The King Kong Mistake and How To Avoid It

Improving the Regulatory Response to 2008 GFC

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Disclaimer: The ideas in this presentation are my own, and do not necessarily represent those of any other person or organization with which I am associated.

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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.

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?

- My guess: “Therefore supervision is an impossible task”, but that was wrong.
- 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 Organization, 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 triumphs 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;

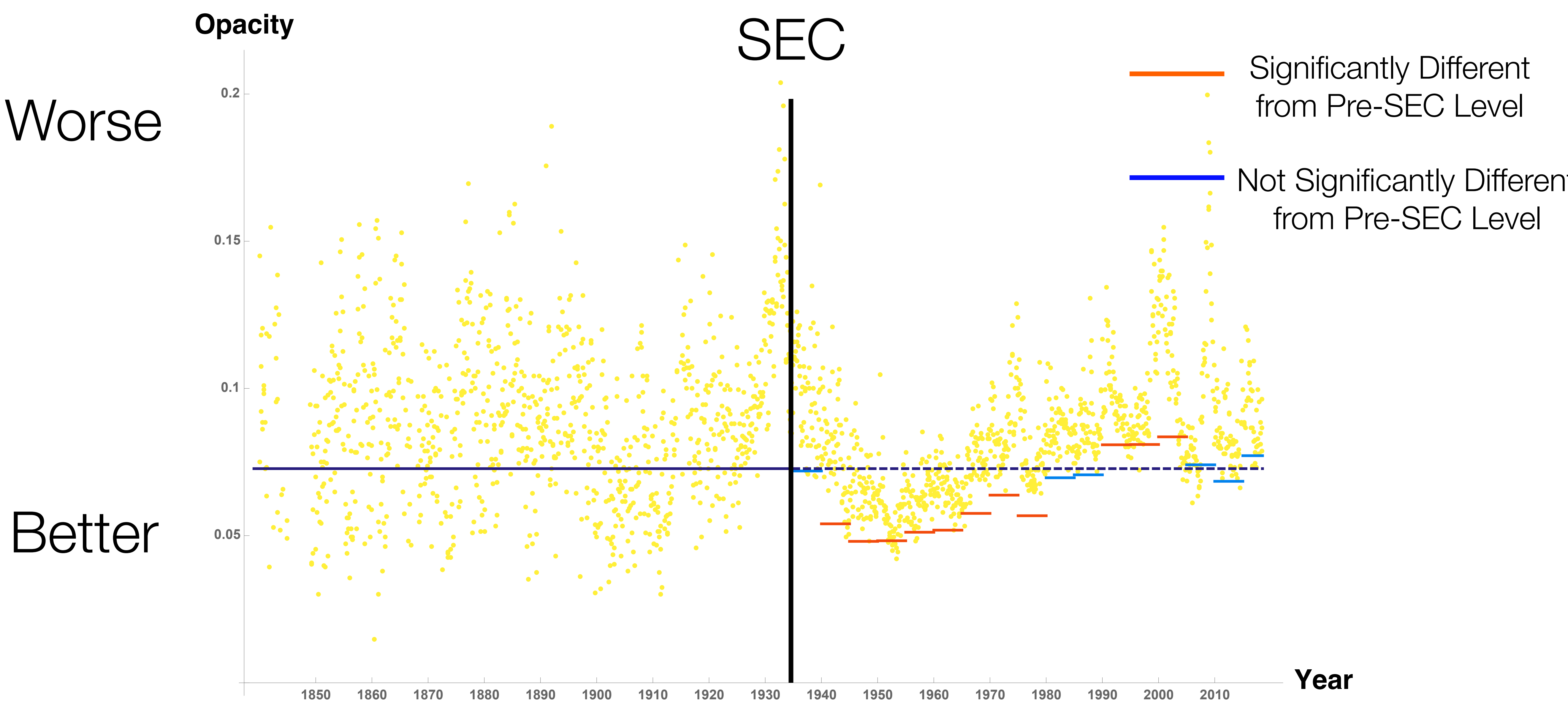
    - There is no (or, at least, *there does not need not to be*) a growth/stability trade-off;

    - 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?

US Financial Market Effectiveness: 1840 - 2018



Opacity: Standard Deviation of Idiosyncratic Returns

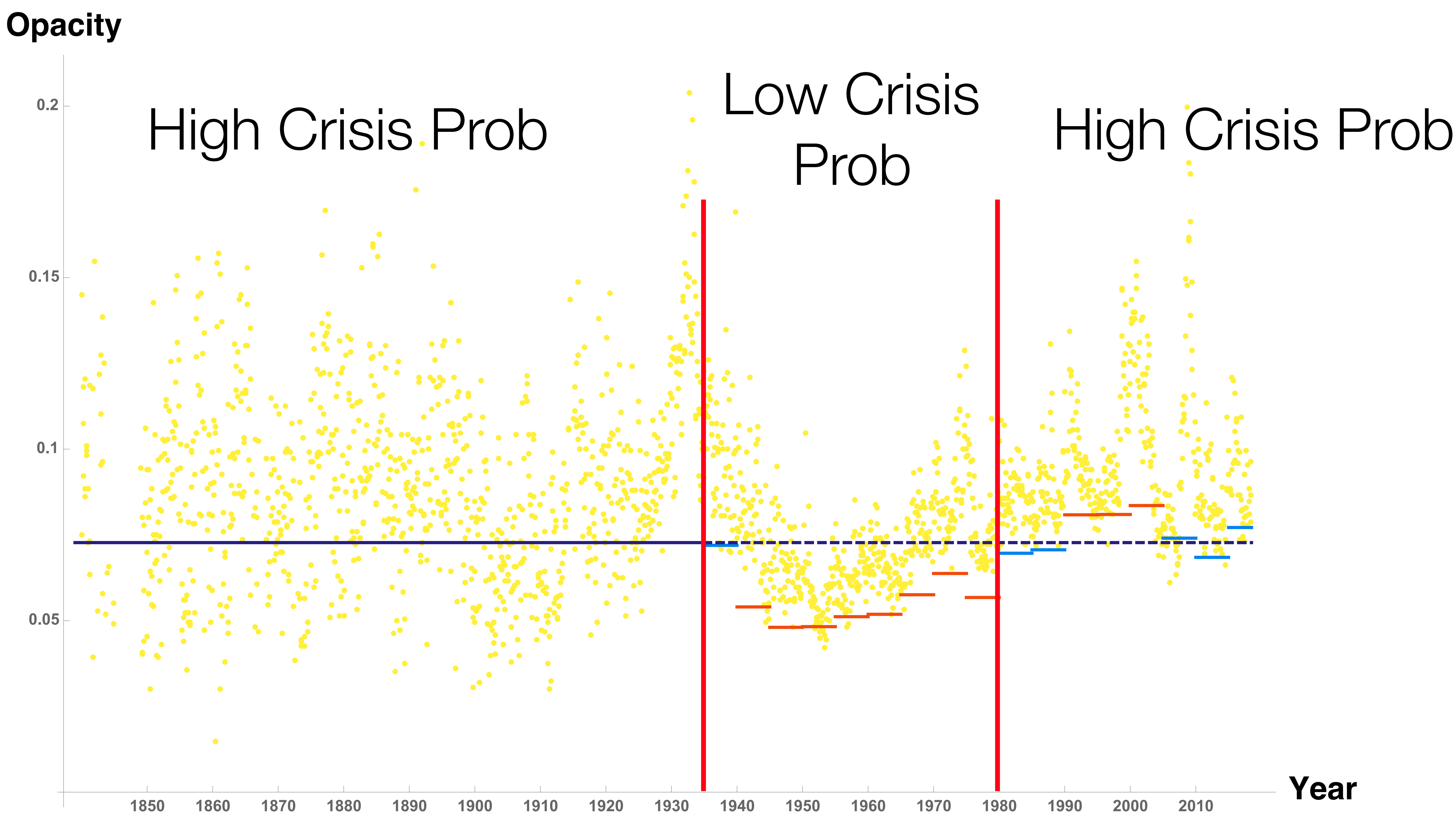
- Intuition
  - If participants lack strong priors on firm value creation potential, prices will react strongly to even small pieces of news;
  - So, the standard deviation of idiosyncratic returns will be high;
- Impact
  - If a firm's value creation potential is opaque, then firms must "show the money" to key stakeholders by pursuing a short-run focused ("flash") strategies rather than a long-run focused ("substance") strategies;
  - So, a Flash strategy leads firms to ignore long-run risks and opportunities, leading to a higher crisis probability and lower TFP growth;
- The creation of the SEC lead to better corporate reporting and better markets and so reduced opacity (for a while…);

Standard Deviation of Idiosyncratic Returns is **NOT**

- The same as IVol (but they are correlated);
  - Campbell, Lettau, Malkiel, and Xu (2001);
  - Ang, Hodrick, Xing, and Zhang (2006);
- The same as the Morck, Yeung, and Yu (1999) measure of opacity;
- Driven by financial repression (using Philippon's (2015) measure of the size of the financial system;
- Driven by the falling costs of information processing (using Nordhaus's (2007) estimate of the cost of information processing).

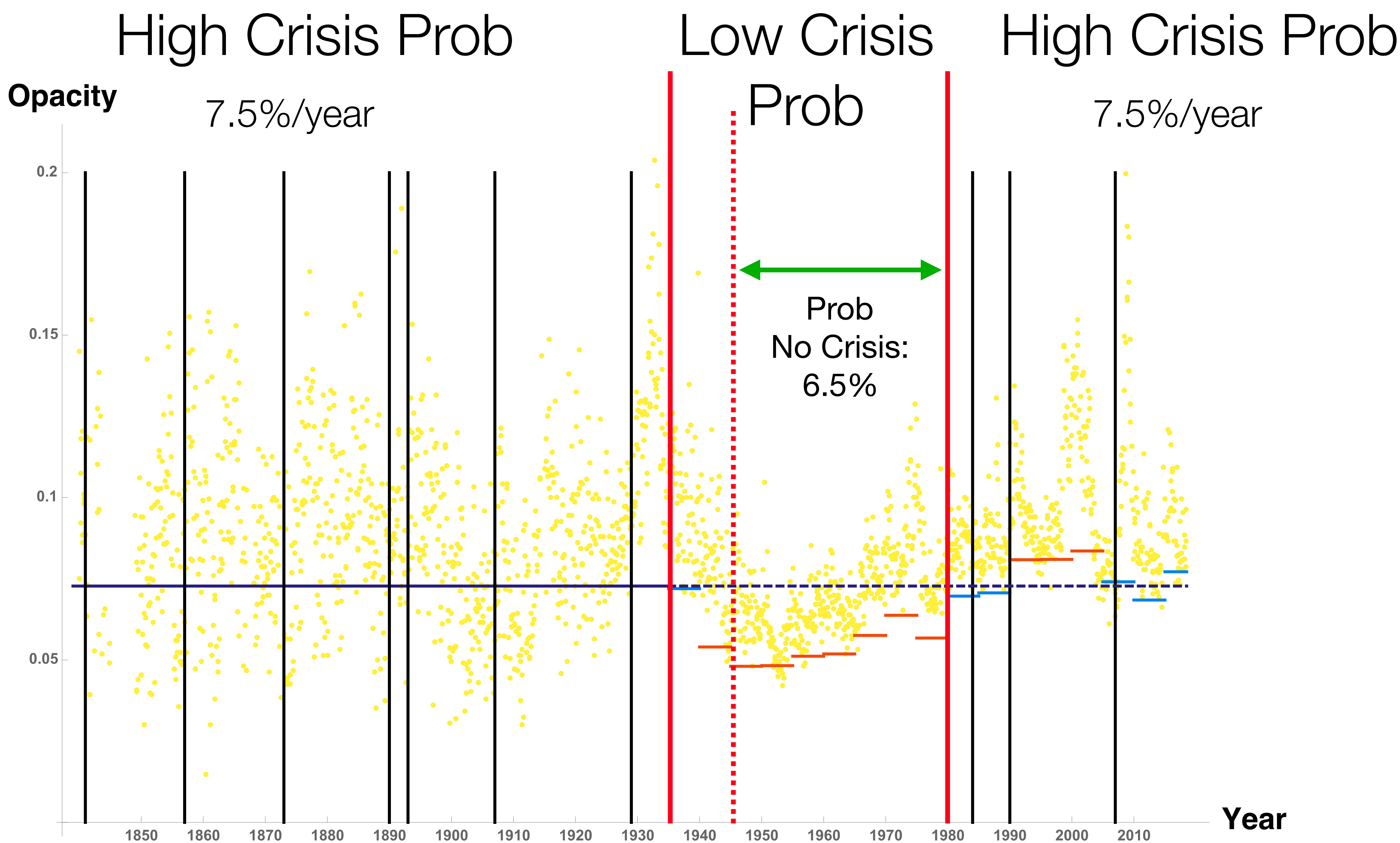
Financial Crises

Hypothesis



Opacity
0.2
0.15
0.1
0.05
High Crisis Prob
Low Crisis Prob
High Crisis Prob
1850
1860
1870
1880
1890
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
2010
Year

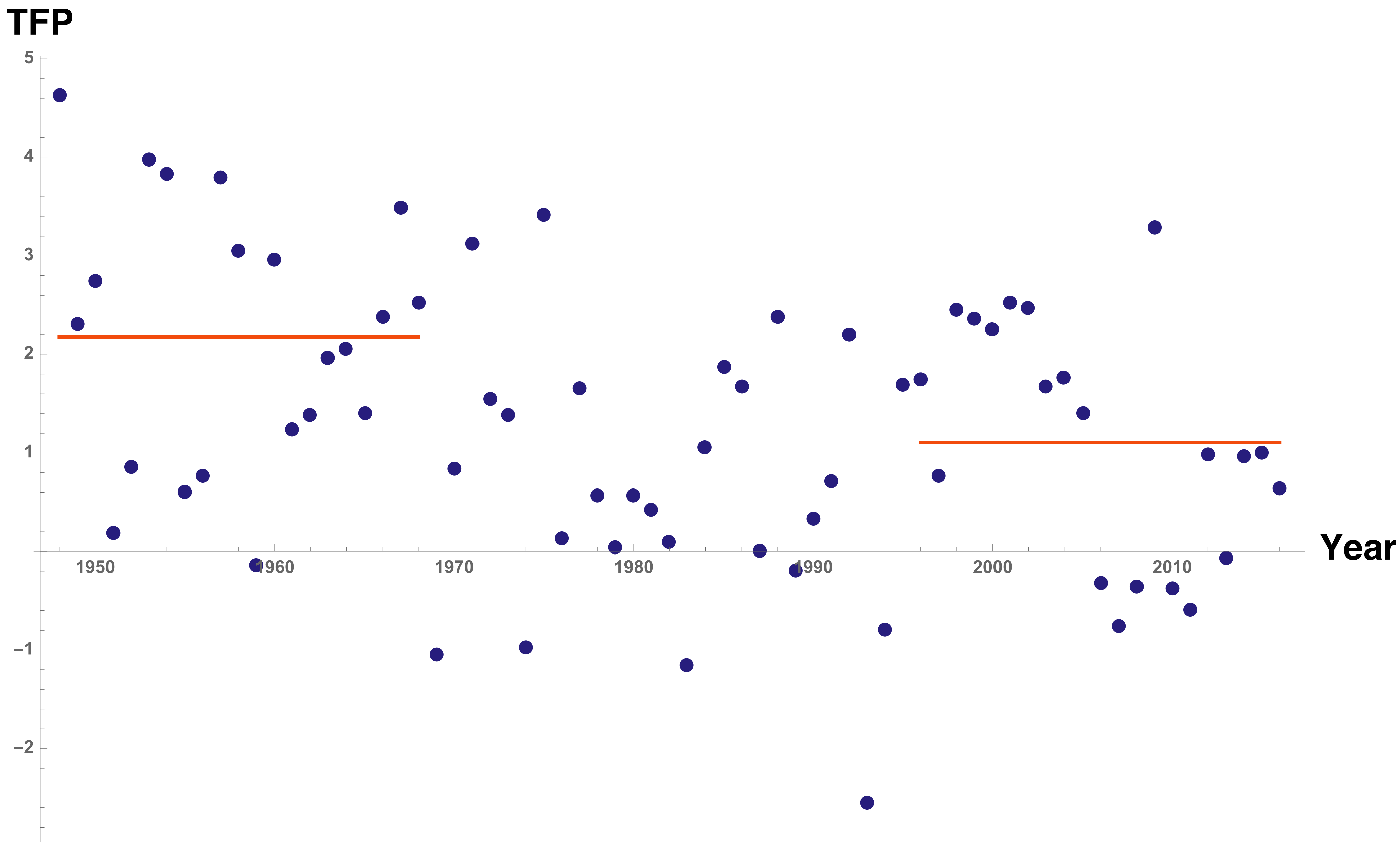
Non-Parametric Results: US Banking Crisis 1840 – 2016



Banking Crises Dates: Baron, Verner, and Xiong (2018)

TFP Growth

TFP Growth Has Been Falling



TFP Growth

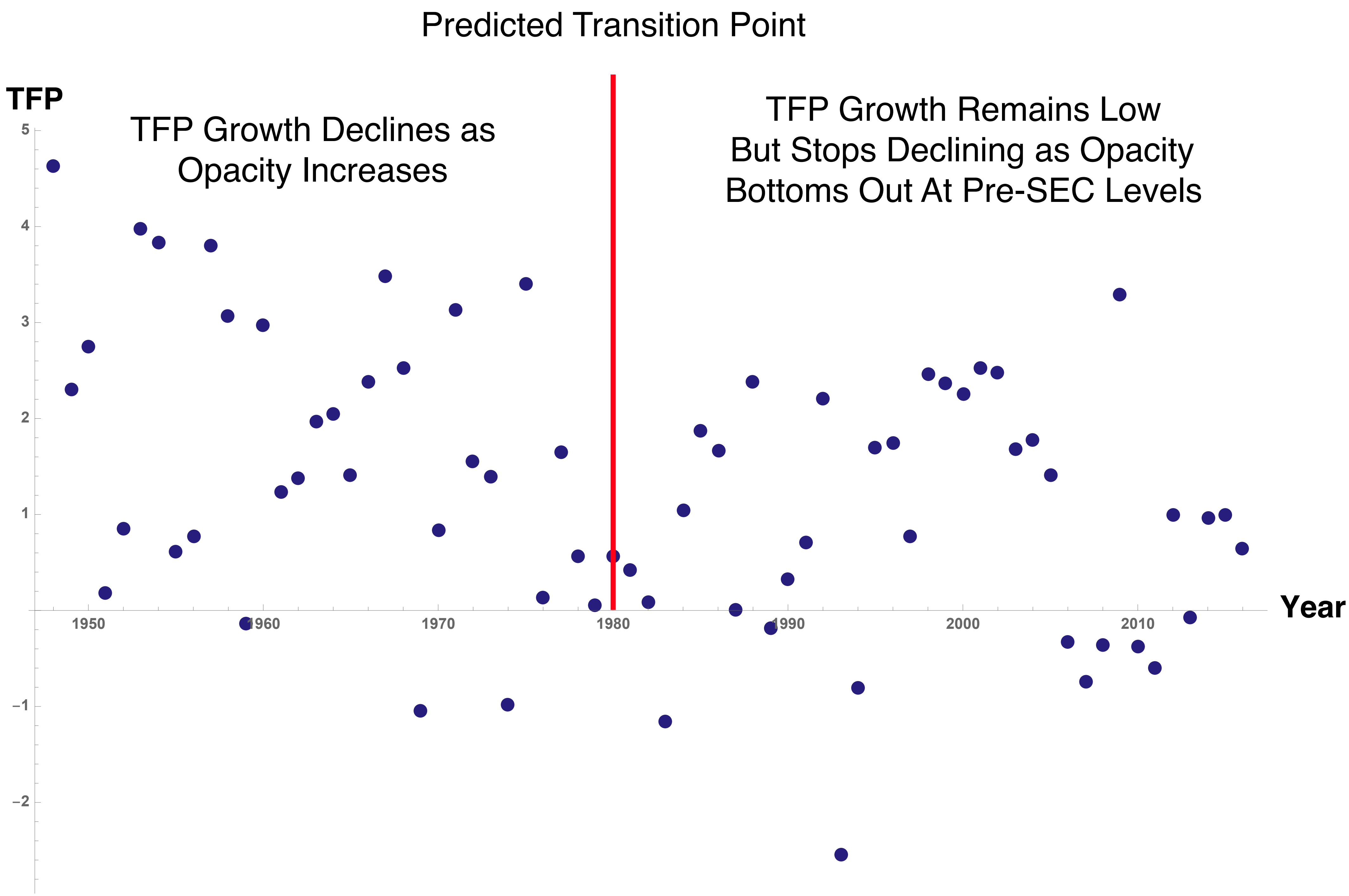
Corporations ride a wave of technological change to create improved products and processes

Robert Gordon’s Explanation for the Decline in TFP Growth

Gordon (2012), “Is US Economic Growth Over?”, NBER WP 18315

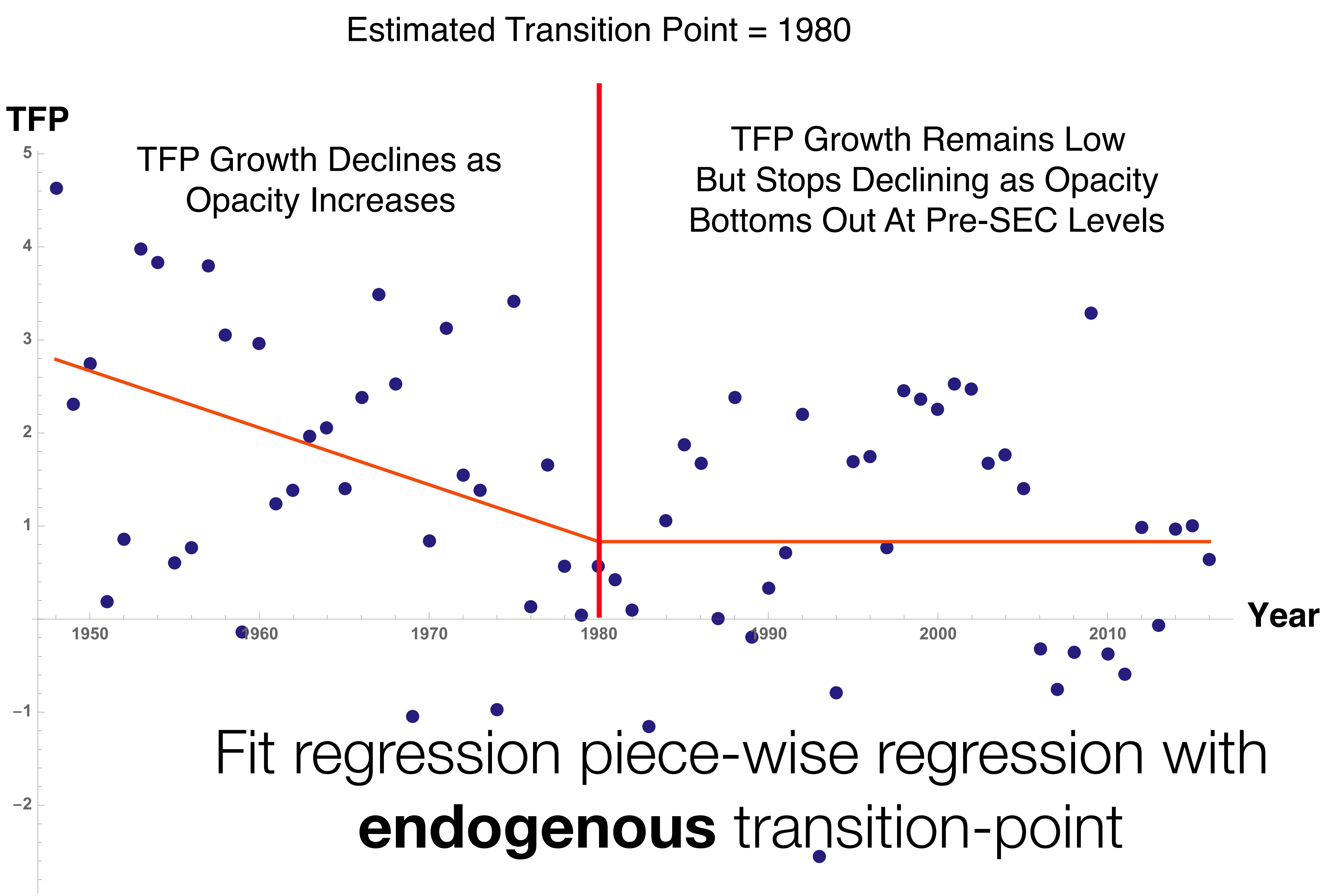
Our Idea: Bad Surfing

Hypothesis



Predicted Transition Point
TFP
TFP Growth Declines as Opacity Increases
TFP Growth Remains Low But Stops Declining as Opacity Bottoms Out At Pre-SEC Levels
5
4
3
2
1
−1
−2
1950
1960
1970
1980
1990
2000
2010
Year

Results



Fit regression piece-wise regression with **endogenous** transition-point

Improving the Regulatory Response to the GFC

Will Next Time Really Be Different?

- 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;
- 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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