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Aspects of Monetary and Banking Theory and Moral Hazard: Discussion

Author(s): D. D. Hester

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irrelevant for the determination of the monetary aggregates? In general, developing a dynamic counterpart to the S-S model would appear a worthwhile (albeit difficult) undertaking.

4. As Bryant, Frankel and Mussa, Henderson, and others, have argued in recent years, the closed-economy paradigm usually adopted by monetary economists contains a variety of pitfalls. Among other things, this literature on making monetary policy in an open economy implies that the multipliers linking policy instruments and the monetary aggregates are sensitive to interest rate differentials and the associated degree of substitutability between domestic and foreign assets.

5. Recent work by Barnett (and others) suggests that simply adding up various types of financial claims into monetary aggregates violates standard postulates of aggregation theory. His work on divisia indexes is especially relevant to a general equilibrium system describing the determination of the higher-order aggregates (M2, M3, and L).

6. Research surrounding the multiplier approach is most often motivated by various questions surrounding central bank attempts to control monetary aggregates. A large body of empirical work bearing on the appropriate procedures to be used and the degree of precision to be expected now exists. Within the S-S formulation, the a_i and k_i are the key parameters. How might these parameters be estimated and can these estimates improve on the Federal Reserve's monthly and quarterly "structural" models of the financial sector, and on existing empirical work on the multiplier by Johannes and Rasche, Balbach and others?

The Federal Reserve's penchant for setting multiple monetary aggregates targets and the associated uncertainties concerning the definition, measurement and determination of the various aggregates, have generated a pressing need for the type of research produced by S-S. The disorientation which often seems to prevail in both the literature and policymaking circles results in part from the failure to take adequate account of the relevant interdependencies within the financial system. By balancing generality with tractability, S-S have produced a synthesis which has the potential for clarifying and handling a number of the key issues in monetary theory and policy.

DISCUSSION

D. D. HESTER*: Sudipto Bhattacharya has presented several very interesting and elegant observations about monetary and banking theory. They are drawn from two examples which like ships passing on a foggy night are similar only in that they are watertight and have sufficient bouyancy (attractiveness) to stay afloat. Such seascapes are not my forte. I therefore intend to focus on each of the vessels and to say little about the overall scene. I do approve of Professor Bhattacharya's goal of attempting to integrate information-based models of investment and intermediation with theories of fiat money, but that port seems very far over the horizon.

* Professor of Economics, University of Wisconsin-Madison.

Consider the first ship. Fiat money is provided by governments for the convenience of individuals and firms who transact with one another and to finance government deficits. He is not interested in financing deficits in this paper. Transactions occur in institutional settings that differ, for example, in terms of whether or not negative cash balances, uncertainty, and representation of the interests of unborn generations are allowed. As Bhattacharya suggests the existence of fiat money helps transactors avoid some pitfalls that would otherwise obtain because of asymmetries and of incomplete information. His argument that monetary equilibrium has a tax interpretation reflects the fact that in imperfect markets the existence of fiat money improves allocations of goods. (I prefer to think of improved allocation as resulting from a government service that flows from the asset, fiat money).

A contribution of Bhattacharya's paper is to advance our understanding of the conditions under which such improved allocation will obtain. He focuses on a stochastic overlapping generations model in which there is a fixed nominal stock of fiat money and all individuals have identical time invariant utility functions. The stochastic element is productivity. An analogy is drawn between an economic planner and the monetary authority. If the economic planner can observe payoffs but not differences in firm productivity, the economy will be inefficient in that too little investment will occur. In an overlapping generations framework, a passive fixed fiat money stock will be similarly inefficient. However, an interventionist monetary policy exists that improves upon the fixed fiat money policy; it implies that the money stock should increase when the previous generation's productivity was high. Except in pathological situations, the results of the activist policy fall short of those that would occur if there were full information and an exhaustive set of lump sum taxes and transfers. I think this is an intuitively appealing and useful result.

The second ship bears a cargo labeled optimal regulation in a model of insured intermediaries. In a world where information is incomplete and moral hazard exists, Bhattacharya argues that efficiency requires that interest rates be subject to discretionary control. He claims but does not demonstrate that his argument applies whether or not deposit insurance exists.

His analysis considers two rationalizations for the existence of intermediaries: 1) savings on duplicated monitoring that may be realized when many investors must repetitiously evaluate (or monitor) the same set of investment projects and 2) diversification which reduces the necessity of surveillance or, at least, the variance of losses that will be experienced through incomplete monitoring. He observes that the optimal degree of intermediation may correspond with a very small number of firms who could in turn behave monopolistically. He proposes an ingenious rationalization for deposit insurance, by suggesting that it permits intermediation scale economies without inflicting the adverse effects of grossly uncompetitive markets.

At this point the story begins to get interesting and intricate. He assumes that a distribution of asset returns exists for an intermediary which is incompletely perceived by the insurer, that preferences are risk neutral, that there is a simple liquidation rule which the insurer enforces, that there are zero liquidation and bankruptcy costs, that there are no default risks in the second of two admissible

decision periods, and that the distribution of asset returns has bounded support. Then, depending upon the parameters of the probability distribution, the rate of return which other intermediaries can earn, and the rate of interest the intermediary promises to pay, he shows that the intermediary will not necessarily choose a portfolio that maximizes expected profits. However, an enlightened insurer could impose a deposit rate ceiling which will insure that the intermediary will hold an efficient portfolio. Bhattacharya proposes to eliminate monopoly rents by auctioning bank charters, but he is more than a bit vague about the number of charters which should be auctioned—especially in light of the extraordinary number of assumptions that have already been made.

I would like to congratulate him on presenting a very stimulating excursion, but urge him in the future to avoid excessive diversification. Most passengers will feel more comfortable traveling in a single bottom, even if the captain has all his eggs in one basket. Each of his vessels could weather quite heavy seas if he would secure his cargo with more formal reasoning and thoroughly work out the details.

DISCUSSION

D. E. LINDSEY*: Paul's paper deals with vital issues of structural disequilibrium in the financial sector and the paper contains many insightful observations. Moreover, I find myself in agreement with his main conclusions that even after the transitional adjustments to the provisions of the Act are complete, remaining structural pressures build into the control system will still reflect a continued disequilibrium state and will induce further structural change. Ironically, however, I cannot agree with the reasons he advances for this conclusion. His summary paragraph contends that the success of the Monetary Control Act "in achieving its objectives is endangered by the inclusion of nonpersonal time deposits in the reserve base control network, by the permission to pay interest on checking accounts, and by the omission of restrictions on checking accounts at institutions not covered by the control provisions of the Act." I would like to consider each of these last three points in turn.

Concerning the inclusion of nonpersonal time deposits among reservable liabilities, I do not see why Paul uses the phrase "built-in self destruct mechanism for the monetary control objectives of the Act." To be sure, control over M1 would be simplified if their required reserve ratio were zero, which the Board has the discretion to do legally. But even with a positive ratio, if reserve requirements on nonpersonal time deposits were accounted for on a lagged basis, as under the Board's current proposal for CRR on transactions accounts only, then required reserves against them would be known with certainty. Reserve targets could thus be adjusted dollar for dollar for movements in required reserves on nonpersonal time to eliminate any effect of changes in these deposits on reserves available to support transactions deposits. In general, I was puzzled by Paul's assumption of fixed total reserves in carrying out his analysis of the impact of various reservable liabilities.

I was also puzzled over why making nonpersonal time deposits reservable made them a better substitute for transaction deposits than nonreservable deposits, like

* Board of Governors, Federal Reserve System.