



Privatizing profits and socializing losses with smoothly operating capital markets[☆]



Benjamin Bental^{a, b, *}, Dominique Demougin^{c, d}

^aDepartment of Economics, University of Haifa, Haifa, Israel

^bDepartment of Governance and Economics, EBS University, Wiesbaden, Germany

^cDepartment of Economics, Finance and Accounting, University of Liverpool Management School, United Kingdom

^dDepartment of Economics, Panthéon-Assas University, Sorbonne University, France

ARTICLE INFO

Article history:

Received 15 September 2015

Received in revised form 30 April 2016

Accepted 24 June 2016

Available online 29 June 2016

JEL classification:

E44

E61

Keywords:

Crisis

Toxic assets

Intervention

ABSTRACT

We design a three periods two overlapping generations model to challenge some of the prevailing views regarding privatizing profits and socializing losses in an environment characterized by smoothly operating capital markets. The model has a secondary asset market impaired by adverse selection and moral hazard. An exogenous stochastic shock renders some assets toxic. In the basic setup a tax financed scheme which removes toxic assets exacerbates the moral hazard problem and worsens the resource misallocation. However, introducing a “search for yield” with dynamic spillover effects and/or considering a labor market with some friction makes intervention welfare improving.

© 2016 Elsevier B.V. All rights reserved.

1. Introduction

The last decade has witnessed financial crises of an exceptional magnitude. One of the defining characteristics of these crises centered around assets that had been regarded as safe but at some point became worthless. Moreover, the prevailing market structures produced an adverse selection environment making it next to impossible to separate “good” assets from “toxic” ones. In response to these dramatic events a plethora of government programs have been developed. For instance, in the 2008 crisis, the U.S. government chose to directly remove “troubled assets” from the market (among other things).¹ The most prominent example is the TARP scheme which had initially allocated up to \$700 billion for that purpose.² In the context of the Greek debt crisis, policies were much more diverse and complicated. Nonetheless, in the final analysis the policy responses involved

[☆] This is a thoroughly revised version of a paper which was originally presented in July 2011 at the Tsinghua Macroeconomics Workshop.

* Corresponding author at: Department of Economics, University of Haifa, Haifa, Israel.

E-mail addresses: bbental@econ.haifa.ac.il (B. Bental), demougin@liverpool.ac.uk (D. Demougin).

¹ There is an immense body of literature discussing the events leading to that crisis. For a succinct overview see Blanchard (2009).

² The goals of the program may be found in <http://www.ustreas.gov/press/releases/hp1150.htm> For details of the program, see <http://www.federalreserve.gov/bankinfo/tarpinfo.htm>. Other countries have implemented similar programs. For instance, in Ireland through the National Asset Management Agency, or in numerous other European countries via a “Bad Bank” concept, see Goddard et al. (2009).

reducing the exposure of private banks to Greek debt (largely through ECB measures) and providing public guarantees on a large part of the remaining debt (see e.g. Arslanalp and Tsuda, 2012, p. 50 Annex Figure 1).

While there is a prevailing sentiment that these government measures were essential to stabilize the system in the middle of the turmoil, the actual policies have raised concerns on several grounds. One of the main misgivings centers around fairness issues summarized by rhetorics around the buzz-phrases “privatizing profits and socializing losses” or “Main Street vs. Wall Street”. Such policies appear particularly unfair since it means that while investors were expecting to keep their profits in good times, they could shed their loss during a crisis. Moreover, as most governments used debt to finance their respective policies, additional intergenerational equity issues were voiced.³ Further concerns regard the impact of moral hazard on resource allocation once the policy is anticipated. Intuitively, the intervention amounts to a subsidy of investors’ return in the bad state of the world.⁴ If this is anticipated, it induces investors to ignore the down risk and over-invest in risky assets.⁵

There is a recent literature briefly overviewed below explaining the collapse of financial markets and lending freezes based on informational frictions. A natural component of that research program is to consider public policies aimed at restoring confidence in adverse states of the world. Notwithstanding the findings of that line of investigation, the aim of our paper is to show that the aforementioned fairness and moral-hazard arguments cannot be used to rule out intervention even when financial markets operate smoothly.

For that purpose, we introduce a stylized model with which we perform a qualitative logical exercise. The model uses a three periods and two overlapping generations framework.⁶ The key element is the introduction of an intermediate good traded across risk-neutral generations in a secondary asset market.⁷ In that context, a crisis is characterized by the following features. Before intermediate goods are traded, it becomes common knowledge that a fraction of them have turned worthless. Moreover, adverse selection impairs trade because buyers cannot distinguish across assets. As a result, the price of all intermediate goods becomes depressed by the worthless assets referred to hereafter as “toxic”.⁸

In the absence of a public intervention, the rational expectations equilibrium leads to underinvestment in safe goods and overinvestment in the risky ones relative to the first-best allocation. A tax financed policy which removes a fraction of the toxic assets at market price is shown to increase all investments. However, it turns out to be welfare decreasing. Intuitively, the rational expectations price always adjusts to fully incorporate the market risk. When toxic assets are removed the market risk understates the social risk, which cannot be welfare improving with risk-neutral individuals.

While the foregoing analysis seems to lend support to opponents of intervention, we argue that its conclusion is in fact a “knife-edge” result. For that purpose, we consider two minor extensions of the basic model. In the first extension, we introduce *search for yield* which has been often identified as a main culprit contributing to recent financial crises (see, e.g. the ECB’s 2014 *Financial Stability Review*). We identify a condition which guarantees that in the presence of dynamic search externalities removing some of the toxic goods becomes socially beneficial. Intuitively, “socializing losses” acts like a subsidy of investors’ return. It increases search by the first generation which has a positive spillover effect on the next generation. On the whole, the policy trades-off a worsening in the resource allocation of savings across investment alternatives against an improved allocation in search and knowledge creation. It is noteworthy that the second generation also benefits from the intervention program, thus alleviating some of the intergenerational “fairness” concerns.⁹

The second extension focuses on the “Main Street vs. Wall Street” tension. To do so, we introduce a labor market characterized by sticky wages. Ex-post, this feature implies an inefficient allocation of labor. In this context, a policy of removing toxic goods has two effects. As above, it acts as a capital subsidy and raises investments. Due to the complementarity of factors, demand for labor increases in all states of the world. In and of itself, this has a positive welfare effect. More importantly, the policy stabilizes the price of the intermediate good during a crisis. In view of the pre-determined wages, this is welfare improving.¹⁰ Intuitively, the stable price avoids a sharp decrease in labor demand during the crisis which would have exacerbated the

³ For instance, Tagkalakis (2013) studies the significant increase in national debt due to financial crises in OECD countries. With respect to the 2008 crisis, he notes that “the debt to GDP ratio increased due to financial rescue packages” (see p. 199).

⁴ This concern is also reflected by Katsimi and Moutos (2010, p. 575), who note that “(I)mplicit loan guarantees provided by governments have also intensified private-sector moral hazard” as “(U)nderpriced loan guarantees...lead to greater lending, due to the lower cost of capital, and as well riskier lending.” See also Tagkalakis (2013, p. 198) for a related observation.

⁵ These concerns are reflected in President Obama’s speech at Wall Street on the first anniversary of the Lehman Brothers bankruptcy, where he said: “Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall.” http://www.huffingtonpost.com/2009/09/14/obama-wall-streetspeech_n_285841.html

⁶ Bental and Demougin (2014) use a standard OG framework with similar conclusions. The current version greatly simplifies the derivation of asset prices.

⁷ The idea is taken from the paper by Bencivenga et al. (1996).

⁸ The adjective “toxic” is commonly associated with assets whose value suddenly drops, causing markets to freeze when due to adverse selection owners of “good” assets withdraw from the market (see, e.g. Morris and Shin, 2012). We use this terminology even though in our setting toxicity does not lead to market collapse.

⁹ The intergenerational externality underlying intervention would also justify direct subsidization. This raises the question as to whether society may not be better off using direct tools to align incentives. Our study does not provide an answer to this important question as we do not conduct a cost-benefit analysis across different subsidy schemes. However, in practice governments are unlikely to correctly identify and subsidize all innovative activities (including among others developments of new financial instruments, new management and marketing methods, etc.) while avoiding opportunistic behavior at the receiving end. If this is the case, the remaining intergenerational externalities should continue to warrant some intervention based on the above justification, albeit to a lesser extent.

¹⁰ A similar observation to footnote 9 applies, as we do not include other corrective instruments. However, as is known from the new Keynesian literature, governmental policies cannot fully restore efficiency in face of labor market frictions (see e.g. Gali, 2008).

Download English Version:

<https://daneshyari.com/en/article/5067875>

Download Persian Version:

<https://daneshyari.com/article/5067875>

[Daneshyari.com](https://daneshyari.com)