Alt-M
Ideas for an Alternative Monetary Future

Futures Unbound

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Futures Unbound, this year's Cato-CMFA Summit on Financial Regulation, took place in Chicago on June 6th. The event consisted of lectures from five speakers; Congressman Blaine Leutkemeyer, CMFA's Thaya Brook Knight and George Selgin, the Federal Reserve's Thomas Sullivan, and University of Chicago Law Professor Omri-Ben Shahar. Here, I supply synopses of these talks. Complete podcasts can be found here.

Congressman *Blaine Leutkemeyer* (R-Missouri) reported that every financial services professional he has recently spoken to, from large firm executives to community bankers, is complaining about the increasing onerousness of federal regulation. Although insurance is mostly regulated at the state level, Dodd-Frank dramatically increased the Federal government's role in insurance, transferring "a third of the insurance industry to federal supervision." Leutkemeyer also mentioned a notable Dodd-Frank statistic, that the percentage of checking accounts with free checking dropped from 75% to 35% since that law was enacted. He closed by calling attention to the FDIC/DOJ's Operation Choke Point, which he described as a "shadow regulatory system" that intimidates banks.

Negative reactions to financial speculation have a long history. Old Testament, New Testament, Roman, and other ancient and classical sources decry speculatory practices. Why does speculation have such a "bad rap?" *Thaya Brook Knight* compared a common view of speculators to the dog in the "dog in the manger" parable. Speculators do not produce mangers, but they do take hay away from wolves that actually need them. Even today, proclamations against speculation persist. Pope Francis recently blamed speculators for high food prices, and many commentators blamed the '07-'08 crisis on speculation.

Commodities and securities market regulation attempts to discourage speculation. In securities markets, speculation is regulated through the tax code. Long term investments are taxed at a higher rate than short term investments. In commodities markets, the law differentiates between legitimate hedging by producers and excessive speculation by investors. This election cycle, candidates and advocacy groups proposed reducing speculation via a financial transactions tax.

Knight showed that many of the commonly assumed negative characteristics of speculation are actually beneficial. Speculation stabilizes prices, not only because of the well known ability for say, agricultural producers to hedge against seasonal fluctuations, but also because of the role speculation plays in price discovery. What about speculating during a commodity shortage? As the pejorative term "price gouging" demonstrates, betting on shortages is often thought of as a particularly immoral form of price destabilization. Knight counters that price gouging is an incentive for the production increases necessary for shortages to clear. What about in securities markets, does speculation disrupt the pricing mechanism by driving bubbles? Knight suggests we consider what equity markets would look like if all investors "bought and held," news about a company's health and development be damned. In general, traders' ability to react to information and change positions frequently leads to more accurate pricing.

George Selgin discussed clearinghouses' role in the pre-Fed American financial system, which came to include providing liquidity during panics. After the failure of the Ohio Life and Trust Insurance Company in 1857 led to a system wide suspension of specie payments in New York, the recently formed New York Clearing House issued temporary loan certificates to member banks for use in settling transactions. This emergency measure prevented a complete halt in the flow of payments and credit during the Panic of 1857. Financial turmoil only became more frequent after the Civil War due to the National Currency Act, which tied bank note issue to the quantity of government bonds a bank held as reserves. As in the 1857 case, the clearinghouse dealt with post-bellum panics by providing troubled banks with loan certificates. These certificates were a way for banks to extend credit to one another. Participating banks essentially stretched their collective reserves and dispersed risk throughout the system. Clearinghouses, as mere facilitators of credit between member banks, did not assume any centralized risk.

Selgin emphasized that clearinghouses did not provide emergency loan certificates to every troubled bank. Clearinghouses made sure that banks receiving the loans were solvent, and that banks using the certificates to meet obligations would be forced to eventually pay a high, "penalty" interest rate. Also, clearinghouses ensured that banks stayed open during crises, even if specie payments were suspended. This meant that disastrous complete closures of banks, like those that characterized the worst periods of the Great Depression, were avoided.

Selgin closed by noting the advantages of the 19th century's spontaneous and private clearinghouses relative to today's government imposed and run versions. In addition to the Fed, Dodd-Frank's mandated central clearinghouses for OTC derivatives will socialize risk and create moral hazard, removing an incentive for the private sector innovation that might actually improve payments and settlement in the derivatives market.

Omri Ben-Shahar investigated mandated disclosure in regulatory regimes. While his presentation covered American regulatory law in broad, disclosure has a particular importance to capital markets, where Louis Brandeis's idea that "sunlight is the best disinfectant" has underpinned regulation since the Securities Act of 1933. Asking "are we doomed to drown in disclosure?" Ben-Shahar points out disclosure's absurdities and questions whether mandated disclosure is ever necessary.

Some of the most egregious examples of the disclosure overload are on the Internet. By law, a website's terms and conditions and privacy policy must be disclosed to users. Ben-Shahar notes that not only are such notices rarely skimmed, from a practical standpoint it is essentially impossible for anyone to closely read them. An average Internet user would have to spend three months out of the year reading privacy notices to actually understand what each "I agree" click means.

Are the Internet's disclosures simply an outlier? What about nutrition product labels, or medical informed consent? Even if these disclosures seem more intuitively necessary, research shows we don't read these disclosures either, nor do they affect our behavior. Disclosure, therefore, should no longer be used as a de-facto regulatory solution to information asymmetry problems. Fans of disclosure, energized by Cass Sunstein's "nudge" ideas, think disclosure can affect behavior if done simpler and smarter. Ben-Shahar cautions against viewing simplification as a panacea. Simplified, nudge style disclosures, designed to be easily understood and to encourage a desired outcome, like nutrition labeling, often don't change behavior. Since mandatory nutrition labeling, for example, Americans eat less calories per meal but eat more meals, which comes out to a slight overall increase in calorie intake.

In close, Ben-Shahar warns that any future attempts by policymakers to mandate the disclosure of information would represent "the triumph of hope over experience."