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How should the crisis affect our views about financial intermediation?

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The financial sector, which had been hailed as a hub of innovation and a driver of growth, led to a crisis that brought the world economy to the brink of collapse and caused unemployment for many millions. As a result, there is broad agreement on the need for reform that minimizes the chances of future catastrophes, while maintaining as much as possible of the social benefits of the financial sector. Unfortunately, there is little agreement beyond that.

I. Whose fault? Markets or the government?

One set of issues concerns the role of government in laying the groundwork for the crisis. In one view, the problem is that the financial system is inherently prone to instability, and that the key failure of policy was excessive deregulation and faith in laissez-faire. But another view is that the roots of the crisis stem from excessive government involvement. The usual suspects here are implicit government guarantees (of institutions that are too big to fail and of various assets that are not formally guaranteed by the government); other suspects are formal deposit insurance, with its attendant reduction in incentives for private monitoring, and government efforts to steer credit in particular directions.

Of course, many views are more nuanced. For example, one could argue that some basic types of government involvement (for example, insurance of small depositors and the bailing out of institutions whose imminent collapse threatens enormous disruptions) are either clearly desirable on economic grounds or inevitable on political ones. Once those involvements are taken as given, preventing them from generating adverse consequences (though moral hazard, for example) may require additional regulation.

II. The social value of the financial sector?

One end of the spectrum is the view that the financial sector has enormous social value through channeling saving to its most productive uses and spreading risk. The other end is the view that much of what happens in the financial sector consists of rent-seeking (for example, arbitraging away mispricings that would otherwise be arbitraged away a few milliseconds later). Again, of course, there are more nuanced possibilities. But how socially valuable the sector's activities are obviously has important implications for how it should be regulated. For example, the lower its social value, the stronger the case for slowing financial innovation and deregulation to the point where regulators can minimize the chances that they are creating macroeconomic risk.

III. How active should regulation and supervision be?

It is appealing to think that we can greatly increase stability by building substantial "shock absorbers" into the system. Most notably, substantial capital requirements both increase the size of the shocks needed to push institutions into insolvency and better align private and social incentives. Down payment requirements for mortgages and margin requirements for purchases of equity can play similar roles.

But this view may be too facile. In a world of sophisticated financial instruments, arbitrarily large risks can be held on arbitrarily small balance sheets. Thus there may be an inherent need for more active supervision and regulation. And there are presumably social costs to shock absorbers. (Otherwise, why not have 100 percent capital requirements, 100 percent down payment requirements, and so on?) Thus, there is a case that regulators should be monitoring the tradeoffs between the costs and benefits and adjusting the regulations in response.

IV. How to design financial institutions?

Of course, shock absorbers and supervision are not the only tools of regulation. A different approach is to try to change the institutions of capital markets to improve incentives. Examples include greater emphasis on long-term compensation, greater roles for shareholders and boards of directors, transactions taxes, and taxes on leverage or debt.

V. How to mitigate the effects of crises?

A final set of reforms considers ways not to reduce the risk of crises, but to mitigate their effects when they occur. Examples include resolution authority for insolvent financial firms, for which traditional bankruptcy does not work well; requirements that some or all of the debt issued by financial firms convert to equity in a crisis; and requirements that financial firms purchases some type of crisis insurance.

VI. How limited is our understanding?

One underlying challenge in thinking about reforming the financial system is a lack of a firm understanding of the market failures that warrant intervention. In the case of, for example, pollution, although there may be disagreement about the specifics, there is a clear framework underlying the case for government involvement: pollution involves negative externalities, and so can be addressed by such tools as Pigouvian taxes and the auctioning of tradable permits. In the case of financial markets and financial failures, analysis tends to operate at the level of metaphor (for example, credit is the "lifeblood" of the economy), analyses of particular markets and institutions, or specific models whose generality is unclear.