What reforms does the U.S. financial system need?

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Our financial reform framework is too narrow

I will make two points regarding financial system reform, one **cyclical** and the other **secular**

1. Macro-prudential policies aimed at taming the business cycle should not be solely targeted at protecting the financial system. The real economy tradeoff to keep in mind is **risk-sharing**

2. Long-run imbalance is dangerous for the financial sector and the real economy. In particular, intermediating persistent **savings glut** through the financial sector can lead to debt traps and stagnation

The bottom line is, we are all connected. The economy is an ecosystem and financial sector regulation must take the entirety of the ecosystem into consideration.
The crux of macro-prudential is typically around “protecting the financial sector”, e.g. Basel rules such as risk-weighing of capital, liquidity provision by central banks, fiscal support etc.

Yes, preventing the financial system from imploding is important. We have clearly learnt that through history.

But this objective cannot be the only criteria. An important new insight post-2008 is that financial system must be designed to promote risk-sharing

Many examples of a failure of this principle resulting in high-costs: Ireland, Greece, households in the United States etc.
Natural experiments regarding risk-sharing
Reduction in mortgage payments comes with *consumption response* and *deleveraging*. This effect is persistent:

![Graphs showing mortgage payments, mortgage payments to initial mortgage payment ratio, new car spending, and voluntary mortgage repayment.](image-url)
Natural experiments regarding risk-sharing
Non-tradable employment
However, our capital regulation (e.g. risk weights), tax laws (e.g. interest deduction) and broader bankruptcy laws often ignore the risk-sharing principle.

More generally, we do not have policies that promote risk-sharing such as shared responsibility mortgages.
Financial system in the long-run

We are all connected and inter-dependent

One person’s spending is another person’s earning – Supply equals Demand

Just like an ecosystem, a healthy economy requires balance

In nature, self-regulating process of homeostasis guarantees the balance needed for survival

An economy also needs homeostasis for survival. But that depends on the institutions it builds and the rules of the game it defines

Will our system maintain balance, or tip-over?
Large increase in share of income going to top 1%
Rise in saving coming from the top 1%

Scaled by national income (relative to 78-82)

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Where does the saving glut of the rich go?
Where does the saving glut of the rich go?

- Top 1% Saving Glut
- F

[Bar chart showing the comparison between Top 1% Saving Glut and F.]
Where does the saving glut of the rich go?
Where does the saving glut of the rich go?

- Top 1% Saving Glut
- Bottom 99% Saving

F

1

Bar chart showing the saving glut of different income groups.
Where does the saving glut of the rich go?

- **Top 1% Saving Glut**
- **F**
- **1**
- **Bottom 99% Saving**
- **Government Borrowing**
- **ε**

The graph shows the distribution of saving glut among different income groups, with the top 1% saving a significant amount, while the bottom 99% and government borrowing have a smaller impact.
The macroeconomic consequences of “indebted demand”

[Graph showing the relationship between Total credit to GDP and 10-year real rate from 1980 to 2020]
Can this Economy keep its balance?

Top 1%

Next 9%

P51-90

Bottom 50%
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