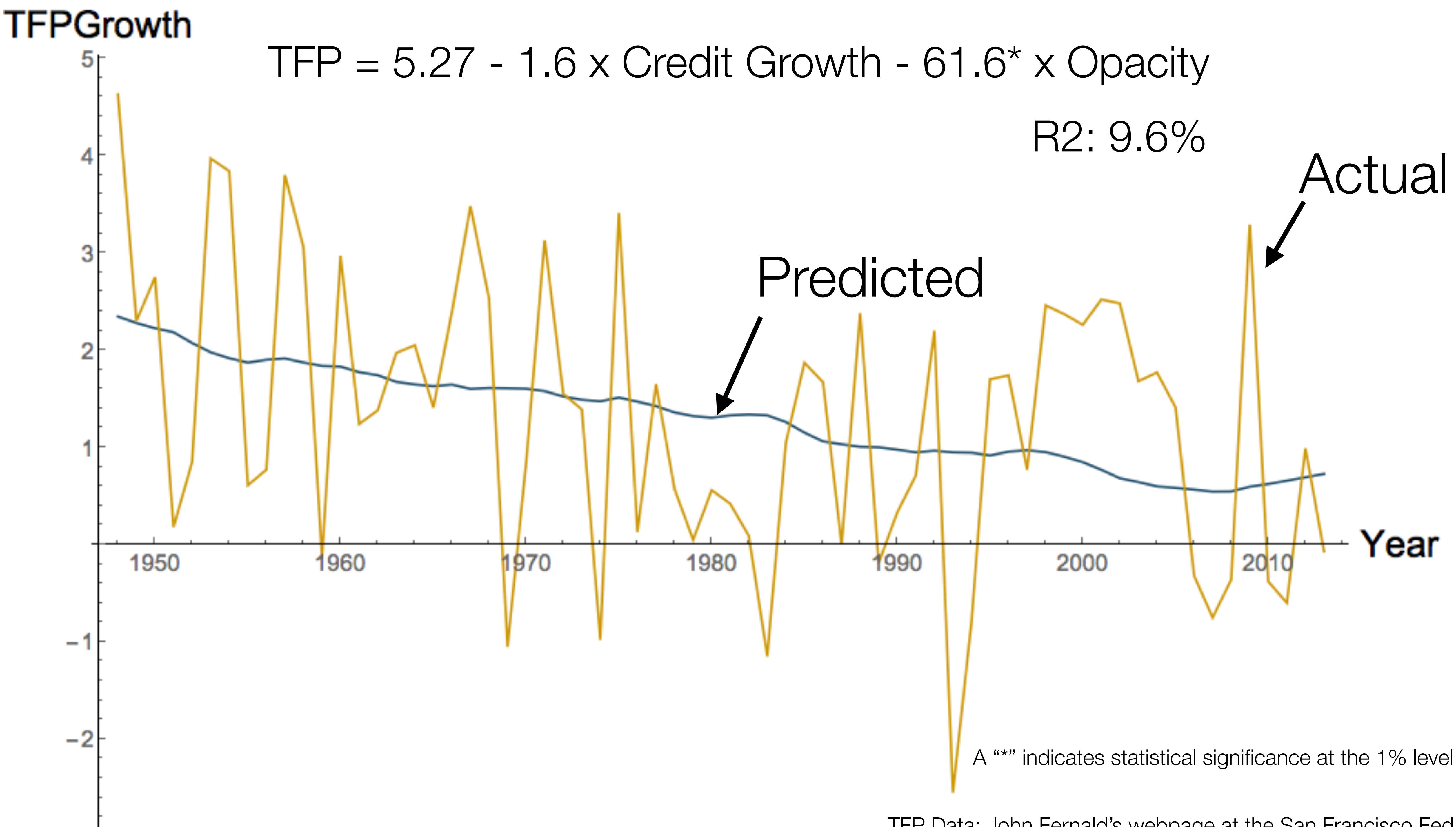


When markets work well, credit booms do not cause crises

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



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…

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