BARRON'S

This Nobel Is No Prize

The economics committee's award to Jean Tirole honors a flawed view of financial regulation.

By Gene Epstein
October 18, 2014

The 2014 Nobel Prize in Economics was awarded last Monday to French economist Jean Tirole for what the committee referred to as "his analysis of market power and regulation." To understand why Tirole's win was not exactly a victory for economic thought, imagine a rough analogy.

Say Adam Smith and others had never shed light on the gains that result when one nation freely exchanges goods and services with another. Without a compelling theory of the benefits of free trade, we would no doubt assume that tariffs, duties, and subsidies to domestic exporters were just a case of government doing its job.

Then along comes an economist who determines just what kinds of tariffs, duties, and subsidies work optimally. With a nod to the efficacy of markets, he might even caution that government shouldn't always shield domestic industry from the pressure of global competition. Lacking a theory of free trade, we might award this dismal scientist a Nobel for his useful formulations.

Happily, we do have a theory of free trade that mainstream economists honor, even if the theory is often honored in the breach. Unhappily, since the mainstream lacks a theory of free banking, Jean Tirole can be given a Nobel for useful formulations that include the optimal regulation of finance.

The Nobel committee's paper duly acknowledges that regulation of financial markets isn't always warranted. But such nuances are brushed aside once the paper discusses his 1994 book, *The Prudential Regulation of Banks*. In that book, Tirole and his co-author "focused" on the implications of a special "problem." Since "many bank lenders, such as depositors, are too small and dispersed to exercise any control over the bank," the paper declares, "…the role of regulation is to represent the interests of these lenders, exercising control over banks and mitigating excessive risk-taking by bank managers."

Economist George Selgin, author of a 1988 book called *The Theory of Free Banking* that Tirole and the Nobel committee probably haven't read, has a very different view. "The book's premise that banks will be insufficiently monitored and disciplined by depositors," he remarks, "is flatly contradicted by history."

THE ONLY REASON DEPOSITORS in the U.S. have become indifferent to risk-taking by banks, Selgin explains, is that the federal government now insures individual deposits running in the millions of dollars. When deposit insurance was originally introduced, none other than Franklin D. Roosevelt opposed it, stating presciently in October 1932 that this insurance would "lead to laxity in bank management and carelessness on the part of both banker and depositor."

Prior to the introduction of deposit insurance, notes Selgin, banks did not fold due to a failure of discipline from depositors. “They generally failed,” he observes, “because legal restrictions limited their ability to diversify”—a case of too much regulation rather than too little.

“The other crucial premise of Tirole’s book,” adds Selgin, “is that government regulators can be trusted to guard against bank insolvency. But regulators are notoriously not the first, but the last to discern that a bank is on the road to failure, as was amply demonstrated in the lead-up to the 2008 crisis.”

George Selgin is director of the newly created Center for Monetary and Financial Alternatives at the Cato Institute, dedicated to promoting awareness of free-market banking. The Nobel committee might take notice.