

Dissertation Abstract:

Financial Regulation, Financial Derivatives, and the Effectiveness of Different Regimes of Risk Management in the United States

My dissertation proposes an analysis and assessment of the two regimes of financial risk management in the United States since the 1950s: one based on financial regulation and government controls, from 1950 to 1972, and another based on financial derivatives, from 1972 to the present. It compares the two regimes and discusses the means to assess the relative effectiveness of each regime, emphasizing some characteristics of the financial regulatory regime that cannot be replicated under financial derivatives. These features are the public good nature of financial regulation, the reduced volatility in regulated financial markets and the consequent mitigation of speculative incentives, the reduced potential for systemic instability, and the reduced scope for creating additional risks. Financial derivatives, on the other hand, possess all the opposite complexions: private contracts create room for residual volatility for firms exposed to financial risks and not hedged, the increased leverage provided by derivatives enhances speculation and the potential of systemic disruptions, and financial derivatives tend to create additional, after-hedge risks such as credit default risk. In order to test the proposition that financial derivatives are relatively less effective than financial regulation, the liquidity preference of nonfinancial firms, assumed to be the natural hedge mechanism in capitalist economies, is considered. At the aggregate level, it is shown that nonfinancial corporations have been accumulating more liquid assets since the beginning of the eighties, in contrast to the declining liquidity preference under the regulatory regime. And at the firm level, for a sub-period within the second regime of financial risk management, the liquidity preference of firms using financial derivatives is compared to that of firms not using. The evidence here suggests that the difference between users and non-users is economically insignificant, implying that financial derivatives do not substantially reduce the necessity of holding liquid assets. These results seem to indicate that financial derivatives are relatively less effective in hedging financial risks, making the case for financial regulation.