This is a response to an Economist.com debate between John Berlau (CEI) and Paul Moore (University of Ulster) on financial regulation.

Freedom and Its Digital Discontents: A Comment

Mar 29th, 2008 | THOMAS A. FIREY

Let's revisit the proposition:

> **By intervening to regulate business and financial risks, governments have made things worse.**

Two questions immediately come to mind: What is meant by "regulate" and what is meant by "worse"?

Concerning "regulate," Paul Moore points out that even the most liberal markets require basic regulation — e.g., enforcement of contract, maintenance of order, prohibition of fraud, protection of property rights — in order to function. John Berlau, in his rebuttal, unreservedly accepts that notion. But what regulations beyond basic rule of law should be adopted? To date, none of the participants in this debate have offered proposals.

What is to be made of "worse"? Consider that some political activists have called for prohibitions or limits on "subprime" home loans. Would that be worse or better than the status quo? If the loans had been prohibited, that would have benefited the lenders and at least some of the borrowers of the nearly one million subprime U.S. loans that are now in default.[1] But what of the other five million subprime loans that are in good standing[2] — most of which have provided people with homes that they otherwise could not have purchased? Many of those homeowners (who are higher-risk and often lower-income) have experienced tremendous equity gains in the decade since the first warnings were issued on subprimes. If those loans had been prohibited, the five million homeowners would most certainly be worse off than they are today, as would be their lenders. Whose "better" should outweigh whose "worse"?

BANKING

There are other, similar vague terms in this discussion. Robert Pollin claims that U.S. banking regulation from the end of World War II to the mid-1970s "worked." To be sure, the U.S. economy — and by relation the banking sector — in the post-war era was stable and growing (ignoring the six recessions, oil crunch, and Vietnam War–induced inflation). But that growth seems the product not of banking regulation but of the United States emerging from World War II with its

[1] Mortgage Bankers Association, "National Delinquency Survey: Q4-2007" (March 2008).
[2] Mortgage Bankers Association, op. cit.

industries and resource supply chains largely intact while much of the rest of the world had to rebuild from ruins.

Let's consider just how well U.S. banking regulation "worked" in the post-war era:

Regulation Q capped interest rates on deposits at levels that, from the late 1960s to the early 1980s, were periodically below the rate of inflation.[3] Moreover, throughout the post-war era, costs to borrowers were much higher than they are today. Since the banking deregulations of 1980–1991, terms for both depositors and borrowers have improved greatly.

Federal regulations in the post-war era established one type of banking institution, the savings-and-loan (S&L), that was required to invest most of its deposits in home mortgages within 50 miles of the bank. As a result, S&Ls were highly vulnerable to local economic conditions. By 1980 after a decade of U.S. economic malaise, some two-thirds of S&Ls were on the brink of insolvency. [4] A Democratic Congress and President Carter scrambled to adopt the first banking deregulatory act in the hope of saving the S&Ls, but the institutions' subsequent "bet the bank" desperation investment in oil country real estate (encouraged by the protection of regulation-mandated deposit insurance) failed to pay off. The result was the S&L crisis and a massive taxpayer bailout.

Perhaps the most telling cautionary tale about financial regulation is the multiple waves of bank failures in the early years of the Great Depression.[5] I disagree with Prof. Pollin's claim that "the 1929 Wall Street crash…led to a collapse of the U.S. banking system." My reading of the literature indicates that the waves of bank failures were primarily the result of local economic crises — often droughts that crippled farming — followed by bank runs and contagion.[6] Banks were vulnerable to this dynamic because state regulations (banking has been heavily regulated in the United States from colonial times onward[7]) severely limited branching and diversification across assets and geography. Traditional banks, like S&Ls, were thus highly vulnerable to local economic conditions. Canadian banks, in contrast, were much less regulated and much more diversified; hence, Canada experienced practically no bank failures from the Great Contraction.

Returning to Prof. Pollin's claim that banking in the post-war era "worked," if you were a local banker protected by your state-granted market power, or a homebuilder confident that your local S&L was pumping mortgage loans into your area, or a state politician who could manipulate local banking to advance political goals, the regulations certainly "worked" well. If you were a depositor whose

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[3] Charles Calomiris, *U.S. Bank Deregulation in Historical Perspective* (Cambridge University Press, 2000).
[4] Lawrence White, *The S&L Debacle* (Oxford University Press, 1991).
[5] See Milton Friedman, Anna Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton University Press, 1971), Ch. 7: "The Great Contraction."
[6] See Gary Richardson, "Bank Distress during the Great Contraction, 1929 to 1933, New Evidence from the Archives of the Board of Governors" (August 2005).
[7] Calomiris, op. cit.

savings lost value while in the bank vault, or a small borrower facing high-cost loans, you probably felt differently.

ADDITIONAL REGULATION?

I worry that, in a similar fashion, new regulation of business and financial risk would be better than the status quo for some market actors and worse for others. Contrary to Walden Bello's assumption that there is some homogenous "public interest" that regulation can advance, the world and the market are filled with many different actors with many different interests, risk tolerances, and needs. Regulation cuts against that diversity, establishing specific, enduring market paradigms — until desperate times require desperate change, as with the insolvent S&Ls of 1980 and the general U.S. economic malaise of the 1970s. Perhaps the benefit of lower risk is worth the loss of diversity — but I question that tradeoff.

What new regulations could be adopted? Rep. Barney Frank (D, Mass.) has suggested a limit on the use of leverage. But how many creditors will repeat the mistake of lending to investors that have little of their own skin in the game? At best, a new wave of financial and business regulation would protect market actors from making mistakes that they now know to avoid. (Markets are loathe to commit the same mistake twice.) At worst, new financial regulations would follow the same "don't just stand there — do something!" formula as the Sarbanes-Oxley Act and the Patriot Act: every bad idea that has been floating around Washington for a decade will get rolled into a single piece of legislation and passed before anyone can analyze and question it.

Moreover, I question Ed Mierzwinski's assumption that new financial regulations would protect the vulnerable and inflict risk and cost only on the "masters of the universe." U.S. history shows that regulation (whether of banks, railroads, trucking, telecommunications, airlines, etc.) often benefits well-established and politically well-connected firms and market actors at the risk and expense of most everyone else.[8] Perhaps an omniscient, benevolent, selfless regulator could reliably promulgate good regulation — but such a regulator seems as likely as a marketplace of omniscient, benevolent, selfless private actors. Consider Mr. Berlau's point that part of the blame for the current financial turmoil belongs to the regulation-established cartel of U.S. bond-rating firms that gave high marks to the securities that are now melting down.[9]

The world is full of market actors with radically different goals and needs. We should take great care before we restrict their ability to strike voluntarily deals with each other that they consider mutually beneficial. Sometimes those deals go horribly awry — as market actors are now experiencing and learning from. But

[8] For a brief history of U.S. regulation and deregulation, see the Summer 2002 issue of *Regulation*.
[9] See Lawrence White, "A New Law for the Bond Rating Industry" (*Regulation*, Spring 2007).

many of those deals do work — consider again the five million homeowners who have successfully used subprime loans.