Comment on Alan Blinder
‘It’s Broke, Let’s Fix It’

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Alan is, as usual, the voice of sweet reason. Very difficult for me to disagree with him. So what does he miss out, or not discuss sufficiently? A few headings:-

1. Bank taxes
2. Transitional costs of tougher regulation
3. International legal problems
4. Rationale for liquidity measures
5. Interface with government

(1) Bank Taxes

We are likely to get them, at least in most countries. Better that they be well designed, than badly.

Externalities can be deterred by ex ante Pigovian taxes, rather than by direct controls (with too little attention to ladder of sanctions). And they provide some fiscal support.

What we look like getting are ex post levies, only dimly if at all related to systemic risk.

(2) Transitional Costs of Regulation

(a) Modigliani-Miller does not hold even in long run, because of interest rate tax-relief wedge (why maintain it?) and under-priced (implicit) insurance. How far can/should we eliminate these factors?

(b) But it really does not hold in short run! IIF (and Jordi Gual, La Caixa) vs NIESR and BIS. 0.7 $ Tr equity capital / $3+ Tr stable funding. Transition period 2012 or 2015. transition period now probably main subject of discussion. BCBS/industry.

(3) International Legal Problems

Regulation must involve laws. Laws are national rather than international. How do you get every country to accept Chapter 16?

In particular bankruptcy/insolvency law:-

Territorial approach: USA, Australia

Universal approach: Most others

US approach to insolvency of cross-border SIFIs leads logically to host country control of separate subsidiaries, with its problems for single European financial area and financial globalisation.

Assuming everyone sticks to their own legal customs, then modified universalism (2010 Geneva Report). May put US SIFIs at a disadvantage?

(4) Rationale for Liquidity Measures?

Buiter argument that creating liquidity is metier of CB. CB can liquefy any asset. Why tax banks by forcing them to finance government (and sometimes not even risk free!).

Counter arguments:-

(i) Gives time to CB. How much time does CB need?

(ii) Avoids TARP problem. How do you price/haircut asset?

Either subsidy or unhelpful.

(5) Interface with Government

Why so keen, like most Americans, to keep government out of financial stability issues? Thus “an effective systemic risk regulator [must] be fiercely independent of politics”, p. 14.

But

Unless damaging financial collapses can be ruled out completely (hardly), resolution may need taxpayer funding. (N.B. the cost of taxpayer support of failing SIFIs is far less than the cost of failing to support them, i.e. Lehman Bros). If taxpayer funding may need to be involved, so then must Treasury.

Financial stability issues involve laws, effective taxation and redistribution. Are not these proper issues for a government in a democracy?

With inflation targeting, measurement and accountability, and hence delegation to an independent agent, much simpler. Not so with financial stability. Hence need for a more hands-on approach in this field.