



Macroprudential policies in an agent-based artificial economy

Economics Department

Marco Raberto
Andrea Teglio
Silvano Cincotti

2012 / 05

Macroprudential policies in an agent-based artificial economy

Marco Raberto
University of Genova
marco.raberto@unige.it

Andrea Tegli
Universitat Jaume I
Department of Economics
teglia@uji.es

Silvano Cincotti
University of Genova
silvano.cincotti@unige.it

2012 / 05

Abstract

Basel III is a recently-agreed regulatory standard for bank capital adequacy with focus on the macroprudential dimension of banking regulation, i.e., the system-wide implications of banks' lending and risk. An important Basel III provision is to reduce procyclicality of present banking regulation and promote countercyclical capital buffers for banks. The Eurace agent-based macroeconomic model and simulator has been recently showed to be able to reproduce a credit-fueled boom-bust dynamics where excessive bank leverages, while benefitting in the short term, have destabilizing effects in the medium-long. In this paper, we employ the Eurace model to test regulatory policies providing time varying capital requirements for banks, based on mechanisms that enforce banks to build up or release capital buffers, according to the overall conditions of the economy. As conditioning variables for these dynamic policies, both the unemployment rate and the aggregate credit growth have been considered. Results show that the dynamic regulation of capital requirements is generally more successful than fixed tight capital requirements in stabilizing the economy and improving the macroeconomic performance.

Keywords: Basel III, macroprudential regulation, agent-based models and simulation

Macroprudential policies in an agent-based artificial economy

Marco Raberto ^a, Andrea Teglio ^b, Silvano Cincotti ^a

^a*DOGE.I-CINEF, Università di Genova, Via Opera Pia 11a, 16145 Genova, Italy*

^b*Universitat Jaume I, Campus del Riu Sec, 12071 Castellon, Spain*

Abstract

Basel III is a recently-agreed regulatory standard for bank capital adequacy with focus on the macroprudential dimension of banking regulation, i.e., the system-wide implications of banks' lending and risk. An important Basel III provision is to reduce procyclicality of present banking regulation and promote countercyclical capital buffers for banks. The Eurace agent-based macroeconomic model and simulator has been recently showed to be able to reproduce a credit-fueled boom-bust dynamics where excessive bank leverages, while benefitting in the short term, have destabilizing effects in the medium-long. In this paper, we employ the Eurace model to test regulatory policies providing time varying capital requirements for banks, based on mechanisms that enforce banks to build up or release capital buffers, according to the overall conditions of the economy. As conditioning variables for these dynamic policies, both the unemployment rate and the aggregate credit growth have been considered. Results show that the dynamic regulation of capital requirements is generally more successful than fixed tight capital requirements in stabilizing the economy and improving the macroeconomic performance.

Key words: Basel III, macroprudential regulation, agent-based models and simulation

Introduction

The recent economic and financial crisis has cast serious doubt on the idea of efficient self-regulating financial and credit markets, and consequently the need for a more effective regulation of these markets unquestionably has arisen. As a response to the crisis, a new global regulatory standard has been proposed under the name of Basel III ¹, with the objective to improve the resilience of

¹ For details and documents on Basel III, please visit the Bank for International Settlements (BIS) website at: <http://www.bis.org/bcbs/basel3.htm>

the banking system.

The rationale behind Basel III regulation, which is founded on the same three pillars² characterizing its previous version Basel II, is that one of the main reasons why the economic crisis became so severe was that the banking sectors of many countries had built up excessive on and off-balance sheet leverage. The erosion of the level and quality of the capital base determined that the banking system was not able to absorb systemic trading and credit losses nor could it cope with the large off-balance sheet exposures. The crisis was further amplified by a procyclical deleveraging process. The weaknesses in the banking sector were rapidly transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability (for more details see BIS (2011)).

Some previous works by the authors reproduced these economic mechanisms by means of the agent-based model and simulator Eurace (see Raberto et al (2011); Teglio et al (2012)). In particular, Raberto et al (2011) showed that excessive bank leverages can drive economies into severe recession in the medium-long run. The pressure on wages and labor costs during credit-fueled economic booms, in conjunction with the speed of growth of credit-money, causes a rise of inflation, that in turn can determine higher interest rates. Excessively indebted firms may be unable to fulfill their financial commitments with the cash proceedings of their revenues, and may be obliged to take new loans to pay interests on their debt, therefore entering in a Ponzi scheme. However, the deterioration of firms creditworthiness causes a further rise of interest rates due to the widening of the risk spread on policy rates. This further deteriorates the balance sheet of highly indebted firms, which may become soon insolvent. Debt write-offs reduce banks's equity and their lending capacity, thus causing a widespread credit rationing and a forced deleveraging of the corporate sector that may trigger a possible wave of bankruptcies of even good but illiquid firms. A credit-fueled economic boom may thus turn out in a depression.

Given this economic dynamics, emerged in Raberto et al (2011), the aim of this paper is to understand if some of the post-crisis measures proposed by the Basel Committee can have a positive impact in our model.

According to Borio (2011), the institutional response after the crisis has taken two forms. Policymakers have been strengthening the systemic (or macro-prudential) orientation of regulatory and supervisory frameworks, and they have begun to question the premise that financial stability can be secured without a more active support of macroeconomic policies. The established pre-crisis policy framework was focused on the stability of individual institutions (micro-prudential orientation) while the reforms introduced in Basel III

² The three pillars are: minimum capital requirements, supervisory review process and market discipline. <http://www.bis.org/publ/bcbs107.htm>

provide a macro-prudential approach to regulation and supervision that has a system-wide focus, with the goal to limit the risk of episodes of financial distress with serious consequences for the real economy (“systemic risk”).

Claiming that one of the most destabilizing elements of the crisis has been the procyclical amplification of financial shocks throughout the banking system, the new regulation framework introduces some measures in order to make banks more resilient to such procyclical dynamics, like encouraging banks to create countercyclical capital buffers in order to accumulate capital when the economy is strong and use it when the economic conditions are bad. The problem, pointed out again by the Basel Committee in BIS (2011) and also emerged from the computational experiments of Raberto et al (2011), is that losses incurred in the banking sector can be extremely large when a downturn is preceded by a period of excess credit growth. These losses can destabilize the banking sector, creating a credit crunch that contributes to a downturn in the real economy that then feeds back on to the banking sector again.

According to Drehmann et al (2010), the main target of countercyclical capital standards is to encourage banks to build up buffers in good times that can be drawn down in bad ones. In this paper we design two endogenous adaptive policy rules for the Eurace agent-based model, that set capital requirements in the spirit of encouraging banks to build up capital buffers in good times. Details about the implementation of these policy rules, as identifying bad and good times and choosing the conditioning variables which could guide the build-up and release of capital, are discussed in section 1.2.

The Eurace agent-based model and simulator has then been used as a computational laboratory to test and validate new macroprudential policy regulations. The completeness of the Eurace framework is particularly important to perform these tests, where it is necessary to consider the interplay and spillovers between the production and financial as well as credit sectors of the economy. In the last decade, several agent-based economic models have been developed in order to focus on the relation between the credit and financial factors and the real economy, see e.g. Delli Gatti et al (2005, 2009); Raberto et al (2008a); Dosi et al (2010); Chiarella and Di Guilmi (2011). However, the novelty and the advantage of the Eurace framework is the simultaneous presence of the most important economic agents interacting in many different markets. This feature allows for a totally endogenous and very realistic representation of the whole economic system, with no antecedents in the history of economic modelling, and gives the opportunity to examine at the same time the economic outcomes in all markets in an evolving and dynamic setting.

The paper is divided as follows. Section 1 presents an overview of the Eurace model with a detailed description of a new model for the demand of capital goods as well as a description of the implementation of the Basel II capital

requirements rule and of the new countercyclical policies. Computational results are presented and discussed in Section 3, while Section 4 draws our concluding remarks.

1 An overview of the model

Eurace is a model and simulator of an artificial economy which belongs to the class of agent-based computational models (see Tesfatsion and Judd (2006) for a review). The agent-based approach to economics addresses the modelling of economic systems as complex adaptive systems, i.e., systems made by many self-interested interacting units (economic agents here) that may change their behavior in order to adapt to the changing (economic) environment and the change of other units' behavior. The main distinguishing features of an agent-based artificial economy with respect to the mainstream dynamic stochastic general equilibrium (DSGE) modelling can be summarized as follows: out-of-equilibrium dynamics versus market equilibrium, decentralized markets with pairwise bargaining and price dispersion versus centralized markets and the law of one price, adaptive expectations with myopic behavior versus rational expectations and infinite foresight, endogenous shocks and business cycles versus exogenous shocks.

The Eurace artificial economy has been constantly evolving since the start in 2006 of the Eurace project within a EU-funded research grant under the sixth framework programme. Eurace is a fully-specified agent-based model of a complete economy that includes different types of agents and integrates different types of markets. Agents include households which act as consumers, workers and financial investors, consumption goods producers as well as capital goods producers, banks, a government and a central bank. Agents interact in different types of markets, namely markets for consumption goods and capital goods, a labor market, a credit market and a financial markets for stocks and government bonds. Except for the financial market, all markets are characterized by decentralized exchange with price setting behavior on the supply side. Agents' decision processes are characterized by bounded rationality and limited information gathering and computational capabilities; thus, agents' behavior follow adaptive rules derived from the management literature for firms and banks, and from experimental and behavioral economics for consumers and financial investors.

The real side of the Eurace artificial economy as well as the functioning of the credit market are described in details in Raberto et al (2011); Tegli et al (2010b); Cincotti et al (2012), the EURACE financial market has been outlined in Raberto et al (2008b); Tegli et al (2009), while the balance sheet approach to agent-based modeling is described in Tegli et al (2010a) and

in Cincotti et al (2010) where computational experiments about the use of quantitative easing policy have been reported.

The computational experiments reported in this study have been realized within an enriched version of the Eurace model. In particular, beside the new regulatory policies designed and investigated in this study, the Eurace model and simulator employed here is characterized by a new model for capital goods demand and a more realistic model of bankruptcy probability for firms, as described in the following sections.

1.1 *A new model for capital goods demand*

Physical capital K is employed with labor L by consumption goods producers, henceforth CGPs, to produce an amount of consumption goods q according to a Cobb-Douglas technology, as follows

$$q = \gamma L^\alpha K^\beta, \quad (1)$$

where γ is positive and constant returns to scale are considered, i.e. α and β are positive constants with the constraint $\alpha + \beta = 1$. CGPs need new capital goods both to replace capital depreciation and to expand the production capacity. In the previous version of the Eurace model, see e.g. Raberto et al (2011), CGPs computed the desired amount of physical capital, given the planned production quantity, by means of a static optimization method based on the Cobb-Douglas technology and isoquants. In the new model presented here, the demand for capital goods is based on the net present value (NPV) approach, which, according to a recent empirical survey (Graham and Harvey, 2001, 2002), is, along with the internal rate of return (IRR)³, the most popular method used by managers to evaluate investments. The new investments model should be therefore considered more founded on the realistic behavior of economic actors.

CGPs compute their demand for new capital goods, henceforth investments or I , at the beginning of any production month⁴. The amount I of new capital goods will then be delivered and will be ready to use during the next production month. The first step in computing the demand of new capital goods

³ It can be shown, however, that the IRR is generally equivalent to the NPV, except for some special cases.

⁴ It is worth remembering that 1 month, i.e., 20 business days, is the basic time span for the production process in Eurace and that the starting production day of the month is fixed for each firm but can be different (asynchronous) among different firms.

is the estimation⁵ by every CGP of the expected demand \widehat{q}^d of consumption goods it should face during the month. Based on this estimate and on the inventories amount \mathcal{V} , the CGP computes the production needs \bar{q} as $\bar{q} = \widehat{q}^d - \mathcal{V}$, if $\mathcal{V} < \widehat{q}^d$, or $\bar{q} = 0$ otherwise. Given the production goal \bar{q} , its present capital endowment K and the Coob-Douglas technology, any CGP computes the necessary workforce L^d in order to meet the production goal as:

$$L^d = \left(\frac{\bar{q}}{\gamma K^\beta} \right)^{\frac{1}{\alpha}}. \quad (2)$$

Considering the present workforce L , the CGP opens new vacancies, if $L^d > L$, or decides layoffs if $L^d < L$.

It is worth noting that, if the present workforce L and the present endowment of physical capital K are not sufficient to meet the production goal, i.e., $\bar{q} > \gamma L^\alpha K^\beta$, increasing the workforce to L^d is only feasible way to meet the production goal during the present month. The reason is that the new demanded physical capital would be available to the CGP only from the next month. Nevertheless, the expected demand \widehat{q}^d is still used to determine the demand of new capital goods. The rationale is that the CGP has to check if the increase of the stock of physical capital to meet the production goal, given the present workforce, is profitable in the reasonable hypothesis that q^d would be a lower bound for demand in the future.

If $\bar{q} > \gamma L^\alpha K^\beta$, the CGP computes the desired endowment of physical capital K^d as follows:

$$K^d = \left(\frac{\bar{q}}{\gamma L^\alpha} \right)^{\frac{1}{\beta}}. \quad (3)$$

The difference $K^d - K$ is a reference point for investments. It is worth noting, however, that according to the realistic hypothesis of imperfect capital markets in Eurace and according to the difference between internal and external financing for producers, we stipulate, in line with Fazzari et al (2008), that cash flows are a bound for nominal investments and we consider last month CGP revenues as a proxy for cash flows.

The CGP computes the NPV using a grid of investment values I in the range between 0 and I_{max} , where I_{max} is given by the minimum between $K^d - K$ and last months revenues divided by the price of capital p_K , which is posted

⁵ The estimate is based on a linear interpolation of the sales made during a given number of previous months.

by the capital good producer⁶.

The NPV is computed considering the present cost of investments, i.e., $p_K I$ and the discounted values of the future cash flow given by the augmented productive capacity.

In particular, we consider

$$NPV(I) = -p_K I + \sum_{m=1}^{m^*} \frac{\hat{p}_C^m \Delta q_C^m}{\left(1 + \frac{r}{12}\right)^m}, \quad (4)$$

where \hat{p}_C^m is the expected consumption goods price level at month m , r is the weighted average yearly cost of capital for the CGP, and Δq_C^m is the additional amount of monthly production given by the capital investment I , after properly taking into account the depreciation given by ξ , i.e.,

$$\Delta q_C^m = \gamma L^\alpha \left(K + (1 - \xi)^{(m-1)} I \right)^\beta - \gamma L^\alpha K^\beta. \quad (5)$$

The end value m^* of the sum is given by the number of months when investment is still higher than a given threshold after considering the monthly depreciation rate ξ . The CGP demands the amount I of capital goods that maximizes the $NPV(I)$. If $NPV(I) < 0$ for any I in the grid, no investment should be done. Finally, it is worth remembering that CGPs are never rationed in the demand for capital goods; however, they may be obliged to reduce the investment schedule because rationed in the credit market.

1.2 Modelling capital requirements

The banking sector provides loans to consumption goods producers if capital requirements constraints are met by the bank giving the loan. Following the Basel II capital adequacy rules, we stipulate that a minimum percentage of the risk-weighted loan portfolio should be held by the bank in the form of equity capital as a buffer for possible loan write-offs and equity losses. We denote this minimum percentage as κ and we call it capital requirement. The risk weight ω^λ of any loan λ depends on the borrower credit worthiness after the loan and is measured by using its balance sheet entries. Let us suppose that a bank b , with equity E^b and risk weighted loan portfolio W^b , receives a loan request amount λ^f from CGP f , characterized by debt D^f and equity E^f , then the bank is allowed to lend to the CGP an amount $\ell^{bf} \leq \lambda^f$ given

⁶ See e.g. Raberto et al (2011) for some details about the stylized modeling of capital goods producers in Eurace.

by:

$$\ell^{bf} = \begin{cases} \lambda^f & \text{if } E^b \geq \kappa(W^b + \omega^\lambda \lambda^f), \\ \frac{E^b - \kappa W^b}{\kappa \omega^\lambda} & \text{if } \kappa W^b < E^b < \kappa(W^b + \omega^\lambda \lambda^f), \\ 0 & \text{if } E^b \leq \kappa W^b. \end{cases} \quad (6)$$

The rationale of the rule is that the bank is allowed to lend up to the amount ℓ^{bf} that, weighted by the loan riskiness ω^λ and summed to its present risky weighted portfolio W^b , can be sustained by its equity base E^b , which should be at least κ % of $W^b + \omega^\lambda \ell^{bf}$. The loan riskiness ω^λ is computed by considering first the borrower's default probability, along the lines of the Moody's KMV model (Saunders and Allen, 2010), then by adopting an ad-hoc approximation of the so-called Basel II internal ratings approach that, given the credit rating of the borrower (here given by the default probability), provides the loan riskiness ω^λ , also interpretable as the percentage of the loan to be held as capital. Further details about the relation between credit ratings and the percentage of exposure to be held as capital are discussed in Yeh et al (2005)

Following the recommendations of the Basel committee, we implement into the model a mechanism to encourage⁷ banks to build up and release capital buffers, according to the overall economic conditions of the economy, that are generally identified with “bad times” and “good times”. The main idea is that in “good times” banks should build up a precautionary capital buffer and release it in bad times when credit is scarcely available. The concept of good and bad times is clearly related with expansion and contraction of the economic cycle, but the tricky part is to chose the conditioning variable that permits to identify if times are good or bad. Several possibility has been already suggested. Drehmann et al (2010) suggest three typologies of conditioning variables. The first one includes measures of the aggregate macroeconomic conditions (GDP growth, banks and non banks credit growth, or their ratio), the second one focuses on the banking sector activity (banks aggregate profits and losses, banks credit growth), while the last one is related to the cost of funding for banks (spreads and cost of liquidity). We chose to use in our study a conditioning variable for each of the first two typologies, the unemployment rate as a measure of aggregate macroeconomic conditions and aggregate banks loans as a measure of the banking sector activity.

⁷ Let us note that we are more “compelling” that encouraging banks, because our mechanism cyclically moves minimum capital requirements, as shown in equation 7 and 8. This may be questionable (see Repullo et al (2010); Repullo and Saurina (2011); Gordy (2009)) but it appears to us an acceptable simplification, considering that in the model banks only have loans as risky assets in their portfolio

The first rule for setting the minimum capital requirement κ is a piecewise linear rule that maps the unemployment rate into κ . The logic is that the capital requirement should be tighter when we are in “good times” (low unemployment rate) while should be more relaxed when we are in “bad times” (high unemployment rate). The capital requirement⁸ κ_t^u is then given by:

$$\kappa_t^u = \begin{cases} \kappa_{\max} - (\kappa_{\max} - \kappa_{\min}) \frac{u_t}{\bar{u}} & \text{if } u_t < \bar{u}, \\ \kappa_{\min} & \text{if } u_t \geq \bar{u}. \end{cases} \quad (7)$$

We use the notation κ_t^u here to highlight the dependence on time and on the unemployment rate. The values of κ_t^u then lies in an interval between a minimum level κ_{\min} , reached when the unemployment is higher than a given threshold \bar{u} , and a maximum value κ_{\max} that is assumed at full employment. In the computational experiments presented here, we have set $\kappa_{\min} = 8\%$, which is the the actual reference in the Basel II accords, $\kappa_{\max} = 12\%$ and $\bar{u} = 25\%$. The parameter \bar{u} determines the slope of the straight line in the (u_t, κ_t^u) plane, and represents the threshold unemployment rate above which the maximum leverage is set to κ_{\min} .

The mechanism of the second rule is essentially the same as the previous one, using the aggregate loan portfolio of all banks as the conditioning variable. If L_t is the sum of all outstanding bank loans at month t , the decision making about capital requirement is made according to:

$$\kappa_t^c = \begin{cases} \kappa_{\min} + (\kappa_{\max} - \kappa_{\min}) \frac{u_t}{\bar{u}} & \text{if } \frac{\Delta L_t}{L_t} < \eta, \\ \kappa_{\max} & \text{if } \frac{\Delta L_t}{L_t} \geq \eta. \end{cases} \quad (8)$$

where $\Delta L_t/L_t$ is the percentage increase (or decrease) of aggregate credit L from month $t - 1$ to month t . The parameter η represents in this case the threshold monthly credit growth above which κ_t^c is set to κ_{\max} . The notation is κ_t^c to highlight the dependence on time and on the unemployment rate. In the set of simulations presented in this paper, $\eta = 5\%$, i.e., if monthly credit growth is higher than 5%, capital requirement is the maximum one (12%). The rationale behind the rule is again to force banks to build up buffers in good times, which are usually characterized by a rapid growth of credit, that can be drawn down in bad ones. Buffers should be understood as capital in excess that is available to absorb losses in bad times. Real world experience as well as Eurace simulations have showed that a too rapid credit growth, while

⁸ We omit the adjective “minimum” here to avoid confusion between κ_t^u that is the minimum level of capital required to banks at time t , and κ_{\min} that is the minimum level under which the time varying κ can not drop, and that is independent from time

benefitting in the short term, can result in a bubble burst in the long run, when high levels of leverage become unsustainable. In this perspective, this new rule for κ_t^c can also be interpreted on one hand as a way to moderate a too rapid growth of credit by increasing the minimum requirements of capital for banks and, on the other hand, as an attempt to prevent the effects of banks's loans write-off on the credit supply. Finally, it is worth noting that whatever the negative value $\Delta L_t/L_t$ can be, we stipulate that capital requirement can never drop under the minimum level of κ_{\min} , set to 8%.

2 Computational experiments

We present in this section several tables resuming the average values (with relative standard errors) of some of the main economic indicators in order to compare the overall performance of the artificial economy for the three different values of minimum capital requirement. In the same tables we also present the values of the same economic indicators in the two implemented cases of macro-prudential policy, i.e., a countercyclical buffer capital mechanism that uses the unemployment rate as conditioning variable, as shown in eq. 7, and a second one based on banks credit growth, as in eq. 8. Moreover, consistently with the presentation plan adopted in Raberto et al (2011), we separate the simulations into two time periods. The first period shows the first 5 years of simulation while the second period represents the remaining 25 years.

Even in a different setting, results are in agreement with the explications discussed in Raberto et al (2011). When capital requirement is low the economic performance is good in the short term, due to the major amount of credit granted by banks, but bad in the long term because of the augmented financial fragility of firms that leads to a higher risk of insolvency. This mechanism closely mimics what is reported in BIS (2011), i.e., that banks capital losses “can destabilize the banking sector, which can bring about or exacerbate a downturn in the real economy. This in turn can further destabilize the banking sector...”. This is exactly what happens in our model. In the short run real consumption, employment and investments (and therefore real GDP) are higher for loose capital requirements, due to the easier access to bank loans. However a worrying element is already present in the short run: firms leverage increases when relaxing capital requirement, raising economy's financial fragility (or systemic risk). Table 1 corroborates this narrative with the proper economic indicators. To observe the vicious circle between banking sector and real economy, emphasized by BIS (2011), we have to move to the medium-long run. Table 2 shows that the hierarchy emerged in the short run is completely reversed. Tighter capital requirements allow for better economic performances in the long run, in terms of consumption goods production, unemployment rate and real GDP level. Basically, loose capital requirements tend to push

firms towards an unbalanced debt-equity ratio, with excess of debt. This can be observed in figure 5, where firms leverage is plot for a sample case. The higher financial fragility of firms determines a higher probability for firms to get into insolvency bankruptcy, as shown in table 4, with obvious damage for commercial banks equity capital (see figure 4) that undermines the resilience of the banking system. Banks capital losses trigger in turn a credit contraction that prevents firms to roll over debt, therefore exacerbating the downturn in the real economy through chains of illiquidity bankruptcies. In table 4 it can be observed a clear trend for banks equity and firms insolvency bankruptcies, showing that these economic indicators deteriorate when relaxing capital requirements.

From figure 4 it clearly emerges the difference between $\kappa_{min} = 8\%$ (that is the minimum capital currently required by Basel II) and $\kappa_{min} = 12\%$. In both cases a turbulent period starts in the 5th year (look at figure 2), first with a severe crisis and then with a period of stagnation that ends in the 7th year of simulation. Observing the dynamics of the aggregate banks equity capital in figure 4, it can be noticed that a tighter capital requirement ($\kappa_{min} = 12\%$) forces banks to raise their equity while when the requirement is lower ($\kappa_{min} = 8\%$) banks can match the credit demand with a lower level of equity capital. The capital surplus (or buffer) owned by banks in the case of $\kappa_{min} = 12\%$ makes the difference when facing the following crisis starting in the 9th year, allowing the economy to recover quickly from the recession by means of an injection of new credit money by the banking sector. On the other hand, when equity capital is too low, the banking system is not able to fuel the economy with new credit, even if capital requirement is looser, and the depression continues much deeper and for a much longer time. It is interesting to observe the clear bifurcation of the two time trajectories representing the total outstanding credit, emerging as a consequence of the 9th year crisis, and revealing the apparent paradox that banks will be much more "generous" lenders for the following 20 years in the case of higher capital requirement.

The lesson learned by this example is that having a capital buffer in bad times is useful. As extensively commented in the introduction, the same lesson seems to be shared by the main banking policy regulators, thus we present here the results of two computational experiments where two different rules to build-up capital buffers have been implemented. The first one uses the unemployment rate as a conditioning variable, as reported in eq. 7, while the second uses banks loans, as in eq. 8.

The two rules seem both to have a positive impact on the economic performance. In particular, the capital buffer rule based on the unemployment rate (i.e., κ_t^u) improves all the economic indicators in the long run. These results confirm and extend preliminary explication discussed in Tegli et al (2012). Table 2 shows that in the case of κ_t^u the average unemployment rate is lower

than for fixed capital requirements, and the average output is higher. The interesting point about this result is that dynamic requirements κ_t^u , varying in a range from 8% to 12% with mean 11.34, perform better than the two range extremes, including the highest one (12%). So it is not true that tighter capital requirements are a better option overall, because it depends from the state of the economy. In some cases, according to our outcomes, relaxing the capital requirement is beneficial.

In order to analyze in more detail the effects of these policies, we plotted the time trajectories of the simulation with bank credit growth as a conditioning variable (case κ_t^c) along with the two extreme cases $\kappa = 8\%$ and 12% (for the sake of plots readability we omitted to superimpose the case of κ_t^c). Before looking at them, let us highlight the excellent performance of the “credit rule” κ_t^c . Whilst suffering in the first five years (see table 1) the economy of the “credit rule” is characterized by the best economic indicators: consumption, investments, unemployment rate, real wages, firms financial fragility, and others. Tables from 2 to 4 attest these results. The only apparently jarring note in this idyllic picture is banks equity, significantly lower than the rest of the cases. Moreover, from an overall glance at the presented plots it clearly appears that the economy is considerably more stable in the case of the “credit rule”. In the following we try to interpret these outcomes.

First, let us note that the initial conditions are the same for all cases, and that banks are characterized at the beginning by a strong capitalization with equity equal to 20% of weighted assets. We remind also that banks raise their equity capital when the capital requirement constraint is binding, i.e., when they are not able to satisfy the credit demand because of the low equity. The “credit rule” states that when credit grows, capital requirement also grows, but it remains lower when credit stagnates. So, at the beginning of the κ_t^c case simulation, there is no need for banks to raise the equity because of the low credit growth (see figure 4). In the other two cases ($\kappa = 8\%$ and 12%), on the other hand, banks have to raise equity to match the growing credit demand. However, looking to figure 5, we can see how firms high borrowing raises the interest bill, increasing consequently firms bankruptcy risk. On the contrary, in the κ_t^c case the situation is much more stable. In fact, the high level of firms debt ends in a big economic crash around month 100, accompanied by a quick deleveraging process. This crisis, strong for $\kappa = 8\%$ and milder for $\kappa = 12\%$, does not affect the κ_t^c case at all. When the “credit rule” rule is active, the total outstanding credit is growing much more smoothly. The same holds for banks equity, that is rarely affected by falls caused by insolvency bankruptcies (4). Illiquidity bankruptcies are more frequent but the banking system is not directly affected, remaining robust and propagating its robustness to the real economy.

Figure 6 compares banks equity variations considering the whole simulation

set. The higher robustness of the banking sector in the case of κ_t^c is therefore extended from a single simulation seed to the general case. In particular, it can be observed from the plot that the falls of banks equity are much more infrequent in case banks build up capital buffers according to the rule based on credit growth. These results tell us that lower aggregated values of outstanding bank loans and of banks equity capital do not have negative implications on the economy if credit is granted at the right time. In this sense, it seems to be desirable to have active (public) institutions in charge of ruling banks credit supply according to the macroeconomic conjuncture.

Concluding remarks

After the recent financial and economic crisis the Basel III global regulatory standard has been proposed in order to improve the resilience of the banking system. This new framework is oriented towards a more active support of macroeconomic policies, and presents a set of macro-prudential regulations with the objective to limit systemic risk. In particular, it has been identified the procyclical amplification of financial shocks through the banking system as a critical issue, and in order to cope with such procyclical dynamics new countercyclical capital buffers regulations has been proposed. The rational is to encourage banks to accumulate capital during good times and use it when the economic conditions are bad.

A coherent economic analysis has emerged from some previous works by the authors, where computational experiments were performed with the Eurace model. In particular, it has been shown that excessive bank leverages can drive economies into severe recession in the medium-long run. In this paper we implement into the model a mechanism to encourage banks to build up and release capital buffers, according to the overall economic conditions of the economy. As conditioning variables that set banks capital requirements, thus ruling the capital buffers build up and release phases, we use both the unemployment rate and aggregate banks loans.

Moreover, the setting of the model has been improved incorporating a new demand for firms investments that is based on the net present value (NPV) approach, which is one of the most popular methods used by managers to evaluate investments. Therefore, the new model to model for investments can be considered well grounded on a more realistic behavior of economic actors.

Results confirm an extend our previous studies, showing that loose capital requirements can affect the economic performance in the medium-long run, raising the financial fragility (or systemic risk) in the economic system and potentially triggering chains of firms insolvency bankruptcies. The situation

is generally better when setting tighter capital requirements. Furthermore, results have shown that the dynamic regulation of capital requirements successfully stabilizes the economy and improves the main economic indicators. In particular, when the “credit rule” is adopted, the economic scenario seems to change in a significant way, showing a much more solid banking sector with a resulting positive effect on the real economy.

Acknowledgement

This work was carried out in conjunction with the Eurace project (EU IST FP6 STREP grant: 035086). AT acknowledges also the project Bancaja: P1-1A2010-17.

References

- BIS (2011) Basel III: A global regulatory framework for more resilient banks and banking systems. Tech. rep., Basel Committee on Banking Supervision, URL <http://www.bis.org/publ/bcbs189.htm>
- Borio C (2011) Rediscovering the macroeconomic roots of financial stability policy: journey, challenges and a way forward. Tech. rep., Bank for International Settlements Working Paper 354
- Chiarella C, Di Guilmi C (2011) The financial instability hypothesis: A stochastic microfoundation framework. *Journal of Economic Dynamics & Control* 35(8):1151–1171
- Cincotti S, Raberto M, Teglio A (2010) Credit money and macroeconomic instability in the agent-based model and simulator eurace. *The Open-Access, Open-Assessment E-Journal* 4(2010-26), URL <http://dx.doi.org/10.5018/economics-ejournal.ja.2010-26>
- Cincotti S, Raberto M, Teglio A (2012) The Eurace macroeconomic model and simulator. In: *Agent-based Dynamics, Norms, and Corporate Governance. The proceedings of the 16-th World Congress of the International Economic Association*, Palgrave, vol II, forthcoming.
- Delli Gatti D, Di Guilmi C, Gaffeo E, Giulioni G, Gallegati M, Palestrini A (2005) A new approach to business fluctuations: heterogeneous interacting agents, scaling laws and financial fragility. *Journal of Economic behavior & organization* 56(4):489–512
- Delli Gatti D, Gallegati M, Greenwald BC, Russo A, Stiglitz JE (2009) Business fluctuations and bankruptcy avalanches in an evolving network economy. *Journal of Economic behavior & organization* 4(2):195–212
- Dosi G, Fagiolo G, Roventini A (2010) Schumpeter meeting keynes: A policy-

- friendly model of endogenous growth and business cycles. *Journal of Economic Dynamics and Control* 34(9):1748–1767
- Drehmann M, Borio C, Gambacorta L, Jiminez G, Trucharte C (2010) Countercyclical capital buffers: exploring options. *Bis working papers*, Bank for International Settlements
- Fazzari SM, Ferri P, Greenberg E (2008) Cash flow, investment, and keynes-minsky cycles. *Journal of Economic Behavior & Organization* 65(3-4):555–572
- Gordy M (2009) First, do no harm a hippocratic approach to procyclicality in basel ii. Paper presented at the conference Procyclicality in the financial system, jointly organised by the Netherlands Bank and the Bretton Woods Committee
- Graham J, Harvey C (2001) The theory and practice of corporate finance: evidence from the field. *Journal of Financial Economics* 60(2-3):187–243
- Graham J, Harvey C (2002) How do CFOs make capital budgeting and capital structure decisions? *Journal of Applied Corporate Finance* 15(1):8–23
- Raberto M, Tegli A, Cincotti S (2008a) Integrating real and financial markets in an agent-based economic model: an application to monetary policy design. *Computational Economics*, forthcoming
- Raberto M, Tegli A, Cincotti S (2008b) Prospect Theory Behavioral Assumptions in an Artificial Financial Economy, *Lecture Notes in Economics and Mathematical Systems*, vol 614, Springer, pp 55–66
- Raberto M, Tegli A, Cincotti S (2011) Debt deleveraging and business cycles. an agent-based perspective. *Economics Discussion Paper* (2011-31), URL <http://www.economics-ejournal.org/economics/discussionpapers/2011-31>
- Repullo R, Saurina J (2011) The countercyclical capital buffer of basel iii: A critical assessment. *Cepr discussion papers*, C.E.P.R. Discussion Papers
- Repullo R, Saurina J, Trucharte C (2010) Mitigating the pro-cyclicality of basel ii. *Economic Policy* 25:659–702
- Saunders A, Allen L (2010) *Credit Risk. Measurement In and Out of the Financial Crisis*. Wiley
- Tegli A, Raberto M, Cincotti S (2009) Explaining equity excess return by means of an agent-based financial market, *Lecture Notes in Economics and Mathematical Systems*, vol 631, Springer Verlag, chap 12, pp 145–156
- Tegli A, Raberto M, Cincotti S (2010a) Balance sheet approach to agent-based computational economics: The Eurace project. In: *Combining Soft Computing and Statistical Methods in Data Analysis, Advances in Intelligent and Soft Computing*, vol 77, Springer Berlin / Heidelberg, pp 603–610
- Tegli A, Raberto M, Cincotti S (2010b) Endogenous credit dynamics as source of business cycles in the Eurace model. In: Li Calzi M, Milone L, Pellizzari P (eds) *Progress in Artificial Economics, Lecture Notes in Economics and Mathematical Systems*, vol 645, pp 203–214
- Tegli A, Raberto M, Cincotti S (2012) The impact of banks' capital adequacy regulation on the economic system: an agent-based approach. *Advances in Complex Systems* Forthcoming

Tesfatsion L, Judd K (2006) Agent-Based Computational Economics, Handbook of Computational Economics, vol 2. North Holland
Yeh A, Twaddle J, Frith M (2005) Basel II: A new capital framework. Tech. rep., Reserve Bank of New Zealand: Bulletin, vol. 68, no. 3

κ (%)	cons. goods production	inv. goods production	unempl. rate (%)	banks' loans	firms' leverage
8	9629 (25)	1620 (14)	2.84 (0.18)	151393 (1042)	3.21 (0.02)
10	9530 (29)	1530 (18)	2.86 (0.18)	143659 (1090)	2.85 (0.02)
12	9486 (27)	1486 (14)	2.88 (0.18)	138126 (840)	2.60 (0.01)
κ_t^u	9411 (40)	1442 (24)	2.95 (0.20)	136749 (1246)	2.58 (0.02)
κ_t^c	8518 (57)	1069 (12)	7.54 (0.57)	121650 (512)	2.23 (0.01)

Table 1

Values of the main economic indicators in the first 5 years of simulation for different capital requirements (κ). An unemployment rule κ_t^u (average value = 11.54) and a credit rule κ_t^c (average value = 9.65) has been used to set dynamic requirements. Values are averaged over 20 different random seeds (standard errors are in brackets)

κ (%)	cons. goods production	inv. goods production	real GDP level	unempl. rate (%)
8	14296 (160)	3650 (188)	17946 (333)	8.1 (0.5)
10	14637 (126)	3460 (154)	18097 (243)	7.6 (0.4)
12	15081 (154)	3729 (137)	18810 (270)	6.2 (0.4)
κ_t^u	15040 (157)	3686 (131)	18727 (270)	5.5 (0.5)
κ_t^c	15419 (151)	3901 (103)	19320 (224)	3.2 (0.4)

Table 2

Values of real variables in the last 25 years of simulation for different capital requirements (κ). An unemployment rule κ_t^u (average value = 11.34) and a credit rule κ_t^c (average value = 9.61) has been used to set dynamic requirements. Values are averaged over 20 different random seeds (standard errors are in brackets)

κ (%)	price index	inflation rate (%)	wage index	interest rate (%)
8	1.53 (0.03)	5.92 (0.20)	6.76 (0.13)	8.41 (0.21)
10	1.53 (0.02)	6.12 (0.23)	6.84 (0.09)	8.61 (0.23)
12	1.55 (0.02)	6.33 (0.17)	7.03 (0.12)	8.82 (0.15)
κ_t^u	1.51 (0.02)	6.22 (0.21)	6.97 (0.12)	8.58 (0.14)
κ_t^c	1.43 (0.02)	6.13 (0.12)	7.27 (0.15)	6.90 (0.25)

Table 3

Values of price variables in the last 25 years of simulation for different capital requirements (κ). An unemployment rule κ_t^u (average value = 11.34) and a credit rule κ_t^c (average value = 9.61) has been used to set dynamic requirements. Values are averaged over 20 different random seeds (standard errors are in brackets)

κ (%)	total loans	banks' equity	firms' leverage	illiquidity bankrupt.	insolvency bankrupt.
8	720375 (25922)	78003 (4331)	7.19 (0.85)	11.0 (0.5)	4.5 (0.2)
10	681196 (23748)	93022 (4280)	6.74 (0.58)	8.3 (0.4)	4.2 (0.1)
12	722717 (25495)	117812 (5448)	7.12 (1.26)	7.4 (0.4)	4.1 (0.2)
κ_t^u	698161 (17714)	105051 (3474)	6.76 (1.55)	9.0 (0.4)	3.8 (0.1)
κ_t^c	590332 (10978)	53261 (1841)	5.69 (3.31)	15.1 (0.8)	0.6 (0.1)

Table 4

Values of risk signaling variables in the last 25 years of simulation for different capital requirements (κ). An unemployment rule κ_t^u (average value = 11.34) and a credit rule κ_t^c (average value = 9.61) has been used to set dynamic requirements. Columns 4 and 5 show the annual bankruptcy probability for a firm. Values are averaged over 20 different random seeds (standard errors are in brackets)

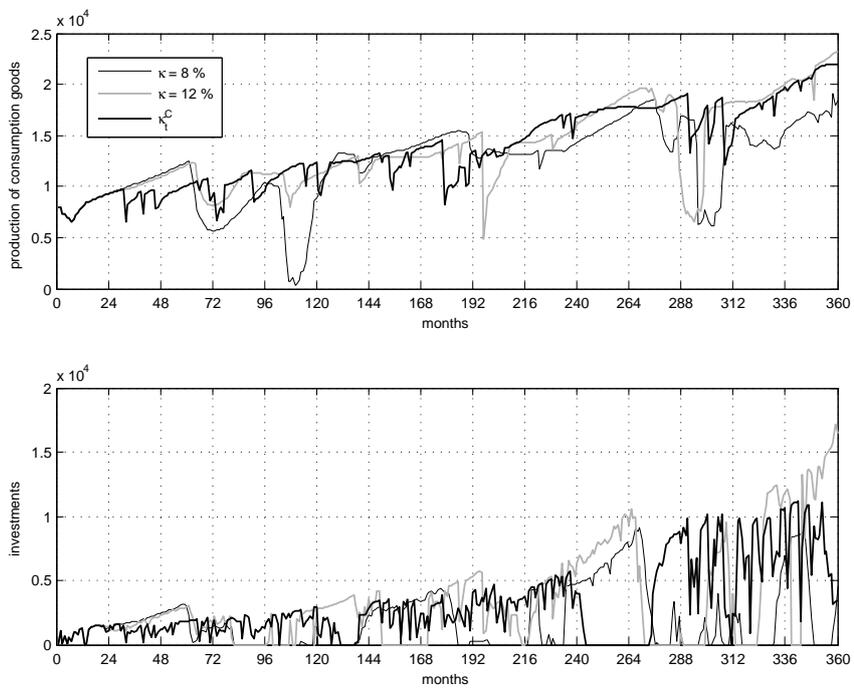


Fig. 1. Time evolution of GDP components. Two lines correspond to different fixed values for minimum capital requirement κ , while the third one represents the outcome of the capital buffer rule based on credit growth as conditioning variable (κ_t^c).

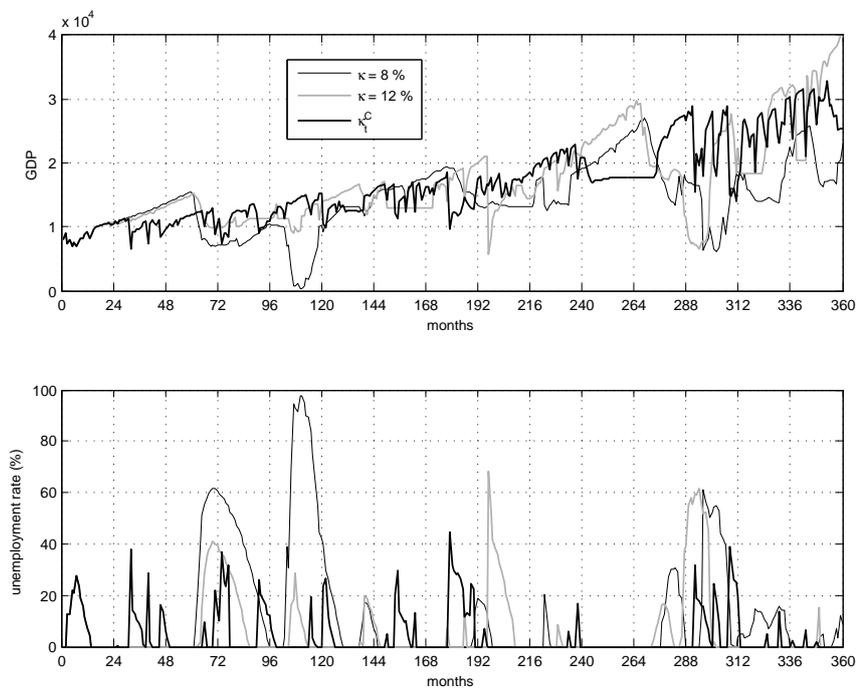


Fig. 2. Time evolution of GDP and unemployment rate. Two lines correspond to different fixed values for minimum capital requirement κ , while the third one represents the outcome of the capital buffer rule based on credit growth as conditioning variable (κ_t^C).

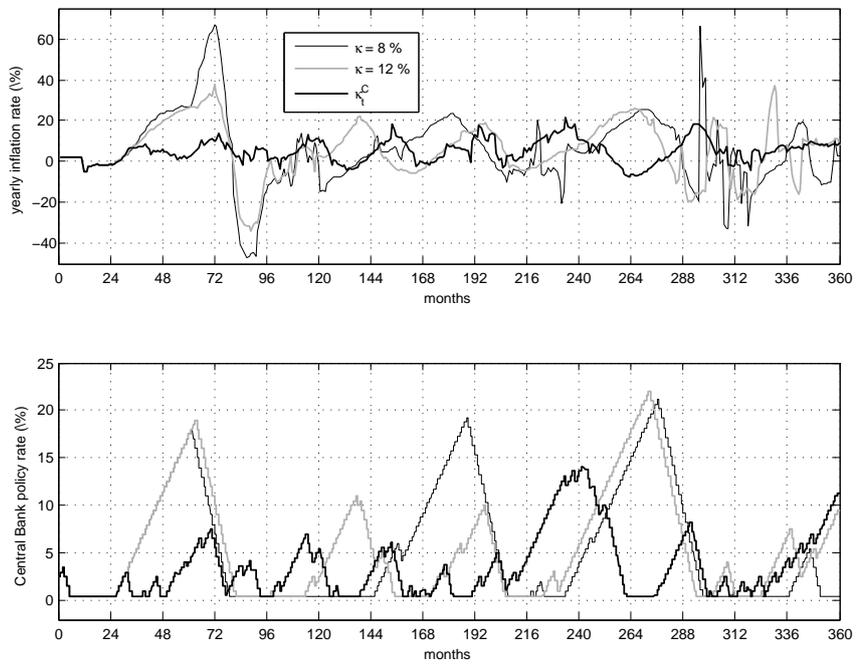


Fig. 3. Time evolution of yearly inflation and base interest rate. Two lines correspond to different fixed values for minimum capital requirement κ , while the third one represents the outcome of the capital buffer rule based on credit growth as conditioning variable (κ_t^C).

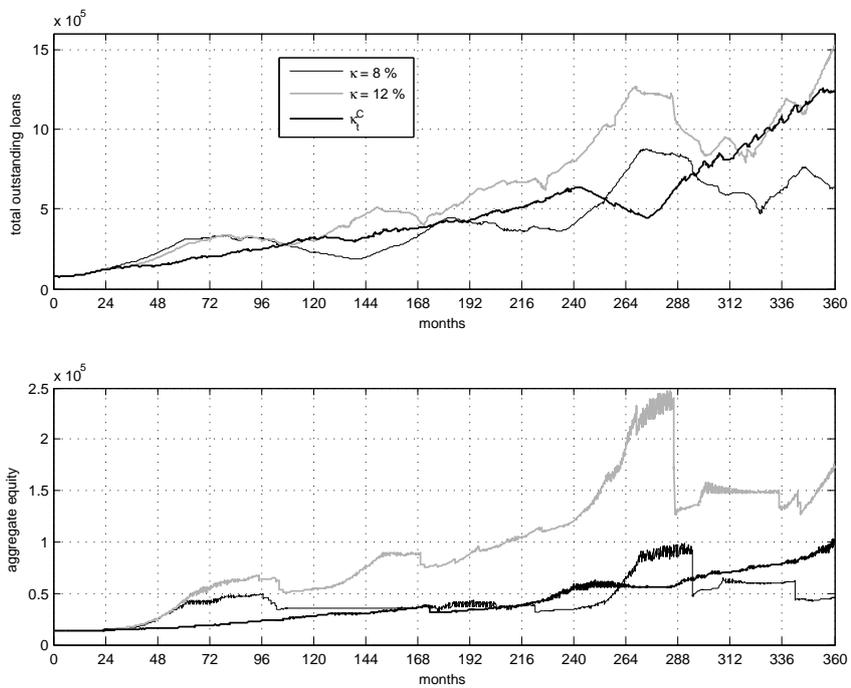


Fig. 4. Time evolution of total credit and aggregate banks equity capital. Two lines correspond to different fixed values for minimum capital requirement κ , while the third one represents the outcome of the capital buffer rule based on credit growth as conditioning variable (κ_t^C).

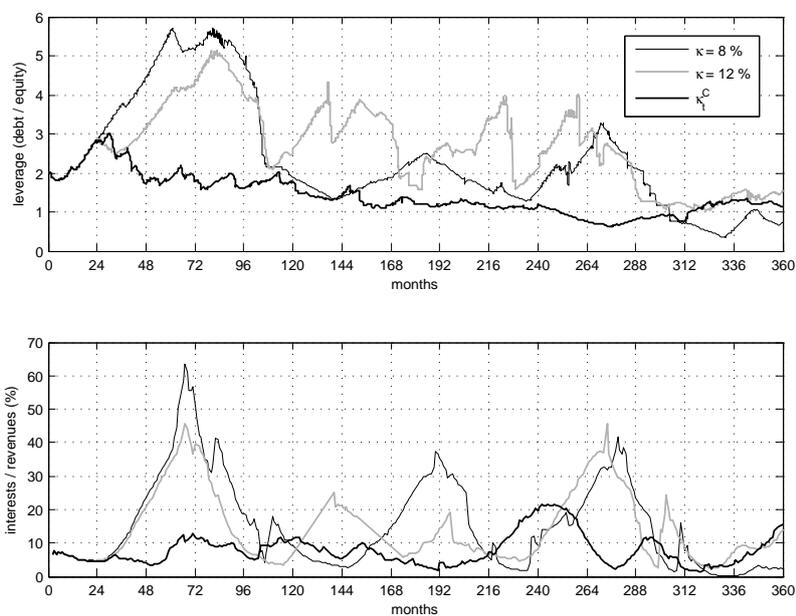


Fig. 5. Time evolution of firms financial fragility indicators. Two lines correspond to different fixed values for minimum capital requirement κ , while the third one represents the outcome of the capital buffer rule based on credit growth as conditioning variable (κ_t^C).

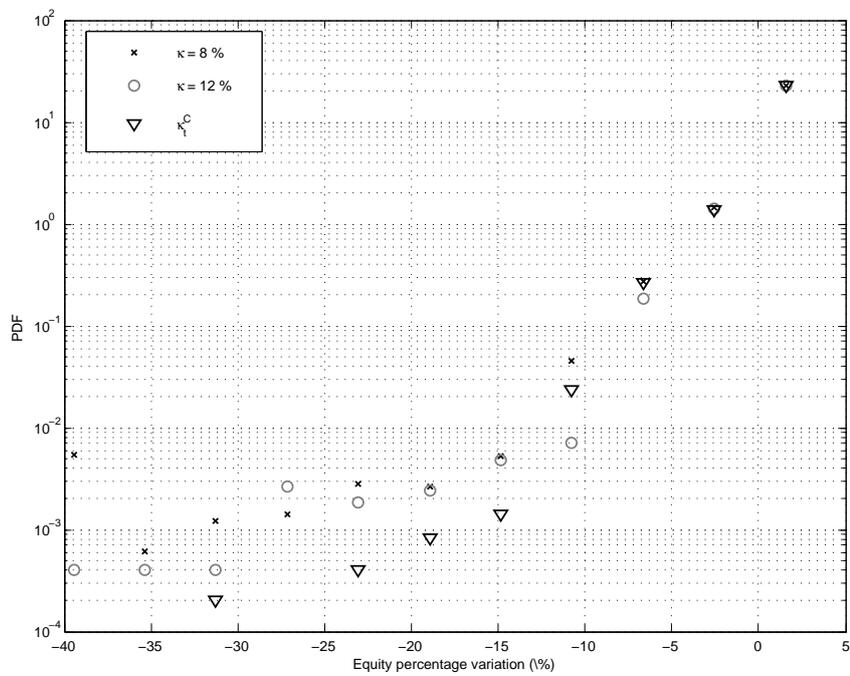


Fig. 6. Probability density function (PDF) estimation of the equity capital percentage variations for three different regulatory policies.