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Do More Regulations and Regulatory Agencies lead to a better Financial System?

...it doesn't' seem to be the case, despite all the legislative efforts to the contrary. In fact, there are growing signs that our once reputedly 'greatest financial system in the world' is rapidly moving from dynamic and agile to one crawling at a turtle's pace.

NOTE BENE (note well)

It is clear that there are always some top management officials in all lines of business across the board that are willing to play on the edge of legality and even cross the line if the reward seems worth it. This newsletter is not a defense of them nor is it a condemnation of efforts to counter them by legislation. Rather it is a commentary on both the inherent problems in establishing regulatory guidelines as well as a sad commentary on some of the regulatory officials for their ineptitude and on occasion their habit of eye blinking.

The seemingly endless failure of existing regulations and regulatory agencies will not be made more effective by doubling down on even more regulations and regulatory agencies. Among some recently [legislatively] established agencies is the increasingly feared Consumer Financial Protection Bureau, referred to by the regulatees as the CFPB, with still-being-defined sweeping

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powers. It seems the greatest achievement of the many years of such legislative efforts is the introduction of four letter agencies apparently having run out of the three letter variety.

We are NOT arguing for the elimination of regulations and regulatory agencies as you will see when reading the rest of this article. We are of the belief that the more intelligent use of existing regulations and a much improved and more knowledgeable cast of regulatory employees is what are needed, not more and more regulations and regulatory agencies. Narcissism and a naïve acceptance of ideology are inferior to knowledge and understanding of the economic and financial principles involved.

A Litany of Failures of Regulatory Agencies

...the ongoing Failure of Monetary Policy with many Regulatory Agencies ineptly playing their Roles

A relatively recent example is the action of the Federal Reserve System (FED), which while noting the rise of the real estate bubble, failed to stop the inflation of this asset bubble and when they did belatedly act by 'pricking the bubble' after it achieved great size, the resulting collapse contributed to fostering the ongoing real estate crisis and its accompanying financial crisis.

Remarks by Chairman Alan Greenspan
Reflections on central banking

At a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming

August 26, 2005

http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050826/default.htm

> "Our forecasts and hence policy are becoming increasingly driven by asset price changes. The steep rise in the ratio of household net worth to disposable income in the mid-1990s, after a half-century of stability, is a case in point. Although the ratio fell with the collapse of

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equity prices in 2000, it has rebounded noticeably over the past couple of years, reflecting the rise in the prices of equities and houses."

The same can be said of past stock market bubbles. The FED seemingly has the power to prevent these bubbles from occurring. Employing such rules as increasing margin requirements on stock purchases (Regulation T) – a down payment so to speak, have rarely been used in recent stock market bubbles in spite of the fact that the Federal Reserve has the power to do just that.

While Greenspan was concerned about 'asset bubbles', he was loathe to do such things as raise margin requirements on stocks, citing the FED's inability to accurately see a bubble until after the fact and the ineffectiveness of those requirements…

Remarks by Chairman Alan Greenspan
Economic volatility
At a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming
August 30, 2002
http://www.federalreserve.gov/boarddocs/speeches/2002/20020830/default.htm

> "We at the Federal Reserve considered a number of issues related to asset bubbles--that is, surges in prices of assets to unsustainable levels. As events evolved, we recognized that, despite our suspicions, it was very difficult to definitively identify a bubble until after the fact--that is, when its bursting confirmed its existence.
>
> Moreover, it was far from obvious that bubbles, even if identified early, could be preempted short of the central bank inducing a substantial contraction in economic activity--the very outcome we would be seeking to avoid."

Comments in Wikipedia on Alan Greenspan at Dot-com bubble

> In 2000, Greenspan raised interest rates several times; these actions were believed by many to have caused the bursting of the dot-com

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> bubble. However, according to Nobel laureate Paul Krugman "he didn't raise interest rates to curb the market's enthusiasm; he didn't even seek to impose margin requirements on stock market investors. Instead, he waited until the bubble burst, as it did in 2000, then tried to clean up the mess afterward."

The current margin requirement is 50% and has remained unchanged since 1974, nearly 40 years ago even though we have since experienced many stock market bubbles since that time. (Regulation T – CFR Code of Federal Regulations)

Our central bank (FED) has often been its own undoing. The current inability to resurrect the American economy with the Quantitative Easings I, II, and III are partly a result of their own and sister regulatory agencies such as the FDIC and the CFPB. The supervisory and regulatory (Sup and Reg) departments of the FED as well as other agencies have raised the fear level among regulatees to such a high level in the financial service sector, (especially the depositories who in the their credit creation efforts, create nearly all of the checkable deposit form of M-1 they 'lend out' or invest), they have become virtually paralyzed in many sectors of lending such as mortgage credit and lending to small business.

Recall also that this checkable deposit form of M-1 or medium of exchange money facilitates the transactions of most of the legitimate or so called above-ground economy. The depositories consist of the commercial banks, credit unions, savings banks, and savings and loan associations. As a result of this heavy handiness of the Sup and Reg Cadre that is perhaps triggered by past failure to prevent the ongoing crisis, credit creation is virtually 'dead in the water'.

At best, expansive monetary policy is beleaguered by an inherent weakness: 'pushing on a string', and a very limp string at that, is often the phrase used to describe this intrinsic weakness.

The FED can only supply an increase in the capacity of depositories' ability to create new money and credit in the form of an increase in the monetary base, much of which becomes additional legal reserves to the depositories, enabling them to create money and credit. The actual creation of money and credit by depositories will not occur until such credit creation is profitable, as we have pointed out in earlier newsletters on this web site.

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The result is the rapid growth of excess legal reserves or unused capacity. This phenomenon was referred to by the Quantity Theorists as 'reflux' and is a chief cause of the 'pushing on a string' frustration of the FED's failure in its expansive monetary policy.

Will the Fed's actions be inflationary? (July 2009)
http://blogs.udmercy.edu/newparadigm/tag/money-creation/

The Great Printing Press Myth (Great Pumpkin) has descended upon the land: Government is printing MONEY; hyper-inflation is imminent; and all of those excess dollars will have to be burned, resulting in an environmental disaster of epic proportions (January 6, 2011)
http://www.econnewsletter.com/46701/41001.html

The Money Supply and those (supposedly) Overworked Printing Presses (January 14, 2011)
http://www.econnewsletter.com/46701/43601.html

THE GREAT CREDIT COLLAPSE OF 2008-2011:
The Smoking Howitzer (May 18, 2011)
http://www.econnewsletter.com/60601/index.html

In the Keynesian tradition, monetary policy was always a weak afterthought to fiscal policy in the effort to stimulate economic activity. Such things as a 'liquidity trap' prevented the further reduction in interest rates below the level of the 'trap'. This would leave savings in excess of investment or in more modern Keynesian analysis, withdrawals in excess of leakages, forestalling recovery.

The regulatory agencies failed to stop the development of the real estate bubble and the disastrous flood of related derivatives such as collateralized debt obligations (CDOs), mortgage backed securities (MBSs), and collateralized debt swaps (CDSs).

These two factors combined with the rating scandals and lack of appropriate due-diligence of the buyers (with a generous portion of old fashioned greed and in some cases desperation mixed in), led to the massive bailouts. The pain of the crisis was shifted from those guilty of causing or contributing to the crisis, to the taxpayers of all income classes.

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Dr. Greenspan received his desired bubble collapse and a return of households to his version of a more normal ratio of household net worth to their disposable income. (Refer to the citations above on Greenspan's comments.) Regulatory agencies both older and a few newer ones, have resorted to what appears be a repeating pattern when financial crises occur, an after-the-fact clamping down on the institutions under their jurisdiction.

It reminds me of a phase I heard at a lecture, "The Lord God Government giveth and the Lord God Government taketh away."
Amen.

Policy failures of Agencies whose Jurisdiction are the Financial Markets

Likewise, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) had the power but failed to exercise it when derivatives grew like wild fire and were a major cause of our ongoing economic and financial malaise. When speculation becomes destabilizing, enough is enough. You don't need a myriad of overpaid agency employees to determine that. Less politicization, less ideologically driven policies, and less concern for the 'old boy network' (a variant of the 'too big to fail' doctrine) is what is needed.

Greenspan Says He Was Mystified by Subprime Market
New York Times (February 12, 2009)

http://dealbook.nytimes.com/2009/02/12/greenspan-says-he-was-mystified-by-subprime-market/

> "Alan Greenspan, the former chairman of the Federal Reserve, told CNBC in a documentary to be shown Thursday night that he did not fully understand the scope of the subprime mortgage market until well into 2005 and could not make sense of the complex derivative products created out of mortgages."

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The federal government was quick to indict, prosecute and imprison Martha Stewart for some dubious actions. Where are the indictments and trials for those responsible for the financial collapse in which we are still wallowing? Surely the harm done by the financial collapse was far greater to society than the actions of Martha Stewart.

Missing: Stats on Crisis Convictions (May 13, 2012) – Wall Street Journal
http://online.wsj.com/article/SB10001424052702303505504577401911741048088.html

> Attorney General Eric Holder said this year he understood "the public desire to...see the handcuffs come to Wall Street."
>
> Much of the conduct that led to the crisis was "unethical and irresponsible," he said in a speech in New York. "But some of this behavior—while morally reprehensible—may not necessarily have been criminal."

Huhhh? Where did the money go? Who took it?

…it's not just the financial collapse where government dropped the ball (regulatory-wise and or legislatively)

Where is Eric [Holder] when we really need him?

A Failure of Antitrust Agencies

Beginning around 1993 and continuing to around 2003, the U.S. segment of the oil industry was being re-cartelized as 13 large firms were remolded into 5 even larger firms including the merger of Exxon with Mobil. They let it be known that they would accept the prices in the market. Those prices of course, were set by OPEC so informally they became part of OPEC. A summary of this regulatory failure by the General Accountability Office emphasized that the antitrust agencies adhered to the Second University of Chicago School. Their ideology is that the market cannot fail and the economic performance of a highly cartelized market is nearly as efficient and equitable as is a much more competitive market. Does anyone really buy that baloney/malarkey?

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U.S. Government Accountability Office

http://www.gao.gov/new.items/d04951t.pdf
July 7, 2004

ENERGY MARKETS - Mergers and Many Other Factors Affect U.S. Gasoline Markets

> "One of the many factors that can impact gasoline prices is mergers within the U.S. petroleum industry. Over 2,600 such mergers have occurred since the 1990s. The majority occurred later in the period, most frequently among firms involved in exploration and production. Industry officials cited various reasons for the mergers, particularly the need for increased efficiency and cost savings. Economic literature also suggests that firms sometimes merge to enhance their ability to control prices."

The First Chicago School, numbering among its members, George Stigler, was much more critical of market concentration, using such terms as regulatory capture.

As we have written in past newsletter on this website and in other venues, free market capitalism, IF IT IS COMPETITIVE, brings the economy and the body politic closer to the microeconomic welfare conditions of efficiency and equity. When competition diminishes in markets, the income distribution becomes excessively unequal violating the welfare condition of equity and the per capita level of income and production fall below their levels that are achieved at the high employment level. Price levels also become increasingly unstable as markets become less competitive.

Microeconomic side

Theoretical Welfare Economics

> If competition is vigorous on both sides of the market, as explained in earlier articles on this web site, the theoretical economic welfare conditions are closely approached. These economic welfare conditions from the microeconomic perspective are equity and efficiency. From the macroeconomic perspective, they are high employment (natural rate of employment meaning that the labor markets are cleared) and a

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reasonable degree of price level stability, the limiting case being very mild deflation.

The Income Distribution and its Relationship to Competition from the Perspective of Theoretical Welfare Economics April 26, 2012

http://econnewsletter.com/131201.html

Theoretical Economic Welfare Conditions

"The effects of this increase in competition bring the income distribution closer to the theoretical economic welfare condition of equity -- consumers pay the lowest price possible consistent with the reward to resources equal to their opportunity cost -- and thus to conformity with commutative justice. It simultaneously causes the market price to approach the theoretical economic welfare condition of efficiency."

"As the distribution of income is more closely based on opportunity costs of the productive resources such as labor and capital, the closer is the economic system to conformity with distributive justice. This in turn reduces the need for government to reallocate income."

Efficiency

Efficiency means that the per capita standard of living is at a maximum given the stock of resources, technology, etc. The consumer is able to purchase the greatest quantity of goods and services at the lowest possible price, thus maximizing the real purchasing power of their income. This can be viewed as the consumer's income having the most 'bang' for the buck. Technically, one condition achieved when efficiency exists is that the price equals marginal opportunity costs.

Equity

Equity means that the consumer surplus is at a maximum subject to the constraint that all productive resources are receiving a reward or

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income just bit higher than their opportunity cost, no more and no less. There is no producer surplus (no 'economic rent' nor surplus rewards to capitalists, labor nor entrepreneurs). This is what keeps you working at your current job. You are compensated just enough to keep you from leaving for greener pastures.

IMPERFECTIONS IN MARKETS

There are some inherent imperfections in free market capitalism that prevent the full achievement of these microeconomic and macroeconomic welfare conditions. The major ones are natural monopolies, natural oligopolies, external costs and external benefits, and the inability to exclude the non-payers from the benefits of a market (the latter sometimes being referred to as goods and services that are non-rival in consumption).

These imperfections are among the major reasons for regulatory agencies and regulations. One such case is that of the regulation of public utilities which are usually composed of natural monopolies. In most cases, since no competitors are present, the goal of regulation is to achieve the welfare conditions of efficiency and equity. In most cases, both welfare conditions cannot be achieved concurrently. Legislative statutes usually guide the regulators as to which is to be achieved by regulation. In the U.S., equity is usually the choice to be sought in the legislative mandates. The unfortunate consequence is that in most cases, efficiency is violated.

Natural oligopolies are generally controlled, and not always successively, by reducing market concentration ratios to reduce market or monopoly power of firms as much as possible. To do so the anti-trust agencies use various concentration ratios such as that of three of five largest firms. The Hirschman-Herfindahl Index is another such measure as is the Lerner measure of market power.

If external costs and benefits are present, the effect of government intervention should be to internalize the externalities binging market production and prices into closer alignment with the optimal ones.

The Macroeconomic side

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Note that the failures of such regulatory agencies also have direct macroeconomic effects. The less competitive are markets, the greater is the downward price rigidity in those markets. As we have pointed out in many newsletters on this web site, the downward price rigidity introduces into the economy the twin biases toward recession and inflation. These macroeconomic violations of economic welfare are in addition to the violations of the microeconomic welfare conditions off efficiency and equity, resulting in lower per capital incomes and production levels than would occur if efficiency was achieved and an excessively unequal income distribution as equity is not achieved. This non-achievement of equity can be summarized in the expression, 'a few gain at the expense of the many'. With this violation of equity and its attendant excessively unequal income distribution, comes the clamor for income redistribution. Enhanced competition in markets, including the labor market as well as the product markets would lessen the excessive inequality of income distribution and do it so much more efficiently than income redistribution…the after-the-fact remedy.

Recall the age old proverb: AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE

The violations of macroeconomic welfare are reflected in the economy's falling short of high employment resulting in lower per capita levels of income and production than if high employment occurred. An excessive degree of price level instability also results.

A good diet beats castor oil every time, just ask the Little Rascals.

A Macroeconomic Perspective (July 6, 2012)
http://www.econnewsletter.com/141701.html

> "As competition increases, the economy moves toward the widely desired goals of high employment and a reasonable degree of price level stability. As these goals are approached, the need for government intervention through monetary and fiscal policies is reduced significantly.
>
> When markets lack significant competition, prices tend to be rigid downward. In pursuit of profit maximization, when demand weakens, in order to reduce market surpluses and rising unwanted inventories, firms tend to reduce output by a greater amount than if the market in which they sell their products were more competitive.

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Pursuant to profit maximization, there is usually little reluctance to raise price when the demand they face increases causing a shortage at the prevailing price. This lack of competition introduces a downward rigidity in pricing giving rise to twin biases toward both recession and inflation.

As markets become increasingly competitive the downward price rigidity weakens as firms lose market power and control over price. Competitive pressures force the price downward and as a result, the economy more closely approaches the macroeconomic goals of high employment and a reasonable degree of price level stability. The fall in the price reduces the decrease in quantity supplied needed to restore equilibrium in the market. This reduces the need for government intervention to achieve the widely accepted goals of high employment and a reasonable degree of price level stability."

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