

# Remarks on “Dealing with Crises in a Globalized World”

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## Looking across these three papers,

- ◆ There is common ground
- ◆ They share
  - A sense of the difficulties introduced by the **complexity** and **interconnectedness** of the financial system
  - A frustration that, as a profession, that economists have not taken these forces to heart
- ◆ The recognition of our collective shortcomings
  - Need not be as nihilistic as yesterday's proceedings
  - In that recognition of failing is a step in recovery
- ◆ After being uncharacteristically upbeat, I reserve the right to be churlish on more minor points

The key to this understanding comes from two people separated by 1-1/2 centuries

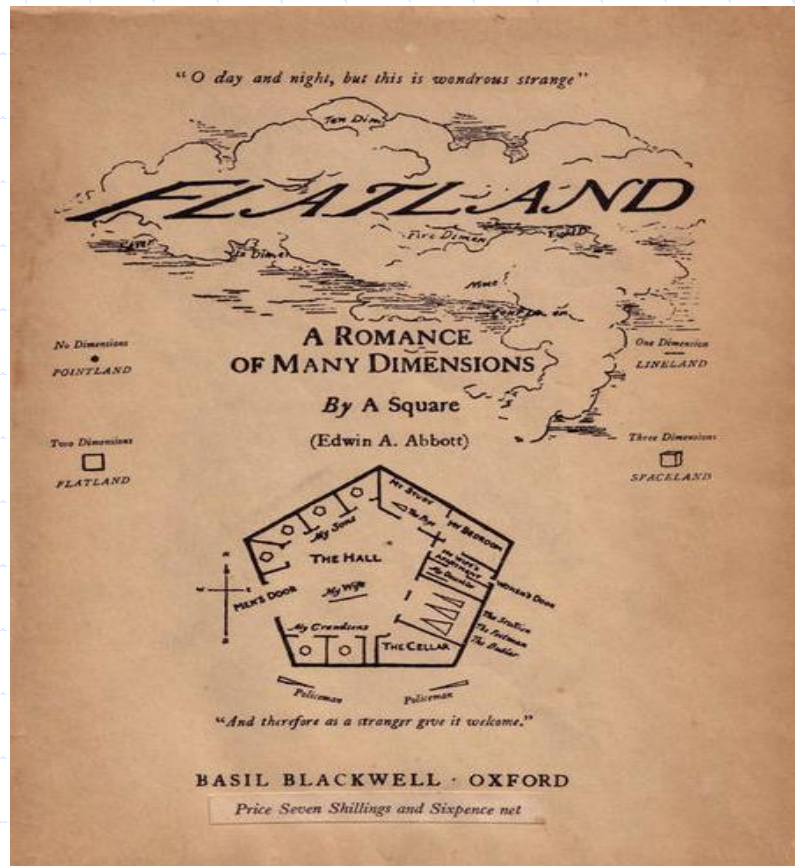
Edwin Abbott Abbott



Kevin Bacon



First, the most useful metaphor for the problem of international financial regulation was written in 1884 by EA<sup>2</sup>



- ◆ Gave individuality to geometric concepts
- ◆ Highlighted the difficulties of perspective and projection
  - Consider the plight of a 2D entity visited by a 3D object
  - Including a sphere (which is easy) and a rectangle (which is hard)

## A national financial regulator...

- ◆ Is a 2D entity observing a slice of a 3D large complex financial institution (LCFI)
- ◆ Taken together, our global system is one in which many regulators observe different slices of the same entity
  - With the slices taken at oblique angles
- ◆ The failure of oversight represents the failure of imagination
  - To visualize a complicated object properly

# From this perspective, consider SC's policy alternatives

- ◆ Coordination through a “college of regulators”
- ◆ Converged approach with common frameworks
- ◆ International banking charter
- ◆ World financial authority

# A geometric explanation...

- ◆ Coordination through a “college of regulators”

- ◆ Converged approach with common frameworks

- ◆ International banking charter

- ◆ World financial authority

- ◆ Pool the visualizations

- ◆ Enforce a common shape at each cross section

- ◆ Invent a higher dimensioned authority

## A cautionary note...

- ◆ A LCFI arrives at its overall shape by manipulating its appearance in each national slice
  - Tax avoidance
  - Regulatory arbitrage
  - Too-big-to-fail protection
- ◆ The resultant entity is
  - Quite complex in its full dimensionality
  - Hard to visualize at a lower dimension
  - Quite changeable from only a small rotation

# A practical consequence of this complexity, as highlighted by Athanasios Orphanides

- ◆ From the outside, an LCFI is
  - **Hard to supervise**
    - ◆ Leading authorities to be more likely to protect it
  - **Hard for the market to discipline**, lessening
    - ◆ Shareholder oversight of management
    - ◆ Counterparty discipline
    - ◆ Takeover threat
- ◆ From the inside, an LCFI is
  - **Hard for management to supervise**, creating
    - ◆ Incentive misalignments
    - ◆ Suitability problems
    - ◆ Compensation abuses
- ◆ In a crisis, an LCFI is
  - Less resilient and subject to sharp changes in view as objects turn and collide



The solution to the problems of complexity is not hardening too-big-to-fail and adding another layer of supervision

## Second, Andrew Sheng introduced another dimension to the problem

- ◆ One firm is linked to many other firms
  - A deterioration in one national market spreads
- ◆ Should we be surprised?
- ◆ Kevin Bacon is linked to anyone who ever made a movie
  - In the Kevin Bacon Game, the goal is to meet the “six degrees of separation” and link him to anyone else
  - That can be done for 83 percent of anyone who ever appeared in the history of film

# The second crisis we are witnessing...

- ◆ Is in economics and finance
  - A<sup>2</sup> discussed the problems of visualization in 1884
  - The Kevin Bacon game has been played since 1994
  - And owes to a paper on chains from 1929
- ◆ Macro modeling over the past decade has focused on a single policy interest rate,
  - With no role for quantities,
  - Implying that QE is hard to evaluate, and
- ◆ Financial economists have not taken to heart absence-of-arbitrage arguments
  - So there has been little attention to gross positions and
  - Netting arrangements

# Here is the problem

- ◆ This is a crisis in economics and finance
  - Macro modeling over the past decade has focused on interest rates,
  - With no role for quantities, and
  - Financial economists have not taken to heart absence-of-arbitrage arguments
- ◆ Any evaluation of Quantitative Easing (QE) is *deus ex machina* from the perspective of models
  - Role for event studies, for good or ill
- ◆ Difficult to embed financial strains

