Can the **centre** hold?

*Despite the inevitability of tighter and more intrusive regulation, **David Rowe** argues this alone will not prevent future financial crises as long as 'too big to fail' remains an issue*

An unfortunately consistent characteristic of history is a tendency for public attitudes to swing sharply, with such movements based more on emotion than on reasoned analysis. Once a trend is under way, it is eventually pushed to an extreme. At some point, a crisis precipitates a reaction and the pendulum of public attitudes suddenly reverses course. Quite clearly, we have been in the early stages of such a reversal since the market meltdown last September.

For much of the past 25 years, markets have been apotheosised as the ultimate arbiter of economic valuation and capital allocation. Much has been said and written recently about the 'efficient markets hypothesis'. Its basic logic is quite straightforward, suggesting that all information is reflected very quickly in market prices and things that will affect future changes in prices are not yet known. Thus it is impossible to outperform the market consistently based on information the market already knows.

In one sense, the efficient markets hypothesis is a variation on the wisdom of crowds. Individuals acting in their own best interest will inject their collective information into the establishment of equilibrium market prices. Recent experience clearly shows, however, that under certain conditions markets can go massively wrong. While some of the current crisis can be attributed to huge shifts in the global economy, the rise of China and other emerging markets, the rapid spread of technology on many fronts and huge imbalances in savings and trade flows across countries and regions, a significant element of market failure must be recognised and addressed.

At the moment, discussion is focused almost exclusively on a potentially seismic increase in regulatory oversight and control of financial institutions. Quite understandably, the widespread political and public clamour to increase oversight and control is especially intense relative to those institutions that have required a massive injection of public funds to say afloat.

The nearly universal consensus in favour of tighter and more detailed regulation is both understandable and inevitable. It does, however, contain the potential for an overreaction. In the past 25 years, innovations in finance have opened the funding markets to many small start-ups that would have found such access nearly impossible in earlier eras. Many of these firms have failed but a not insignificant number of successful start-ups have contributed to hugely significant innovations, from the internet to biotechnology, that have transformed our world.

In this way, many of the trends in finance that are so roundly condemned today have nurtured the kind of creative destruction that is the essential driver of material human progress. History has also taught us that when investment allocation decisions fall under the sway of politicians, innovation is stifled. Established firms have the resources and political connections to quash revolutionary innovations that threaten their vested interests. Politically motivated legal and regulatory barriers to entry are as perennial as the grass.

Excessively intrusive bank regulation runs the risk of politicising loan decisions and sapping an important engine of progress. Perhaps worse, such regulation will not provide assurance against future crises. Banks have become too large and complex for regulation to be an airtight means of disaster prevention. In fact, political meddling is often more short-sighted than private decision-making and can be just as prone to creating unsustainable circumstances. The strong political opposition to tighter regulation of Fannie Mae and Freddie Mac in 2005 and 2006 is a classic example of political influence standing in the way of corrective action. After all, these agencies' guarantees of subprime mortgages were fostering wider homeownership among constituents. Congressmen were understandably reluctant to be seen supporting anything that would hinder that process.

Sadly, future crises are an inevitable fact of life and the one nearly certain commonality among them is that each will appear cloaked in a new guise of progress. The essential goal of public policy should be to reduce the likelihood of such crises and to minimise their severity when they occur. As argued in this column in March, the one way to accomplish both goals is to minimise (or ideally to eliminate) the systemic threat posed by institutions that are 'too big to fail'. As Adam Smith so eloquently put it: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest".

Effective balancing of risk and return demands that we harness the self-interest of managers by exposing them to the very real prospect of financial and reputational failure if they pursue growth and profits with no regard for the associated risks. Maintaining a system of financial institutions sufficiently small that the failure of any one does not present systemic risks would go a long way toward achieving this goal. Such institutions can and should be allowed to fail, and their limited size and diversity is the best assurance of containing the broader social damage from a crisis when it occurs. ■

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