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Commentary:

The Financial System and Economic Performance

by

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Commentary: *The Financial System and Economic Performance*

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Robert Merton's article should be read by anyone who is interested in the past or future evolution of financial markets. Merton develops parts of finance theory and their implications for financial markets and financial policy in a clear, crisp, and informative way. It is an excellent piece, well worth a reader's investment of time.

The article starts with a broad overview of the services provided by financial institutions in a market economy: the efficient allocation of savings, the development of signals or information in the form of market clearing interest rates, asset prices, and risk premiums that guide resource allocation. It also includes the provision of a payments system that facilitates transactions by reducing the time and effort that households, corporations, and governments devote to purchasing and processing payments for purchases.

The body of the article discusses three main issues: innovation, below investment grade debt (so-called junk bonds), and loan guarantees or insurance. Merton provides a thorough discussion of each topic.

There are two types of innovation. Some innovations provide clear social benefits by lowering transactions costs, reducing costs of acquiring information, lowering risk, or increasing liquidity. These innovations increase wealth and asset values or raise the utility of a given stock of wealth. Other innovations that circumvent regulations are usually presented as posing a conflict between individual benefit and social objective. Merton gives an example, however, of a government imposing exchange controls that reduce individuals' opportunities to diversify their portfolios. He shows how financial innovation can restore many of the benefits of diversification while maintaining the spirit, if not the letter, of the regulation. Although I accept his point in principle, I find his example a bit misleading. Often exchange controls are imposed to prevent capital flight by asset owners concerned about below market returns, taxation, or confiscation. Why would external investors choose to include these assets, or a claim on these returns in their portfolio, as is required for Merton's innovation to work?

A main implication of the section on innovation is that market regulation should be functional instead of institutional. Merton also favors international coordination if regulations are socially optimal. He recognizes that this is a big if, particularly in an innovative financial system. I will return to this topic.

Junk bonds—below investment grade debt—are one of the most widely discussed innovations of recent years. Many of these securities have a relatively high probability of default. The longest section of the article presents a careful, non-mathematical exposition of some basic principles of default risk with application to the policy issues raised by the recent increase in junk bonds.

Merton uses his running example to show that with high leverage, debt acquires part of the default risk that fell entirely on equity in his low leverage example. He then explores several common misperceptions about expected return and shows the fallacy involved in using the historical difference between interest earnings on high grade and junk bonds as a measure of the payment that one can expect for bearing the additional risk. A conclusion often drawn is that the payment for default risk has exceeded the amount required to compensate for default losses. Merton shows that this fact, if true, says nothing about the expected return on junk bonds.

The section ends with a proposal to reduce or avoid bankruptcy costs while providing the functional equivalent of debt, including junk bonds, and equity. The proposal suggests one of the ways in which financial innovation can raise social welfare.

One of the attractive features of the article is the way Merton is able to develop many of his points by building on a single example. The third section carries forward the example of debt and equity finance of risky portfolios to consider government guarantees, of which deposit insurance is one example.

Under many government insurance programs, the federal government issues a guarantee but does not record the value of the expected loss as an expense. Expenses are reported only when the losses are realized, a form of accounting that would not satisfy many current and prospective private sector accounting rules. The fact that no current charge is recorded probably leads politicians to overuse guarantees. Charges deferred to some uncertain future date do not appear in the budget. Charges deferred are usually charges denied by governments; the long delay in admitting the expected losses in the thrift industry is an example.

What is the effect of the guarantee on the owners of the financial firm? Merton extends his example to show that the owners will choose a more volatile portfolio. The reason is that the risk of failure has been shifted to the government, so the owner's expected loss in the event of failure is reduced and the value of the owner's equity is increased commensurately. The added incentive to take on risk arises even if the firm is not bankrupt. In our recent experience with deposit insurance at savings and loans, many firms were allowed to operate after they were technically bankrupt; for these firms the incentive to purchase high risk assets with volatile returns was often overwhelming. Subsequent realization of the losses on these portfolios wiped out the Federal Savings and Loan Insurance fund and shifted the loss to the taxpayers. Moral: an improperly designed insurance system can be costly.

Merton concludes that if there is to be insurance, whether private or public, there must be regulation to control losses. He suggests that the restrictions can take three possible forms: (1) portfolio restrictions that prevent insured firms from holding volatile assets; (2) frequent monitoring by the regulator and prompt seizure of assets; and (3) charging proper fees for the guarantees.

In a 1967 article, I argued that the basic premise of the deposit insurance system is incorrect (Meltzer, 1967). The reason I gave is that government does not have a comparative

advantage in insuring commercial banks. I suggested that government became the insurer of banks and other intermediaries because the Federal Reserve failed to prevent the collapse of large parts of the banking and financial systems during the Great Depression. The principal mistake, I argued, was to confuse the solvency of an individual bank or financial institution with the solvency of the financial system. Insurance can protect an individual bank, not the system. But, as Merton emphasizes, insurance must be correctly priced and that, I suggested, was more likely to happen if the insurance system is privately owned and managed.

There is a role for government. Private insurers cannot insure against systemic risks, particularly risks arising from government policy mistakes, as in the 1930s depression. To reduce the risk of systemwide failures, a lender of last resort must have the power to create money. An insurance company, private or public, cannot create money. The task falls to the central bank.

Looking again at the insurance problem after 25 years, I would make one change in my earlier discussion and in Merton's. There is some benefit to the public in using checks as instruments of payment. Risks of loss and theft are larger for currency than for deposits, so risk can be reduced by encouraging the use of checking deposits. But relatively small depositors cannot be expected to monitor the safety or soundness of their bank, and there is a social benefit in avoiding runs on bank deposits to convert deposits into currency during periods of alarm.

An institutional change would eliminate monitoring costs on some deposits. In place of deposit insurance, let privately owned banks or money market funds offer deposits fully collateralized by portfolios of short-term government securities that are marked to market. Anyone who wants to avoid loss on all or part of his money balances can hold the relevant amount in these deposits. All other deposits would be either uninsured or privately insured. This does not require a new "narrow bank." Money funds limited to holding only short-term government securities currently exist.

Government does not have a comparative advantage in the insurance business. Governments can best reduce risk by establishing institutions that give proper incentive to decisionmakers. The lender of last resort function is an example. Maintaining stability of the anticipated price level is another. Offering indexed bonds may be a third. Many government insurance programs redistribute risk bearing across time or across groups. The thrift industry bailout is one example of such redistribution. The problems posed by Medicare insurance funding are another.

The conclusion I draw from Merton's analysis is, once again, that public policy should distinguish between risk shifting and government actions that reduce the risks that society bears. There are net social benefits from the latter but generally not from the former. As I see it, the issue is not whether deposits or brokerage accounts should be insured *and* regulated, as Merton suggests. Ideally, government activity would be limited to those actions that provide net social benefits – actions where government has a comparative advantage. Merton includes promoting competition, ensuring integrity, providing public goods; I would add, for emphasis, reducing risks to the minimum inherent in nature and trading practices.

Merton recommends that financial regulations should be coordinated internationally only if the regulations are socially optimal. I would add that even if regulations are socially

optimal at one time, they are unlikely to remain optimal in a dynamic industry like the financial industry. Furthermore, I see no clear presumption that a regulatory cartel is an optimal arrangement. Here, as elsewhere, competition has benefits.

One area in which government has a role is in maintaining a stable real value of money. Economists argue over whether governments should maintain stable domestic value or stable external value. In the postwar era, most governments have done neither. Neither price levels nor exchange rates have been stable.

Consider the problem faced by a representative person who works until 60 or 65 and lives for 15 or 20 years on a pension. With a stable domestic price level, he can invest his pension in bonds with stable purchasing power and a fixed rate of return. He knows what his income will be and can estimate the size of the estate he will leave to his heirs. In an economy subject to variable inflation, he runs the risk that his real income will be reduced and that he will face poverty before he dies. This risk can be reduced by increasing saving during his working years, but this is unlikely to happen. Inflation shortens horizons and reduces saving, which adds to the problem. Part of the risk of inflation can be avoided by holding real assets or equities but, as Merton's analysis shows, the decision to hold equities requires that he accept a risk of a different kind. And, in practice, capital gains taxes fall on nominal values, reducing their attraction as a hedge against inflation.

Government could solve part of this problem by issuing indexed bonds and by indexing capital gains taxes. Government can reduce the risk of inflation by pursuing policies that maintain anticipated price stability. This is a valuable service that only government, or its monetary authority, can provide.

Finally, I would like to comment briefly on one paramount issue: whether there are advantages to a country in having a strong financial sector. Several of the articles in this issue point out that a principal product of the financial sector is information as reflected not only in efficient markets for financial assets but also in customized lending and borrowing arrangements where markets are not organized. The accumulation of information about borrowers, the skill and knowledge with which competitive lenders assess risks and opportunities, and the innovations that create standardized, tradeable assets from heterogeneous loans are part of the process by which information is used efficiently. More efficient use of information, reductions in the cost of acquiring information and transacting, and better resource allocation are the result. These are the source of productivity gains from the use of money and financial assets (Brunner and Meltzer, 1971).

Much public discussion is based on the incorrect assessment of the nature of these activities. Financial innovators are often pilloried by the regulators, in Congress, in the press, in many parts of the business community, and by the public. Financial innovators are often treated as parasites or worse, concerned only with the minute-to-minute happenings on markets. This view fails to distinguish between the rapidly vanishing value of a particular item of information and the value of an efficient system for producing information and change. The latter is a source of productivity, growth, and economic welfare. Regulation of the financial system should not ignore this relation of the financial system to economic performance. Robert Merton's article brings out some of the reasons why.

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