

Discussion

The Political Economy of Prudential Regulation

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This paper

- ▶ Motivation
 - ▶ Large body of *normative* work on financial regulation
 - ▶ Pecuniary externalities \Rightarrow constrained inefficiency \Rightarrow prudential regulation
 - ▶ Normative work assumes welfare objective (prescriptive)
 - ▶ Which regulatory policies will individuals actually support?
 - ▶ *Political Economy* (descriptive)
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- ▶ This paper: **voting model**
 1. Canonical pecuniary externalities framework (overborrowing)
 2. Regulatory policies (debt limit) chosen by voting

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▶ **Key insights**

1. Policy implemented depends on voter responsiveness
2. Increase in inequality relaxes regulation iff high-income borrowers are more responsive
3. Exempt borrowers favor tighter borrowing limits

Outline of Discussion

1. Model with remarks
 - ▶ Equilibrium
 - ▶ Constrained efficiency
 - ▶ Political process \Rightarrow **Main results**
2. Comments/Thoughts

Model

- ▶ Three dates: $t \in \{0, 1, 2\}$
- ▶ **Borrowers**
 - ▶ Utility

$$u^B(c) = \log(c_0^B) + \log(c_1^B) + c_2^B$$

- ▶ Budget constraints

$$c_0^B \leq d_0^B$$

$$c_1^B \leq d_1^B + y_1^B + p(k_1^B - k_2^B) - d_0^B$$

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- ▶ Borrowing/collateral constraint

$$d_1^B \leq \phi p k_2^B$$

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- ▶ **Lenders** are passive

- ▶ Large endowments, no default, always indifferent

$$u^L(c) = c_0^L + c_1^L + c_2^L$$

Remarks + Equilibrium

1. Perfect foresight \Rightarrow no uncertainty
2. Borrowers must borrow to consume at date 0 \Rightarrow smoothing
3. No capital investment \Rightarrow focus on over-borrowing
 - ▶ Over-investment often discussed too
4. Lenders never hold capital
 - ▶ Fire sale from borrowers to other borrowers
 - ▶ Somewhat unconventional: natural holders assumption?

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- ▶ Equilibrium
- ▶ Borrowers borrow at 0 and 1
 - ▶ Borrowing constraint binds at 1
 - ▶ Poor borrowers sell capital to rich borrowers
 - ▶ $p(\cdot)$ endogenous \Rightarrow "Fire sale"

Constrained Inefficiency

- ▶ Constrained inefficiency: planner's FOC $\frac{dW}{dd_0} = 0$

$$\lambda_0^B - \lambda_1^B + \underbrace{\frac{\partial p}{\partial D_0}}_{<0} \frac{1}{\sum_{b \in \mathbb{B}} \theta^b \chi^b} \sum_{b \in \mathbb{B}} \theta^b \chi^b \underbrace{\left[\phi \kappa_1^B K_2^b + \lambda_1^B (K_1^b - K_2^b) \right]}_{\text{Externality}} = 0$$

- ▶ Pecuniary externalities (terminology from Davila/Korinek 18)
 1. Collateral externalities \Rightarrow over-borrowing
 2. Distributive externalities \Rightarrow over- or under-borrowing
 - ▶ differences in valuations
 - ▶ net buying/selling positions
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 - ▶ differences in valuations
 - ▶ net buying/selling positions
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- ▶ Under some conditions \Rightarrow **overborrowing at 0**
 - ▶ Debt cap is optimal
 - ▶ Exact cap depends on χ^b (welfare weights)

Political process: Description

- ▶ Probabilistic voting game
- ▶ Two politicians $\{A, Z\} \Rightarrow$ choose debt limits \bar{d}_A and \bar{d}_Z

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- ▶ Biases (idiosyncratic and aggregate)
 - ▶ Smoothness
 - ▶ ψ^v is responsiveness to policy

$$b^{i,v} \sim U \left[-\frac{1}{\psi^v}; \frac{1}{\psi^v} \right] \quad \text{and} \quad b \sim U \left[-\frac{1}{\Psi}; \frac{1}{\Psi} \right]$$

Political process: Equilibrium

- ▶ Symmetric equilibrium $\Rightarrow \bar{d}$
- ▶ Optimal choice

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 2. Equilibrium debt limit increasing in $\gamma^r = \frac{\psi^r}{\psi^p}$ (relative responsiveness of rich borrowers)
 - ▶ Why? Distributive externality
 - ▶ Rich borrowers are buyers of capital \Rightarrow they are worse off with high prices \Rightarrow prefer laxer borrowing limits (large fire sales)

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- ▶ More results on imperfect enforcement with connected/unregulated borrowers
 - ▶ Unregulated borrowers prefer tighter regulation

Comments/Thoughts

1. **Political economy (PE) + financial regulation \Rightarrow testable predictions**
 - ▶ Very little work on these issues
 - ▶ Very nice to consider PE in the context of prudential regulation based on pecuniary externalities
 - ▶ Political Economy is a positive field
 - ▶ It delivers testable predictions

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 - ▶ Can we explain the regulations that we observe as an outcome of a voting/decision-making process?
 - ▶ Can we explain deregulation waves in the 90's, early 00's? Connection to Fault Lines, Rajan 2011?
 - ▶ Can we explain post 08/09 crisis regulatory push? Dodd-Frank, CFPB, OFR, etc. (with rising inequality)

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 - ▶ In this paper, rich borrowers like deregulation because they can buy cheap capital during fire sales

2. General conclusions with more general primitives

- ▶ Can we consider general income patterns?
- ▶ What is the role of persistent versus temporary income shocks
 - ▶ Role of wealth?
- ▶ Are there general connections between, let's say, inequality and regulation? Or policy connections and regulation?

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3. How is responsiveness ψ actually determined?

- ▶ This paper: welfare weights \Rightarrow policy responsiveness
 - ▶ Both χ and ψ are exogenous
- ▶ Is there a way to further endogenize the responsiveness to policies?
- ▶ Is the move from welfare weights to responsiveness sufficient?
 - ▶ Some of the main results are also true with welfare weights

Comments/Thoughts

4. Role of **transfers**

- ▶ What if a planner/politician can implement transfers?

5. More broadly: **richer models of policy formation**

- ▶ Voting is a natural first step
 - ▶ And there alternative voting models
- ▶ But regulatory policies are often not voted
- ▶ Alternative setups
 - ▶ Regulatory discretion
 - ▶ Delegation
- ▶ More to be done here