

Discussion 2

Angela Redish

I want to thank the organizers for inviting me to participate in the conference and for the opportunity to think about the broad issues in the development of public policy and the evolving financial system. The agenda set out by the organizers seems clear: we need models of the financial system that can be used to show the impact of alternative policies, and we need empirical analyses to test the models and to quantify the impacts of policy. This is an ambitious agenda. Indeed, most of the papers worked with the banking system rather than with the financial system. Banks are complex enough, and to analyze the *future* financial system seems perhaps hopelessly ambitious given the state of the art. This leads my remarks to have a rather pessimistic flavour, emphasizing how much has to be done. Yet the importance of the agenda for Canadian economic performance cannot be overstated. The financial system will evolve and the payoff to appropriate policy is likely to be high; more importantly, the payoff to inappropriate policy could be devastating.

I will begin with a brief run-through of what I learned from some of the papers presented here and then describe a possible framework for the research agenda.

Where We Are

This is a good news/bad news story. The good news is that the papers consolidate a wide array of information about the issues, the facts, and the ways to model the financial system. New data are introduced, and theorists show how models of the financial system can incorporate constructs such as liquidity markets and capital-adequacy ratios. The bad news is that the issues are complex, the facts are ambiguous, and models of the financial system are in their infancy.

For example, do we have good models of the financial system? The papers of Gobert et al., Van den Heuvel, and Gale all modelled the financial system, but abstracting from either the complexities of financial system functioning or from the complexities of dynamic structure. Doug Gale described his model as a “toy model,” which I think describes where we are in modelling the financial system.

The empirical papers were tantalizingly inconclusive. Is there contagion in financial markets? Gropp and Vesala creatively use equity prices of European banks to suggest that there is both inter- and intra-country contagion, in that a negative shock (a “tail” event) to equity values of one bank is correlated with shocks to equity values of other banks, even after controlling for common fundamentals. In contrast, Santor, using a new data set on Canadian bank asset allocations, argues against contagion, since Canadian banks moved *into* lending to countries that were similar to countries that had experienced crises.

Studies of diversification revealed similar ambiguity: does diversification enhance profits while reducing risk? D’Souza and Lai argue that diversification across business lines does while regional diversification does not. Stiroh suggests that U.S. bank holding companies that diversified into riskier activities (notably trading) saw an increase in risk and a decrease in profits.

But we should remember that these papers represent a search for “stylized facts,” and while, as in the arena of monetary policy, the significance of the Lucas critique should not be overstated, it should be kept in mind. Reduced-form estimates of correlations are useful, but in the absence of a deep understanding of the financial system, they provide only noisy guides to how current policy will affect an evolving financial system, or how alternative policies will affect the existing system. This concern has less bite for the papers measuring contagion, but is more significant for the measure of the benefits of diversification. If banks are not seen to be optimizing, is it because we are seeing average, not marginal, behaviour? Bank managers follow fads? Regulation constrains optimizing behaviour?

The fascinating discussion generated by the papers by Van den Heuvel, Dionne, and Gale, left me convinced that we don’t know what optimal policy would look like, and indeed that we don’t understand the implications of current policies such as regulations on capital-adequacy ratios.

Where Next?

As Beaudry proposed in his discussion of the wealth of information in Dionne’s survey of risk regulation, we need an organizing framework. I found that I needed to structure the material to see how it all fit into the

research agenda implied by the conference title. Many frameworks could be imagined, but I began with the question of how the financial sector differs from other sectors of the economy, and to make the question concrete, I compared banking with meat packing.

Public policy can then be classed into three areas: (i) policies that address concerns in all sectors, and are not particularly important to the financial system; (ii) policies that address issues of concern in all sectors but where the concerns are particularly acute in the financial sector; and (iii) policies that are specific to the financial sector. In the first two groups would be issues around competition policy, fraud, and good governance. Also included would be such issues as “too big to fail”—a policy that has been applied to other industries as much as to banking—and even issues of contagion. (I had thought contagion idiosyncratic to the financial sector, but the experience of beef farmers in Alberta suggests that it is generic.)

How is the financial sector idiosyncratic? Because of the payments system, intermediation, and the implementation of monetary policy. Whether or not these are distinct functions will depend on the model of intermediation that one uses. For example, Chant (1987) and Calomiris and Kahn (1991) argue that it is not a coincidence that demandable debt and loans are provided by the same institutions. Do these functions necessitate the range of policies that were discussed here—lender of last resort, deposit insurance, ownership restrictions, and capital-adequacy ratios?

Conclusions

What have we learned about public policy towards an evolving financial sector? There wasn't much “evolution,” and there wasn't much “financial”! In fact, many of the papers were models of banking or tests using banking data—the latter often admittedly a response to data scarcity rather than preferences. Still, we know that the “business lines” of banks are blurry. Where are the lines between insurance companies, brokers, trust companies, and banks? Where should they be? If it is appropriate to be concerned over the soundness of the banking system, but banks are financial holding companies, will deposit insurers/lenders of last resort end up backing the entire entity?

Finally, to end on a positive note, Doug Gale suggested in his paper that financial system architecture evolved not in response to theoretical breakthroughs but through “seat of the pants” responses to crises. Despite the lack of general-equilibrium models and structurally identified empirical analysis, a sound system emerged. Now, we are working on optimal.

References

- Calomiris, C. and C. Kahn. 1991. "The Role of Demandable Debt in Structuring Optimal Banking Arrangements." *American Economic Review* 81 (3): 497–513.
- Chant, J. 1987. *Regulation of Financial Institutions—A Functional Analysis*. Bank of Canada Technical Report No. 45.