Creating Financial Harmony: What Role for Government versus the Market?

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The Cato Institute has coined a fresh phrase—"financial harmony"—to describe the challenge we face in the aftermath of the biggest financial mess since the Great Depression. But what is financial harmony? Does it prize innovation or stability, the absence of crises or the efficient intermediation of credit?

It is tempting to answer "all of the above." And given where we are today, there probably is room for improvement on all fronts. But there are also real tradeoffs involved in financial reform—and where you stand on those tradeoffs determines the appropriate role of government versus the markets (see Beddoes 2008). Dramatically raising capital requirements, for instance, may reduce the odds of crises, but likely at the expense of costlier borrowing.

Those who believe that modern finance has brought plenty of crises with few real economic benefits are keener to turn the clock back to an era of stodgy banks and plain vanilla products.[1] Those who believe deregulation and inadequate supervision were the primary causes of the financial mess focus on the need for more stringent

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[1]I am using "modern finance" as a catch-all term for the arms-length market-based system of allocating capital that evolved on Wall Street over the past 30 years, a system characterized by the evolution of securitization and the explosion of derivatives, whose growth was driven by deregulation, technological innovation, and the growing international mobility of capital.

rules and closer oversight. If, by contrast, you put greater weight on policy errors, from loose monetary conditions to the subsidization of leverage, you see less to be gained, and more to be lost, from a reform effort focused too heavily on regulation. Such skeptics also tend to be more worried about the unintended consequences of government intervention.

Path to Financial Harmony

The right route to financial harmony also depends on where you start from. And we begin from a position where the balance between government and markets has dramatically shifted. Finance has long been subject to greater government involvement than other areas of the economy. With good reason. Finance is special, both in its predisposition to booms, its vulnerability to panics, and its ability to wreak havoc on the rest of the economy. From Walter Bagehot onwards that fragility has, rightly, been seen to justify both regulation and intervention in times of crisis. We have central banks to act as lenders of last resort; we have deposit insurance; we have learned over successive crises in the past decades that systemic bank collapses invariably demand an infusion of public capital.

But over the past year we have taken a great leap toward government—with fiscal and monetary intervention that is mind-boggling in its size and scope. Given the scale of the collapse, and the risks of repeating another Depression, most of that intervention was appropriate. But in its aftermath we have a world where global financial markets are swaddled in a multi-trillion-dollar cocoon of explicit and contingent public support; where the perimeter of too-big-to-fail institutions has been extended and the guarantees behind them strengthened; and where the monetary spigots that underpin a fragile recovery in post-bubble economies risk fuelling new asset bubbles elsewhere. No one is happy with this balance. But the public sector's success at stabilizing the crisis has tipped the direction of reform momentum toward government.

Policy priorities are ultimately driven by political priorities. And the popular narrative now blames the crisis squarely on Wall Street. Paul Volcker caused a stir when he assigned Wall Street's financiers a "D" grade, and argued that, "for all its talented participants . . . the bright new financial system has failed the test of the market place." Today, at least in the public perception, that assessment is common-

place. Large majorities in opinion polls pin most blame for the crisis on bankers' risky lending and newfangled products. Financial innovation is seen as a source of fat profits for insiders but fragility and instability for the broader economy.

Among policymakers the debate is more nuanced. The standard list of causes of the crisis includes factors beyond finance. The macroeconomic backdrop to the asset boom is routinely cited: a world of loose monetary policy and, especially, one of "global imbalances," in which a surge in net saving in big emerging economies pushed long-term interest rates to historically low levels. But while macroeconomics gets a mention, the focus, both domestically and internationally, has been on addressing the failures within financial markets themselves. The G20 group, like the Obama administration and, indeed, the U.S. Congress, regard the main route to safer finance to be through improved regulation and better supervision. And, for all the focus on differences between House and Senate reform proposals, or between Britain and America's reform priorities, the broad agenda is remarkably consistent in its emphasis on regulatory remedies.

Its components are well known. The perimeter of financial regulation is to be extended into the nonbank financial sector, and holes (such as the oversight of state-based mortgage originators in America) filled in. The supervision of individual institutions is to be complemented with systemic oversight. Capital requirements are to rise and be bolstered with rules on liquidity (with the rules designed to boost capital buffers in boom times). Over-the-counter derivatives are to be encouraged onto exchanges. And frameworks are to be put in place to allow the orderly demise of systemically important institutions.

Judged narrowly in terms of fixing the "failures" of modern finance, this agenda skillfully optimizes the tradeoffs. It tackles some of the key weaknesses that became evident during the crisis. Trading derivatives on exchanges and through clearinghouses, for instance, mitigates the fear of counterparty risk that prompted liquidity to evaporate. Counter-cyclical capital requirements will help mitigate the boom-bust leverage cycle. To be sure, those gains will come at some cost. The specter of higher capital requirements is already discouraging banks from lending. It will surely raise the cost of future financial intermediation. If it becomes costlier to create and trade derivatives over-the-counter, some risks

will no longer be efficiently hedged. How big those costs are will depend on the severity of the new rules. But all indications suggest the balance will be better than in the boom years that preceded this crisis.

An Insufficient Reform Agenda

My worry is that this will not be enough. Today's reform agenda is insufficient more than misguided. It is premised on a partial analysis of the causes of the crisis, an excessive faith in government supervision, and a complacent attitude on how much the government's response to the crisis has changed the nature of the subsequent cleanup.

Start with the governments' response. By upping the ante on government intervention we have plainly increased the moral hazard inherent in the system. The universe of systemically important institutions has been increased and the government backstop has become more explicit. Disagreement about how to deal with this is one of the rare areas of dispute between regulators. One side argues that these behemoths demand closer supervision and should pay higher capital charges in return for their government guarantee. The other side of the debate, epitomized by Paul Volcker in America and Mervyn King in Britain, is that institutions that are too big to fail are simply too big. Thus the mitigation of systemic risk requires paring back giant global banks, for instance by hiving off riskier proprietary trading from stodgier deposit-taking and loan making.

This argument focuses on tradeoffs. What would be the costs, in terms of efficiency foregone, from dismantling global financial institutions in a world of global companies and global supply changes? It is focused on practicalities. Which bits of banks would become utilities and which casinos? But it deflects attention from the broader lesson of the past year: that our definition of what is systemically important is elastic. Two years ago no one would have regarded Bear Stearns as a firm that was too-important-to-fail. Let alone AIG. Now the idea that we can credibly ring-fence an institution, or set of institutions, and declare them, and only them, within a government-supported orbit seems fanciful. We have shown that whenever financial stability is threatened, from whatever source, government will step in. Breaking up big banks may mitigate the problem of too-systemic-to-fail. But it will not be a panacea. Rather than try to draw impossi-

bly clear lines between the systemically important and others, we should focus on measures—such as greater use of mandatory cushions of debt that can be converted into equity—which would render all financial firms more resilient to failure.

My second worry is the faith in supervision and regulation on which today's reform agenda is based. The ideas on the table—a systemic regulator, more complex cyclically adjusted capital standards and so on—all have merit. But what makes us so confident that a systemic regulator would head off new crises when regulators, central bankers, and the entire policy community missed the last one? Minimizing systemic risk is a laudable goal, but (as yet at least) we can barely define it, let alone measure it. More important, today's regulatory confidence risks ignoring the lessons of history. Modern deregulated finance did not evolve in a vacuum; it evolved in response to the incentives created by earlier regulations. Bankers created structured investment vehicles (SIVs) and other off-balance sheet vehicles to get around capital requirements. Regulatory arbitrage will occur as long as there are financial regulations. And for as long as financiers are paid multiples of what regulators earn, they are likely to be one or more steps ahead. That reality points to a further concern: that while the policy debate has focused heavily on how to improve private sector incentives in finance, there has been far less discussion about how to ensure regulators do a better job.[2]

Finally, I fear today's reform debate is far too narrowly focused. Whether it is because the popular blame-Wall Street narrative has become dominant, or whether the regulatory agenda is the easiest to implement, the post-crisis discussion has zeroed in on "fixing finance." But just as finance evolved in response to regulatory incentives, so it was influenced by macroeconomic conditions and deeper distortions caused, especially, by government tax policy.

There is no doubt that government policy decisions, particularly China's refusal to allow the yuan to appreciate, exacerbated the global macroeconomic imbalances. There is no doubt that the tax treatment of debt in most Western economies implies an artificial bias towards leverage. Nor is it any coincidence that the sector most distorted by tax subsidies—housing—is the one that fuelled the rise in consumer indebtedness. Dealing with these big underlying

[2]For an interesting discussion of regulators' incentives, see Di Mauro (2009).

distortions will be far harder than rewriting the supervisory rulebook. But until we do, the search for financial harmony will be quixotic.

Reference

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