

RISK AND REGULATION: LESSONS FROM THE CRISIS OF 2008

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Introduction

- Epochal economic events.
- Three sets of issues for this talk:
 - 1 How to think of risk and risk management
 - 2 The role of regulation.
 - 3 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 opportunistic 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 opportunist 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

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 interaction between reputation, organizations and markets.
- Recognizing that even in developed nations, political economy threats to growth are real.