PROPOSAL: PROBLEMS OF THE FINANCIAL SYSTEM: SYMPTOMS, CAUSES AND POLICY APPROACHES.

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Development and adoption of computer and communications technology during the past half-a-century shifted the costs of rendering financial services from variable towards fixed, and pushed this industry towards being a natural monopoly. Unlike classical economies, economies prone to monopolistic pressures do not generate aggregate efficiency from individual rationality. In equilibrium, risk, as the possibility of harm or loss, is necessarily related to expected return; but no such relationship has been identified between return and risk defined as the dispersion of outcomes of an investment. Popularity of the dispersion measure of risk, combined with the presumed ability of “complete” markets to efficiently allocate such risk, has underpinned a mistaken belief in the positive welfare consequences of more complex and numerous security markets that have arisen from cheaper trading technology and pursuit of rents. Rent-driven growth of the size, profits, and wages in financial services has often been mistaken for welfare gains. Removal of frictions in cross-border capital flows has also generated global volatility, risk of market malfunctions, and growth of giant firms. Monopolistic forces in financial services call for state regulation, but the political economy and moral hazard do not permit effective regulation of giant firms by political/bureaucratic structures who depend on the former’s crumbs. For a democratic polity to subject financial services industry to effective and efficient controls requires starting from a clean slate of simplest banks given the guaranties of public exchequer.