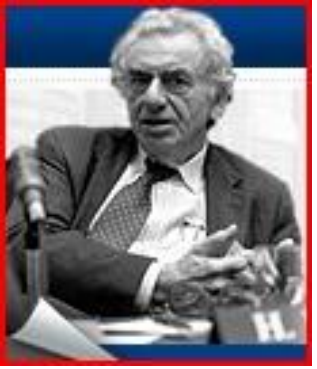

23rd Annual Hyman P. Minsky Conference on the State of the US and World Economies

Stabilizing Financial Systems for Growth and Full Employment

Minsky and Dynamic MacroPrudential Regulation

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What is MacroPrudential Regulation?

A. Haldane:

- "Since the crisis, financial regulation has become explicitly *macro-prudential*. This is an expression much-used, ***but generally little-understood***.
- In a nutshell, it means that policymakers have begun using *prudential* means to meet *macro*-economic ends. Those macro-economic ends include tempering swings in credit and leverage – the classic credit cycle. Or, put differently, curbing the credit cycle appears to be an important ingredient of broadly-based macro-economic stability.

Prudential Regulations for the Macro Economy

A. Persaud:

- "A growing consensus around three ideas:
  - Capital requirements need a countercyclical element to "dampen rather than amplify the financial and economic cycle" by "requiring buffers of resources to be built up in good times."
  - … Greater emphasis on rules rather than supervisory discretion to counterbalance the political pressures on supervisors.
  - … rules should include
    - leverage limits
    - liquidity buffers."

Prudential Regulation without Theory

- Minsky's early work (Commission on Money and Credit, Fed Study on the Discount Mechanism) on Regulation:
- Regulation requires an underlying theory to explain system crisis
- Keynesian or neoclassical general equilibrium theory provides no support
  - A theory of self-adjusting equilibrium provides little scope for discussion of systemic crisis since it could not occur.
  - It is difficult to formulate prudential regulations to respond to systemic financial crises if they only occur from random, external shocks or idiosyncratic, non-rational (fraudulent) behaviour.
- Justification for regulation was eradication of the disruptive behaviour of bad actors or mismanaged financial institutions

Minsky on Traditional (microprudential) regulation

"The instability of banks and other financial institutions is usually described in terms of runs and defaults at particular institutions without a clear explanation of why such strong assets substitution quite suddenly becomes the rule of the day. When conceived in terms of bank runs and defaults, a particular bank fails because of its own, idiosyncratic attributes. Its management has been incompetent or committed fraud."

The FIH as Theoretical Basis of Regulation

- In Minsky's view regulation requires "A more complete description of the instability of an 'economy with banking'."
- needs to look behind the runs and analyze the structure of balance sheets, payment commitments and position-making activities.
- Position-making for a bank consists of the transactions undertaken to bring the cash position to the level required by regulation or bank management.
- **In the "position-making" view, bank failures do not arise simply because of incompetent or corrupt management.**
- **They occur mainly because of the interdependence of payment commitments and position-making transactions across institutions and units."**

Cash flow Examinations to Support Macro Prudential Regulations

- Examination and analysis balance sheets based on the view that liquidity is not an innate attribute of an asset but rather that liquidity is a time related characteristic of an ongoing, continuing economic financial institution."

- Basic to the idea of liquidity as an attribute of an institution is the ability of the unit to fulfill its payment commitments.
- Any statement about a unit's liquidity, therefore depends upon estimating how its normal activities will generate both cash and payments, as well as the conditions under which its assets (including its ability to borrow as an "honorary" asset) can be transformed into cash.
- . . . Any statement about the liquidity of an institution depends upon assumptions about the behavior of the economy and financial markets. As the assumptions are changed, the estimate of the liquidity of the institutions will vary.

Limiting the "Dual Vulnerability"

- The objective of regulation and examination is to identify and limit:
- "position liquidity": funding of the position
- "market liquidity": can I sell the position
- This represents the "dual vulnerability that emerges wherever cash flows from operations are insufficient to meet financial commitments"

Importance of Alternative Economic and Policy Scenarios

- Use the examination process to generate information on both the liquidity and solvency of particular institutions,
- but also on threats, if any, to the stability of financial markets;
- information has to be forward-looking; the implications of alternative economic and policy scenarios investigated.
- Examination procedure to focus upon the actual (past) and potential (near-term future) position-making operations of a bank,
- so that the Federal Reserve authorities would be aware of actual or threatened financial fragility.

Importance of Institutional Change

- In an update of his initial 1967 examination proposal:
- Minsky points to the importance of institutional changes:
  - the emergence of “giant multi-billion dollar banks”
  - “fringe banking institutions and markets”
  - —should be a focal point of examinations
- To “enable the authorities to get a better handle on the operations” of these large banks and their linkages to “non-bank financial institutions and various short term financial markets.”

Regulations must be dynamic

- Regulatory structures eventually become obsolete or perverse.
- The normal, profit-seeking activities of agents lead to innovation in order to create new sources of profits; innovations can be in products, processes or finance.
- The search for profits also drives agents to avoid, evade and adapt to the structure of regulation and intervention put in place to constrain incoherence. In time this undermines the effectiveness of a regime of intervention that "stabilizes the unstable system."
- "As the monetary system, the financial system and the economy are always in the process of adapting to changing circumstances, the quest to get money and finance right may be a never ending struggle," because what is an appropriate structure at one time is not appropriate at another
- **Therefore if regulation is to remain effective, it must be reassessed frequently and made consistent with evolving market and financial structures.**

Examples: S&L Crisis & the FSLIC

- Basic difficulty in insurance is risk of moral hazard,
- but why did the problems of moral hazard and increased risk transference only appear to threaten survival of the FSLIC system after 40 years of successful operation?
- For Minsky the answer was in the institutional and policy changes in the system:
  - "the shift in position-making from trading in liquid assets in the 1960s to transactions in liabilities in the 1970s,"
  - "the decrease in the margins of safety used to cushion fluctuations in cash flows"

Institutional and Policy Changes

- Payment commitments have become more closely coordinated with payment receipts so that small changes in conditions can cause a large increase for units (households and businesses who are indebted to banks and banks that are indebted to depositors) to acquire cash by selling assets that may have thin markets.
- This leads to a need to sell assets to acquire liquidity, which causes a decline in asset prices and a “process that leads to a deep depression”.
- But the change in institutional operations was accompanied by a **change in central bank operating procedures** from interest rate management to money supply management, which made the issue of 30-year, fixed-rate assets, which had been safe assets, inherently risky.
- “the problems today are the result of competition for profits that has transformed an initially robust financial structure into a fragile system and in so doing made obsolete the structure of deposit insurance established 50 years ago”.

Failure of Deposit Insurance

- It was the changed institutions, changed theory, and changed monetary policy that produced increased financial fragility and made deposit insurance untenable in the presence of systemic crises.
- "Whenever bank failures are due to idiosyncratic behavior, actuarial estimates of the probability of payoffs are possible.
- In such cases the insurance model is applicable and the proposed reforms of the structure of deposit insurance could be beneficial".
- But "a system-wide decline in asset values cannot be contained by a guarantee or bailout of some restricted class of deposits or institutions. If instabilities that can generate large, system-wide losses of output, employment, and asset values are to be contained, more than deposit insurance is needed"

How to Fix Deposit Insurance

- The introduction, in today's environment of risk-adjusted premiums or capital requirements and greater public disclosure of problem institutions, would make it more, not less, likely that insurance payoffs will be required.
- In addition, these reforms would increase system instability.
- Federal insurance agencies **do not administer deposit insurance as insurance for depositors** but as a mechanism to insure the safety and soundness of the U.S. banking system. One of their goals is to prevent bank failures. . . .
- Recent innovations in the securitization of assets and the globalization of finance have introduced risks of financial dislocations that are only peripherally related to those the authorities are set up to handle.
- **A stability-enhancing response would be for the government to accept that it has an open-ended, contingent liability**

Continental Illinois and Too Big to Fail

- FDIC Report:
- It is not surprising that few observers recognized the problems inherent in Continental's rapid growth;
- most indicators of the bank's financial condition were good, and some were outstanding.
- **With hindsight** some aspects indicate increased risk
  - First, Continental's loans-to-assets ratio increased dramatically
  - It also took more than the average risks in selected areas:
    - The energy sector (Penn Square),
    - Latin American Syndicated Loan exposure.
    - Involvement with three of the largest corporate bankruptcies of 1982
- Thus the rapid growth was aggravated by the impact of two macroeconomic factors on the bank's assets:
  - Monetary policy changes after the appointment of Paul Volcker
  - A change in oil prices
- Factors that Minsky insists should be a major part of the macroprudential assessment of financial fragility and the supervisory process.

Minsky's Dynamic Macro Prudential Approach

- 1. A theory of Systemic crisis is essential to formulation of regulations
- 2. Regulation should reflect "a dynamic, evolving set of financial institutions and relations…"
- 3. Regulation must reflect current and future economic conditions,
- 4. Regulation must reflect current and expected monetary policies
- 5. Regulation must be institution specific.
  - Minsky's theory of the stages of Capitalist Finance
    - "Money Manager" Capitalism requires different regulations
- 6. Regulation must reflect current theory

What about current Macro Prudential Regulation?

Still No Theory of Systemic Crises/Cyclical behavior to support the macroprudential measures

- Still No Dynamic Response to liquidity and Countercyclical capital buffers
- Ignores perverse incentives, regulatory arbitrage
- One size fits all approach – that was the problem with Basel I and II
- Mistaken conception of "liquidity" buffer
- Still works on the basis of a single institution
  - Stress tests are still a very lonely affair
- Can prudential regulation provide support macro regulation? The Haldane Question. The Minsky rule exercise proves nothing.
- Minsky believed that macro and prudential regulations were contradictory.
- Better to have macro policy support prudential regulation

Implications of Minsky's Approach

- Deposit Insurance:
  - Explicit Government Guarantee or Guarantee of the Insurance Fund
  - But: Dodd-Frank is designed to prevent the tax-payer from having to make good on a total contingent liability
- Alternative: **Get Rid of Deposit Insurance**
  - It is not a macroprudential took
  - It is a major source of Too Big Too Fail
- Direct Government provision of the payments system (eliminate private system)
- Narrow (100% reserve) Banking
  - Minsky Bank Holding Company Proposal
    - Insure productive loans
  - How do you provide the necessary provision of liquidity?
  - Would Require Government Budget Deficit
    - Fiscal policy and monetary policy become unified
    - Treasury and Central Bank could become unified
- National Development Bank (RFC reborn)
- Start control of asset growth from top-down:
  - Set desired limit to ratio of credit to GDP
  - Apportion is across banks
  - Bring emphasis back to ROA to maximise P/A (ROE)
  - Instead of maximise A/B (leverage) P/B = (P/A) (A/B)

Haldane's Ambidextrous Regulator and the Two Hands and the Minsky rule

- This is where macro-prudential policy comes in. One of the aims of macro-prudential policy is to act counter-cyclically on the credit cycle, constraining credit booms and cushioning busts. In this role, macro-prudential policy is complementing monetary policy in its role of stabilising the macro-economy. Macro-economic policy then becomes, in effect, two-handed or ambidextrous.
- The so-called Basel III reforms introduced for the first time a "Counter-cyclical Capital Buffer" (CCB) to be adjusted to counteract the credit cycle.
- It is also, inevitably, something of a step into the unknown. What will be the impact of changes to the CCB on credit and growth?
- Will the two arms of policy (monetary and macro-prudential) be better than one?
- And, if so, what institutional arrangements best deliver those benefits? Policy experience from the recent past and the present can shed light on these questions.
- The Minsky rule: Apply the CCB to the "Credit Gap" (the ratio of US credit-to-GDP, relative to its long run trend).

Second Generation Macro Prudential Regulation Haldane

- "Yet if risk in the financial system, and activity in the wider economy, are shaped importantly by asset management behaviour and associated pro-cyclical swings in risk premia, then … Macro-prudential action may be justified even when leverage is not present … Modulating the price of risk, when this is materially mis-priced, could be every bit as important as controlling its quantity.

- This is the next frontier for macro-prudential policy – whether, and if so how best, to moderate excessive swings in risk premia across financial markets which risk damaging the financial system or wider economy.

- This will require new analytical techniques to measure risk premia and their impact. And it will require fresh thinking on new policy tools to moderate movements in these risk premia. This is, in effect, an agenda for the second-generation of macro-prudential policy frameworks"

Thank You

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