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From: Lloyd Etheredge <lloyd.etheredge@policyscience.net>

Subject: 203. Red Team (+ National Academy) Economics: Fwd: The Economist, "The Great Unknown . . ." re the new, outsmartable data systems; the CIA's Office of Political Psychology & profiling hedge fund managers

Dear Dr. Fischhoff and Colleagues:

Concerning National Academy recommendations for a joint Red Team challenge to conventional assumptions in economics, I enclose a (partly critical) review of innovations in global government data systems from the current Economist.

One task of the Red Team will be to challenge whether the new conventional thinking embodied in these data lessons is good enough. For example, the Economist predicts that these new data systems can (and will) be outsmarted technically and by asymmetries of brainpower and wealth that allow leading private actors to penetrate and neutralize the watch dogs of public regulatory agencies.

Adding Watch Lists and Individual Profiling?

- Of the universe of innovations for national security in this new world, one Red Team/National Academy recommendation in the Fischhoff spirit might be to develop "Watch Lists." The CIA's Office of Political Psychology can be tasked to develop psychological profiles of leaders of hedge funds and other major actors about whom traditional assumptions of ethical behavior and restraint, that normally have been made about leaders of major institutions, may no longer be appropriate. The new, statistically sophisticated, "Watch List" of individuals and firms may be easy to create: The wave of books about the current global financial crisis suggests that many informants in the financial sector had astute psychological observations about the people who ended-up being messianic, very smart, very wealthy, and sociopathic in their impact. Many of them are still around. Observations of what they were able to acquire in this last round may be attracting a new generation.

At this point, too, it seems likely that the new conventional thinking only will prevent the last crisis. It may not defend against smart, adaptive opponents.

If the DNI is doing psychological/sociological profiling of potential bombers to keep them from getting onto airplanes, wouldn't it also be rational to identify and keep a close eye on activities of potential trouble-makers in the global financial sector as individuals? The *real* government economic analysis and forecasting models do not have to be constrained by the data systems that are in the public domain.

Experience-Based Meta-Lessons: Ratings of Compromised Institutions?

One of the new, non-traditional, bases of Red Team Economics could be the (experience-based) meta-lesson that most of the world's government regulatory institutions, and even political bodies, are susceptible, in various degrees, to penetration, corruption, and being slowed-down, circumscribed, or neutralized. [Indeed, the veils of secrecy in America's DNI world may be one of the last lines of strong defense for the public interest in the new world of asymmetries of brainpower and wealth.] When former Committee Chair and staffers with inside knowledge are hired, in the US or abroad, by lobbying firms, a green light should change color to activate a higher level of monitoring. New global rankings of the degree of penetration, compromise, and weakened integrity of key regulatory and policy institutions should be part of the Watch List and game-theoretic methods (then) deployed to analyze the strategies on the other side and counter-moves.

- [I make these recommendations as a conceptual exercise: In practice, the CIA's Office of Political Psychology may have legal barriers to profiling a sub-set of US hedge fund managers and major investment bank CEO's in the US, or deploying human spies or wiretaps (etc.) involving Americans inside the US. And the CIA as an institution probably should not develop even a highly classified Watch List of penetrated/compromised US government regulatory or political bodies. The Red Team/National Academy of Sciences project should make a conceptual recommendation nonetheless: It is possible that such Watch List and forecasting assessments can be effected by non-US intelligence services and shared; or by public interest watchdogs or journalists if they receive financial support..<1>]

- There is an obvious reluctance, by many leading, independent social scientists, to do any classified work or advising. And the paperwork involved to obtain high security clearances also is a barrier. If the National Academy of Sciences/Red Team project goes forward, might it be structured as a conceptual audit/evaluation/dialogue? Your rethinking project might go forward with the same kinds of non-disclosure agreements that are normal for many National Academy panels.

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<1> It might be reasonable to assume that the Chinese spying penetration of US hedge funds, for commercial insight/advantages and in defense of its own national interests, already is established; and that duplicate books of the shadow banking world (discussed

in the Economist article) already are available in the intelligence agencies of several major nations.

The alternative to a Red Team/National Academy joint project is worrisome, as it is a future in which - increasingly - key data used to forecast, and make policy about, international economics are removed from the public domain and free access by academics to discuss and improve the new generation of models and forecasting tools.

The Great Unknown: Can policymakers fill the gaps in their knowledge about the financial system?

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IN THE depths of the Great Depression, Presidents Hoover and Roosevelt had to set economic policy on the basis of information that decision-makers today would consider pathetic. Along with manufacturing output, factory employment and department-store sales, they counted the number of freight wagons transported by rail. As a result America subsequently developed national accounts, which try to measure the economy better, using concepts such as gross domestic product.

The world has since invented a vast array of financial and economic statistics and the processing power to crunch them. Yet policymakers are today in a similar position with regard to the financial system. New “macroprudential” bodies have been tasked with maintaining financial stability, such as the European Systemic Risk Board (which has its inaugural meeting next week) and America’s Financial Stability Oversight Council. But the crisis exposed vast gaps in knowledge. From conduits and subprime-related securities to the regulatory-capital-enhancement swaps written by AIG, there was a bewildering list of financial exotica that played a significant role in the meltdown.

The International Monetary Fund (IMF) and the Financial Stability Board (FSB), a global club of regulators, have picked some priorities. Three things are at the top of the wish-list. First, system-wide measures of borrowing and “maturity mismatch”, where banks use short-term funding to buy long-term assets. As in the past, these were the root causes of the financial crisis. The world’s ten biggest banks more than doubled the size of their balance sheets between 2003 and 2007. As they made loans faster than they gathered customer deposits, banks plugged the gap by short-term borrowing, often from other financial firms. After the collapse of Lehman Brothers in September 2008 many banks faced severe difficulties rolling over this funding.

The second priority is data on the links between big banks and other bits of the financial system. It was not just the investment banking giants that had exposures around the world. Many European institutions were up to their necks in securities linked to the American housing market. This suggests that more information is needed on banks’ exposures across borders and the concentration in underlying asset classes.

The final priority is data on the “shadow banking system” which comprises non-bank financial firms that often slip below regulators’ radar. In the run-up to the crisis, regulated banks became too reliant on shadow banks for funding. Off-balance-sheet vehicles were used to create further layers of intermediation, making things even more opaque.

The IMF and FSB will report back in June this year. Some progress has been made. The Bank for International Settlements (BIS), a club of central banks, has used its data on international banking to develop a measure of maturity mismatch. But this is restricted to banks, and covers only their international activities and on-balance-sheet positions; and, as the euro-zone crisis has shown, the BIS data can also be difficult to interpret.

To get a better handle on global banks, the FSB has developed a common reporting template, which will identify exposures to different financial sectors and national asset markets. Persuading banks actually to fill it in may be harder: widespread consultation will be needed and there are confidentiality and legal issues to grapple with.

The shadow banking system poses a thorny problem too. The IMF is trying to measure the problems of sectors where data do not exist or are sparse: for instance, for hedge funds, money-market funds and over-the-counter derivatives. This will require twisting the arms of financial firms that currently do not report data. Until then, the most severe gaps may be in the most leveraged parts of the financial system.

Paul Tucker of the Bank of England worries about the threats to financial stability that are created from outside the regulated sector and wonders whether the “regulatory perimeter” should be widened to encompass such institutions. That would allow regulators to supervise these firms, but would also give policymakers better information.

What you don’t know will hurt you

For all the effort expended on data gaps, the constant evolution and footloose nature of the financial system complicates matters hugely. As bank whizz-kids dream up new products, it will be hard for officials to keep up. Indeed, there is a good case that new financial techniques are created precisely because regulators cannot spot or understand them and therefore do not penalise them for being risky.

The insurance contracts that made AIG so entwined with the banking system were designed to help banks boost their capital ratios. The bundling of risky loans into complex securities was attractive for many firms precisely because they had low capital charges. Regulators, therefore, are not just in a race to keep pace with finance, they are in a constant battle to outwit it. The hope is that good market intelligence, for example discussions with clued-up investors, can help officials to become more savvy.

Yet imagine data nirvana: a colossal, constantly updating spreadsheet of the trading and lending exposures, cross-border activity, interconnectedness and funding risks of all regulated and unregulated institutions. Even if a few humans could get their heads around it—a collective nervous breakdown is more likely—they would still have to decide when to act.

In the run-up to the crisis policymakers and supervisors, like most other people, managed to rationalise bad things that were plain for all to see, such as inflated house prices and some banks' rock-bottom capital levels. As Claudio Borio of the BIS puts it, "The main reason why crises occur is not lack of statistics but the failure to interpret them correctly and to take remedial action."

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