General Discussion*

The discussion in this session can be divided into two parts. The first part was concerned with what a policy-maker could extract from Gale's model. For instance, John Murray wondered whether Gale was suggesting that policy-makers were incorrect in substituting reserve requirements with various capital controls in the early 1990s. Claudio Borio asked Gale what role the central bank should have in his model.

Gale responded that his model did not provide a clear insight as to the best course of action for policy. In some cases, capital controls worked better than liquidity buffers, and vice versa. Either way, policy usually evolved as a result of trial and error and in an ad hoc fashion; Basel I is an example. Gale said that there was no solid argument for using capital controls over other forms of intervention. Gale felt that the central bank could act as a substitute for certain missing mar-kets, much as credit derivatives serve as a proxy at the present time.

The second part of the discussion was related to Gale's modelling choices. Many felt that he was missing the mark by not properly accounting for the form of market failure that makes capital requirements necessary. Charles Freedman wondered if considering the bank as a delegated monitor that needs to be supervised might better explain a rationale for capital. Kevin Clinton asked whether capital controls were necessarily meant to deal with liquidity risk (as in Gale's model) or more likely to deal with bank incentives towards excessive credit risk. Walter Engert argued that capital

* Prepared by Greg Caldwell.

requirements exist to manage moral hazard resulting from deposit insurance, and that this could justify the need for capital controls.

Gale thought that private markets better allow the government to dictate a proper level of capital. Problems of credit risk and managing moral hazard are indeed by-products of deposit insurance, but not the sole reasons for capital controls. Gale felt that two wrongs did not make a right. While capital requirements could prove useful, he noted that there was no a priori evidence that they were superior to other solutions. He said that, if anything, prudential supervision created additional political moral hazard by introducing forbearance among regulators seeking the "quiet life."

At the close of the discussion, several participants agreed that John Kuszczak would have very much appreciated this work. Walter Engert said that "John had a strong predisposition towards the markets and keeping government out." On behalf of conference organizers, he extended thanks to John Kuszczak's wife, Sheila MacDonald, for attending the memorial lecture.