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Questions: How Should the Crisis Affect Our Views about Financial Intermediation and Regulation?

The financial sector, which until 2008 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 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. The range of issues concerning financial intermediation that policymakers must consider is exceptionally wide.

Whose Fault: Markets or Governments?

One set of issues concerns the role of government in laying the groundwork for the crisis. In one view, the financial system is inherently prone to instability, and 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 deposit insurance, with its attendant reduction in incentives for private monitoring, and government efforts to steer credit in particular directions.

Many views are more nuanced. For example, some basic types of government involvement (such as insuring small depositors and bailing out institutions whose imminent collapse threatens enormous disruptions) are arguably either clearly desirable on economic grounds or inevitable on political ones. If those involvements are taken as given,

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preventing them from generating adverse consequences (through moral hazard, for example) may require additional regulation.

Determining the sources of financial crises and the interactions of government involvement and private drivers of instability is thus a crucial step in deciding how to move forward.

The Social Value of the Financial Sector?

Another basic issue that must be addressed before policymakers can decide how to treat the financial sector is its economic importance. At one end of the spectrum is the view that the sector has enormous social value by channeling saving to productive uses and spreading risk. At the other end is the view that much of what happens in the sector consists of rent seeking (for example, arbitraging away mispricings that would otherwise be arbitraged away a few milliseconds later).

The social value of the financial sector's activities 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.

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. Downpayment 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 presumably, there are social costs to shock absorbers (otherwise, why not have 100 percent capital requirements, 100 percent downpayment requirements, and so on?), so there is a case to be made that regulators should monitor the tradeoffs between the costs and benefits and adjust the

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regulations in response. In short, the issue of comparatively passive versus comparatively active regulation is another critical one.

How to Design Capital-Market Institutions?

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. Policymakers need to better understand the tradeoffs among shock absorbers, supervision, and institutional reform, and the costs and benefits of various types of institutional changes.

How to Mitigate the Effects of Crises?

Another 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 purchase some type of crisis insurance. In designing such policies, policymakers must consider both their likely effectiveness in a crisis and how they would affect the performance of the system in normal times and the likelihood of a crisis developing. Unfortunately, knowledge about these subjects is limited; thus they too are important and pressing topics.

How Limited Is Our Understanding?

The final and perhaps most fundamental challenge in designing reforms of the financial system is a lack of agreement about the appropriate conceptual framework. In the case of pollution, for example, there may be disagreement about the specifics, but 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

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taxes and the auctioning of tradable permits. In the case of financial markets and financial failures, in contrast, analysis tends to operate at the level of metaphor (for example, credit is the lifeblood of the economy), analyses of particular markets and institutions, and specific models whose generality is unclear. A requirement for being able to confidently design appropriate financial regulation is a clear understanding of the market failures that warrant intervention—which is something that we do not currently have.

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In the Wake of the Crisis

Leading Economists Reassess Economic Policy

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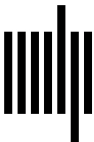

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