

## Regime Shift and Economic Model Performance – October 2009



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The events of the last two years have put economic models and model performance in the spotlight in both academic and policy circles. Serious questions are being asked about how well economic models have coped with the deep recession and the structural and policy shifts we have all experienced in recent years. Academic research highlights that at times of significant change the structural parameters in major economic relationships tend to shift and this requires careful handling.

Econometric models are rarely stable in the face of such large changes in structure and policy regime, made worse by the variable quality and timeliness of the economic data underpinning these models. Maintaining or restoring confidence in the use of econometric models will be a difficult challenge for economists and policymakers alike. This is the time to go back to first principles rather than fine tuning, patching up or adjusting existing models. Econometric models struggled when we moved from a fixed exchange rate regime to a floating exchange rate system and likewise after the deregulation of the city when capital flowed more freely and credit constraints were lifted. We are now on the cusp of more major regulatory and government policy shifts which will need to be modelled and analysed over a reasonable period to provide robust results.

The actual supply of new credit and the need for greater liquidity in the banking sector will result in very different behaviours from banks and businesses. Assuming that the supply of credit is fairly elastic is unlikely to be sensible for some time to come. Government funding will also be far more influential in affecting private financing as 'crowding out' becomes a big issue again. This occurs when a larger public sector makes it more difficult for the private sector to invest or get funding. Government funding will dominate the landscape over the next 3-5 years and increasingly imaginative schemes will make it more difficult for corporate bond finance and borrowing for the private sector.

The announcements this week from the FSA on how they intend strengthening liquidity standards typifies the rapidly changing policy regime we face. This move will make it more expensive and more difficult for banks to manage liquidity but at the same time make banks more resilient to market shocks and discontinuities. The FSA are insisting on a very narrow definition of liquid assets and in practice this will be largely government bonds and cash deposits. The higher costs of managing liquidity under this regime will at some stage be passed on to customers in the form of increased prices and charges. There are many more regulatory and policy changes coming down the line for 2010 and 2011 and these will reshape the way we structure and use models going forward.

In addition, the bank and building society sector will also directly feel the public sector finance pressures as public sector institutions such as National Savings, Northern Rock and other part public organisations (Lloyds and RBS) scramble for personal sector deposits and savings. The price of and availability of retail funding is going to be a key factor in any model of the retail sector for the next few years.

So what are we likely to see in practice? Many institutions will hold onto their existing models and approaches under false belief that the market environment and regime will return to normal and the performance of existing models and forecasts will be restored. Others will attempt to build new models on relatively limited current data and produce approaches and forecasts far simpler than in the past but also highly data dependent on short period of elapsed time. There is no doubt it is time to rethink approach and to plan for new models and techniques. During this time model validation and testing is going to be more challenging and those institutions with a combination of rich and deep historic data combined with a willingness to adapt and change will produce the best results. Defensiveness and 'the not invented here' mindset so prevalent in our industry will need to change. Benchmarking and external reference points will grow in importance and greater sharing of data with competitors looks inevitable.

The rapid adjustment to a new regime and business environment will put far more emphasis on scenarios and stress testing. Risk models calibrated to the experience of the 5-6 years in the run up to 2007 are unlikely to be robust and even the most extreme economic scenarios are unlikely to generate the resilient forecasts required. The need for the right calibre of people to navigate a course through this difficult and challenging phase

is one of the major positive changes likely to occur from this crisis. Many of the modellers and economists who have been kept in the background in recent times will return to the hub of decision making again and will be presented with an opportunity not seen for two decades. Openness, transparency, flexibility and robustness will hopefully become the watch words.

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