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New theories to underpin financial reform[☆]

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ABSTRACT

Before 2007, financial crises were not widely studied in economics and finance. The lack of importance ascribed to financial stability and our limited knowledge of this topic were significant contributors to the crisis. This paper suggests five areas where new theories are needed. These are asset price bubbles, central bank checks and balances, global imbalances, banking regulation, and competition in financial services.

1. Introduction

As Carmen Reinhart and Kenneth Rogoff remind us in the title of their book, *This Time is Different: Eight Centuries of Financial Folly*, financial crises are nothing new (Reinhart and Rogoff, 2009). However, they often come as a surprise to many people because in most countries they appear only periodically. The current crisis has come as a particular shock partly because it has been over seventy years since the Great Crash of 1929 and the Great Depression that followed. There have been crises in many other parts of the world in the last few decades. Many of these were in emerging or middle income countries such as Argentina, Mexico, and Turkey, but not all. The crises in Japan, Scandinavia and Asia in the 1990s stand out as being particularly severe. However, these crises had little impact on mainstream economics. Despite being the second largest economy in the world and the large severity of the shock, the Japanese experience during the 1980s and 1990s was very little studied by macroeconomists.[1] The Asian crisis of 1997 was studied by international economists but much of their focus was on currency crises. The Scandinavian crises did not receive much attention. Banking crises were little studied in major economics departments and the design of financial regulation to prevent them and ameliorate their effects was regarded by most economists as an anachronism.

The recent crisis has underlined how important market failures in the financial sector are and the need for theories of such failures. In this paper we focus on five areas where new theories are needed to allow the design of effective intervention in the financial system.

1. Asset price bubbles
2. Central bank checks and balances
3. Global imbalances
4. Banking regulation
5. Competition in financial services

We argue that the basic cause of the recent crisis was the bubble in real estate in the U.S., Ireland, Spain, and elsewhere. Such bubbles are not exceptional. As Herring and Wachter (2003) and Reinhart and Rogoff (2009) document, collapses in real estate prices are the most common cause of banking crises. We therefore need good

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1 A notable exception is the work of Hoshi and Kashyap (2004).

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theories of asset price bubbles. What are the market failures that lead to bubbles? What is the role of monetary policy in causing bubbles? Section 2 considers these and other issues concerned with bubbles.

A number of people have suggested that central banks played a significant role in causing bubbles through monetary policy that was too loose in the early years of the century after the bursting of the dot.com bubble. While central bank independence has worked well for the control of inflation, it does not appear to have worked well for financial stability. While a return to political control is certainly not desirable, this does not mean that there cannot be checks and balances designed to improve central banks' ability to perform their role in maintaining financial stability. The design of such checks and balances is considered in Section 3.

A second important factor in the growth of real estate prices at the heart of the U.S. financial crisis was the easy availability of funds. It has been argued that this was due to global imbalances, and in particular to the large reserves accumulated by Asian central banks. Section 4 discusses the types of theories of global imbalances that would be helpful.

Banking regulation is different from most other forms of regulation in that there is no widely agreed underlying theoretical framework. The main way in which banks have been regulated in recent years is through capital regulation. These regulations have mainly been laid down by the Basel agreements. One of the most surprising things about these, perhaps, is that they are not based on theory. There is no position taken on the nature of the problem that they are trying to solve and there is no justification for the particular measures or the numbers in the regulations. Section 5 considers theories of banking regulation, focusing mainly on capital regulation.

There has been much discussion in the recent crisis of controlling the compensation of bankers because the amounts they are paid are so large. Such controls will be difficult to implement in practice. A more interesting issue, perhaps, is how is it that financial services firms can afford to pay so much to their employees? In particular, are these high earnings due to some form of monopoly power? While the usual price setting form of monopoly power is probably not a serious issue in many of these markets, other forms of monopoly power based on asymmetric information and transaction cost factors may be important. Theories of how financial institutions make such large returns are discussed in Section 6.

2. Asset price bubbles

Herring and Wachter (2003) and Reinhart and Rogoff (2009) have demonstrated that banking crises are very often caused by the bursting of bubbles in real estate prices. For example, in the 1980s and 1990s in Japan, Scandinavia, and Indonesia, Thailand, South Korea and other countries involved in the Asian Crisis, real estate bubbles played an important role.

As Kaminsky and Reinhart (1999) document, these bubbles in asset prices typically have three distinct phases. The first phase starts with financial liberalization or a conscious decision by the central bank to increase lending or some other similar event. The resulting expansion in credit is accompanied by an increase in the prices for assets such as real estate and stocks. This rise in prices continues for some time, possibly several years, as the bubble inflates. During the second phase the bubble bursts and asset prices collapse, often in a short period of time such as a few days or months, but sometimes over a longer period. The third phase is characterized by the default of many firms and other agents that have borrowed to buy assets at inflated prices. Banking and/or foreign exchange crises may follow this wave of defaults. The

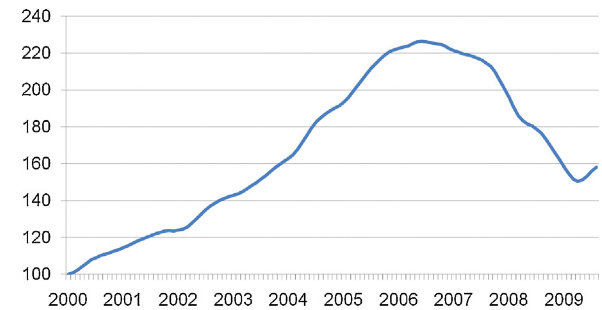

Fig. 1. The Case-Shiller 10 Cities composite index.

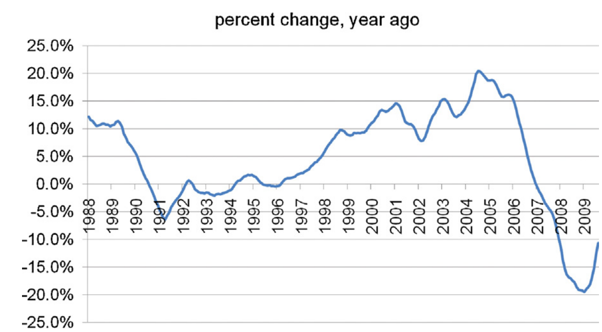

Fig. 2. Changes in the Case-Shiller 10-city composite index year-on-year.

difficulties associated with the defaults and crises often cause problems in the real sector of the economy which can last for a number of years.

It can be argued that the basic problem that caused the recent crisis was that there was a bubble in real estate in the U.S. and also in a number of other countries such as Ireland and Spain.[2] When the bubble burst, the result was the huge problems in the securitized mortgage market and in the real economy. Fig. 1 shows the Case-Shiller 10-city index since 1990. The figure illustrates the dramatic acceleration in house price increases in the early 2000s and their fall since July 2006. Fig. 2 shows the year-on-year change in this index.

What caused this bubble? We argue that there were two main causes. The first is the low interest rate policies adopted by the Federal Reserve and other central banks after the collapse of the technology stock bubble. The second is the appetite of Asian central banks for dollar and euro denominated (debt) securities that led to the easy availability of credit. We discuss this factor in detail in Section 4 below. Here we focus on the first factor.

One of the important reasons that the bubble was so big in the U.S. was the policies of the Federal Reserve in 2003–2004. To avoid a recession after the collapse of the tech bubble in 2000 and the 9/11 terrorist attacks in 2001 interest rates were cut to the very low level of 1%. Taylor (2008) has argued that this was much lower than in previous U.S. recessions relative to the economic indicators captured by the "Taylor rule". During 2003–2004 housing prices were already rising quite rapidly. For example, it can be seen from Fig. 2 that the Case-Shiller 10-city composite index was growing at a rate above 8% throughout this period. The Federal Reserve created a significant incentive for people in many parts of the country to borrow at 1% and buy houses going up at a much higher rate. In addition

[2] Problems exacerbating the effects of the crisis include poor regulation of the shadow financial system, short termism in executive compensation, the too-big-to-fail problem and conflicts of interests in rating agencies (see, e.g., Cukierman, 2011).