THE DESIGN OF REGIMES FOR FINANCIAL STABILITY

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OUTLINE

1) Nature of stability problem
2) What can decently be delegated
3) Missing regimes persist

Social Costs

1) *Booms*: misallocated resources and over-indebtedness. Possibly impaired productivity
2) *Busts*: collapse of system, withdrawal of core financial services.

   Economic slump

New policy regimes overwhelmingly focused on (2)

Frictions associated with Busts

- Fire sales: collateral, wealth and cost of capital effects
- Inter-linkages: cascade of defaults
- Bankruptcy non-linearities: cessation of services, close out
- Barriers to entry: fresh capacity does not substitute for failed firms

New regimes overwhelmingly focused on avoiding bankruptcies and, a new emphasis, reducing social costs of bankruptcy (resolution policy)

A Standard for Resilience

- Core of regime for resilience of financial system as a whole: a *standard of resilience*
- Three inputs:
  1) Societal tolerance for crises
  2) Assumption re first-loss generating process
  3) Propagation of shocks: structure/map of system

The Resilience Commons

- Common to think of finstab as a public good
- Resilience better thought of as a common good: non-excludable but rivalrous
- Taking stability for granted, intermediaries have incentives to take more risk than the market grasps
- This consumes the resilience grass

The problem of Hidden Actions

- Common to frame public policy in terms of Pigouvian taxes
- Very hard to make work in presence of hidden actions (general moral hazard)
- Reg Arb endemic: finance is a shape shifter
- So: a problem of the commons bedeviled by hidden actions

Components of a regime for system resilience

- *Application of Resilience Standard* to different sectors and activities
- *Micro-supervision* of individual intermediaries designed to detect and deter hidden actions
- *Macro-system surveillance* to identify threats to system, and hidden actions beyond ‘regulatory perimeter’
- *Macro-prudential policy*, which dynamically adjusts core regulatory parameters to maintain desired degree of system resilience under changing conditions (ie shifts in stochastic loss-generation or propagation mechanism)

Applying the *Resilience Standard*

- Pushes in the direction of functional regulation
- Should take account of fault lines in infrastructure (neglected pre-crisis)
- *Institutional design*: implies need for unitary authority that either sets or blesses/vetoes application by sector-specialist regulators

Micro-supervision

- Much more important than generally recognized in macro-finance literature due to Hidden Actions problem
- Rules-based system doomed to failure
- Adjudicatory judgments
- *Institutional design*: implies need for forensic skills and *authority*

Macro-system surveillance

- Requires synthesis of information and analysis on intermediaries, markets, infrastructure, macro economy

- *Institutional design*: either
  1) Unitary authority for surveillance, or
  2) Seamless information flows
- Info flows: incentives problem; and hard to evidence obstructionism

Dynamic macro-pru policy

- Problem of credible commitment
- *Institutional design*: implies delegation to an independent agency, with full access to all information

High-level institutional structure

1) A high-level authority for stability policy: applying the RS
2) Micro-supervisors for all parts of system
3) An authority responsible for system surveillance
4) A macro-prudential policy authority

- Natural to combine (1), (3) and (4)
- US close to separating all four. UK close to combing all four under single roof, given FPC override power over FCA

Implications for central banks

- Objective: *monetary system stability*

- Don't make big distributional *choices*:
  - ✓Better (for legitimacy) to set limits on % of intermediary portfolios accounted for by high LTV or LTI mortgages etc than to set rules binding on households
- As multiple-mission agencies, must have strong incentives to pursue all responsibilities with equal seriousness: *separate committees*

The Gap

- Ensuring system resilience not same as
  - ✓managing the credit cycle
  - ✓mitigating every resource misallocation caused by fin system pathologies
  - ✓leaning against real economy over-indebtedness that does *not* threaten system stability
- Not same as addressing the first type of social cost
- Missing regime for *national balance-sheet management*: akin to fiscal policy

Need for debate on the Gap

- A lot of macro-finance literature on pecuniary externalities is about the social costs of booms
- But not really what is happening in policy world
- Priority on system resilience is right
- But need to face up to the Gap

There is more than one Gap

- A complete regime of regimes would cover:
  1) Nominal stability and inter-temporal stabilization
  2) Financial/Monetary system resilience
  3) National balance-sheet management
  4) Global macroeconomic imbalances

- Central banks can lead on only (1) and (2). Could advise on (3) and (4)