NEW ECONOMICS OF REGULATION: FINANCIAL STABILITY AS A SOCIAL DILEMMA
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Abstract

The dilemma: Controlling the evolution of individual strategies with high potential for systemic risk without unduly impeding market dynamism is a very complex task. This is an exploratory essay on financial regulation and stability that draws upon the basic issues studied within Public choice and Social choice in Economics. In the tradition of mechanism design approach it is Myers, this article comes within the scope of the New Economics of Regulation (Laffont, 1994) and seeks to implement the principal-agent methodology in the analysis of the relationship between public/private regulatory arrangements in order to identify the conditions for an optimal regulation.

Keywords: Collective action, cooperative games, financial regulation, mechanism design, public good

JEL Classification Codes: C70, D82, H18, H44

Introduction

Compared with the literature developed on this issue, this article offers an alternative perspective to financial regulation. It assumes that systemic financial stability is a public good to be governed by appropriate mechanisms and cannot only rest on market self-regulation because of the specific characteristics of monetary and financial operations and dynamics that lead to a crucial distinction between “market” (i.e. producing/consuming tomatoes, software or holidays) and financial activities. Financial regulation is of systemic importance since the smooth functioning of markets requires a continuous and sustainable provision of financial activities, and thus financial stability at the macro-level. From self-regulation to state regulation, different regulatory models could be outlined; however, in the light of the 2007-2008 financial turmoil, composite micro-macro-based regulatory models may have a political and ideological attraction for policy-makers and private institutions. I borrow from the analysis of Ostrom (1998) on the commons and collective action through polycentric governance to develop a framework under the conditions under which an optimal regulatory model might be designed and implemented in a smooth and flexible way to meet the dilemma.

Two constraints must be considered in order to assess the relevance and the feasibility of the preferred regulation model. First, the model must be compatible with a minimum level of decentralized individual action. Second, regulatory arrangements for systemic financial stability should seek at supporting market activities. Second, regulation must be designed according to an ultimate macro objective, financial system’s stability.

1. Regulation

1.1. Industry-interest related regulation

“As a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit” (Stigler, 1975: 135)

1.2. Regulation as a market-permit

Regulation supplies to society “a structure of beliefs that make prosperity possible (…) Regulation (...) in some sense creates the very possibility of marketplaces” (Carpenter, 2009: 164).

1.3. Regulation as a system of constraints for the common good

As a set of restrictions/constaints imposed over individual/market activities through a binding set of rules, usually implemented by the public power to influence business or social behavior, regulation aims at preventing actions that might harm society or to facilitate/encourage/invite actions to enhance society’s welfare (Baldwin et al. 2012).

1.4. Regulation as mechanism design

“Regulation (…) is defined as a ‘system of goals, specifications, and enforcement mechanisms’” (Myerson, 1988: 283). In a sense, regulation is the principal-agent relationship between the state as principal that seeks to influence the behavior of the firm. A specific conceptual tool to be used in such an analysis is the concept of incentive efficiency (Myerson, 2008) that leads to the design of incentive-compatible regulatory mechanisms.

The study of financial regulation as a mechanism design issue may then be conducted through public choice and the like literature if financial stability is regarded as a public good. Therefore, the question is not whether financial regulation is necessary or not (financial regulation is mandatory through market mechanisms (the so-called self-regulation) or through tight public supervision (constrained regulation)). It is rather related to the type of regulatory framework to be set up between an inter-market independent public regulator and private market players, the regulators (banks, financial institutions, etc.), in order to ensure social coherence.

2. Regulatory design: Cheap talk or mediation

The design and implementation of particular supervision and intervention procedures are related to the choice of a peculiar organizational mode for which “the same equilibrium corresponds as good as possible if one takes into account the constraints imposed by the diversity of information and the interests amongst the members of the organization” (Rahnét, 1985: 7).

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