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Did regulations cause current crisis?

Some economists contend government intrusion into capitalism, and not capitalism, is to blame for the financial mess

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THE intellectual starting point for much of the conventional wisdom regarding the origins of the current financial crisis is that it was brought about by capitalism gone wrong and that it combined with the failure of the US government to prevent it through effective regulation of the financial system.

Not surprisingly, most of the policy prescriptions advanced by economic pundits and embraced by lawmakers and officials have called on the government to take forceful steps to discipline the free and wild market system that is supposedly responsible for the mess we are in.

But a contrarian view that points to the government and its regulatory agencies as prime agents of this economic mess has been promoted by free market-oriented research institutions and magazines.

That is the theme of several articles by economists in the new issue of Critical Review (published by Routledge) as well as in a new Policy Report by the Cato Institute, a Washington-based think tank, that analysed the causes of the crisis.

As suggested by the title for an introductory article written by the Critical Review editor Jeffrey Friedman, a fellow of the Institute for the Advancement of Social Science at Boston University, what we have been confronting was 'a crisis of politics, not economics'.

Mr Friedman and other contributors set out to demonstrate that it is not capitalism which has failed - but rather government intrusion into capitalism.

Similarly, Mark Calabria, the director of Financial Regulation Studies at the Cato Institute, challenges in the Policy Report the current narrative in Washington that 'a decades-long unravelling of the regulatory system allowed and encouraged Wall Street to excess, resulting in the current financial crisis'.

Left unchallenged, this narrative will likely form the basis of financial reform measures, he warns, stressing that 'having such measures built on a flawed foundation will only ensure that future financial crises are more frequent and severe'.

The financial crisis was caused by 'the complex, constantly growing web of regulations designed to constrain and redirect modern capitalism', Mr Friedman writes in Critical Review. This complexity made investors, bankers and even regulators themselves ignorant of regulations previously promulgated across decades and which interacted with each other to foster the issuance and securitisation of sub-prime mortgages; their rating as AA or AAA; and their concentration on and off the balance sheets of many commercial and investment banks.

It was impossible 'to predict the disastrous outcome of these interacting regulations', he argues.

In another article, economics professor John Taylor of Stanford University contends that the financial crisis 'was in large part caused, prolonged, and worsened by a series of government actions and interventions'.

The housing boom and bust that precipitated the crisis were facilitated by extremely loose monetary policy. After the housing boom came to an end, the Federal Reserve misdiagnosed financial markets' uncertainty about the location and value of risky sub-prime mortgage-backed securities as being,

instead, a liquidity problem, and 'it took inappropriate compensatory actions that had side effects that included raising the price of oil'.

And finally, in mid-September 2008, the government's ad hoc bailouts, and the unpredictable terms of the proposed TARP (Troubled Assets Relief Program) legislation, appear to have caused a sharp spike in uncertainty in the financial markets, Prof Taylor explains.

The contributors to the Cato Institute's Policy Report argue that contrary to the widely held belief that our financial market regulations were 'rolled back', the past few decades have witnessed a significant expansion in the number of financial regulators and regulations.

In a study conducted by the Mercatus Center at George Mason University in Virginia, Veronique de Rugy and Melinda Warren found that outlays for banking and financial regulation increased from only US$190 million in 1960 to US$1.9 billion in 2000 and to more than US$2.3 billion in 2008.

Focusing specifically on the Securities and Exchange Commission, the agency at the centre of Wall Street regulation, budget outlays under president George W Bush increased in real terms by more than 76 per cent, from US$357 million to US$629 million.

At the same time, Mr Calabria disputes the claim that deregulation, and in particular the Gramm-Leach-Bliley Act, the core of which was the repeal of the New Deal-era Glass-Steagall Act's prohibition on the mixing of investment and commercial banking, caused the crisis by clearing the way for investment and commercial banks to merge, and thus giving investment banks the incentive to take greater risks, while reducing the amount of equity they are required to hold against any given dollar of assets.

But Mr Calabria notes that even before the passage of the Act, investment banks were already allowed to trade and hold the very financial assets at the centre of the financial crisis, such as mortgage-backed securities, derivatives, credit-default swaps and collateralised debt obligations.

And secondly, very few financial holding companies decided to combine investment and commercial banking activities. The two investment banks whose failures have come to symbolise the financial crisis, Bear Stearns and Lehman Brothers, were not affiliated with any depository institutions.

In fact, as Mr Calabria suggests, 'had either Bear or Lehman possessed a large source of insured deposits, they would likely have survived their short-term liquidity problems'.

And he refers to an interview that former US president Bill Clinton had given to BusinessWeek in 2008, in which he contended that signing the Gramm-Leach-Bliley Act had nothing to do with the current crisis.

'Indeed, one of the things that has helped stabilise the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn't signed that bill,' Mr Clinton said.

According to Mr Friedman, the financial crisis demonstrated that market participants - very much like government regulators - tend of make cognitive rather than 'incentives-based' errors, challenging the case for government regulations and calling into question 'the feasibility of the century-old attempt to create a hybrid capitalism in which regulations are supposed to remedy economic problems as they arise'.

Indeed, as Mr Friedman concludes: What may have saved the world from complete economic chaos in 2008 was the fact that the regulations were loose enough that many investors and many bankers had resisted buying the 'safe' securities that most banks seem to have bought.

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