Annual Cambridge, DSF-TI & Penn Seminar on ‘Current Issues in Financial Economics’

The Macroeconomy and Financial Risks
Friday 27 May, DSF-TI, Symphony building, Gustav Mahlerplein 117, Amsterdam,

Programme
08.30 - 09.00 Registration

09.00 - 09.05 Opening remarks by Herman van Dijk (DSF-TI)

Session one Chair: Dirk Schoenmaker (DSF-TI)
09.05 - 10.45 ‘Systemic Risk Diagnostics’ by Bernd Schwaab (European Central Bank); André Lucas (DSF-TI); Siem Jan Koopman (VU University Amsterdam)
Discussant: Michael Dempster (Cambridge)

‘Bubbles and Crises in Open Economies’ by Henri Buchsteiner (Cambridge) and Kirill Zavodov (Cambridge)
Discussant: André Lucas (DSF-TI).

10.45 Coffee break

Session two Chair: Frank Diebold (Penn-Wharton)
11.00 - 12.30 ‘Earnings Announcements and Risk Premia’ by Pavel Savor (Wharton Finance)
Discussant: Ingolf Dittman (Erasmus University)

‘A Tale of Two Treasuries’ by Krista Schwarz (Wharton Finance)
Discussant: t.b.a.

12.30 - 14.00 Lunch

Session three Chair John Eatwell (Cambridge)
14.00 - 15.30 ‘Exponential Conditional Volatility Models’ by Andrew Harvey (Cambridge)
Discussant: Dick van Dijk (DSF-TI)

‘Risk diversification, Hedge Funds and Systemic Risk’ by Casper de Vries (DSF-TI)
Discussant: Frank Diebold (Penn-Wharton)

15.30 Tea break

16.00 - 17.00 Panel discussion: Financial stability: The Policy Research Agenda
Chairman Panel: Jeroen Kremers (Head of Global Country Risk, RBS Group)
Members: Dick Herring (Penn-Wharton), John Eatwell (Cambridge), Dirk Schoenmaker (DSF-TI), Sweder van Wijnbergen (DSF-TI),

17.00 Drinks
Summary

27 May 2011

After a full day of presentations, the annual Cambridge, DSF-TI & Penn seminar was concluded by a panel discussion between Dick Herring (Penn-Wharton), John Eatwell (Cambridge), and Dirk Schoenmaker (DSF-TI), chaired by Jeroen Kremers (Head of Global Country Risk, RBS Group). The topic of the discussion was the policy research agenda regarding financial stability. Below is a summary of the discussion.

Dick Herring started the discussion by arguing that the Basel II capital ratio was a comprehensive failure. The 4%/8% standard was never justified, and the ratio did not capture the banks’ risk exposure, nor did it reflect the ability of an institution to absorb loss without going through resolution. However, it is not clear what the appropriate capital ratio should be. Overall, we lack a firm knowledge base to predict the impact of Basel III's requirements to better quality and higher equity capital.

Points usually brought forward by economists and politicians against higher capital requirements are not always supported by the empirical literature. Practitioners often rely on accounting identities to argue that they will be forced to charge a higher spread if their leverage decreases, and that this would deteriorate business conditions. This is, however, not supported by the data. Over the period 1920 until 1990 there seems to be no obvious impact of leverage on spreads. Moreover, bank leverage also did not have a strong impact on growth during that period. Another well known critique of an increased equity buffer is the feared increase of capital costs. Miles, Yang and Marchessiano (2011) investigated financial crises in a wide range of countries over 200 years and found that a very substantial increase in required equity capital would lead to a relatively little increase in cost of capital of 10 to 40 bps. On the other hand, the benefits of reducing the probability of a banking crisis are very high. From this we should conclude that the appropriate equity to asset ratio is substantially higher than even the Basel III ratios.

The next point in the discussion was brought forward by John Eatwell. As macro-prudential regulation is concerned with the stability of the system, the regulation applied to an institution depends crucially on how systemic its activities are. This is, among others, related to its size, degree of leverage and interconnectedness. In evaluating interconnectedness, results from transportation economics and communication network routing prove to be useful. The idea is that increasing the number of links between financial institutions is beneficial, as it gives providers of financial services more opportunities to cut costs and maximise profit. At the same time, congestion poses a big risk. When the density of financial services on a given network becomes too high, then there can be a sudden collapse, imposing a huge social cost. Ideally we would tax financial institutions based on their use of the network to curb this risk. This is difficult though, as we do not have a good way to measure the intensity of use of the network, we do not know the precise form of the social cost, and financial institutions are not alike in the risks they pose. One of the challenges for macro-prudential regulation is to tackle this issue.

Finally, Dirk Schoenmaker argued that one of the main problems with policy concerning financial stability is a lack of knowledge. Where micro-prudential has policy instruments to check the soundness of financial institutions in order to protect consumers and monetary policy makers have very clear instruments to maintain price stability, macro prudential lacks any clear tools to maintain financial stability. This is mainly caused by a lack of theory on financial stability.

The main challenge for academics and policy makers these days is to get a better understanding of what is underlying financial stability and to develop sound theories and policy instruments for the maintenance of financial stability. Another challenge is to analyze the interrelations between the three policies. Monetary stability and financial stability (macroprudential) policies are complementary, as they are both working at the level of the economy. Microprudential works at the level of individual institutions. When macro and micro are in conflict, macroprudential should be able to override microprudential concerns.