Preventing the Next Catastrophe: Where Do We Stand?

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As I listened to the presentations and discussions, I found myself thinking about the conference from two perspectives. One is intellectual: Did we ask provocative questions? Were interesting ideas proposed? Were we talking about important issues? By that standard, the conference was very successful: the contributions and discussions were extremely stimulating, and I learned a great deal.

The second perspective is practical: Where do we stand in terms of averting another financial and macroeconomic disaster? By that standard, I fear we are not doing nearly as well. As I will describe, my reading of the evidence is that the events of the past few years are not an aberration, but just an extreme manifestation of a broader pattern. And the relatively modest changes of the type discussed at the conference—and that policymakers are putting into place in some cases—are helpful but unlikely to be enough to prevent future financial shocks from inflicting large economic harms.

Thus, I believe we should be asking whether there are deeper reforms that might have a large effect on the size of the shocks emanating from the financial sector or on the ability of the economy to withstand those shocks. But there has been relatively little serious consideration of

ideas for such reforms, not just at the conference but in the broader academic and policy communities.

The Financial Sector as a Continued Source of Shocks

My view that we should think of financial shocks as closer to commonplace than to exceptional is based on history. Consider the United States over the past 30 or so years. By my count, there have been six separate times over that period when financial developments posed important macroeconomic risks. In three of them, the risks were largely averted and the costs ended up being minor. In two, the costs were modest to moderate. And in one, the damage was enormous.

Concretely:

- In the throes of the Volcker disinflation in the early 1980s, the combination of the severe recession and banks' exposure to Latin American debt caused many major banks to be in serious trouble. It was only a last-minute turn in policy and the willingness of regulators to ignore the banks' extremely shaky financial condition for a few years that kept the financial system from falling apart. So that was a danger averted.
- The 1987 stock market crash was a significant financial shock, but rapid and highly visible responses by the Federal Reserve to keep markets functioning and reduce interest rates again prevented large damage to the economy.
- The savings and loan crisis of the late 1980s and early 1990s did some damage to the economy through misallocation of investment and impaired lending, and somewhat more damage to the government budget through direct bailout costs.
- The Russian debt crisis and the collapse of Long-Term Capital Management (LTCM) in 1998 caused central bankers some sleepless nights as they worried about the stability of

the world financial system. Stability was preserved through the arranged rescue of LTCM, lower interest rates, and other actions. That is the third case in which the danger was averted.

- The dot-com bubble and bust of the late 1990s and early 2000s caused a considerable misallocation of investment and, more importantly, a recession.
- And, obviously, we had the housing-price collapse and financial meltdown of the past few years, which have had catastrophic effects.

In light of that record for just one country over a third of a century, the idea that large financial shocks are rare, and that we therefore should not worry greatly about them, seems fundamentally wrong.

What I find striking about this list is not just its length but its variety. And if you look outside the United States, it is easy to find examples of other kinds of financial shocks. You see Iceland and Cyprus, where the financial shock came from a vastly expanded banking sector with huge foreign deposits. You see Greece, where the problem was disguised fiscal profligacy. You see the classic sudden stops. And I am sure that with a little more work, you could add even more types of financial shocks to the list.

In short, the range of potential financial shocks is long and varied. There are only a few on my illustrative list of domestic and foreign financial shocks that took the form of big run-ups in asset prices followed by some kind of crash. Indeed, there are only two, the dot-com episode and the recent crisis, that one could reasonably call "bubbles." So I think the right conclusion to draw is that financial shocks are likely to be both frequent and hard to predict, not just in their timing but also in their form.

Small-Scale Solutions

The question, then, is what to do. Let me start with two small-scale policies, one of which I think is largely a nonstarter and one of which I think will be helpful but very far from a complete solution to the risks of future crises.

The nonstarter is using the short-term policy rate as a tool for dealing with financial imbalances and risks. Even if that were the only objective we were using the policy rate for, it is much too crude. Often the concern with the financial system involves a potential problem in one part of financial markets, or different types of problems in different markets. In such situations, a single tool that affects all markets is of limited value. Indeed, as Janet Yellen pointed out at the conference, often it is not even clear which direction you would want to move the policy rate to address a potential financial risk to the economy. And, of course, we want to use it for other very important purposes as well. So we can debate whether there is a little bit of benefit to taking financial developments more into account in the setting of interest rates, but at best it can improve outcomes only marginally.

The type of small-scale policy that I think is more promising is the one advanced in the discussions of macroprudential policies and capital account management. The positive way to put it is that it is the wise central banker model; the negative way to describe it is that it is the Whac-A-Mole strategy. Regardless of how one labels it, the idea is to use regulations and interventions creatively to address potential problems as they develop. For example, if you think a bubble is developing in the real estate market in Seoul, you adopt regulations directed specifically at mortgages in Seoul.

I was very impressed with the descriptions of policymakers' actions in such countries as Israel, Korea, and Brazil in dealing with a wide range of financial developments, and something I

learned from the conference is that such targeted actions are a useful addition to the policy toolkit. But in light of the enormous range of potential financial shocks, the idea that we can stabilize the financial system by counting on very smart policymakers to perceive each problem as it is developing and design a specific intervention to target it quickly is surely wishful thinking.

What I take from this is that we need to be thinking more broadly and creatively, looking for more fundamental solutions rather than particular interventions. At a general level, these can take two forms.

Deeper Solutions on the Financial Side

The first approach is to reform the financial system so that the shocks it sends to the real economy are much smaller. The discussion of microregulation showed that there are promising ideas in that area. Here I am thinking of stronger capital and liquidity requirements, special rules for institutions that create more systemic risk, and restrictions on the form or capabilities of what financial institutions can do, such as ring-fencing in the United Kingdom and the Volcker rule in the United States. Those approaches are broader than responding to individual problems as they arise, and they appear promising.

But at the end of the day, it is hard to believe that the relatively modest changes along these dimensions that were discussed at the conference are really big enough to give us a financial system that is so robust that it is not going to periodically cause severe problems. Shadow financial institutions may escape the rules altogether; rules can be gamed; and shocks can be so large that they overwhelm the moderate changes that were considered.

Thus, I was disappointed to see little consideration of much larger financial reforms. Let me

give four examples of possible types of larger reforms:

- There were occasional mentions of very large capital requirements. For example, Allan Meltzer noted that at one time 25 percent capital was common for banks. Should we be moving to such a system?
- Amir Sufi and Adair Turner discussed the features of debt contracts that make them inherently prone to instability. Should we be working aggressively to promote more indexation of debt contracts, more equity-like contracts, and so on?
- We can see the costs that the modern financial system has imposed on the real economy. It is not immediately clear that the benefits of the financial innovations of recent decades have been on a scale that warrants those costs. Might a much simpler, 1960s- or 1970s-style financial system be better than what we have now?
- The fact that shocks emanating from the financial system sometimes impose large costs on the rest of the economy implies that there are negative externalities to some types of financial activities or financial structures. This suggests the possibility of Pigovian taxes. So, should there be substantial taxes on certain aspects of the financial system? If so, what should be taxed—debt, leverage, size, other indicators of systemic risk, a combination, or something else altogether?

I do not know the answers to these questions, but it seems to me that they deserve serious analysis. Yet radical redesign of the financial system was largely missing from the conference.

Larger-Scale Solutions on the Macroeconomic Side

The other way to make large changes is to try to make the macroeconomy more resilient to financial shocks. I thought the lack of discussion of possible changes in this dimension was the

largest gap in the conference. Let me discuss this issue in three areas of macroeconomic policy: measures to deal with shocks to a common currency area, monetary policy, and fiscal policy.

With regard to a common currency area, imagine that at some point in the not too distant future, the euro area is hit with another large financial shock that has asymmetric effects across different countries. Are things going to play out very differently than they have over the past few years?

There would surely be fewer late-night meetings, because policymakers have learned more about how to do short-term crisis management. But I see little progress toward measures that would cause fundamental changes in the effects the shock would have. Policymakers have taken, at most, baby steps toward addressing the instabilities created by the fact that the responsibility for cleaning up insolvent banks is at the level of individual countries rather than of the euro area as a whole. And even less has been done in terms of a fiscal union and mechanisms to deal with large differences in competitiveness.

Concerning monetary policy, inflation targeting appeared to be an almost ideal framework for its first 15 or 20 years. But we have now had an extended period during which it has shown itself incapable of providing aggregate demand at the level that is widely recognized to have been needed. So it seems important to think about whether we should have a different approach to monetary policy. But again, we have not gotten very far. The idea of targeting a nominal GDP path has been mentioned on and off for a few years, but the debate has not proceeded to serious quantitative analysis of its costs and benefits and of whether it could make the economy substantially more resilient. Other ideas for significant changes in the monetary policy framework have been discussed even less.

With regard to fiscal policy, the biggest idea that has achieved substantial support is that it

would be desirable to have more fiscal space. But how to get from here to there, given the challenges of just getting back to the amount of fiscal space we had before the crisis, is a hard issue, and one on which progress has been minimal. And in light of the terrible problems that have afflicted some countries that entered the crisis with very responsible fiscal policies, fiscal space is clearly not a magic bullet.

I heard virtually no discussion of larger changes to the fiscal framework. The possibility of measures to make automatic stabilizers stronger (for example, through macroeconomic triggers for changes in fiscal policy) was not mentioned. And the status of this idea in the broader policy community resembles the status of targeting a nominal GDP path: the idea is mentioned from time to time, but the discussion has not proceeded to the point of concrete proposals and quantitative evaluation.

Another fiscal idea that has received little attention, either at the conference or in the broader policy debate, is the idea of fiscal rules or constraints. For example, one can imagine some type of constitutional rule or independent agency (or a combination, with a constitutional rule enforced by an independent agency) that requires highly responsible fiscal policy in good times and provides a mechanism for fiscal stimulus in a downturn that is credibly temporary. Roberto Perotti and Avinash Dixit raised the idea of fiscal rules or councils very briefly, but it got no further than that.

The fact that we are making so little progress in terms of larger changes to our approaches to macroeconomic policy appears to further strengthen the case for thinking about deeper financial reforms. But I also think we need broader thinking about the macroeconomic side.

Conclusion

After five years of catastrophic macroeconomic performance, "first steps and early lessons" (to quote the conference's subtitle) is not what we should be aiming for. Rather, we should be looking for solutions to the ongoing current crisis and strong measures to minimize the chances of anything similar happening again. I worry that the reforms we are focusing on are too small to do that, and that what is needed is a more fundamental rethinking of the design of our financial system and of our frameworks for macroeconomic policy.