

REFORMING FINANCE: MACRO AND MICRO PERSPECTIVES

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KEY POINTS:

- Reforms of the financial system in the wake of the global financial crisis are incomplete. Beyond reforms, good judgment is essential in a crisis.
- Short-termism in finance cannot be completely controlled by regulation and supervision. Financial crises are inevitable but need not be as virulent at the global financial crisis.
- Central banks will have to rethink their policies and how they interact with other agencies partially responsible for maintaining financial system stability.



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INTRODUCTION¹

Although there was great optimism about prospects for reforming finance in the immediate aftermath of the global financial crisis of 2008-2009, only to be followed by the ongoing sovereign debt crisis in Europe, the expectation that lessons learned from the past would translate into meaningful reforms were quickly dashed. As recently as last month, *The Economist* (2014) warned of a “worrying wobble” when the Basel committee decided to weaken rules for bank capital requirements. As the events that created so much stress in financial markets recede from view, there is increasing pressure on policy makers to relax their initial intention to implement regulatory and supervisory changes and ensure that this time would indeed be different. The process of regulatory reform is incomplete. In addition to the backtracking by the Basel committee, the actual regulations that regulators and supervisors in the United States can refer to is still far from complete, while the European Central Bank's ability to supervise

1 This policy brief is adapted, with permission from Elsevier, from the introduction to a special issue of the *Journal of Financial Stability* (Siklos and Bohl forthcoming). To view the special issue in its entirety, please visit: <http://dx.doi.org/10.1016/j.jfs.2014.01.002>.

ABOUT THE PROJECT

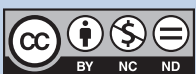
This brief emerges from a project called Essays in Financial Governance: Promoting Cooperation in Financial Regulation and Policies. The project is supported by a 2011-2012 CIGI Collaborative Research Award held by Martin T. Bohl, Badye Essid, Arne Christian Klein, Pierre L. Siklos and Patrick Stephan. In this project, researchers investigate empirically policy makers’ reactions to an unfolding financial crisis and the negative externalities that emerge in the form of poorly functioning financial markets. At the macro level, the project investigates whether the bond and equity markets in the throes of a financial crisis can be linked to overall economic performance. Ultimately, the aim is to propose policy responses leading to improved financial governance.

AUTHOR’S ACKNOWLEDGMENT

The author thanks The Centre for International Governance Innovation (CIGI) for financial support.

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banks in the euro zone is heavily circumscribed by EU finance ministers. Reforming finance is, to put it mildly, a work in progress. Contributing to these developments is recent optimism about the global macroeconomic and financial environments. As a result, there is an opportunity to further explore some issues that need to be put on the agenda. In that spirit, this brief considers some of the outstanding challenges that policy makers will inevitably face when the next crisis erupts.

As part of a research program about promoting cooperation in financial regulation, financed in part by a CIGI Collaborative Research Award, a series of papers were selected that will soon be published in a special issue of the *Journal of Financial Stability*. The project explores the implications of recent events that highlight the inadvisability of separating micro from macroprudential concerns. Microprudential policies regulate the behaviour of individual institutions, while macroprudential concerns ensure good monetary policy is paralleled with financial system stability. The difficulty, however, as Martin Wolf (2014) points out, is that no one really understands yet whether macroprudential policies can be made effective. Canada is a good illustration. While many worry about the possibility of a property bubble in parts of the country, the recent tightening of mortgage rules by the federal government has done little to stem the rising prices that are fuelled, in part, by ultra-low interest rates. While these show little sign of rising anytime soon, which would help dampen the property-buying frenzy, there is continued upward pressure on asset prices more generally. The fact that the Bank of Canada shares responsibility over macroprudential concerns need not be problematic per se, but the potential for tension between the government and the central bank does exist.

The proposed research empirically investigates policy makers' reactions to an unfolding financial crisis. An additional aim is to highlight cases where, in spite of considerable evidence to the contrary, policy makers' knee-jerk reactions in a crisis, although well intentioned, end up creating additional distortions that leave financial markets impaired once the crisis has passed. At the macro level, the project investigates whether the bond and equity markets in the throes of a financial crisis can be linked to overall economic performance. Ultimately, the aim is to propose policy responses that will improve financial governance.

The papers in the forthcoming special issue cover a wide variety of topics that highlight how financial markets are affected by crises and the outstanding questions that policy makers have not, or are as yet, have not been able to address. Nevertheless, even if major reforms are undertaken, some of the papers make it clear that it is impractical to expect any policy changes to end the likelihood of any future financial crisis. Indeed, several key unknowns remain about how to predict the onset of financial crises. A further complication is that the global financial crisis highlights the need to consider both macro- and microprudential elements to accurately understand the anatomy of a financial crisis.

MICRO PERSPECTIVES

In "Stress-Testing Macro Stress-Testing: Does It Live Up to Expectations?" Borio, Drehmann and Tsatsaronis (forthcoming) begin by pointing out that, prior to the financial crisis, indicators of the state of the financial system showed that it was healthy. Even Iceland, which experienced an epic meltdown of the banking sector, was supposed to be resilient to financial shocks. To make matters worse, the resulting failure could not be blamed on a single institution, as central banks and

international organizations collectively failed to foresee the magnitude of the financial crisis. Indeed, the "Great Moderation" prompted many officials to argue that best practices were in place and that the fragility of the financial system was at an all-time low. Borio, Drehmann and Tsatsaronis focus on what is now popularly known as "macroprudential stress tests," as opposed to the better-known stress tests applied to banks. Their broad investigation of the issues finds that while macro indicators can be useful for managing a financial crisis underway, existing indicators are less effective in acting as an early warning system. This seems to underscore a vast literature dating back several years (see, for example, Reinhart and Rogoff 2009 and references therein), which finds a multitude of explanations for the large number of financial crises that have plagued economies since at least the late nineteenth century.

Equally interesting is the suggestion that, while quantitative indicators and models used to determine the state of the financial system are essential, qualitative factors and good judgment are just as important to manage financial crises. Moreover, whereas economic models are naturally specified to assume that a "large" shock is necessary to destabilize the financial system, the authors correctly remind readers that a "small" shock (e.g., Greece's sovereign debt crisis) can easily translate into a bigger shock, with the same ability to threaten the global financial system. One conclusion, reinforced by some of the authors' earlier works (see references in Borio, Drehmann and Tsatsaronis), is that policy makers need to take credit growth more seriously. Of course, what constitutes credit can change over time, thanks to financial innovations. In other words, the concept of credit is a malleable one. For example, approximately two decades ago, policy makers would not have been concerned with what we now call shadow banking. Today, the potential for credit in that sector is a primary

focus of attempts to reform the financial sector. Hence, unless we are flexible about the meaning of the concept of credit, too narrow a focus may well result in new surprises in the future that can threaten financial system stability.

Turning to more micro-level questions, in “Measuring the Costs of Short-termism,” Davies et al. (forthcoming) consider the vexing problem that individuals and institutions are prone to discounting the future. The authors combine a simple model with an empirical exercise to demonstrate that, while firms have the incentive to engage in “short-termism” to please shareholders, for example, the degree to which the future is discounted can change over time. Indeed, one can make the case that short-termism is likely at a peak just as a financial crisis is about to erupt. While survey evidence has established the case for short-termism, the authors present empirical evidence quantifying the economic costs associated with this kind of behaviour. Their model finds that the pressure to deliver returns now, for projects that take time to mature and generate revenues and profits, amounts to a rise in the marginal cost for investment projects and a redistribution of future profits in the form of dividends for the present.

The authors collected data from over 600 firms in the United Kingdom for the period from 1980 to 2009 and generated econometric evidence showing that, as a financial crisis approaches, there is indeed evidence of more short-termism — in part because firms tend to place an increased weight on quarterly earnings. There is, however, an important twist in their empirical work. In particular, privately held companies, not beholden to the short-termism of publicly held firms with shareholders demanding regular dividend payments, are far more likely to reinvest profits into their businesses. In other words, privately held firms are less

susceptible to short-termism. Unfortunately, few policy implications are drawn. While it is unlikely that short-termism can be short-circuited entirely, it would be interesting to investigate the extent to which tax policies or regulations could influence their findings.

In many ways, Milne’s (forthcoming) “Distance to Default and the Financial Crisis” takes up the micro counterpart of the paper by Borio, Drehmann and Tsatsaronis and asks whether a particular approach, namely a measure of the distance to default, could assist policy makers in predicting bank defaults. Milne’s findings are that distance to default is not a useful metric, and is unlikely to assist regulators in preventing defaults before they actually happen. Part of the reason is that the concept is related to market-based measures of risk. If the financial sector did not see the financial crisis coming, then market-based information is unlikely to be helpful as an early warning indicator.

The empirical exercise consists of examining 41 global banks, 11 of which failed during the period in question, based in more than a dozen economies. Because of the size of these banks, the question of whether they were too big to fail arises. Distance to default is the value of the put option offered to bank shareholders by the safety net that effectively covers these types of banks. Of course, the value of this put is not observed. Hence, the value is derived from the banks’ liabilities and their market price. Like Borio Drehmann and Tsatsaronis, Milne concludes that managing bank failures when they happen is likely the better option than to rely on predictive indicators of the kind considered in the paper.

MACRO PERSPECTIVES

The final two papers in the special issue consider purely macroeconomic implications of certain policy regimes

that become engulfed in a financial crisis. The paper by Meulemann, Uebele and Wilfling (forthcoming) offers a historical lesson, while the paper by Tatom (forthcoming) tackles the current predicament facing the US Federal Reserve.

In “The Restoration of the Gold Standard After the U.S. Civil War: A Volatility Analysis,” Meulemann, Uebele and Wilfling revisit the period following the end of the American Civil War and the return to the gold standard in 1879. A key macroeconomic financial indicator is the exchange rate. While proponents of the floating exchange rate have often noted that the volatility of exchange rates pose no particular economic problem, this paper finds that there are consequences from exchange rate volatility for the credibility of a policy regime. Regardless of how finance is reformed, credibility is an essential ingredient.

More precisely, the authors consider a model with two regimes, namely high- and low-volatility regimes. The authors admit that historical evidence suggests the possibility of a third regime — an intermediate regime where exchange rate volatility is neither high nor low — however, this extension is not considered. The combination of a multiplicity of regimes, together with changing volatility naturally suggests that a Markov-switching generalized autoregressive conditional heteroskedasticity model should be estimated. The stated aim of the paper is to empirically demonstrate that the so-called greenback period was a transitional one from a free float to the gold standard which followed. Equally important is the empirical demonstration that news media can move markets, as can important political events. From the perspective of the topics covered in the special issue, the lesson seems to be that the desire for reform is not enough. Policy makers also need to consider the likely credibility of a regime as well

as plan for a transitional period as agents learn the new rules of the game.

Tatom’s provocative paper, “U.S. Monetary Policy in Disarray,” suggests that Fed policies since 2008 have become difficult to characterize. Straightforward indicators that markets and the public could use to determine how Fed actions influence inflation or economic activity more generally are nowhere to be seen, hence, benchmarks that might permit an assessment of monetary policies and their financial stability consequences seem to be absent. Tatom complains that policy makers may have fallen into the trap the Fed fell into decades before by underemphasizing the importance of the real, not the nominal interest rate as determinants of spending. He also laments the downgrading of base money as a monetary policy indicator by pointing out that base growth was declining prior to the onset of the crisis in 2008-2009.

The paper also examines how model development (e.g., the spread of Dynamic Stochastic General Equilibrium modelling) diverted emphasis away from an examination of Fed balance sheet components. Most notably, he zeroes in on the Fed’s reserves policies and argues that current interest rates amount to a large subsidy to certain segments of the financial sector. His analysis is partially prompted by then Fed Chairman Ben Bernanke’s comment a few years ago to Milton Friedman and Anna Schwartz that the lessons of the Great Depression have been learned. Tatom reminds us what Friedman’s positions on credit and bank reserves were and concludes that the Fed, during the crisis, has been on the wrong track.

WHERE DO WE GO FROM HERE?

More than five years after the crisis, there is still much to learn about how financial systems respond in stressful

environments. Reforming finance will be a long process, possibly interrupted by new crises. Nevertheless, a few tentative conclusions and policy implications are apparent. First, the quality of bank supervision is as important as the regulatory rules that govern banks. To the extent that these limits are seen *ex post* as too weak, responsibility should be squarely assigned to the institutions that are held accountable for enforcement of the regulations. Accountability needs to clear.

While many in the financial industry worry that opportunities for profitable trades are needlessly being circumscribed, the tendency towards short-termism compels policy makers to place limits on the potential liability faced by taxpayers. Moreover, given the virulence of financial shocks, there is an added incentive for policy makers to cooperate on an international scale to reduce the impact of future financial crises that are sure to come.

Second, while it is useful to search for indicators of financial stress or other proxies for measuring the health of the financial system, it is naive to believe that these have consistent and reliable predictive power. Long ago, we learned that financial crises come in a variety of forms (e.g., banking, currency, balance of payments) and are explained by multiple factors. One size does not fit all. Indeed, this philosophy carries over to our understanding of central banking policies that have recently shifted away from a focus on policy rates toward policies that have significant impact on central bank finances. We are only beginning to learn the difficulties inherent in comparing central banking activities if we are to assess the inherent risks of different unconventional monetary policies.

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