

“What Type of Economic Research can Support Macro-prudential Policy”

Concluding Conference of the Macro-prudential Research (MaRs) Network of the European System of Central Banks
Frankfurt, June 24, 2014

Anil K Kashyap

- Lessons from MaRs
- Principles going forward
- New results and open questions

MaRs proposals to move beyond 2007 circa DSGE models

1. Default is costly and pervasive
2. Risk premia matter for decision-making and amplify shocks
3. Multiple frictions that invalidate Modigliani-Miller capital structure irrelevance are important
4. Contagion should be taken seriously and network structures matter

Two principles to add

- The financial system has multiple roles -- not just a single purpose.
- Agents are forward looking in their portfolio decisions and prices reflect that

Eric Rosengren on the goals of macroprudential regulation

- “Financial stability reflects the ability of the financial system to consistently supply the credit intermediation and payment services that are needed in the real economy if it is to continue on its growth path.”
- “Financial instability occurs when problems (or concerns about potential problems) within institutions, markets, payments systems, or the financial system in general significantly impair the supply of credit intermediation services – so as to substantially impact the expected path of real economic activity.”

<http://www.bostonfed.org/news/speeches/rosengren/2011/060311/>

How does this fit with the prior literature?

Quite well, there are three leading theories of intermediation

- Monitoring begets credit extension
- Liquidity provision
- Pooling and tranching to improve risk sharing

Modifying Diamond Dybvig to embody these ideas

1. Savers can buy equity in a banking sector and save via deposits.
2. Banks choose to invest in safe assets or to fund entrepreneurs who have risky projects.
3. Banks and the entrepreneurs face limited liability.
4. Use global game logic so that the decision whether to run is governed by the banks' leverage and mix of safe and risky assets.

What does this setup deliver?

1. Banks improve savers options by offering debt and equity claims against risky loans
2. Improved risk-sharing leads to more lending than if savers had to directly lend to entrepreneurs.
3. Liquidity insurance (as in Diamond Dybvig).
4. Can get excessive lending (because of limited liability) or too little lending (due to run risk).
5. Regulation might improve competitive outcomes.
 - Can study capital regulation, liquidity regulation, deposit insurance, loan to value limits, and dividend taxes

General findings

- Runs hurt savers, banks and borrowers, so stopping them is highly desirable
 - Banks don't fully internalize benefits of higher capital or of a safer asset mix
- Many regulations limit run risk, but most lead to additional lending
 - Reducing runs without boosting lending is hard
- Powerful incentives for regulatory arbitrage or lobbying to alter the incidence of regulation

Some open issues/interesting topics

- Two views on shadow banking: more efficient risk sharing vs. pure regulatory arbitrage?
- Calibrating liquidity regulation: do we have enough safe assets?
- Foundations of reaching for yield and connections to monetary policy: do we care if MP changes risk premia or just path of expected rates?
- How to monitor and regulate network structures? Can we nest three motives: gambling, efficiency of credit delivery and systemic concerns that are not internalized?

Background Material

Anil Kashyap, Dimitrios Tsomocos and Alexandros Vardoulakis:

"How Does Macroprudential Regulation Change Bank Credit Supply?" NBER WP 20165

"Principles for Macroprudential Regulation,"
Banque de France Financial Stability Review, No. 18, April 2014.