Journal of Monetary Economics 68 (2014) S55–S67

Contents lists available at ScienceDirect

Journal of Monetary Economics

journal homepage: www.elsevier.com/locate/jme

The redistributive effects of financial deregulation

Anton Korinek [a,b,*], Jonathan Kreamer [c]

[a] Johns Hopkins University, United States
[b] NBER, United States
[c] University of Maryland, United States

ARTICLE INFO

Article history:
Received 20 June 2013
Received in revised form
23 August 2014
Accepted 27 August 2014
Available online 10 September 2014

Keywords:
Financial regulation
Distributive conflict
Rent extraction
Growth of the financial sector

ABSTRACT

Financial regulation is often framed as a question of economic efficiency. This paper, by contrast, puts the distributive implications of financial regulation at center stage. We develop a model in which the financial sector benefits from financial risk-taking by earning greater expected returns. However, risk-taking also increases the incidence of large losses that lead to credit crunches and impose negative externalities on the real economy. A regulator has to trade off efficiency in the financial sector, which is aided by deregulation, against efficiency in the real economy, which is aided by tighter regulation and a more stable supply of credit.

1. Introduction

Financial regulation is often framed as a question of economic efficiency. However, the intense political debate on the topic suggests that redistributive questions are front and center in setting financial regulation. In the aftermath of the financial crisis of 2008/2009, for example, consumer organizations, labor unions and political parties championing worker interests have strongly advocated a tightening of financial regulation, whereas financial institutions and their representatives have argued the opposite case and have issued dire warnings of the dangers and costs of tighter regulation.

This paper makes the case that there is a distributive conflict over the level of risk-taking in the financial sector, and by extension over the tightness of financial regulation. Financial institutions prefer more risk-taking than what is optimal for the rest of society because risk-taking delivers higher expected returns. However, it also comes with a greater incidence of large losses that lead to credit crunches and negative externalities on the real economy. This link between financial regulation and volatility in the real economy has been documented e.g. by Reinhart and Rogoff (2009).

We develop a formal model to analyze the distributive conflict inherent in regulating risk-taking in the financial sector. The financial sector plays a special role in the economy as the only sector that can engage in financial intermediation and channel capital into productive investments. This assumption applies to the financial sector in a broad sense, including broker-dealers, the shadow financial system and all other actors that engage in financial intermediation. For simplicity, we will refer to all actors in the financial sector broadly defined as "bankers."

* Correspondence to: Mergenthaler Hall 456, Johns Hopkins University, 3400 North Charles Street, Baltimore, MD 21218, United States. Tel.: +1 410 516 7601.
E-mail address: akorinek@jhu.edu (A. Korinek).

http://dx.doi.org/10.1016/j.jmoneco.2014.08.007
0304-3932/

There are two types of financial imperfections. First, bankers suffer from a commitment problem and need to have sufficient capital in order to engage in financial intermediation. This captures the standard notion that bankers need to have "skin in the game" to ensure proper incentives. Second, insurance markets between bankers and the rest of society are incomplete, and bank equity is concentrated in the hands of bankers.

Because of the "skin in the game"-constraint, a well-capitalized financial sector is essential for the rest of the economy. In particular, the financial sector needs to hold a certain minimum level of capital to intermediate the first-best level of credit and achieve the optimal level of output. If aggregate bank capital declines below this threshold, binding financial constraints force bankers to cut back on credit to the rest of the economy. The resulting credit crunch causes output to contract, wages to decline and lending spreads to increase. At a technical level, these price movements constitute pecuniary externalities that hurt the real economy but benefit bankers.

When financial institutions decide how much risk to take on, they trade off the benefits of risk-taking in terms of higher expected return with the risk of becoming constrained. They always find it optimal to choose a positive level of risk-taking. By contrast, workers are averse to fluctuations in bank capital. They prefer less financial risk-taking and a stable supply of credit to the real economy. This generates a Pareto frontier along which higher levels of risk-taking correspond to higher levels of welfare for bankers and lower levels of welfare for workers. Financial regulation imposes constraints on risk-taking, which move the economy along this Pareto frontier. Financial regulators have to trade off greater efficiency in the financial sector, which relies on risk-taking, against greater efficiency in the real economy, which requires a stable supply of credit.[1]

The distributive conflict over risk-taking and regulation is the result of both financial imperfections in our model. If bankers were not financially constrained, then Fisherian separation would hold: they could always intermediate the optimal amount of capital, and their risk-taking would not affect the real economy. Similarly, if risk markets were complete, then bankers and the rest of the economy would share not only the downside but also the benefits of financial risk-taking. In both cases, the distributive conflict would disappear.

Drawing an analogy to more traditional forms of externalities, financial deregulation is similar to relaxing safety rules on nuclear power plants: such a relaxation will reduce costs, which increases the profits of the nuclear industry and may even benefit the rest of society via reduced electricity rates in good states of nature. However, it comes at a heightened risk of nuclear meltdowns that impose massive negative externalities on the rest of society. In expectation, relaxing safety rules below their optimum level increases the profits of the nuclear sector at the expense of the rest of society.

We analyze a number of extensions to study how risk-taking in the financial sector interacts with the distribution of resources in our model economy. When bank managers receive asymmetric compensation packages, they will take on greater risk and expose the economy to larger negative externalities. If bankers have market power, their precautionary incentives are reduced and they take on more risk which hurts workers, highlighting a new dimension of welfare losses from concentrated banking systems. Financial innovation that expands the set of available assets allows the financial sector to take on more risk, and in some cases can make workers unambiguously worse off. Finally, greater risk-taking induced by bailouts likely leads to a significantly larger redistribution of surplus than the explicit transfers that financial institutions receive during bailouts. These extensions suggest that the externalities from credit crunches may easily represent the most significant social cost of distortions in the financial sector.

Our analytic findings suggest a number of policy interventions in the real world that regulators could implement if their main concern is a stable supply of credit to the real economy: they could (i) separate risky activities, such as proprietary trading, from traditional financial intermediation, (ii) impose higher capital requirements on risky activities, in particular on those that do not directly contribute to lending to the real economy, (iii) limit payouts if they endanger a sufficient level of capitalization in the financial sector, (iv) use structural policies that reduce incentives for risk-taking, and (v) force recapitalizations when necessary, even if they impose private costs on bankers.

A Pareto-improvement could only be achieved if deregulation was coupled with measures that increase risk-sharing between bankers and the rest of the economy so that the upside of risk-taking also benefits workers. Even if formal risk markets for this are absent, redistributive policies such as higher taxes on financial sector profits that are used to strengthen the social safety net for the rest of the economy would constitute such a mechanism.

Literature: This paper is related to a growing literature on the effects of financial imperfections in macroeconomics (see e.g. Gertler and Kiyotaki, 2010, for an overview). Most of this literature describes how binding financial constraints may amplify and propagate shocks (see e.g. Bernanke and Gertler, 1989; Kiyotaki and Moore, 1997) and lead to significant macroeconomic fluctuations that affect output, employment and interest rates (see e.g. Gertler and Karadi, 2011). The main contribution of our paper is to focus on the redistributive effects of such fluctuations.

Our paper is also related to a growing literature on financial regulation (see e.g. Freixas and Rochet, 2008, for a comprehensive review), but puts the distributive implications of such financial policies center stage. One recent strand of this literature argues that financial regulation should be designed to internalize pecuniary externalities in the presence

[1] Our findings are consistent with the experience of a large number of countries in recent decades: deregulation allowed for record profits in the financial sector, which benefited largely the financial elite (see e.g. Philippon and Reshef, 2013). Simultaneously, most countries also experienced a decline in their labor share (Karabarbounis and Neiman, 2014). When crisis struck, e.g. during the financial crisis of 2008/2009, economies experienced a sharp decline in financial intermediation and real capital investment, with substantial negative externalities on workers and the rest of the economy. Such occasionally binding financial constraints are generally viewed as the main driving force behind financial crises in the quantitative macro literature (see e.g. Korinek and Mendoza, 2014).