Excess-Countering versus Countercyclical Policies

Roman Frydman
New York University

Initiative for Policy Dialogue

Task Force on Governance, Transparency and Accountability

27 April 2009

Roman Frydman and Michael D. Goldberg
Imperfect Knowledge Economics: Exchange Rates and Risk, Princeton University Press, August 2007.

Roman Frydman and Michael D. Goldberg "Macroeconomic Theory for a World of Imperfect Knowledge," ***Capitalism and Society***: Vol. 3 : Iss. 3, Article 1, December 2008.

Roman Frydman and Michael D. Goldberg "Financial Markets and the State: Price Swings, Risk, and the Scope of Regulation," forthcoming in ***Capitalism and Society***, 2009.

- Few still doubt that the radical deregulation of the financial system in the late 1990s and early 2000s has been one of the primary causes of the current crisis.
- Nevertheless, there is still widespread agreement among policy makers that financial markets are vastly superior to regulators in setting values and allocating scarce capital.

If so, what is the rationale for and appropriate scope of re-regulation?

- The ongoing policy debate has largely focused on traditional market failures:
  - lack of transparency,
  - inadequate incentives,
  - weak competition.

- As this conference underscores, the new regulatory framework must aim to rectify the glaring market failures exposed by the crisis.

Beyond Market Failures

Financial Risk, Business Cycles, Swings in Asset Prices

- It is by now recognized that sharp upswings in the real economy prior to the crisis substantially contributed to the vulnerability of banks' loan portfolios when the inevitable downturn arrived.

- Many have also pointed to excessive upswings in house and equity prices, followed by sharp reversals, as key factors behind the current financial crisis and its devastating effects on the real economy.

- Beyond transparency, rectifying other market failures, and managing leverage in the system, we need regulatory policies that emphasize the inherent connection between financial risks, the business cycle, and price swings in asset markets.

Inadequacy of Basel II Accords

- They are based on standard measures of risk
  - depend on default probabilities that fall during expansions and rise during contractions.
- Consequently, capital requirements implied by Pillar 1 of Basel II are pro-cyclical.
  - During upswings, they require banks to hold provisions that are insufficient to cover losses during subsequent declines in real activity.

- Major reform proposals recognize the need to build up capital buffers during upswings to protect banks against inevitable downturns.

- Spain’s approach to reducing the pro-cyclical impact of capital requirements is often cited as a model of how this can be done.

- Bank of Spain’s “statistical provisioning” (July of 2000)
  - In expansions, the banks set aside **additional** provisions equal to the difference between “the statistical provisioning” based on average default rates over the cycle and “current” capital requirements based on *standard risk measures* implied by the current economic conditions.
  - In recessions, “current” capital requirements are greater than the cycle-average, and the banks draw down on the accumulated reserves to cover the difference.

- The post-crisis accounts indicate that the Spanish scheme has clearly helped to protect the banking system and the regulators from underestimating risks inherent in the rapid expansion of banks’ loan portfolio during expansion.

- However, as reported by the Economist (May 15, 2008), statistical provisioning scheme failed to require the Spanish savings banks to set aside sufficient provisions against mortgage loans issued during the sharp upswing in house prices.

- This suggests that gearing banks’ provisions to excessive swings in underlying asset values and the real economy may be at least as important as smoothing provisions on the basis of an average default rates over the past business cycles.

- Countercyclical Policies Dampen Economic Activity in the Early Phase of Expansion
  - dangers of under financing of sustainable new and expanding activities.

- Motivated by contemporary macroeconomic theory, the Spanish regulatory framework ignores the economic importance of swings in the real economy and therefore views the smoothing of business cycles as having unambiguous social benefits.

- Indeed, Governor of the Bank of Spain, Miguel, Fernandez Ordonez singled out "*anti-cyclical*" nature of statistical provisioning capital requirements as one of their main advantages.

Alternative (IKE) View of Swings

- Financial markets and real economy are hardwired to undergo swings that revolve around historical benchmark levels.
  - The innovativeness of modern societies implies that economic, political, and social relationships unfold in ways that no one can fully foresee.
  - Imperfect knowledge about the way past trends in fundamental factors of all kinds are related to future outcomes implies that swings emerge as investors and markets appraise the ever-changing prospects of projects and companies, and allocate capital accordingly.

The Indispensable Role of Swings and Countercyclical Capital Provisions

- Countercyclical policies slow down the issuance of loans throughout expansionary phases of the cycle.

- They are thus likely to reduce the volume of real activity even in the early phase of the expansion, which involves the financing of potentially the most beneficial new products and processes.

- This brings us to one of the key problems concerning the regulatory reform of the financial system.

  – How can we reconcile regulation with the capitalist economies' key feature – their superior ability to spur innovation and growth?

Excess-Countering versus Countercyclical Policies

- The excess-countering approach varies the degree of *active* state involvement depending on whether the levels of real activity and/or asset prices is within a “non-excessive” or “excessive” range.

- Non-Excessive Range
  - capital requirements at Basel I levels
  - regulations aiming at transparency and rectifying other market failures.

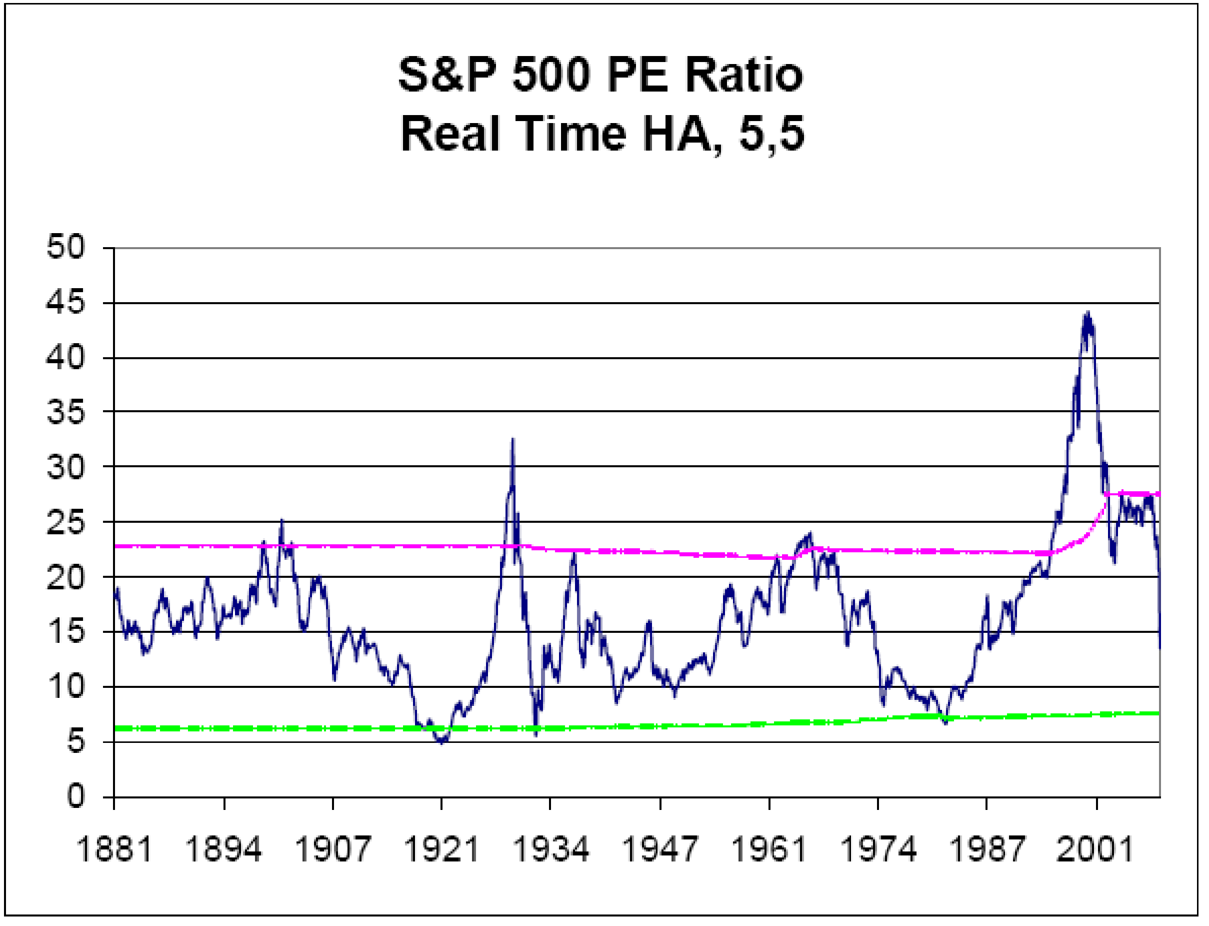
- Excessively high and excessively low levels of activity
  - capital requirements gradually raised (lowered) above (below) Basel I levels.
  - other excess-countering measures in asset markets.

- A key question concerning the merits of excess-countering measures is whether policy officials can ascertain, with some degree of confidence, that the levels of real activity and/or asset prices have become excessively too high or too low.

- In our background paper on “Financial Markets and the State,” we discuss this thorny question in the context of financial markets.

- A good place to start would be with the historical evidence on the US stock market
  - stock prices undergo long swings and sometimes these swings become excessive
    - when stock prices rise to levels far above historical benchmark levels, the market itself judges them excessive and self-corrects.

Guidance range: 5% threshold historical values at each point in time



- For the first 50 years (1881-1931) compute the average P/E ratio (monthly data).
- Starting with year 51 (1932) select out the top and bottom 5% P/E ratios in “real-time,” leaving the 90% “guidance range” of non-excessive values.

- Although the market eventually self-corrects, as the current crisis reminded us yet again, this can happen so late as to lead to sharp reversal and enormous costs to the financial system and the real economy.
- This leads us to propose that policy officials announce at regular intervals guidance ranges and a panoply of measures aimed at counteracting, but not eliminating, movements further into the excessive range.
  - **We stress that this policy is very different than target zones**

- Note that the guidance range should not be based solely on historical benchmark levels.
  - Beyond ignoring swings in asset prices, relying solely on historical default rates and fixed provisioning rule have clearly contributed to the failure to provide for excessive swing in house prices.

- Although such historically based guidance ranges are a useful rough guide, the future does not unfold from the past in a mechanical way.
  - Modern economies change in new ways all the time,
    - there are occasional periods in which change is particularly great and policymakers need some discretion to adjust the range and should be required to explain such adjustments to the public

Non-Excessive and Excessive Levels of Real Activity

- One could adapt the framework we sketched for asset markets to develop useful guidance ranges for the real economy based on unemployment, real gdp, etc.

- Another possibility is to explore the explore the connection between asset markets and the real economy to develop excessive and non-excessive ranges.

- George Soros's reflexivity approach and Edmund Phelps' and Gylfi Zoega's empirical evidence, among others. show that there is a close interdependence between swings in asset prices, particularly stock prices, and swings in real activity.

- Our IKE model of swings in asset markets shows that imperfect knowledge may lead *rational* individuals to bid prices to levels that are excessively far away from guidance ranges.

- Although more research needs to be done, these two strands of arguments indicate that both asset prices and the real economic activity may at times reach excessive levels.

- From a broader perspective, the regulatory policies that Michael Goldberg and I are proposing acknowledge that within limits markets are far superior than regulators in allocating capital.
- However, by arguing that active state intervention is necessary for society to guard against the consequences of occasionally excessive swings, IKE’s excess-countering approach aims to restore a much-needed balance between what should largely be left to the markets and what only the state and collective action can accomplish.