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Comment Richard Berner

I first met Charles Goodhart when, as a young economist at the Federal Reserve, I sought his advice in understanding the UK financial system. He was then a source of wisdom to me.

So it's hardly surprising to me that Professor Goodhart remains so nearly four decades later in his chapter, "Global Macroeconomic and Financial Supervision." In my comments on it, I'll try to be analytical and to explore policy options.

Full disclosure: I'm a former colleague and coauthor. Lest I be accused of being too sympathetic to him, I'll be clear on where I disagree and on those things I think he could have emphasized more.

Charles identifies two problems in macro- and financial policymaking:

- Markets are global, but policymakers are local, and surrendering sovereignty is difficult.
- Our macroframework remains flawed, lacking the analytics for a financial system that includes the messy real world phenomena of banks, markets, leverage, default, illiquidity, and fire sales.

These two problems are interrelated. And they magnify the tendency of the burden of adjustment to fall both asymmetrically and late on borrowers, and thus to promote, or at least allow, credit excesses to build to the brink of default. Similar cliff effects occur with funding and market liquidity. Charles's remedies sensibly include efforts to instill gradually increasing market discipline as risks rise and tails grow fat.

Asymmetry in Global Macroeconomic Adjustment

Charles's insight that the burden of adjustment for global imbalances "falls asymmetrically" on the deficit, indebted country, at least when it has borrowed in a foreign currency, is a commonplace, but still important. There are exceptions, but for most cases, Charles spells out policy options that could reduce both the asymmetry of adjustment and the amplitude of crises:

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- First, he suggests that we need new indicators to warn that imbalances are unsustainable. Credit ratings and risk weightings for the purpose of setting capital requirements that are adjusted presumptively in response to changes in such imbalances could make credit extension progressively more costly for the borrower and riskier for the lender before crisis thresholds are reached.
- Second, he observes that sovereign debt is not riskless, and that we must move beyond this notion.
- Third, he suggests that authorities should consider supporting debt restructuring when internal adjustment would be so draconian as to promote debt/deflation. And do it sooner rather than later; kicking the can down the road almost never ends well.

I'm highly sympathetic to these goals. And the crisis in Europe arguably has made some of the policies described by Charles much more appealing than they would have seemed only eighteen months ago.

Yet a look at history suggests why these remedies are hard to implement. At least three factors contributed to the asymmetry of adjustment: the difficulty in assessing default risks and adjusting ratings, the asymmetry in credit, and the expectation of bailouts.

Perceptions of default risk and ratings adjustments lag for good reasons. And the best-laid plans for setting out criteria for action are hard to implement; witness the Stability and Growth Pact. Nonetheless, I believe that building Charles's indicators into debt on origination (like covenants) and more forward-looking and/or through-the-cycle appraisals of creditworthiness would lean against the wind of credit-fueled threats to financial stability.

The asymmetry in credit is intrinsic; it derives from lenders always writing options, namely puts on the probability of default. Understandably they feel they should get timely repayment of principal and interest, often with contractual protection, which can stymie negotiated haircuts or workouts. Moreover, intermediation in the "shadow banking" system magnified that asymmetry in the run-up to 2007, because it was backstopped with credit and liquidity puts written on private balance sheets that were significantly underpriced. As a result, there was no natural seller of protection apart from the authorities when all those options came in the money.

Finally, limiting moral hazard will always be a challenge. We have relied on sovereign debt as the benchmark, risk-free asset. So the failure of the sovereign would imperil the financial system, and the failure of financial intermediaries could imperil both the economy and the sovereign. As a result, there is a bias to support both, either through a put to the taxpayer or easy monetary policy. Announcing the threat of restructuring in advance might help discipline lenders; the trick, as Charles notes, is exactly how.[1] In the United States, we have experience with bank resolution, and Dodd-Frank gives us new authority for orderly liquidation, but we all have work to do to establish a credible, cross-border resolution mechanism. (Note that the recent collaboration between the Bank and the FDIC on resolution regimes is encouraging in that regard.)

Global Financial Supervision: Where Next?

To discuss financial supervision, Charles reviews the shortcomings of capital buffers under Basel I and II. I agree that their flaws arose partly from a lack of global governance and partly from the defects in our macroparadigm. To improve on them, Charles points to three fundamental requirements for any system of capital buffers.

First he suggests a ladder of sanctions imposed on financial institutions as equity capital declines below some "fully satisfactory" level and the level at which prompt corrective action becomes mandatory. I read him as wanting capital buffers thick enough to cushion loss, high enough to constrain excessive leverage, but with some leeway to avoid excessive deleveraging in a bust, and with prompt corrective action aimed at restoring the amount of capital needed rather than deleveraging to bring CARs back to the right level.

This raises four questions:

1. How to estimate capital levels. Balance is needed; CAR design should balance the need for financial stability and adequate self-insurance with the requirement that a vibrant, efficient financial services industry should be able to earn a reasonable return over its cost of capital. The CAR design, moreover, should also recognize what Charles, Anil Kashyap, and I emphasize in a recent paper: too-high capital ratios will likely drive financial activity into less regulated parts of the financial system.[2]

2. How to introduce a more graduated ladder of sanctions for transgression of CARs (and liquidity requirements). I think that regulation of dividend and capital policy, as in the US CCAR process, limits on compensation, and dynamic provisioning may all help promote better behavior.

3. The use of CoCos and bail-ins. CoCos, especially with high strikes, may discipline lenders into being more prudent. But I side with Charles's view that, in a crisis, CoCos won't help banks who need cash.[3]

4. Pigovian taxes. Pigovian (not transaction) taxes could discourage excessive risk taking. They could be useful both to influence behavior in banks

1. Two academic proposals to build in such contingencies in advance are sovereign contingent debt and growth-indexed bonds. See Barkbu, Eichengreen, and Mody (2011) and Forbes (2004).

2. Kashyap, Berner, and Goodhart (2011).

3. See Goodhart (2010).

and in funding markets. One could characterize them as insurance premiums that cover the cost of providing backstops.[4]

The second big issue is the need for better tools to assess risk. Better models and data will help. I think we can improve stress tests, complemented by top-down models of the financial system; there is progress here, by Charles and his collaborators, among others. Stress tests must recognize the "endogenous risk," or the inherent instability of the financial system. Likewise, they must capture the joint impact of market participants' collective actions across the financial system.[5] Reverse stress testing may help produce more robust results that are less dependent on specific models. Better, more granular data are also essential. Work to encourage and facilitate data sharing among global regulators is needed.

Consistency across borders is also needed for capital regulation and risk metrics. How to navigate consistently ratings provided by ratings agencies also is an unresolved challenge.

Finally, we need better ways to reduce procyclicality. Implementing countercyclical macroprudential measures in practice is a daunting challenge. And it's not because, as Charles charges, we regulators are gutless wimps. Instead, the challenge is analytical and numerical. For example, the credit-to-GDP ratio gap, which has been proposed as a reference point for accumulating countercyclical capital buffers, is subject to significant measurement problems, especially for the latest data points, that can mislead policy.[6] But I agree that this is fertile ground for research and discussion; we need more work to assess the costs and benefits of countercyclical versus through-the-cycle measures that could reduce procyclicality.

What about the Lucas critique? Like Charles, I'm concerned that his or any indicators could fall victim to Goodhart's Law or to other unintended behavioral changes. But in many cases, we *want* behavioral change; we should seek policies that promote good behavior and restore market discipline.

Charles's list of our tasks ahead is long, but it is nonetheless incomplete. I'll close with four issues that deserve more emphasis.

First, as I already noted, better data are needed. I couldn't agree more with Charles that our analytical framework needs revamping; I know he agrees with me that better data are needed globally to help assess threats to financial stability. In the United States, Dodd-Frank requires that the new Office of Financial Research (OFR) contributes to both goals. The OFR will function as a shared provider of data and analysis for the Financial Stability

4. See Perotti and Suarez (2011).

5. Recent work has begun to address the need for stress testing across the financial system. See Greenlaw et al. (2011).

6. Edge and Meisenzahl (2011).

Oversight Council (FSOC) and its member agencies. We are working hard—and I believe thoughtfully—to satisfy our statutory mandates and mission:

- To collect data on behalf of the Council, and to provide them to the Council and member agencies.
- To standardize the types and format of data collected and reported.
- To perform applied and essential long-term research.
- To develop tools for risk measurement and monitoring.

Second, most discussions of macroprudential regulation remain overly bank centric. That's ironic. As this group knows well, threats to financial stability can arise anywhere, and macroprudential analysis and tools should look across the entire system. We need more explicit capture of nonbank FIs in our analysis. We must analyze the behavior of markets and instruments, in addition to institutions. An analysis of the factors that influence funding liquidity and market liquidity and the connection between them is essential. Tools to limit leverage, maturity mismatch, and to ensure adequate self-insurance in repo markets may prove helpful in reducing threats to financial stability. And such tools may limit the regulatory arbitrage that stems from elevated CARs. Those are key reasons why Secretary Geithner has called for a global margin regime, specifically in, but not limited to, noncentrally cleared over-the-counter (OTC) derivatives. Such tools can help level the playing field in funding and derivatives markets.[7]

Third, we need to assess better the implications for monetary policy of macroprudential developments and policies and vice versa, and assess how to resolve conflicts between them. Central bankers are clear that we should use the right tool for the job, but the assignment of instruments to targets does not mean we can ignore the real world considerable scope for one to act as a headwind or tailwind in relation to the other.[8]

Fourth, the financial crisis required that policymakers address not just illiquidity for institutions, but also solvency and market dysfunction. Repair and reform of markets may enable central banks to be more traditional lenders of last resort, but it makes more sense to encourage regular borrowing from central bank facilities to reduce the stigma. And like it or not, backstopping market functioning is now an explicit part of the financial stability mandate.[9] The quid pro quo for such facilities is obviously appropriate prudential oversight.

Finally, we must evaluate and manage the risks in the plumbing of the financial system—in payments, settlement systems, and clearinghouses. The CCPs' netting helps reduce risk in normal times, but their expanded role means that the failure of significant counterparties could threaten them and

7. See Kashyap, Berner, and Goodhart (2011); Ashcraft, Garleanu, and Pedersen (2010); Haldane (2011).

8. See Yellen (2010) and Carney (2009).

9. See Goodhart (2009); Madigan (2009); Mehrling (2010).

financial stability.[10] That is why Dodd-Frank gave the FSOC authority to designate financial market utilities for heightened prudential supervision.

Hopefully I've added slightly to the rich buffet that Charles has set for us in this chapter.

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10. Bernanke (2011); Tucker (2011).