General Discussion

The paper by Franklin Allen and Elena Carletti was well received and prompted discussion across a broad range of topics. One discussion centred on the potential for asset market mispricing, with deviations from fundamentals due to panics or overconfidence, and the systemic effects that this can have. Professor Allen stated that asset prices typically looked fine until one had the benefit of hindsight after a crisis had occurred. In his view, bubbles were harmful to the economy, rejecting the MIT view that efficient bubbles can exist and, indeed, may be beneficial in some circumstances.

In response to a question about whether the academic literature had much to say about why core-periphery structures were common in financial markets, Professor Allen commented that the endogenous formation of core-periphery structures was not well understood. He suggested that there must be a more important fundamental cause for this type of structure to evolve than merely regulatory arbitrage. Another participant noted that if core-periphery structures evolved endogenously to remove the need for expensive collateral, as had been suggested in the literature, then some post-crisis regulatory change could be offsetting these forces. Information asymmetries were cited as another potential driving factor in these developments.

The importance of information was also raised. One participant asked about what had been learned from the global games literature, where the equilibrium reached depends on the nature of public and private information. In particular, they asked about the policy implications arising from fire-sale externalities, whereby illiquid firms are forced to sell assets at detrimentally low values in order to stay liquid, resulting in bad equilibria.

Another discussion considered whether policymakers had a sufficiently systemic perspective in dealing with crises. It was noted that without this perspective there was a tendency for policymakers to 'fight the last war'. The ability of policymakers to effectively minimise systemic risk by tempering risky activity was also discussed. One participant asked whether empirical evidence suggested that macroprudential policy tools such as LVRs were effective. Evidence from Italy was cited to suggest that while LVR restrictions could dampen house prices in the short run, this effect was not sustained in the long run.

Another participant raised the issue of bank runs, pondering why they were conspicuously rare during the recent financial crisis. Implicit government guarantees on deposits, potential naivety of depositors, and less reliance on deposits due to asset diversification were all noted as potential contributors to this stability. Professor Allen posited that standard models of rationality were not particularly successful in resolving this issue.

The precise role banks play in the global economy was also discussed. One participant suggested that large corporations had the scale and credibility to participate in funding markets directly, with the corollary that banks should focus on servicing the funding needs of small and medium enterprises (SMEs). In response, Professor Allen noted that the reason for layers of financial intermediation were also not well understood, but agreed that the need for banks to facilitate funding of firms had not disappeared.

Another discussion concerned liquidity regulation. One participant noted that the provision of liquidity by central banks during crises was well understood as a public good, and that the resulting moral hazard issue could be offset by regulation, such as liquidity requirements. However, they also suggested that it was not well understood whether it was necessary to address these concerns through regulation, or whether these systemic concerns could be left to the central bank to deal with. With respect to liquidity requirements, participants generally agreed that it was more efficient for the financial sector to hold liquid assets, rather than for corporations (the end users of financial services) to hold these assets directly. Professor Allen further argued that it was particularly inefficient for the private sector to hold large amounts of liquid assets because these holdings were still likely to be insufficient when large negative systemic shocks eventuated.