Liquidity, Default and Market Regulation

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Liquidity and default have frequently been regarded as two separable concepts. Our view, instead, is that these two concepts are inherently intertwined; you cannot have one without the other. For example, if no one ever defaulted, and was without any credit risk, then everyone's IOU would be perfectly acceptable in payment. The concept of gradations of liquidity in such circumstances would be invalid. There would be no need for money, nor for financial intermediaries. And such an assumption of zero default unfortunately lies at the heart of most of the macro-economic models currently in mainstream use, which explains why they have been so spectacularly useless during the recent crisis.

Inevitably, concerns about liquidity and default interact. The original idea that the start of the financial crisis in August 2007 was just a liquidity problem, though a widely shared view at the time, was always ludicrous. Instead, the economic shock arising from the US housing market and its effect on mortgage-based securities raised the prospect of a higher probability of default amongst an increasing range of banks and their associated conduits. In turn, this concern about enhanced default risk led to a reduction in market liquidity and hence to a fall in asset prices. But this fall in asset prices then reinforced concerns about banks' and other financial intermediaries' solvency, and this further reduced liquidity in a range of asset markets, with a variety of self-amplifying spirals then bringing the whole financial system to its knees. Lack of liquidity dries up key financial markets, thus preventing institutions from restructuring their portfolios, adapting their strategies, and steering away from potential dangers caused by exogenous economic shocks. In turn, defaults start accumulating and the domino effect leads to further reductions in liquidity, and ultimately leads financial institutions, corporates and other non-financial bodies to start failing to meet their contractual obligations.

One response of the authorities worldwide has been to propose a new and separate body to introduce tougher regulation on systemic financial institutions. While we agree with this in general, we would also wish to point to two difficulties. First, the boundary between an institution which is systemic, and one which is not, is not constant and fixed, but depends on economic conditions at the time, and these will vary. Northern Rock was systemic in 2007, but would not have been in 2005. The idea that there is a given set of systemic institutions which can be clearly identified and treated differently, is just wishful thinking. One of the key exercises for the systemic regulator will be to try to observe how the boundary between the more systemic, and the less so, is continually shifting.

Moreover, the current proposal is that the bigger, and more systemic, financial intermediaries should face more onerous regulation. That would cause shifts in competitiveness, whether through regulatory arbitrage or not, between those defined as systemic and those defined as less so. By regulating banks only and not all participants of a key capital market is to ignore the likelihood that business and risk will tend to shift over time to the less regulated. Consider the inter-bank market or exotic derivatives markets with their esoteric financial instruments. The purpose of any regulatory intervention could be neutralised, if not reversed, should only large banks be regulated. In any race track the same rules of the game apply to all cars, and not only to those built by well-established car manufacturers.

The forthcoming regulatory architecture should recognise that there are markets that are ‘too important to fail’ and not only banks that are ‘too big to fail’. So regulation should also be focussed on ‘systemic markets’ as well as ‘systemic institutions’. In particular, the close interconnections between property and bank credit means that financial controls on the mortgage market should be a critical element in the overall regulatory system. The mortgage market acted as a catalyst in this latest crisis, and yet a significant proportion of its financial participants in the USA were virtually unregulated.

The ability to adjust monetary policy appropriately to economic conditions requires measurement of key economic variables, such as inflation and output growth. Imagine how difficult it would be to set interest rates sensibly if there was no quantification of inflation pressures. Similarly, if the authorities are going to be able to maintain financial stability, some equivalent measures of financial fragility must be developed. Such measures could be used as a yardstick to assess the success of regulatory policy, and even render central bankers and regulators accountable to governments. Such a measure should be simple enough to understand. We, and others, are seeking to develop such measures, an exercise which urgently needs to be done. Perhaps a research centre to develop such measures, and to study systemic financial stability more widely, should be set up under the aegis of the BIS (Bank for International Settlements) at Basel.