The evaporation of trust: Prasanna Gai on financial crises

Interview conducted by David Hargreaves

Prasanna Gai is a Professor at the Australian National University and a consultant to the Bank of England, where he has previously worked on financial stability matters. Prasanna visited the Reserve Bank early in 2009. In this interview, he talks about the current financial crisis and the challenges it poses for policy makers and academic economists.

You've been at the Bank of England for quite a bit of your career, but doing your PhD before that. Now you're back in academic life at ANU. What do you think of the two different environments?

I think the two environments are actually quite closely connected. The US model, where an academic moves into policy institutions and out again, is a nice one. Central bankers, in general, would benefit from it, and with the entry of academics like Mervyn King, Alan Blinder and Ben Bernanke into senior central bank positions, we are seeing a lot more exchange. That's healthy for both sides because both parties can really engage with the other. The difference is not as big as people might expect.

Prasanna Gai on New Zealand Parliament steps, Wellington. Photo: RBNZ/Tim Ng

How has that interplay affected the topics you have worked on?

I left the Southern Hemisphere to go to the UK to do my PhD in 1990. My motivation for leaving Australia at the time was to work on a policy related topic. My interests at the time were in (what I thought then) were developing country issues. I did my PhD on sovereign debt defaults in the 1980s, and the debt crisis. At the time I thought that was something that would probably lead me into a career in development economics, but I was lucky enough to get a job at the Bank of England. And financial crises have obviously been a developed country phenomenon since! I was offered a position at the Bank of England at the time of the ERM crisis and I left the Bank of England when Northern Rock was going on. And in between we've had Barings, Asia, LTCM and the dotcom bubble. So my research and policy interests were always nicely matched.

Do you think crises are going to keep coming at the same rate?

I hope not. I hope they'll slow down so I can write a few papers! But I think it's largely in the nature of the financial system that you will see imbalances building up and being corrected very sharply from time to time. I don't think we'll ever be in a world without crises. It's a case of whether or not we have the policy framework to manage them effectively, and to temper their frequency.

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One of your areas of expertise is systemic risk - the idea that institutions can appear safe at the individual level, but there could still be something in the makeup of the whole financial system that introduces risk. Could you talk about that a bit?

Systemic risk is something that academic economists have thought very little about. The literature on it is relatively thin. In a way, central bankers are taking the lead in developing thinking on this.

The idea behind my work on the topic is that there are important spillovers or externalities in the actions that individual financial institutions take. So you need a policy framework that will make institutions take into account the effects of those externalities on others. These externalities can take a number of different shapes, which is what makes the current crisis so complex.

For example, there are agency externalities between the principals (eg, depositors) and agents (eg, bank managers) relating to their different objectives. There are informational frictions that come from lack of common knowledge about valuations. The lack of understanding about what collateralised debt obligations, for example, really are is a good example of how the end user of a product can have very little information about the risk they've taken on. And then there are the sorts of collective action problems that arise from balance sheet interdependency, where each creditor has an incentive to free ride on the others in terms of monitoring. The carry trade is a good example, where everyone wants to pile into a particular position or trade because others are doing so – there's a herd type of behaviour.

“Banks and capital markets are now very closely intertwined.”

And people get surprised when the herd suddenly changes course?

That's right. It's not just financial institutions that are subject to some of these externalities. Markets change course, so a liquid market can suddenly become illiquid when there are only sellers and no buyers, or vice versa. In a way, that's been the big lesson of this crisis – that you can get a run on markets. It's not just bank runs. Banks and capital markets are now very closely intertwined, and the two types of runs are now very closely linked.

You talked about how people would buy something like a collateralised debt obligation without really knowing what was in there. That presents some difficulties for the standard economic assumption that investors are well informed and rational. Why were people piling their money into these things if it wasn't clear what it was that they were buying?

Well, I think they were confident, and confidence is at the heart of a lot of financial transactions. Investors were quite willing to take on certain transactions thinking that their counterparty was AAA-rated. They were pretty sure you could trade with Lehman Brothers and be confident about counter-party risk. What we've seen now is the evaporation of trust. People are no longer willing to trust the counterparties and the institutions that they're used to dealing with.

Why were institutions set up in a way that allowed them to suddenly collapse?

I think the labour market for financial experts and how they are compensated is key in a lot of these things. Going forward, policy makers are likely to set more rules about executive compensation, and that's probably not a bad thing. For example, they might focus on bonus structures being linked to long term profitability rather than year to year performance. You need to gauge performance over a long term window without the peaks and troughs. The nature of bonus schemes will have to be revisited.

In 1982, the debt default occurred in the public sector. By contrast, this crisis pretty much started out in the private sector. That's probably partly because international capital flows have become largely private sector based over that intervening period. Is that going to have to change now?

I think capital flows will remain mostly private sector. What recent crises really highlight is the importance of creditor coordination issues. There is a family resemblance in creditor runs seen in the LTCM episode, the country run in Thailand and the problems in Iceland, but I don't think you'll see a change away from private sector flows to public sector flows. In part this is because the scale of capital flows is huge and public sector capital inflows will not really be able to meet the demands of developing countries for capital. But we're going to need to rethink the way in which we control and shape those private capital movements. In a way, the lessons haven't changed from the last big crisis.

> "How do you plug the hole left by a sudden departure of private capital?"

What are some of the issues that policy makers should look at in this area?

The policy concerns are about the pros and cons of the fickleness of private capital, and some of the externalities that I was talking about a minute ago. The ability of private investors to be able to reverse their investment decisions very quickly is necessary for ensuring good behaviour amongst borrowers, but at the same time, the consequences can be extremely costly.

So, at the heart of better crisis management will be trying to design a framework that both deals with the positives of short term capital, while offsetting some of its potentially sharp consequences. In other words, how do you plug the hole left by a sudden departure of private capital? Having contingency plans in place for that is really the way in which we need to think about crisis resolution mechanisms, both at the international level and the regional level.

What about reform of national banking systems?

I think there needs to be a serious revisiting of banks' approaches to liquidity management. Also, the idea of dynamic provisioning, or building capital cushions in the boom times to ward off possible future crises, is an important policy area that needs to be looked at seriously. Finally, I would like to see a more targeted approach that identifies the financial institutions that are most central to the system, and that puts the onus for adjustment on those institutions. In a way, requiring them to hold additional capital or liquidity cushions can serve as a tax on some of their activities.

The challenge for central banks, really, is to take a system-wide perspective, and to be able to identify the central financial institutions. That's easy in the case of very large players, but in the case of marginal players like Lehmans in the US for example, it's quite difficult to judge whether or not a particular player should be allowed to go under.

In all of this, we don't have a counterfactual – how bad it could've been.

That's very true.

Explaining these repeated crises seems a challenge for macroeconomics. Some academics, particularly outside of current macroeconomics, have been critical of how macroeconomics has developed in the last 10 or 15 years – the lack of attention to the possibility of default, for example. Do you think it's true that current macroeconomics struggles to explain the events of the last couple of years?

Macroeconomics has certainly been the victim of its own success over the last few years. Certainly the joke at the Bank of England was that for a long time a lot of macroeconomists were moving to the Financial Stability Department because the economics was more interesting! But of course this was partly because of the great successes seen with inflation targeting in the UK during the late 90s. Macroeconomics in the academic profession hasn't developed quite as fast. The work on financial crises is very much the terrain of microeconomists and financial economists at the moment.

Is it good to have the monetary policy and financial stability functions inside the same public institution in a crisis of that sort?

I think it's very important, and the two functions should be talking closely to each other. They can seem like quite separate functions in normal times but are inseparable in crises. I think the sort of ideas mooted by people like Claudio

Borio, who are trying to knit together a macro-prudential approach, will be key going forward. Central banks need to make sure they have a structure that allows them to respond to that new reality.

> "Central banks need to make sure they have a structure that allows them to respond to the new reality [of macro-prudential thinking]."

How do you think macroeconomics should change?

The crisis highlights the importance of taking a more eclectic approach to macroeconomic modelling. Focusing on a particular class of models – New Keynesian models for example – is not enough to address the sorts of policy problems that we're actually confronted with. We need to look at a broader array of literatures ranging from microeconomics to micro structure, to banking and finance, risk management and risk modelling, and so forth.

You can't really afford to take a dogmatic approach to the way you think about financial stability. What you'll probably find is different models, but which share a similar heritage. You're not necessarily going to see a particular model becoming the central tool – but you will see models of financial stability that marry elements of macro in different ways. And different central banks will have slightly different perspectives on the topic which will be healthy.

Some of these issues will be discussed in your forthcoming book.

Hopefully! I'm waiting for the crisis to settle down before I put actually pen to paper. At the moment it's a little bit premature to try to articulate it all.

I remember Krugman saying that the Exchange Rate Mechanism crisis in Europe was quite a nice thing in some ways for macroeconomists, because they could see it coming. It validated their theories about the dangers in that system. Is there anything similar to that in the current situation – views that have been validated by the current crisis?

Certainly, if you look at both the theoretical academic work on the "new style" of financial crises, and if you look at the central banks' financial stability reports from the last five years or so, there are clear indications that experts in the fields could see a crisis of this kind coming. An important example was the paper Rajan presented at Jackson Hole way back in 2005[1]. This was a very prescient exposition of the idea that financial development has made the world riskier.

Overall, central banks have done quite a good job in anticipating some of the problems. But they've not been so good at thinking through how to manage the possible fallouts. For example, the "lender of last resort" and "market-maker of last resort" functions that have been required in many countries were put together very quickly. The tools and ideas (such as broadening eligible collateral for central bank operations) were not things that were openly discussed even within the central banks before the crisis hit.

Perhaps we're quite lucky to have a Chairman of the Federal Reserve that has studied the Great Depression and the Japanese situation in the 1990s. Chairman Bernanke had thought and written about some of these possible policy responses.

There is some truth to that. There is definitely an advantage to having thought through what the causes of the crisis are and what the right sort of remedies might be. But there can also be a big difference between thinking about it from an academic perspective, and actually applying it. And once they have a course of action planned, central bank governors have also had to convince a lot of different players that they have the right remedies – politicians, markets, the public.

Great. Thanks for chatting, and for your visit.

Thank you. It's been a pleasure visiting. I'll have to enjoy this beautiful Wellington weather again sometime

[1] Rajan, Raghuram (2006) 'Has Financial Development Made the World Riskier?', in *The Greenspan Era: Lessons for the Future*, Jackson Hole Symposium Proceedings, Federal Reserve Bank of Kansas City.