By Bob Davis

Princeton economist Hyun Song Shin made his reputation studying asset bubbles. Now he's become a top adviser to Korea’s president where his job is to figure out how to head off financial debacles.

Mr. Shin’s policy recommendations have global reach because Korea this year chairs the Group-of-20 industrialized and developing nations. The G-20 is trying to remake global financial regulation by the end of the year, a month after Korea hosts a G-20 leaders summit in November.

In a policy memo he prepared for Korea, he praised a bank tax proposed by President Barack Obama as a model for developing countries. His thinking was incorporated into an International Monetary Fund proposal for bank taxes, which is now being debated by G-20 finance ministers who are meeting in Washington.

The Obama team proposed a tax of 0.15% on nondeposit liabilities of financial institutions in the U.S. A big rise in noncore liabilities — commercial paper, repos, securitized notes among other things — is a big warning signal, Mr. Shin argues, that banks are getting overleveraged, and moving into a financial danger zone. The tax would limit that build-up.

“The proportion of noncore liabilities of banks serves as a useful indicator of the stage of the financial cycle and the degree of vulnerability of the banking system to a downturn of the financial cycle,” Mr. Shin wrote in his policy memo. “The larger is the proportion of non-core liabilities, the greater is the boom, and hence the greater is the vulnerability to a setback.

Taxing such liabilities, he says, is likely to keep banks more in check.

Such a tax would be especially useful in emerging markets like Korea, he argued, which live in fear of huge capital inflows followed by sudden outflows, especially in the banking sector.
"A tax on noncore liabilities can serve as a corrective tax," he wrote. "During a boom, the tax on noncore liabilities makes the noncore funding more expensive, and hence can dampen the boom in the upswing caused by the underpricing of risk," he writes.

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