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Reflections on the crisis and on its lessons for regulatory reform and for central bank policies☆

Alex Cukierman*

Berglas School of Economics and CEPR, School of Economics, Tel-Aviv University, Tel-Aviv 69978, Israel

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ABSTRACT

This paper discusses the problems exposed by the global financial crisis in the areas of financial regulation and supervision and possible solutions. It describes and evaluates current proposals regarding the role of the central bank as a systemic regulator, the pros and the cons of locating financial supervision in the central bank, and the conflicts and synergies that such an arrangement entails. Once a crisis erupts, central bank liquidity injections constitute a first line of defense. But in the longer term these injections create a trade-off between price and financial stability, and may compromise central bank independence.

Problems exposed by the crisis include the growth of a poorly regulated shadow financial system, short-ermism in executive compensation packages and consequent adverse incentive effects, the too-big-to-fail problem, procyclicality in the behavior of financial institutions, conflicts of interest in the rating agencies industry and the trade-off between the scope of intermediation through securitization and transparency in the valuation of assets. The paper also discusses international dimensions including international cooperation in regulatory reform and the scope for limiting exchange rate variability. The conclusion points out inherent difficulties in distinguishing ex ante between a fundamentals based expansion and a "bubble."

When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.[1]

1. Introduction

The global financial crisis (GFC) has exposed numerous problems of moral hazard and of asymmetric information in financial intermediation. In good times such problems are not as salient because various excesses – such as exaggerated commissions, large compensation packages, biased financial advice and outright fraud – are overshadowed by the generally good performance of the economy. When everybody is making money and credit is plentiful the general public, as well as politicians, are not inclined to be inquisitive and various excesses are more likely to be glossed over. Easy access to credit makes it possible to maintain such excesses and even outright fraud over long periods of time.[2]

Many of those problems call for substantial reforms in the regulation and supervision of financial institutions and some reconsideration of the way central bank policies operate. Paradoxically, a benefit of the crisis is that it has exposed the fact that in a world with serious asymmetries of information, vigorous financial innovations and incomplete regulatory frameworks, "self-regulation" does not work. This realization will, no doubt, induce institutional changes designed to reduce the likelihood of systemic crises through reforms of the current regulatory and supervisory systems. Some of this process is already taking place. The crisis also presents new challenges for recent conventional wisdom regarding monetary policy procedures.

Many reasons – such as inadequate regulation of financial institutions, overly expansionary monetary policy and a global savings glut – have been suggested as reasons for the crisis.[3] With an eye to potential reforms in the regulation of financial institutions, the paper focuses mainly on inadequate regulation and supervision. It takes the view that suggestions for reforms must start with an

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* Tel.: +972 3 5405360; fax: +972 3 6409908.
E-mail address: alexcuk@post.tau.ac.il.

[1] Interview with Citigroup CEO in the *Financial Times*, July 9 2007.

[2] A salient example is the Madoff case.

[3] See respectively Roubini (2008), Taylor (2009) and Bernanke (2005).

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identification of the factors that contributed to the eruption of the subprime crisis in the US and then to its transformation into a GFC.[4] The most glaring regulatory failures are the rise of an unregulated shadow banking system, the existence of compensation packages that encourage excessive risk taking behavior, the too-big-to-fail problem, procyclicality in the behavior of financial institutions, and moral hazard problems in the rating agencies sector. Section 2 describes the roles of those factors in the generation of the crisis and suggests detailed regulatory reforms to address the problems that surfaced in each of those areas.

Contrary to the great depression, both fiscal and monetary policies in the US, and to a lesser extent in Europe, have responded swiftly and vigorously to the crisis and are likely to be maintained for some time. It is highly likely that in the absence of those quick and large policy responses the crisis would have been deeper and more sustained. Particularly notable here is the response of the Fed which, unlike fiscal policy that requires a longer legislative process, was very quick and determined. This swift response maintained financial markets afloat in face of the panic that took hold following the bankruptcy of Lehman Brothers. This experience revealed the crucial role of the central banker as a first line of defense in the face of a panic. Section 3 discusses this "old-new" aspect of short run central bank policy and argues that it is likely to lead to a resuscitation of this function in parallel with the (recently) more traditional inflation targeting regime.

Although warranted by the seriousness of the crisis, the short-run response of monetary policy, and subsequently of fiscal policy, created a new state of affairs in which the central bank (CB) holds a large (and more risky) share of debt in the economy and in which the share of public debt in GDP is expected to increase substantially. This is particularly notable in the case of the Fed. When the US ultimately emerges from the crisis, this new state of affairs may create a painful trade-off between price stability and financial stability. However, price and financial stability may also reinforce each other, as was the case during the Savings and Loan Association crisis in the US. Section 4 discusses those issues along with other longer-term lessons for regulatory reform and for the role of the CB within the newly created regulatory environment. The section discusses the pros and cons of delegating responsibility for financial stability and regulation to the CB, and in particular, its potential role as a macroprudential regulator. It also discusses the long-term risks posed by the crisis for CB independence as well as the independence and professionalism of other financial regulators.

The globalization of financial flows and of trade in conjunction with the central role of the US in both of these areas contributed to the quick transformation of the subprime crisis into a GFC. Thus, along with its substantial benefits, globalization also contributed to a quick transmission of the adverse effects of the subprime crisis to the rest of the world. This suggests that although the crisis originated in the US, other countries have to adapt their institutions as well. In the presence of globalization, regulatory reforms should not be confined to the US and should be sufficiently coordinated in order to prevent regulatory arbitrage.[5] The onset of the crisis dramatically increased volatility on forex markets. In times of global crisis, when much of the world is hit by a common shock, there may be room for beneficial coordination of monetary policies among major central banks in order to offset some of this volatility. Those international dimensions are discussed in Section 5. This is followed by concluding thoughts including, inter alia, some conjectures about the relation between the likelihood of bubbles and the effectiveness of regulation and of supervision.

2. Regulatory problems exposed by the subprime crisis in the US and potential remedies

This section reviews the contributions of supervisory forbearance and of regulatory incompleteness to the emergence of the crisis as a starting point for possible remedial measures in those areas.[6] It centers mainly on the US for two reasons. First, the crisis originated in that country. Second, the swift adoption and spreading of financial innovations in the US, many of which were driven by regulation avoidance, quickly led to an increasing gap between the sophistication of private financial operators and the abilities of financial supervisors to effectively regulate the financial system. This occurred through several channels, such as the emergence of lightly regulated shadow banking institutions, compensation packages that encouraged shortermism and excessive risk taking, various conflicts of interest related to the operation of rating agencies and of financial research departments within investment banks, and overly sophisticated financial assets whose fundamental values became more and more opaque as the state of the real economy gradually moved from boom to recession.

2.1. The growth of poorly regulated segments of the financial system

Parts of the US financial system, such as commercial banks, are subject to reasonable levels of regulation and supervision, while other parts such as hedge funds are very lightly regulated, or not regulated at all. The Glass Steagell Act of 1933 separated commercial banking from other financial activities like underwriting, brokerage and securitization that were performed by such institutions as investment banks. As long as the act was in force commercial banks were largely confined to narrow banking. Bowing to pressures from the financial community, the 1999 Gramm-Leach-Bliley Act effectively repealed this separation, widely opening the door for universal banking and the growth of a shadow banking system. This led to regulatory arbitrage that transferred a significant fraction of financial intermediation to non-bank financial institutions such as broker dealers and hedge funds. Commercial banks also participated in this expansion by setting up special investment vehicles (SIV), conduits and other legal entities that allowed them to shift a rising fraction of their business away from tightly regulated activities into unregulated or lightly regulated activities.

The growth of the shadow financial system had the following consequences. First, the fraction of intermediation not subject to capital requirements increased. Second, many institutions in this segment of the market did not have access to the lender of last resort facility, making them potentially subject to runs—not by bank depositors who are insured by the Federal Deposit Insurance Corporation (FDIC), but by the more sophisticated holders of their liabilities. Third, like banks, many institutions in the shadow system had liabilities whose average maturity was shorter than that of their assets. This created a liquidity risk akin to the classic liquidity run analyzed in Diamond and Dybvig (1983). Fourth, some of those institutions, such as hedge funds, engaged in highly leveraged operations. Finally, with light or nonexistent regulation, the

[4] A companion discussion that focuses on the reasons for the crisis and the regulatory reform in the UK appears in Goodhart (2008).

[5] The April 2 2009 declaration on strengthening the financial system following the London summit of the G20 is well aware of this requirement. But its translation into specific recommendations is only partial at this stage.

[6] An early discussion of some of those issues appeared in Roubini (2008).