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Regulation and Its Unintended Consequences

By **Johan Norberg**

Most bankers deserve the backlash they are experiencing right now. The absurd mistakes and sheer stupidity we have seen in the financial markets in the last decade are not what we were supposed to expect from the Masters of the Universe. And the cost of the bailouts gives a whole new meaning to the concept of "bank robber."

But bankers are not the only ones we should look at in a new light. Another casualty of the crisis should be belief in the powers and virtues of government regulators, because their fingerprints are all over the crime scene as well.

There are 39,000 individuals working full time to regulate the financial markets in the U.S. alone. What did they do when the bubble was inflated? Well, they helped inflate it.

In the 1970s and 1980s, we learned that regulation of product markets caused many problems. The public choice school taught us that when regulators have to choose between increasing their powers and budgets and what improves society, they often choose the latter. Even well-meaning regulation often produces unintended consequences that turn small problems into big ones.

But when the financial markets seemed to be doing reasonably well, that criticism never really had an impact on the world of finance.

What a difference a crisis makes! A detailed anatomy of the bubble shows that many of the policies and regulations meant to reduce financial risk actually increased it. The most obvious example is the government's policy of bailing out financial institutions to avoid crises, which made it more likely that they will engage in risky behavior. And the Fed's attempt to abolish recessions with drastic reductions of the interest rate it sets resulted in the biggest credit bubble in history, and one of the worst recessions.

But there are several other examples in this crisis. In the 1970s, the SEC gave the big rating agencies a regulatory role. They got the right to officially define risk, and other investors were forced to abide by them; many funds were not allowed to invest in anything that was not considered investment grade, and other institutions were forced to hold more capital if they did.

This oligopoly was granted in order to control risk. But the institutions used their new role to inflate the ratings, and dangerous mortgage-backed securities were suddenly considered risk-free. The deal would get the same generous treatment even if it was structured by cows, as an analyst at a big rating firm said in an internal discussion. Since the cows paid well, and the market was forced to follow the ratings anyway, why not?

The banks did not hold these securities in a transparent way, but in the opaque "shadow banking sector, " in an attempt to reduce risk. The smartest bank regulators in the industrialized world met for six years to produce the Basel agreements on capital requirements for banks. Their requirements made it expensive for banks to hold assets - like mortgage-backed securities - on their balance sheets, but very profitable to put them in non-transparent conduits or vehicles financed by short-term loans on the market.

So even if the best and the brightest introduce regulation because they think it is in mankind's best interest, there are unintended consequences. Indeed, bureaucracies and governmental authorities also have their own agendas and their own interests, and sometimes that trumps social welfare. One reason why financial regulators did not notice what was going on was that they were engaged in turf war. One former SEC commissioner admitted that his agency failed to develop open marketplaces for mortgage-backed securities because it was "distracted." The object of its time and resources: grabbing power from other government agencies by starting to regulate hedge funds and introduce new types of supervision of mutual funds.

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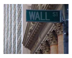
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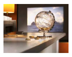
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We need to take another look at regulation. The world is a complex place, and often progress is made by trial and error. Introducing a standard means confining everybody to the present knowledge of the bureaucrats, and preventing individuals and businesses from adapting to new information as it is discovered. This cannot be avoided in every instance, but it is important to always evaluate it critically and to keep unregulated parts of the economy unregulated so that we don't put all of our eggs in one basket.

The unregulated hedge funds were still standing and supplied the economy with liquidity when everything else failed last September, partly because they were not subject to the same capital requirements as other sectors. If the attempts to regulate them now were to succeed, we would give all financial actors the same Achilles' heal. It might not be likely that this is the heel that will be hit the next time, but if it is, everybody falls at the same time.

Do not expect too much from new regulations. Tomorrow's crisis is often a result of the solution to the last crisis.

Norberg is a senior fellow at the Cato Institute and author of the new book Financial Fiasco: How America's Infatuation with Home Ownership and Easy Money Created the Economic Crisis.

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