Would Macroprudential Regulation Have Prevented the Last Crisis?
Thurs, Feb 21, 2019 | 12:00 – 1:30 PM | 641 Jon M. Huntsman Hall

A key response of official sectors around the world to the financial and economic crises of ten years ago has been the formation of financial stability committees. Such committees now exist in over 40 countries worldwide and Liang 2017). The remits of these committees are “macroprudential.” Macroprudential policy focuses on potential system-wide risks and amplification mechanisms, complementing the detailed firm-specific risk assessments of micro-prudential regulators. In addition, it has the explicit objective to ensure that the financial system does not amplify a downturn in the real economy—for example, by being forced to cut back on the supply of credit in a stress (Borio 2005; in this journal, Hanson, Kashyap, and Stein 2011).

This paper asks whether macroprudential authorities, as they have been designed over the past decade, could prevent—or materially dampen—a rerun of the last crisis. To be clear at the outset, macroprudential regulation does not seek to eliminate recessions. Instead, it is aimed at ensuring that the financial system does not create shocks that trigger recessions or amplify other shocks to make recessions materially worse. With this in mind, the first part of our paper provides an account of the amplifying factors that made the last crisis so severe. Our diagnosis centers on two overlapping but distinct vulnerabilities: the increase in leverage and short-term funding at financial intermediaries, and the build-up in indebtedness in the household sector. These factors, we argue, can account for around two-thirds to three-quarters of the fall in US GDP that followed the financial crisis. We describe and calibrate the policy interventions required to address these vulnerabilities.