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By Invitation | Finance

The global economy needs to be better prepared for the coming storm, says Kathryn Judge

The law professor says systemic fragility is a choice made through design

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The likelihood of a global recession is growing and inflation is already taking a significant toll. A prolonged period of stagflation—that painful combination of high inflation and low growth—looks increasingly probable even if a global recession is averted. The pandemic and Russia's invasion of Ukraine triggered the problems now on display. But blaming the current morass on those shocks is like blaming the implosion of the financial system in 2007-09 on the correction in housing prices that triggered the dysfunction. Shocks happen. Whether a shock is generated endogenously by a financial system that fed a housing bubble or comes out of nowhere, the core question is the same: does the system mitigate the impact, or does it magnify it?

In 2007-09, financial dysfunction created more dysfunction, ultimately bringing the global economy to its knees. Similar dynamics are now at work, but with origins that lie outside of finance. Long, complex supply chains and the information gaps within them are exacerbating the impact of recent shocks and leaving policymakers in the dust. The good news is that, since the financial crisis, policymakers and banks have worked together to produce a far more resilient banking system. Despite meaningful differences between the financial sector and the rest of the economy, and a far more modest role for government oversight outside of finance, changes in the financial system provide a blueprint for the types of changes that could help the economy better weather the next storm.

The first lesson is that when firms choose to prioritise resilience—whether on their own initiative or because policymakers require them to—they can produce a system able to withstand very big shocks. When the pandemic hit, no bank runs occurred. Banks continued to lend, continued to issue and redeem deposits, continued facilitating payments and, in America, even helped distribute government grants to small businesses. Fragilities in the financial system remain, particularly outside the formal banking sector. But in general, the banking system is far more able to absorb shocks than it was 15 years ago. Even if another recession hits, it appears well positioned to withstand it.

One change that has improved risk management and resilience in the banking sector is cutting back on costly complexity. Lending and borrowing will never return to the simplicity of the 1950s, when money flowed from depositors to banks to borrowers. But the past decade has seen a meaningful rebalancing. Layered securitisation vehicles are largely a thing of the past. The amount of asset-backed commercial paper outstanding has declined from over $1.2trn in the summer of 2007 to less than $260bn today. And changes in the structure of the derivatives market make it easier for banks today to understand and manage their counterparty risks.

These types of alterations enable banks to understand their exposure more readily in the event of shock—whether it's falling house prices or a global pandemic—making it more probable that they will respond in a measured way instead of overreacting and creating yet more shockwaves. And even though some of these reforms were imposed by government, banks started avoiding excess complexity as soon as the full risks became apparent and long before any government mandate.

In a similar manner, the current supply-chain dysfunction has been magnified by what companies didn't know about their upstream exposures. For firms focused on short-term efficiency, adding one more step to a production process to eke out marginal-cost savings can seem like a good idea. But non-financial firms are now learning what banks realised in 2007-09: the length of those chains introduces new sources of fragility. Simplifying supply chains and strengthening relationships along those chains can help firms identify risks and reduce the disruption that often follows shocks.

A second lesson is that well designed data standards can help firms and policymakers better understand and manage risk exposures. When Lehman Brothers failed, for example, the dysfunction that followed was magnified by a dearth of good information about just who was exposed and by how much. Lacking credible information, banks refused to trust one another, increasing the magnitude of the crisis that followed. To reduce these information gaps, the industry worked with policymakers to create a global system of "legal entity identifiers". Regulators then helped ensure widespread adoption by mandating their use in certain markets

Uncertainty and unknowns often magnify the consequences of bad news. Well designed, widely adopted data standards can render the unknown knowable. This can reduce the tendency to panic and lead to more targeted and timely government interventions. If a new trade war breaks out or a recession takes hold, these types of responses will help the financial system absorb that shock and keep functioning.

More can be done to enhance the quality and ubiquity of data standards in finance, and non-financial firms are already hard at work to improve their ability to trace goods along a supply chain. But finance further shows that even data standards that make everyone better off often need a nudge from policymakers. Regulators can bring together the various perspectives required to produce a workable standard, and can help smooth the path for widespread adoption.

The final lesson from finance is the value of "stress testing"—trying to work out just how a firm would fare in an adverse scenario before anything bad actually happens. What would happen to a firm's operations and finances if China invaded Taiwan and all trade between America and China temporarily ceased? What if short-term interest rates hit 10% and the stockmarket falls by half? Or if wildfires take out a critical supplier?

Banks have long used stress tests to assess their own viability when problems hit, and they also use them to assess the robustness of important counterparties. These forward-looking exercises can reveal hidden vulnerabilities, allowing firms to take corrective action before it is too late. Stress tests can also reveal shortcomings in the ability of a firm to make informed predictions, leading to better risk management.

Regulators now mandate and oversee bank stress-testing, but many banks engage in more and different stress tests than the government requires because these exercises yield valuable insights. In today's highly intermediated economy, what you don't know can hurt you. Stress testing—particularly when coupled with simpler structures and data standards—can go a long way in reducing those unknowns. And credible information is just what market participants, in banking and beyond, need to stay calm and respond in an orderly fashion when bad things happen.

Banks are far from perfect models of resilience and few industries should be as regulated to the same degree as finance. But analogies need not be perfect to provide valuable insights. Many of the changes in finance came about not because of government mandates, but because the crisis provided banks with new insight into the dangers of excessive complexity and the value of planning for catastrophe. And with shortages hitting critical supplies, from medical dyes to baby formula, regulators may have a growing role to play in ensuring resilience in domains beyond banking. The health of individual banks and the banking system has improved enormously since 2007-09. Today's supply-chain problems and the systemic consequences flowing from them suggest it is time for companies and regulators to start catching up.

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