Avoiding Systemic Crises: Will Prudential Regulation and Easy Money be Sufficient?

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Financial stability and the role of regulation

- Financial instability can lead to economic crises
- Financial instability can aggravate economic crises
- Instability arises from market failures that regulation can offset
- But regulation has costs as well as benefits
- Implying market failures might be better addressed at source

Regulation – necessary but not sufficient?

- Economic history shows recurrent crises under a variety of regulatory and monetary regimes
- Economies can be hard hit even with a stable financial sector
- Excessive credit creation can lead to inflation or deflation (via cycles of “boom and bust”)
- Current global crisis has its roots in “unnaturally easy monetary policy” over decades

Post crisis macroeconomic policy failures

- G20 creditors fail to stimulate consumer demand
- Failure to resolve problems of over indebtedness and excessive leverage
- Too low levels of public and private investment
- Inadequate coordination between monetary and regulatory authorities
- Excessive reliance on “ultra easy monetary policy”

Post crisis regulatory reforms – good news

- More and better capital and liquidity for banks
- Greater attention being paid to the "shadow banking system" and to the insurance industry
- Increased focus on systemic risks arising from size, interconnections and concentration
- Greater efforts to reduce "procyclicality"
- And agreements reached at the global level

Post crisis regulatory reforms – not good news

- Reform challenge greater due to crisis management
- Analytical foundations of reform measures questioned
- Implementation challenges credibility of whole exercise
- Lobbying and innovation could circumvent reforms
- As always "The Law of Unintended Consequences"

The need for more radical thinking about regulation?

- Is the financial system serving the needs of society?
- Implications of treating the financial system as a "complex adaptive system"?
- Should countercyclical monetary and regulatory policies be more closely integrated?
- Should capital requirements be both much higher and much simpler?
- How to encourage self and market discipline?
- Should the basic structure of the system be altered?

Post crisis easy money (UEMP) – necessary but not sufficient?

- Unprecedented, even in the Great Depression
- Central bank actions differ markedly
- Generally premised on belief in short-term "Keynesian" stimulus of demand BUT
- The policy signal might not get through
- And consumers and investors might not react

Just as Keynes himself predicted

UEMP: unintended macro consequences?

- Warnings by Wicksell, Hayek, Koo, Minsky and Shin
- Zombie companies and zombie banks lower potential
- Debt/GNE globally now 20% above pre crisis levels
- Imbalances and "bust" have spread to EME's
- Moral hazard and imprudent behavior encouraged
- Asset prices have risen to unsustainable levels
- Fostered unpredictable and inefficient RORO trading

UEMP: and other side effects as well?

- Worsens income distribution
- Threats to central bank “independence”
- Capital and solvency of financial institutions also threatened
- Governments forebear on polices that could restore “strong, sustainable and balanced growth”

UEMP: the bottom line

- Systemic crisis now more likely than ever
- Every geographical region has economic problems
- In an interconnected world, problems anywhere become problems everywhere
- Serious economic problems have social and political implications

A postscript on complexity

- Analytical shortcomings of economic models
- The domestic economy as a complex adaptive system
- The global economy as a complex system of complex systems
- Fundamental lessons suggested for policymakers
- The need for a “paradigm shift”

And why it isn’t and will not happen

- Muddling though rather than thinking big thoughts
- Paradigm shifts in normal times
- The retreat into “false beliefs”
- Cast the blame on others, both domestically and internationally