Doug Elmendorf
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Question:

What market failure would be addressed by further government regulation of risk-taking of financial institutions?

Answer:

The central market failure in financial markets is asymmetric information, which creates problems of adverse selection and moral hazard. Private intermediaries exist, in part, to address these problems, but they suffer from the same problems themselves and thus do not provide a complete solution.

Government regulation can improve the quantity and quality of information, but this approach cannot completely solve the problems because: 1) some information is proprietary; and 2) the complexity of the institutions (and their inter-relationships) means that, even with information, many market participants cannot accurately assess the risks they face. Thus, the government also limits institutions' risk-taking and provides a safety net for small depositors. Pricing of risk-taking (for example, through risk-based capital standards or deposit-insurance premiums) may lag behind financial innovation, so direct restrictions on risk-taking is necessary. Note that the safety net worsens the moral hazard problem, which then justifies further regulation.

One specific effect of asymmetric information is to increase the risk of a general financial panic ("systemic risk"). Because market participants cannot judge the financial health of institutions they deal with, bad news about one institution has a contagion effect on other institutions, reducing their access to capital as well. The doctrine of "too big to fail" is based on this point. This externality increases the chance of a self-fulfilling drop in economic activity that monetary policy would not be able to counteract. Note that the Federal Reserve's key argument for why it should be involved in bank regulation is that understanding of bank conditions is critical to making monetary policy. Note also that if we are using monetary policy to stabilize macroeconomic conditions, we are admitting that general slumps in aggregate demand are not optimal.

Financial innovation has worsened this problem. Institutions have many new avenues for taking risk that are difficult for even sophisticated market participants to fully understand, and the inter-relationships are even more complex. Moreover: 1) unsophisticated participants are affected by their involvement with institutions that take risks, so stricter regulation of banks might be required just to maintain the defense of the safety net; 2) some participants have market power in some of these new markets, which is a standard market failure.

One summary:

The central market failure in financial markets is asymmetric information. The asymmetric information makes it harder to firms to obtain funds when they need them, and in particular makes the financial system vulnerable to general panics, in which bad news about one institution has contagion effects on others. It also exposes small, unsophisticated savers to risk they do not understand and cannot deal with. The rapid pace of financial innovation has worsened this problem.

Limited liability of bankruptcy system?