

Doubling Down on Failure: Subsidizing More One Way Bets?

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Bagehot for our Time

New Rules for the Fed:

- Liquidity, not Solvency
- Markets, not Institutions
- Outside spread, not Inside spread
- Core, not periphery

Obstacles:

- Conventional Economic Theory
 - Banks as intermediaries—solvency/institutions not liquidity/markets, Basle III
 - Triple coincidence assumption—versus financial globalization
- Political Economy
 - Externalities frame, vs Inherent public/private hybridity (par)
 - Westphalian frame, vs Inherent money/credit hierarchy (FX)
 - Money veil frame, vs Infrastructure of market economy

Tiering as hierarchy

- Private and Public
 - Bond markets price liquidity not just risk premia
 - Central bank collateral frameworks privilege core
- Shock absorber differentiation
 - Elasticity (credit) at top vs. Discipline (price) at bottom
 - International dimension: Core vs. periphery
- Moral Hazard therefore **a particular problem of the top/core**
 - Mutual reinforcement and the doom loop
 - Public/Private Hybridity (Haldane)
 - Liquidity and Solvency

Post-GFC Financial Infrastructure

- Funding now “termed out”
 - But expanded derivative hedging, CCP risk concentration
- Interbank money markets now “secured”
 - But negative basis swap, dealer profit
- EME debt bubble: financial deepening, ex-US shadow banking
- Dealer of first resort capacity constraints
 - Pricing liquidity or barriers to entry
- Dealer of last resort capacity limitations
 - Core C6 liquidity swaps
 - Periphery Reserve Pooling, bi-lateral swaps

State of Present Play

- Stabilization policy in the core, source of moral hazard
 - QE as shadow banking, but with assets deliberately **mispriced**
 - Forward guidance as a profit guarantee for dealers, liquidity risk **mispriced**
 - NIRP as delay of day of reckoning, survival constraint **mispriced**
- The challenge of “exit”: war finance to peace finance
 - Reconstituting dealer of first resort, matched book vs. proprietary trading
 - Negotiating national hybridity, separation and moral hazard
 - Negotiating global hierarchy, elasticity and discipline