

Interdisciplinary Approaches to Financial Stability



Panel 4: Systemic Risks in Non-financial Systems Friday, October 23, 2015 at 8:45 a.m. Hutchins Hall 100

Moderator:

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Panelists:

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Terms that recur again and again in discussion and analysis of the great financial crisis and the reform programme that it set off include: contagion, network, system, opacity, arbitrage.

They capture hugely important features of how the financial system works and how crisis is generated and spreads. Regulatory arbitrage sees firms, funds and other vehicles adapt the form of what they do to step around regulation altogether or to minimize regulatory requirements. The 'systemness' of the system has long been recognized – for getting on for half a century at least – comprising, as it does, intermediaries with similar balance sheet structures and a complex network of credit exposures, actual and contingent. The effect is that the strength, weaknesses, even the activities of individual firms and funds, sectors, and the system as a whole are opaque. When a firm or fund is weakened by losses, the effects can be transmitted to others – to other sectors, to other jurisdictions – in a process commonly referred to as contagion.

Two of those words – contagion and network – are metaphorical. For decades the metaphors themselves went unexplored, but a striking feature of the post-crisis debate has been that, perhaps for the first time, the world lying behind those metaphors is being explored. People have been asking whether financial reformers have big things to learn from biology, from computer science or from the abstract analysis of networks more generally.

The two metaphors are, of course, profoundly different. One concerns adaptable organisms, the other inanimate systems. So one question is whether one or other of these fields has more to teach financial policy makers.

What, on the face of it, neither incorporates is an analogue to human agency. Can these disciplines say much to help us understand the role of intentionality, rationality or myopia in either the build up to crises or their crystallization? They can capture contagion via contact, but can they capture contagion via isomorphic association? Do concepts vital to understanding economic phenomena, such as moral hazard, adverse selection, time consistency, have analogues in these other fields?

And within the realm of collective intentionality, do any of these fields have an equivalent of the state that sets rules of the game that may be followed, avoided, ignored, or enforced; and whose policies are subject to interest-group bargaining (at least in some jurisdictions)

Some policymakers see the objective of new policy regimes as active management of credit cycles and asset-price cycles. Others see the objective in terms of the resilience of the financial system, so that it can maintain the provision of core services – credit, payments, insurance – in the face of big shocks. Can other disciplines enrich our sense of what resilience is, and how it should be measured? Are popular science terms such as 'anti-fragile' illuminating and, if illuminating, can they be operationalized?

Are there more prosaic avenues, based not so much on analogous substance but on learning from leaders in other fields? For example, airlines and airline regulators have to reach decisions about the maximum probability of aircraft failure that the public will tolerate. How do they go about getting political, societal support for that? How should financial policymakers engage with politicians and the public in specifying a standard for the systemic resilience of the financial system?

Similarly, in some other fields, leaders commission 'near miss' analysis and reviews. Should regulators do that? Has anyone assessed how close we were to disaster when the telco-debt bubble burst in late 2002?

The financial authorities have for some years conducted crisis-management games? Indeed, they did so before the crisis. But are these simulations prepared and conducted with the same degree of care as the military's war games?

Does anybody at the conference believe that looking to other disciplines is liable to distract economic and financial policymakers and researchers? Are there fields that are still neglected?

For example, is psychology taken seriously enough? We know that imperfect rationality is a feature of the world. Best-selling books by Nobel Prize winners have made this commonplace. But do we know how to operationalize their insights into economic models? Is the durability of the rational-expectations revolution down to its tractability?

Going further, does it take a model to beat a model? Are policymakers still victims of epistemological blinkers when evaluating accounts of risks or features of the financial system that defy formal elaboration given the current state of 'knowledge'?

This session might range very widely. Its big question is which, if any, other disciplines could make a real, practical difference to ensuring society gets the benefits of modern finance at a lower cost.