# Financial Reform and Monetary Policy in the Wake of the Global Financial Crisis

NAR University

July 7, 2014

Anthony Elson

# Major Impacts of the Global Financial Crisis of 2008-09 in Three Areas

- Reforming the architecture of the global financial system
- Unprecedented experimentation in monetary policy to cope with the collapse of economic activity
- Major re-assessment of prevailing macro-economic paradigm for policy design, academic research and teaching

# Financial Factors that Preceded the Crisis

- Bank finance intimately connected with housing bubbles that preceded crisis in US and other countries (UK, IRE, ESP)
- "originate to hold" converted to "originate to distribute" via MBS and securitization of sub-prime mortgages
- "shadow" banking outside scope of regulation: hedge funds, Inv. Banks, MMFs and SIVs (off-balance sheet)
- Severe maturity mismatches of weakly capitalized, highly leveraged SIVs reliant on over-night repos heavily invested in ABS/CDOs with no liquidity
- Classic elements of a financial crisis

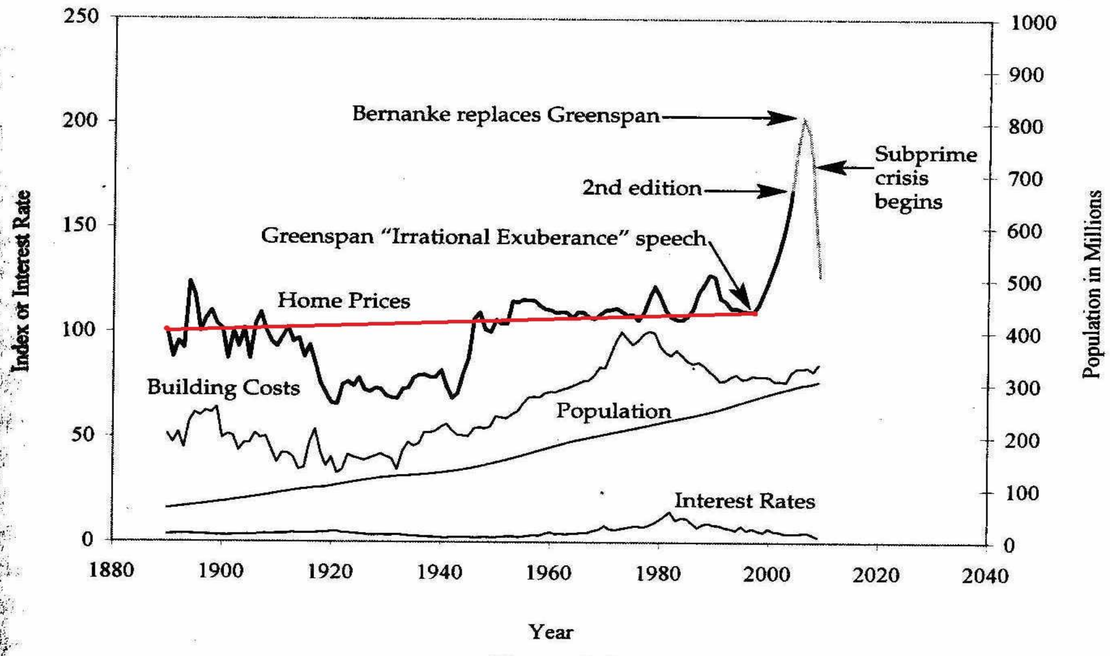



*Figure 2.1*

***U.S. Home Prices, Building Costs, Population, and Interest Rates, 1890–2009***

Heavy solid line (left scale): real (inflation-corrected) home price index, 1890 = 100, for the United States, constructed by the author from various existing indexes and raw data on home prices;[3] thin line (left scale): real building cost index, 1979 = 100, constructed by the author from two published construction cost indexes;[4] thin line (right scale): U.S. population in millions, from the U.S. Census; lowest line, thin line (left scale): long-term interest rate constructed by the author from two sources.[5] (Update since 2005 in gray.)

## Graph 1, The U.S. Housing Bubble:

Case-Shiller National Home Price Index Values

1987-2013

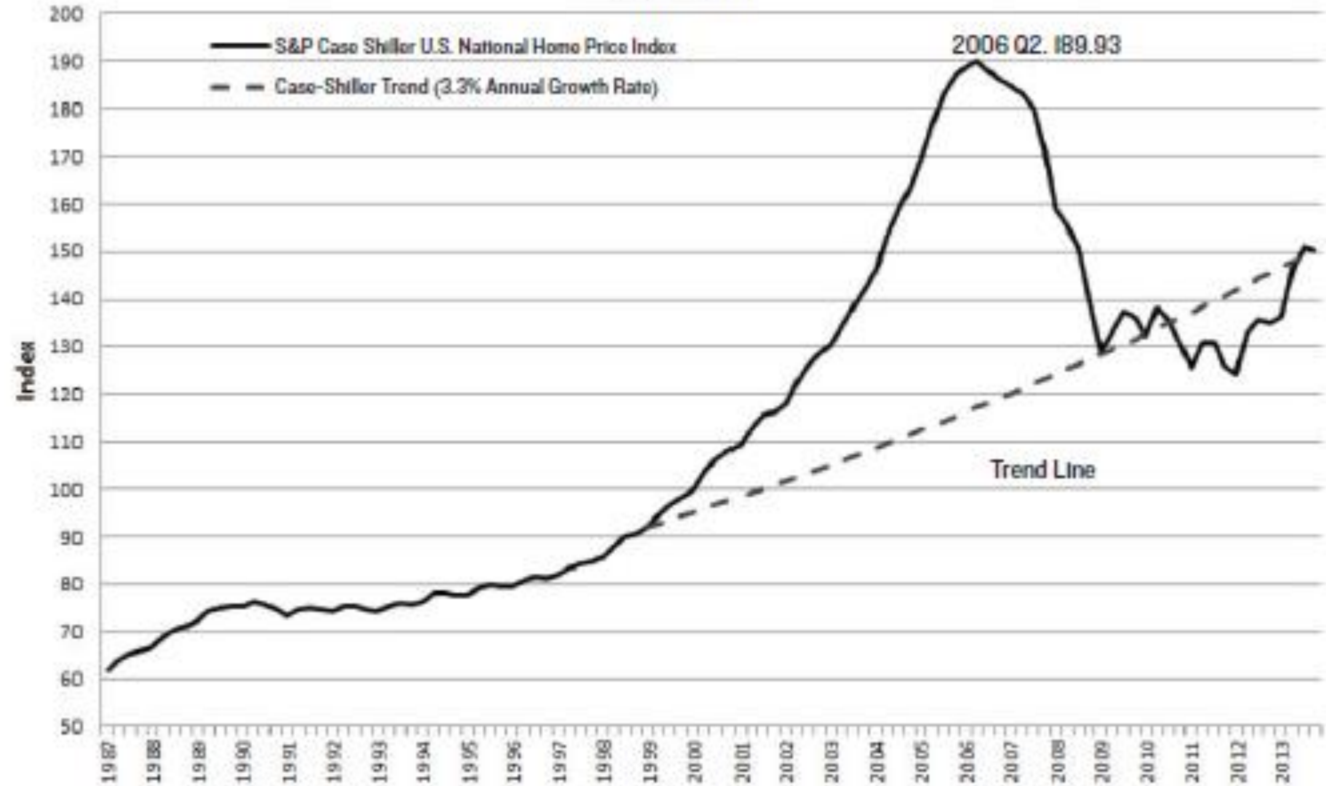
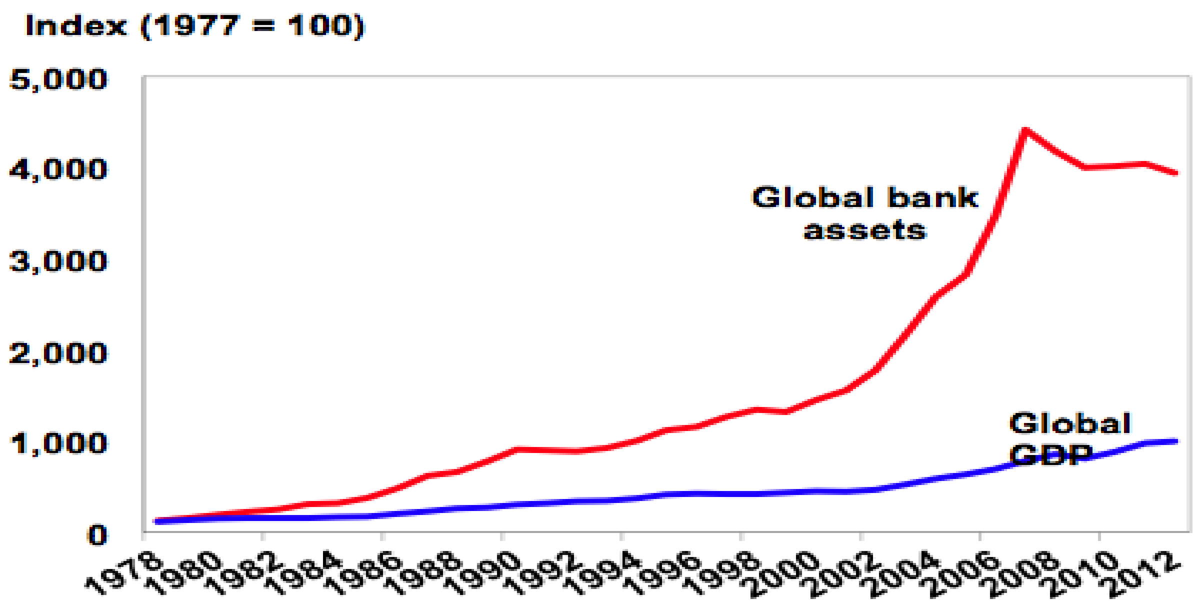


Figure 2. Global Banking Assets (BIS Reporting Banks)




Source, BIS.

# How Did Sub-Prime Crisis in the US Become Global Financial Crisis?

- Widespread holdings of ABS/CDOs and high inter-connectedness of financial institutions via dense financial networks
- Excess reliance on leverage and S-T funding
- Lax financial regulation; no systemic oversight
- Defects in capital adequacy requirements: role of CRAs and internal risk-based models
- Panic in wake of Lehman Bros failure: “ring-fencing” by host regulators to deal with failure of large cross-border financial institutions

# Reform of the International Financial Architecture

- Key Players: G20, IMF, FSB
- International Financial Regulation: FSB, BCBS
- Oversight of Global Financial Stability: IMF, FSB
- International LOLR: Fed Res (CB swaps), IMF
- International Policy Coordination: G20, IMF
- Sovereign Debt Restructuring: IMF, ad-hoc Creditor Committees
- Stability of $-based International Monetary System

# Reform of Int'l Financial Regulation - Micro vs Macro-prudential Risks

- Correcting defects of Basel 2 capital accord (**micro-prudential** risk)
  - Introducing "core" Tier 1 capital requirement of 4 ½%
  - Adding capital conservation buffer of 2 ½%
  - Adding liquidity and net stable funding requirements
  - Problem of internal risk models and RWAs still remain
- Adding new **macro-prudential** dimension to Basel 3
  -  counter-cyclical capital surcharge (up to 2 ½%)
  -  special capital surcharge for SIFIs (2 ½%)
  -  minimum capital-asset ratio of 3% (is this high enough?)
- "Volcker Rule" on non-proprietary trading by commercial banks
- Progress to date – significant, but more needs to be done

# International Financial Regulation - Dealing with Problem of TBTF

- Designated list of SIFIs (banks, nonbanks,& insurance companies) for special oversight
- SIFI capital surcharge (2 ½ %)
- Intrusive supervision/stress tests (e.g., recent case of Citigroup)
- “Living Wills” to assist with bank resolution
- Orderly Liquidation Authority (OLA)
- Despite these actions, implicit gov’t subsidies for SIFIs still exist

# International Financial Regulation - Gaps & Future Issues

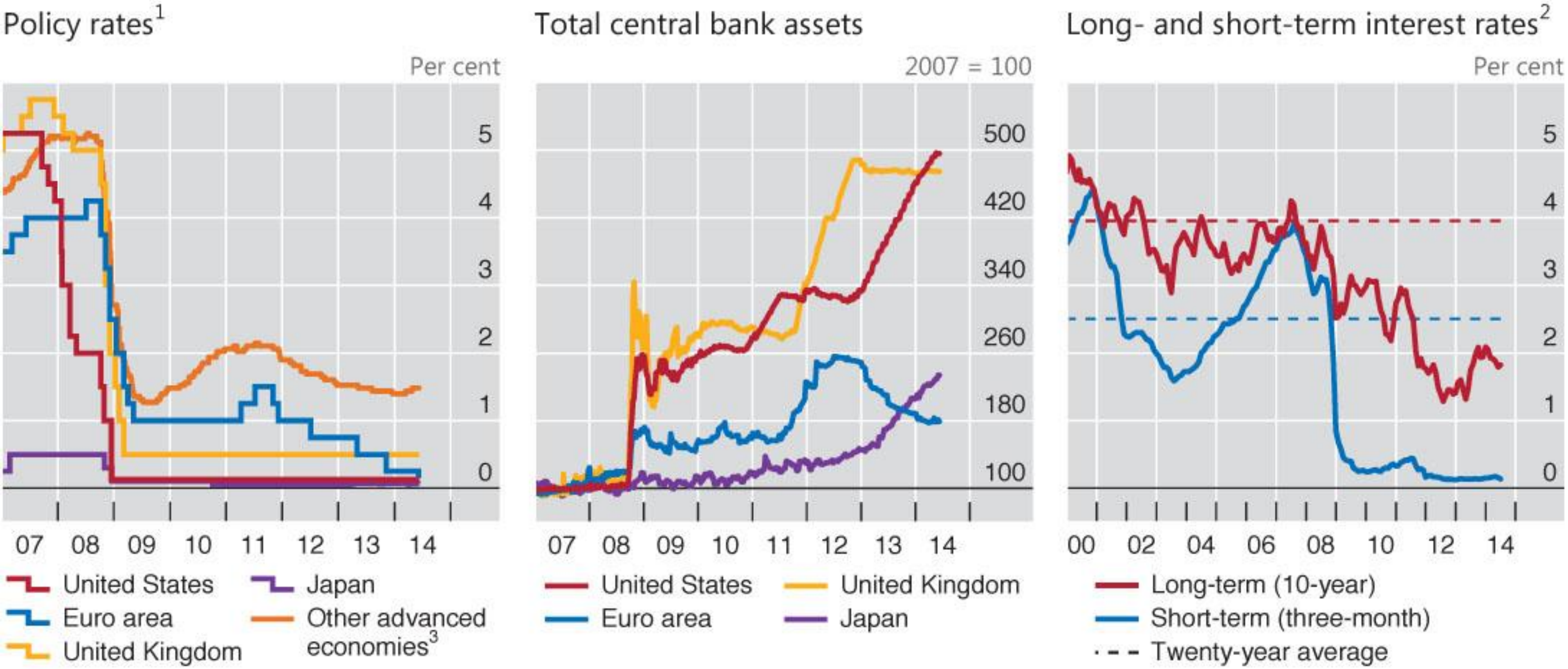
- Extension of capital requirements/supervision to nonbanks to contain “shadow banking”
- Linking financial stability to macroeconomic stability goals of monetary policy (e.g., use of macroprudential tools)
- International resolution mechanism/OLA for SIFIs
- Regulation of credit rating agencies (CRAs)
- Transfer of derivative trading to CCPs
- Potential role of financial transactions taxes (FTT)

# Challenges of Monetary & Fiscal Policies in the United States

- Crisis of 2008-09 has led to a radical change in reigning paradigm of monetary & fiscal policy management
- Pre-crisis fiscal policy focused on LT sustainability w/ automatic stabilizers and monetary policy focused on short-term policy rate (FOMC) w/LOLR for financial instability
- Post-crisis return to Keynesian orthodoxy: fiscal expansion and zero-lower bound for policy rates, liquidity “trap” and “quantitative easing” due to weak aggregate demand
- Medium to LT risk of “secular stagnation” with zero or negative real interest rates, low inflation and weak economic activity and potential financial instability associated w/ high and volatile asset prices

## Accommodative policy in advanced economies holds down bond yields

Graph II.1




[1] Policy rate or closest alternative; for target ranges, the midpoint of the range. [2] Based on monthly averages of daily nominal rates; simple average of the euro area, Japan, the United Kingdom and the United States. [3] Simple average of Australia, Canada, New Zealand, Norway, Sweden and Switzerland.

Sources: Bloomberg; Datastream; national data; BIS calculations.