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POLICY MEMO SERIES: ECONOMICS AND GLOBAL AFFAIRS

Back to the drawing board – regulation and macroeconomics after the crisis

POLICY RECOMMENDATIONS

- Correct specific flaws in regulation (e.g. on off balance sheet commitments, the quality of capital, and the regulation of mortgage origination.)
- "Protect banks against the economic cycle" by requiring them to hold bigger buffers of capital and liquidity.
- "Protect the economy against the banks" by varying these capital requirements directly to limit the expansion of credit in booms and its contraction in downswings.
- Offset the perverse incentives of "too big to fail" by setting higher requirements for the biggest firms, and strengthening special insolvency regimes.
- Coordinate internationally the regulation of global firms and agree to contingency arrangements.
- Give a powerful voice in regulation to a government agency that is not charged with day-to-day supervision, but instead can monitor the system as a whole.
- Interest rates need to be set to help avoid damaging imbalances and the build-up of asset price bubbles; mopping up after they burst is not enough.
- Interest rate policy needs to be coordinated with fiscal policy and variable capital requirements; the governance of Central Banks and regulators needs to reflect that.
- The current orthodoxy in monetary economics needs replacement.

By John Gieve, Senior Fellow, Belfer Center, Harvard Kennedy School

The financial crisis of the last two years has now led to a profound world recession. It calls not just for emergency measures but for major changes in our longer term policy. We need to go back to the drawing board not just on financial regulation but on macroeconomic policy and on macroeconomics itself.

LESSONS FOR REGULATION

The crisis has revealed specific flaws in current rules which need to put right. For example, banks need to hold more capital against off balance sheet vehicles and their trading books. Their capital needs to include more real equity and less hybrid debt (which can only be drawn on after bankruptcy). And some institutions -- for example mortgage originators in the United States -- need to be brought into the regulatory net.

But the bigger message is that the financial system, like other complex networks, is more than the sum of its parts. It is not enough to ensure that each part is sound; we need also to tackle vulnerabilities that arise from their interaction. That is why we need to get

more trading onto transparent exchanges and through central counterparties. We must not only reduce the risks to individual firms from unusual business strategies or inadequate management but also reduce risks to the system from behavior which may be rational for one firm but, when replicated many times, can lead to self-reinforcing booms and busts.

At its simplest, in times of optimism when lending expands and asset prices rise, the number of defaults falls (because people can roll over debt or, if necessary, sell out at a profit). This suggests that risks are low and encourages further expansion of credit. That reverses in the downswing, when rising defaults lead to a tightening squeeze on credit which feeds back into further defaults. And for an individual bank the best return comes from riding the upswing as long as possible and getting out just ahead of the competition. (I suspect what distinguished Citi from Goldmans, for example, was less that they obeyed Chuck Prince's injunction to "dance until the music stops" than that their response at that point was less rapid and disciplined.)

Part of the answer is to "protect the banks against the economic cycle" by making them hold bigger buffers of capital and liquidity on which they can call when defaults rise.

But the financial sector is not so much a passive victim of a cycle in the wider economy as its main driver. So we need also to "protect the economy against the banks" through measures to dampen swings from exuberance to gloom in the financial sector. One way to achieve that would be to raise capital requirements in good times and reduce them in bad. That not only creates bigger buffers to absorb losses when they arise but will directly lower the peaks of the booms, raise the troughs and make the cycle less fierce.

A second big lesson is that we need far better international cooperation. Lehman Brothers' closure would have been difficult anyway, but working under different national regimes without a shared understanding of corporate structure or the pattern of interlocking assets and liabilities made it unnecessarily disruptive. The G-20 agreement to establish stronger colleges of supervisors and agreed contingency plans for the global firms is the least we can do. Otherwise, we may see a retreat to national pools of capital -- each supervised locally.

Third we need to prevent the recent bank rescues exacerbating some perverse incentives in finance. The markets already provide banks considered "too big to fail" with easier credit than others and thus enable them to take bigger risks. While this is helping now to shorten the recession , it threatens to make the next crisis even worse. We need to rebuild market disciplines by redesigning our special insolvency regimes so they could be used for bigger and more complex banks and by requiring higher capital and liquidity buffers for the largest firms. We may need to go further and limit the size of banks or limit the type of business they can do.

Finally we need to reform our institutions to tackle systemic risk. One lesson I have learned is that it is difficult for any regulator to stand out against prevailing market opinion. Some degree of regulatory capture is almost inevitable when the regulator and firms are in constant negotiations over incremental changes in business strategies and structures. One protection against that is to give a powerful voice to a body which is not engaged in day-to-day supervision and has a responsibility to monitor the system as a whole. That role could be given in the euro area to the ECB. In the US the Federal Reserve could play the role if it is not given the leading supervisory job instead.

LESSONS FOR MACROECONOMIC POLICY

In 2006 there was a wide consensus among policy makers and professional economists on how to keep the economy on the right path. The consensus view was that fiscal policy (tax and spending) was too clum-

sy and slow to use for macroeconomic purposes. The management of the economy (macroeconomic policy) should be left to the Central Bank acting through interest rates and targeting (explicitly or implicitly) a low inflation rate. And economists and policymakers also agreed that the Central Bank should set interest rates above all on the basis of the gap between consumer price inflation and its target and the gap between output and its equilibrium level.

The last two years have shown the limitations of the approach. It proved effective in "fighting the last war" – preventing the type of inflationary boom we experienced in the '70s and '80s. But it had little place for the long build-up of global imbalances and of the credit and asset price bubbles in the West which have exploded with such devastating force. We have learned the hard way that we need to prevent the build-up of chronic imbalances and asset price bubbles ; mopping up after they burst won't do.

The crisis has also brought close coordination of monetary, fiscal and regulatory policy, and that will remain essential as the crisis subsides. We have learned that interest rates and inflation targets are not enough to secure stability. Policy needs also to address asset prices, credit expansion, and imbalances between sectors and between economies. That requires more than one policy instrument. Fiscal policy will remain centre stage as central banks wind down their balance sheets and governments struggle with the burden of debt. We need to dampen the credit cycle in future by varying capital requirements, and that will require cooperation between monetary authorities and regulators. Yet, in different ways, the US, UK and Euro-area all lack clear frameworks for this coordination. We have had to make it up as we go along.

No major country manages these functions with less than three institutions and most have more. So we need a clear framework for coordination which specifies the separate remits and powers but also places a clear duty on each to cooperate to achieve joint objectives and sets up a process which helps it happen.

MACRO AND MONETARY ECONOMICS

The influence of professional economists on economic policy has probably never been greater than in the last 10-15 years. The thinking in universities and institutes has been reflected both in policy frameworks and in policy decisions. For most of that time, policy was successful but the reverses of the last two years call for some new thinking. The failings of the orthodoxy with its focus on general equilibrium models, based on near perfect markets and rational expectations, have been exposed. We need a paradigm shift in economics as well as in policy.

Statements and views expressed in this memo are solely those of the author and do not imply endorsement by Harvard University, the John F. Kennedy School of Government or the Belfer Center for Science and International Affairs.

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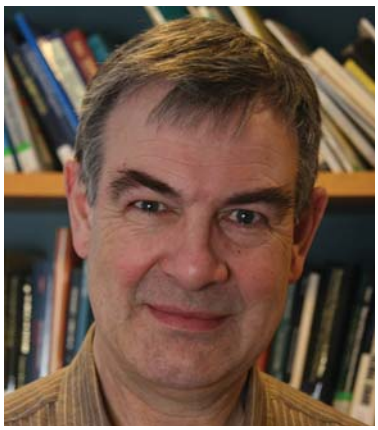

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RELATED RESOURCES

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