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Have policymakers done enough to prevent the next crisis?

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It's been more than a decade since the start of the worst financial crisis since since Great Depression. And while measures to strengthen the global financial system have undoubtedly paid off, one question haunts

policymakers: Have we done enough to prevent the next crisis?

The answer is yes and no, according to a new paper by Kristin Forbes, the Jerome and Dorothy Lemelson Professor of Management at the MIT Sloan School of Management. The paper is being published in an upcoming issue of the *American Economic Review*.

"We've made substantial progress in understanding where risks come from and in devising tools and regulations to build up capital cushions, support the credit supply, and boost liquidity," she says. "But many risks remain. It's not yet clear that these tools can live up to their promise of reducing systemic financial weaknesses and preventing a future shock—from wherever it emerges—from becoming another costly crisis ."

According to Forbes, one of the causes of the crisis was an "insufficient understanding of macroprudential risks"—that is, vulnerabilities in the wider financial system by which shocks spread and become amplified. Before the crisis, most countries relied on central banks for price stability and microprudential regulators for the security of individual banks. The subsequent collapse of the financial system underscored the inherent problems with that approach.

In the aftermath of the meltdown, most countries established some type of macroprudential authority and adopted new policies and tools, including regulations designed to fortify bank balance sheets and support financial institutions. "These rules have made banks safer but risks are still there—in some cases they've just migrated to other sectors," says Forbes. She compares this phenomenon to "shifting snowbanks." "And worryingly, we don't have a good understanding of what these shifting risks mean for broader financial stability."

Another issue, says Forbes, is how financial authorities calibrate these

new regulations. Very tight regulations often significantly reduce risks, but they could also harm economic growth. "Tighter regulations usually entail immediate costs—such as reducing a person's access to credit to buy a home or start a company. Meanwhile, the benefits of tightening may not appear for years—or may be impossible to measure," she says. "As a result, figuring out the right level of tightening is a politically tricky endeavor."

Forbes says that more academic research is needed on macroprudential regulations. In particular, the research ought to focus on better understanding how risks have shifted as investors and institutions find ways around the tighter regulations, as well as creative thinking about future risks.

"Macroprudential regulations today prioritize addressing the vulnerabilities behind the 2008 crisis. This makes sense, and there have been important steps forward, especially in requiring that the banks are better capitalized and less leveraged," she says. "But we simply don't know where the next shock will come from and whether changes in the global financial system—including those aimed at building bank resilience—are sowing the seeds of the next crisis."

Provided by MIT Sloan School of Management

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