Risk and Regulation: Lessons From the Crisis of 2008

Daron Acemoglu

MIT

World Bank/IMF, May 26.

Introduction

- Epochal economic events.
- This talk: an institutional interpretation..
- Four sets of issues:
  1. How to think of risk and risk management
  2. The role of regulation.
  3. Political economy of regulation.
  4. The real threat to economic growth.

Mistakes

- Three sets of mistaken beliefs about risk (we as economists held)
  1. Aggregate volatility has come to an end;
  2. Markets—without supporting institutions and regulations—can curb opportunitistic and excessive risk-taking;
  3. Reputational concerns of large and established firms will make them monitor themselves.

Volatility?

- Myth of the end of the business cycle;
  - Implication of the myth: assets—housing, stocks—will continue to appreciate.
- Volatility is part of the creative destruction process of the capitalist economy;
  - Successful capitalist economies exploit it rather than falling prey to it.
- But also new issues in volatility.

New Ideas in Volatility

- Heterogeneous priors: Typically ignored in economic models for convenience But real and important in practice. Source of excessive risk-taking, particularly when combined with agency relations.
- Tail risks: Laws of large numbers not relevant in many important situations:
  1. In the presence of large firms: there is only one GM and one AIG.
  2. In the presence of network effects: clustered network linkages lead to failure of LLN (example: a few firms supplying many)
  3. In the presence of learning and imitation: a similar practice is spreading across many firms.
- "Conservation law": reducing year-to-year volatility may be at the expense of increasing tail risks;
  - Complex risk sharing and diversification arrangements increase *interconnectedness* and introduce additional counter-party and systemic risks.

Institution-less Markets?

- Consumers, shareholders, citizens not sufficiently informed about complex products and services;
  - Standard *free-rider* problem.
- Example both (albeit imperfect) solution: the role of the FDA in the pharmaceutical market.
- Institutional checks and regulation important for all markets;
  - At the very least, for enforcement of property rights and contracts;
  - But much more necessary in financial markets because of:
    1. Deposit insurance and limited liability;
    2. Network effects and interconnectedness
  - But also equally as a check against fraudulent behavior.
- How do we prevent Ponzi schemes? Or [*put the name of your favorite investment bank*] schemes?

Self-Monitoring?

- Self-monitoring only works because of equilibrium rents;
  - There must be something to lose, but how much?
- Because of limited liability, large rents, to be forfeited in case of failure and fraud, are necessary.
- But punishment not credible, particularly when the "specific capital" of those that need to be punished because of opportunitistic behavior is essential during periods of distress.

A New Framework for Regulation?

- Need for a new framework.
- Capital-based regulation insufficient and creates counterproductive incentives.
- Alternatives?
  - Not clear.
- A few things we know:
  - Take into account the limited amount of information of many participants in financial markets
  - Take into account inefficiencies resulting from regulation avoidance
  - Avoid competition between regulatory agencies
  - Regulation not only for direct stakeholders, but also for systemic risk.

Some Ideas

- Additional *provisional* ideas:
    - Regulation as speed bumps
    - A layered system (a regulated core with high degree of security and limited interactions with a less regulated periphery)
    - Regulation in the presence of heterogeneous priors

Financial Oligarchies?

- How did we get here?
- Alternative views:
    - Well-intentioned and unavoidable mistakes
    - The financial power of Wall Street
    - The informational power of Wall Street
- Yes, the first one is possible, but to accept it without looking into alternatives is the easy way out.
- Many parallels to crony capitalism of Asian crisis. But these parallels can be misleading.
- US system is still successful in limiting explicit corruption.

Complexity, Expertise and Information

- Most promising idea: the power of Wall Street through its expertise.
- As finance became more important and more complex, this expertise became more valuable.
- The key source of information for policymakers is from interested parties.
  - The real "moral hazard" problem.
- Difficulties:
  - The expertise of Wall Street is real.
  - Its hold is non-ideological and nonpartisan
  - It becomes more important during crises.

Regulation against Political Economy of Regulation

- Solution?
- The framework for regulation should be based on expertise and information coming from diverse sources.
- Much more qualified (and more highly paid) technocrats in government, as well as in competing interest groups (a new breed of unions?), necessary when dealing with such complex and important economic decisions.
- Rethinking of "political economy of regulation".
    - Inefficiencies unavoidable.
    - Reduction of bias and variance in important decisions.

What to Do?

- I don't know.

What to Do?

- I don't know.
- But also nobody else does....

What Not to Do?

- *Sacrifice long-run economic growth;*
  - Halting reallocation;
  - Discouraging—directly or indirectly—innovation;
  - Undermining the institutional and political economy foundations of economic growth.
- *Create—or facilitate—an expectational trap.*
  - Consumers cutting back on purchases, especially purchases of durables, because afraid of job losses and low incomes;
  - Banks cutting back on loans, because of indebtedness and opportunistic behavior;
  - Firms cutting back on employment and investment because afraid of declining consumer demand and because of high cost of funds.

Biggest Challenges

- Challenges to the growth potential of the market system.
- Big confusion: between the efficiency of the market system, particularly in generating innovation and ensuring division of labor, and potential problems with risk management in financial markets.
- This confusion as fuel for a general attack on markets.
- Popular discontent understandable, but not productive for the future of innovation, technological progress and economic growth.

Dealing with the Challenge

- Accept that some degree of backlash is not only unavoidable, but perhaps also necessary.
- Special interests—particularly, the financial sector—*stronger in the United States than previously recognized.*
- We do need smart regulation—not repudiation of the free market system.
- We do need innovation—not political economy concerns determining where public funds will be allocated.
- We do need reallocation—not protectionism and blanket bailouts.

Towards a Better Understanding

- Reassessing the role of the financial system in the management of risk.
- Reassessing the role of institutions and regulations in the workings of markets.
- Reassessing the political economy of regulation of (large and powerful) financial firms.
- Reassessing the interaction between reputation, organizations and markets.
- Recognizing that even in developed nations, political economy threats to growth are real.