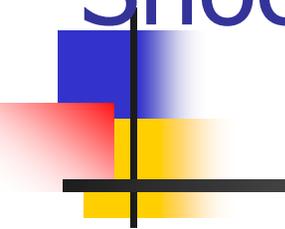
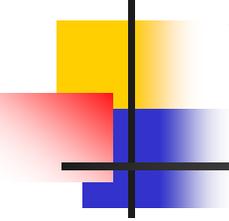


Discussion of “Financial System: Shock Absorber or Amplifier”

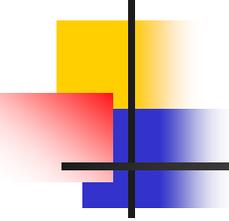


Raghuram G. Rajan
University of Chicago and NBER



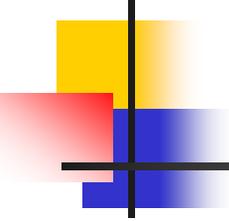
Why are banks regulated?

- A&C follow MM approach – “perfect” world, then aberrations
 - Intuitive and academically effective approach
- What precisely are the aberrations? Will regulation help?
- Can we motivate the existence of banks under such a framework?
 - Theorems on double irrelevance



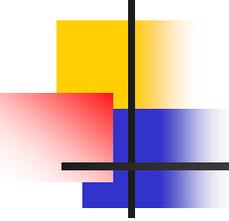
F&C's reasons for regulation

- **Avoiding costs of banking crises**
 - Market failure 1: Coordination problems
 - Depositors panic
 - But why have banks in a modern economy?
 - Immediacy? Protecting value?
 - Why not money market funds?
 - Market failure 2: Inadequate risk sharing
 - Liquidity is costliest when those in need can afford to pay the least
 - No ex ante contracts providing aggregate liquidity insurance
 - Are there other possibilities?
 - Holmstrom and Tirole, Caballero and Krishnamurthi, Diamond and Rajan



Are there other reasons for regulation?

- **To ensure adequate economic competition**
 - FAA, airline regulation, and entry
 - Reputations slow-acting
 - Industry self regulation mingles with self interest
 - But why not third party regulator?
 - JP Morgan, the Knickerbocker crisis, and the setting up of the Federal Reserve
- **To ensure adequate political competition**
 - Financial institutions as leverage points
 - Glass Steagall to cut down the House of Morgan (Roe)
 - Private Equity

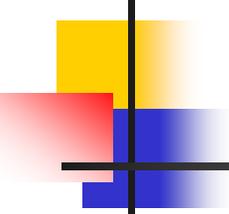


Other reasons for regulation?

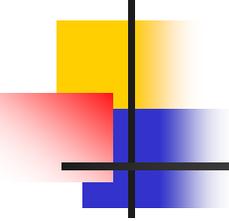
- **Financial sector differs in degree**
 - Nature of business more susceptible to fraud and mismanagement
 - Fungibility of assets
 - Ability to incur large losses in short order
 - Hard to assess performance
 - Agency and coordination problems exacerbated
 - Relative performance evaluation and
 - credit booms/herding
 - tail risk taking
 - Sector more central
 - Regulator has different incentives and can impose penalties (or be intrusive to an extent) private parties cannot

Other reasons for regulation?

contd.

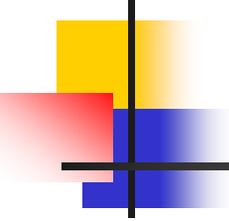


- **Inability to commit to not intervene**
 - Version 1: the Perverse Pottery Barn rule
 - Lenders do not internalize all the value the projects they lend to create
 - Excessive liquidation incentives (Holmstrom and Tirole)
 - Politicians will step in ex post to preserve societal value: You break it, we own it.
 - Should regulators therefore step in ex ante?



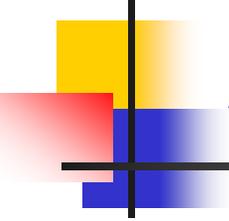
Other reasons for regulation?

- Version 2: Someone must be minding the store
 - NINJA mortgages
 - Who is watching – mortgage broker, lending bank, CDOs, rating agencies, CDO buyers?
 - Who is bearing the hit? How many are they? Where will it hit?
 - TMTF
 - Self-enforcing dereliction – multiple equilibria over responsibility?
- Version 3: The Greenspan put
 - If systemic enough and adverse enough, monetary policy will react.
 - Should the response be symmetric?



In sum

- As the paper argues, the precise rationale for regulation depends on the modeled aberration.
- Could there be more aberrations than the authors discuss?
- Yet as the authors correctly point out, the existence of an aberration does not imply regulators can help.



At the same time

- Direct costs of regulation
- Regulators are fallible
 - Can coordinate mistakes: CC or M to M and procyclicality
 - Improper rescues
 - Interference with private contracting: deposit insurance
- Excessive weakening of market discipline and caveat emptor

Bottom line: Trade-offs that we constantly attempt to revisit.