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Arnold Kling (September 16, 2008)

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SEPTEMBER 16, 2008

What Should Government Guarantee?

Arnold Kling

Megan McArdle writes,

> our regulatory model still works on the assumption that the technocrats can figure out what is safe, and then let the public buy it, and nothing will ever go wrong. Oh, maybe it's not working that way right now . . . but that's because the other party is in charge. Or the regulators got corrupted. Or the Moon was in Taurus while Saturn was in Capricorn, a constellation that will not recur for another seven thousand years.

On financial markets, I am in the middle between the Progressive view that government can guarantee everything and the libertarian view that the government should guarantee nothing.

My view is that financial markets are inherently unstable, because financial intermediation inherently replaces transparency with trust. If my bank were perfectly transparent, then I would know everything about its loans, including the underlying risks of the real estate developers, small businesses, and individuals to whom it is lending money. But in that case, I would not need a bank--I could just make those loans myself. So if you assume perfect transparency, you assume away the need for financial intermediation.

In fact, you have to assume the opposite of perfect transparency. You have to assume highly imperfect transparency, with reputation and trust serving as substitutes.

In banking, deposit insurance helps facilitate trust. A private insurance pool might work, but people trust government-provided deposit insurance even more.

With deposit insurance, the consumer loses all motivation for worrying about the bank's risk management. By the same token, the insurer has to worry a lot. In the U.S., the FDIC has been getting better over the years, but you can never get complacent. Any system can be gamed eventually, so it's a challenge for the regulators to stay one step ahead of the banks.

What we see with Bear Stearns, Freddie and Fannie, Lehman, and AIG insurance are institutions that are not FDIC-insured banks where nonetheless a question arises about whether some of their creditors ought to be protected by the government. I think that just about everyone is unhappy that these decisions are being made *ad hoc*, after the firms got in trouble, rather than having rules set ahead of time. But maybe what the government is doing is actually pretty reasonable. You can think of the Fed and Treasury as trying to buy good assets at cheap prices, at a time when private intermediaries have lost the trust of investors, which puts undervalued assets out there to buy. But you want the government to get out of the hedge fund business sooner, rather than later. It's not a safe business.

Another point to toss into the mix is that the blow-up has *not* come from private hedge funds. If you think that leverage and lack of regulation are the big risk factors, those are the guys that you would expect to be experiencing all the problems.

Overall, I think that having some regulated, insured institutions, like the banks, is good. I don't think we can or should try to regulate everyone. Regulators should try to anticipate crises and prevent them. But almost by definition, the crises that do occur will be ones that they did not anticipate, and the responses will have to be somewhat *ad hoc*.

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COMMENTS (11 to date)

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Christopher Espinal writes:

Well then Arnold, why not suppose that Stiglitz is right? He states that we should force transparency on both ends of a market - supplyside and demandside? I'm not sure of the idea but can that help the market?

Posted September 16, 2008 04:28 PM

cato writes:

i'm worried about what incentives the insurer has to perform well, with the taxpayers money.

maybe the FDIC is getting better, but on average many government programs have gotten worse (spending has increased, while the public good of the programs has generally decreased)

Posted September 16, 2008 04:34 PM

aaron writes:

Speaking of getting out of the hedge fund business, is it possible that hedge funds getting out of the hedge fund business might have exposed some of these big institutions to more risk? Haven't a lot of funds been unwinding their positions?

Posted September 16, 2008 04:35 PM

John V writes:

Arnold says:

In banking, deposit insurance helps facilitate trust. A private insurance pool might work, but people trust government-provided deposit insurance even more.

Well, what would happen in the absence of this insurance? Would people simply not trust and the system not work well?

I have a hard believing that. Do you not put enough faith in organizations and manners of business that would develop to fill that void in a different fashion that promotes trust within another incentive structure?

Posted September 16, 2008 06:00 PM

Curt writes:

I personally view the concept of a "bank" folly. An institution that takes large fixed size bets in the distant future that guarantees small returns in the short-run.

If bet fails, sorry customers, we don't have the cash to pay you.
If bet succeeds, sorry customers, your gain is limited to this small interest rate.

In both cases, it would be better for the customer to simply take the bet themselves.

In my view, we should have an informed investing populace that holds their wealth in real assets. When you need money, sell your liquid equities, reits, treasuries, mortgages, land. If people were educated, there would be increased need for brokerages, and less need for fdic banks.

On a side note. Has there ever been a better time for social security privatisation? Within social security, the general rate of return is around the 30yr treasury rate. People are in mortgage debt up to their ears, where they pay risk free + x%. Allowing drawdowns in social security to cover mortgage expenses would gaurantee an additional return of x. It makes no sense to borrow money at 7% to invest at 4%. This would have the side effect of increasing home-demand and lowering foreclosure rates.

Posted September 16, 2008 06:10 PM

Grant writes:

I'm not following all of your logic here, Arnold:

> So if you assume perfect transparency, you assume away the need for financial intermediation.

Transparency simply means the information is available, not that its interpreted in a way you or I could understand. Opinions on riskiness will vary, so we need a way to aggregate knowledge, i.e. a market.

It seems to me that a lot of the blame must fall on the rating agencies. If there was a working market for credit ratings, would we really be asking for more transparency? Why did the ratings market fail?

Posted September 16, 2008 06:30 PM

James writes:

Arnold,

It seems that you are saying one case of assymetrical information (Peter don't really know how his bank handles his savings deposits.) is worse than another (Peter doesn't know when the central bank will bail out Paul at Peter's expense.)

I don't see how you can claim this.

All capital markets have transparency issues. You don't know what all of the companies in your index fund are really up to, but you trust that capital markets are efficient enough that the prices of the consituent stocks reflect conditions of the individual companies. Are fixed income markets significantly less efficient in your view? How much inefficiency would I have to assume exists in the fixed income market in order to reach your conclusion?

Posted September 16, 2008 07:31 PM

Arnold Kling writes:

Christopher, it certainly would be in the spirit of Stiglitz to say that you can "force" transparency. But that is like saying you can "force" the law of gravity go to away. The only way to force transparency is to get rid of financial intermediation in the first place.

Grant, I just wrote an op-ed on how the ratings agencies cannot be the solution. If it gets printed, I'll link to it. Otherwise, I'll post it.

I think that if you don't have deposit insurance, then banking becomes unstable. A banking system without deposit insurance is like a housing market with 0 percent down payments. Good times get really good, and bad times get really bad.

Posted September 16, 2008 07:57 PM

Patrick writes:

But I would think banks without deposit insurance would be less common than banks with deposit insurance since customers would be concerned about it, assuming they are informed about it (Which they should).

As for financial intermediation, there is a lot of reason why it came into existence. One of them would be the result that since banks were issuing credits (Which were backed by the assets deposited to the banks by the customers, e.g: gold), some of those notes were not redeemed as soon as a month or a week, so they figured they could lend to other people who need it. At least, this is what Mr. Sechrest, a member of the Ludwig Von Mises Institute, explained in his book titled Free Banking. Besides, maybe the reason we have those banks today is because of environment that comes with the adoption of those regulations, in other words, unintended consequence. Just a thought.

Posted September 17, 2008 12:11 PM

Christopher Espinal writes:

Arnold: The only way to force transparency is to get rid of financial intermediation in the first place.

Please explain that!

Posted September 17, 2008 12:19 PM

AB writes:

Like some of the other commenters, I don't understand your view on transparency in banking. Don't financial intermediaries bring expertise (yes, I realize the irony right now) and some sort of economies of scale? I find it hard to believe that, given transparent information, I could achieve the same results on my own.

Posted September 17, 2008 03:51 PM

TRACKBACKS (1 to date)

The author at DiscussEconomics Blog in a related article titled "AIG Seeks Bailout - Web Links," **writes:**

> Collection of AIG Articles In the wake of the recent debacle(s) in the US, now with the bailout of insurance giant AIG, we have combined some links that we've found online in one easy location. Check out what others have to say ranging from news report...... [Read more]

Posted September 17, 2008 02:56 PM

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