10. Creating Political Space for Effective Financial Regulation

By Dean Baker

Three public policy principles for constraining the power of the financial industry:

- **increased central bank accountability to democratically elected officials**
- **limit the size of the financial industry**
- **increase accountability of public officials in economic policy positions.**

The economic crisis has led to a flurry of efforts to rewrite rules of financial regulation to prevent similar disasters in the future. While many useful proposals have been put forward, even the best set of rules can only ensure stability if they can be effectively enforced. This in turn will depend on creating a political environment in which it is possible for government regulators to rein in the excesses of the financial industry.

At present, this sort of environment does not exist. The financial industry, most apparently in the United States, has sufficient political power to obstruct effective regulation. There were numerous incidents over the last decade in which regulators at various levels of government sought to rein in some of the excesses of the financial industry but were prevented from doing so by individuals with close ties to the industry.

Perhaps the best example of this sort of interference with effective regulation occurred in 1998 when Brooksley Born, the Chair of the Commodity Futures Trading Commission (CFTC), was prevented from regulating credit default swaps and other financial derivatives by then Treasury Secretary Robert Rubin and Federal Reserve Board Chairman Alan Greenspan. Two years later, Senator Phil Gramm, a politician with close ties to the financial industry, pushed through the Commodity Futures Modernization Act, which explicitly prohibited the CFTC from regulating credit default swaps.

There are many other publicly known instances where the financial industry's political power obstructed efforts at effective regulation over the last decade. There are undoubtedly many more cases in which the industry thwarted effective regulation that have not yet been publicly exposed. However, the known evidence should make it clear that effective regulation requires constraining the political power of the financial industry.

This essay outlines three principles for public policy that are essential for constraining the power of the financial industry:

1) Increased central bank accountability to democratically elected officials;

2) Measures to limit the size of the industry, such as financial transactions taxes; and

3) Measures to increase the accountability of public officials in economic policy positions.

The first principle opposes a view that had gained widespread support among economists: that central banks should be independent of political control. The

argument here is that rules to guarantee independence from political control effectively gave the financial sector more control over central bank policy. While it is not desirable to have central bank policy manipulated to further the political ends of whichever party or parties happen to hold power, it is also not in the public interest to have central banks run to increase the profitability of the financial industry.

The general argument for restricting the size of the financial industry is two-fold. First, finance is an intermediate good; it does not directly provide utility in the way that sectors like housing or health care do. In this sense, an efficient financial industry is a small financial industry. Measures that limit the growth of the financial sector can restrict the growth of rent-seeking activities. These activities can be very profitable for the actors involved, but they may add little or nothing to total welfare. The second argument for constraining the size of the industry is simply to limit its political power. A smaller industry is likely to be less powerful than a large one. If the size of the industry can be limited, then it will be easier to maintain a regulatory structure that can prevent abuses.

The third principle is to create a new ethic of accountability among public officials and civil servants in economic policy positions. The warning signs for the current economic crisis were everywhere, most obviously in the form of unsustainable housing bubbles in the United States and many other countries. Yet, very few economists in government positions, or at international institutions like the IMF or Organization for Economic Cooperation and Development (OECD), warned of the problems on the horizon. Since these economists are currently suffering no consequences for this failure, they will continue to have little incentive to question the prevailing wisdom.

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These three points will be addressed in turn in the subsequent sections, however, it is worth taking a brief digression on the meaning of “regulation” and “deregulation” in the context of the financial industry. It has become common to describe the last three decades as being a period of deregulation in the financial sector, with the problem being that deregulation went too far and we now require the re-regulation of the sector. This characterization is misleading in ways that carry important political and economic connotations.

In reality, the financial industry was never deregulated in the sense of not requiring government involvement. This is seen most readily in the public sector deposit insurance systems that are in place in the United States and other wealthy countries. (In some cases, the insurance is private, but it almost always involves public oversight). The public involvement also is apparent in the “too big to fail” doctrine under which the government intervenes to protect the creditors of faltering major financial institutions in order to prevent a cascade of financial collapses.

In both cases the government is effectively providing insurance to the financial industry. This insurance can be enormously valuable to the industry since depositors and other creditors can then lend money to firms in the industry without being concerned for the soundness of the industry’s lending practices. Naturally the industry would like to have this insurance at the lowest possible cost, and with the least restrictions, thereby maximizing its value.

The drive for “deregulation” must be understood in this context. It was not literally a drive to get the hand of the government out of the financial industry. There were

few, if any, voices calling for an end to deposit insurance and strong unequivocal denunciations of “too big to fail,” whereby governments assured bank creditors that they would not be protected under any circumstances. Rather, the drive for “deregulation” was about removing the restrictions that went along with the government insurance: restrictions that reduced the probability that taxpayer dollars would be used to pay off the financial sector’s liabilities. Those pushing for deregulation in the financial sector didn’t really want to get the government out; they just wanted government insurance without being forced to pay for it. Calling these people “market fundamentalists” is an inaccurate and overly generous description of their position.

Making Central Banks Accountable

In both wealthy and developing countries there has been a growing trend to promote central bank independence over the last quarter century. The conventional view in the economics profession is that an independent central bank will be better able to resist pressures to pursue inflationary monetary policy. While the evidence on this point is more mixed than is generally recognized (Epstein, 1994), controlling inflation is only one responsibility of central banks. Central banks must also take responsibility for sustaining high levels of employment and maintaining the stability of the financial system. “Independence” may make central banks less well suited to meet these other goals.

In reality, removing the ability of democratically elected officials to affect central bank policy does not mean that central banks can operate exclusively in the public interest, free from the influence of special interests. By their nature, central banks are going to be closely tied to the financial industry, unless there are strong measures put in place to limit these links. This stems from the obvious fact that—as banks are key players in the financial sector—there will be regular contact between bank officials and executives in the private financial sector. There is also likely to be a regular flow of personnel between the central bank and the private sector.

In addition, apart from a relatively small number of people employed in academia or other sectors of government, most of the people who have the ability to understand and pass judgment on the details of central bank policy are in the private financial sector. As a result, the media largely depends on the private financial sector for its analysis of central bank policy. (News articles on central bank policy routinely rely largely or exclusively on analysts employed by the financial industry as their sources). These factors create a situation in which central banks are likely to be overly responsive to the concerns of the financial industry, while downplaying or neglecting altogether issues that matter more to society as a whole.

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The close ties to the financial sector may help to support central bank efforts to curb inflation, since the financial sector will generally have an interest in maintaining low rates of inflation. However, the ties to the financial sector may obstruct efforts to promote high levels of employment, precisely because these entail a greater risk of inflation. Instead, the financial sector is likely to encourage a single-minded focus on low inflation. On the other hand, a central bank that is more directly accountable to democratically elected officials may be more willing to risk modest increases in the inflation rate in order to reduce the unemployment rate.

In this respect, it is important to recognize the high degree of uncertainty

surrounding the levels of unemployment that are consistent with stable rates of inflation. There was near unanimity in the economics profession in the United States in the mid-90s that the unemployment rate could not get below a range from 5.6-6.4 percent without triggering an acceleration of the inflation rate. As it turned out, the unemployment rate fell to 4.0 percent for a year-round average in 2000 with only a modest uptick in the core inflation rate. The estimates for the non-accelerating inflation rate of unemployment in the United States have been far more stable than in most of other countries. It was only due to Alan Greenspan's idiosyncratic background that he was willing to risk higher inflation to allow the unemployment rate to drop. Almost any other recent Fed chair would not have allowed this drop in the unemployment rate.

A central bank that is closely tied to the financial industry is likely to be especially ill-suited for protecting the stability of the financial system, especially when this involves combating asset bubbles. Almost by definition, an asset bubble cannot take place without substantial involvement from the financial sector. This means that attacking an asset bubble would require attacking a main source of profitability in the sector most closely allied with the central bank. This is not likely to happen.

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The set of events around the collapse of the Long-Term Capital hedge fund in the United States are perhaps instructive in this respect. Alan Greenspan argued that it was necessary for the Fed to get involved in the unraveling of Long-Term Capital's position in order to prevent serious damage to the financial system. Of course if this assessment was correct, then it implied a serious failure of regulatory oversight since the reckless actions of an unregulated hedge fund were able to jeopardize the stability of important banks. Yet, no measures were put in place to prevent the recurrence of such incidents. The Fed sought neither stronger regulations on hedge funds, nor restrictions on their loans from regulated banks, leaving open the possibility of such incidents in the future. A central bank that was more directly accountable to democratically elected officials might have insisted on stronger regulatory measures in response to this incident.

In order to prevent more incidents like the Long-Term Capital collapse or the far more dramatic events associated with the collapse of the housing bubble, central banks must have greater independence from the financial sector and be more accountable to elected officials. There is no simple mechanism that can ensure the desired degree of independence from both the financial sector and the political needs of the governing party, but at this point it is clear that central banks are too close to the financial sector.

In the case of the United States, an important step could be to remove any direct role of private banks in the governance of the Fed. Specifically, all of the bank officials who play any role in setting monetary or regulatory policy should be appointed by the president and approved by Congress, as is currently the case with the Board of Governors. These officials can be given lengthy terms (the governors serve 14 year terms) in order to limit their dependence on the government in power.

The policy setting meetings of the central bank governors should be fully open to the public and ideally broadcast over television or the web. Everything possible must be done to increase central bank governors' accountability to elected officials and the public at large. The notion of central bankers as a priesthood that sets monetary and regulatory policy in a vacuum must be put to an end. These policies involve important political decisions that must be subjected to public scrutiny.

It is undoubtedly true that many of the people who currently serve in top positions in central banks would object to the level of openness and oversight described here and may not serve under such conditions. That is appropriate. If people object to such scrutiny then they probably should seek other lines of employment. The current group of central bank managers was obviously not well-suited to meeting the responsibilities of the job, so it would not be a loss if they did not want to serve in a reformed central bank.

Downsizing the Financial Industry

It is important to keep in mind that finance is an intermediate good; it does not directly provide utility. For this reason, it is desirable that the financial sector be as small as possible, so that fewer resources will be used up in this activity.

It is important to keep in mind that finance is an intermediate good; it does not directly provide utility. For this reason, it is desirable that the financial sector be as small as possible, so that fewer resources will be used up in this activity. The economic purpose of the financial sector is of course to intermediate between savers and investors, but there are also enormous potential gains from various types of rent seeking, including tax and regulatory arbitrage. If the sector is growing as a share of the economy, as it has over the last three decades, it is more likely attributable to resources being devoted to rent seeking than to productive activity.

For this reason, it is appropriate to have policies that try to restrict the growth of the sector. One obvious policy that will restrain growth is a modest tax on financial transactions. Taxes that are set at low levels, for example 0.25 percent on each side of a stock trade (the current rate in the United Kingdom) or 0.02 percent on the purchase or sale of a future contract, will substantially reduce trading volume while having very little impact on long-term investment or the ability to raise capital or protect oneself against price fluctuations.

A properly designed set of taxes could also slow the spread of complex derivative instruments, since such instruments might be subject to taxation at several different points. For example, an option on stocks would be subject to the tax when the option was bought or sold. If the option was exercised and the stock was purchased or sold, then the tax would apply to this transaction also. If the financial instrument involved an important innovation that substantially reduced risk or provided some other benefit, then these taxes would not prevent its usage. But, if the innovation was primarily intended to provide a vehicle for short-term speculation, then the taxes would be an important disincentive to its use.

As a general rule, there should be a strong bias against complex financial instruments for two reasons. First, experience has shown that the regulators and even the inventors of complex instruments are unlikely to fully understand how they will affect the economy and what patterns they may follow in response to unusual events. For this reason, new financial instruments can inject a large amount of uncertainty into the system.

The second reason for restricting the complexity of financial instruments is that complexity works directly against transparency and effective oversight. If there are only a small number of people who understand a new financial instrument, then it will be almost impossible for policymakers or the general public to understand its implications. In effect, complexity leads to the same situation as secrecy.

For these reasons, it is appropriate to design the financial system in a way that is unfriendly to innovation. While this may occasionally delay the widespread adoption of useful financial products for a number of years, thereby reducing the efficiency of

the sector, that would be a small price to pay for more effective oversight and greater transparency. If a system of financial transaction taxes (FTT) makes the environment more hostile to financial innovations, then this is another benefit from the tax.

The reduction in trading volume from FTT would substantially reduce the income of the financial industry. A financial transactions tax could also generate enormous amounts of revenue. In the United States, the revenue from a modest set of taxes could easily exceed US$100 billion a year (Pollin, Baker, and Schaberg, 2002). The government revenue would be coming largely at the expense of the industry. A smaller industry will be an industry that is more easily regulated since it will have less political power.

Holding the Economists Accountable

The fact that virtually no economists in government, academia, or the financial industry even saw the US housing bubble, which is at the core of the current crisis, much less understood the enormous implications of its collapse, is a remarkable failure of the profession. However, it is perhaps even more remarkable that this failure has thus far prompted very little analysis of its causes either by those within or or those outside the profession.

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The basic problem—an unsustainable housing bubble—should have been very easy for economists to recognize. Nationwide, US house prices tracked inflation for 100 years from 1895 to 1995, as has been documented by Yale economist Robert Shiller. In the decade from 1996 to 2006, they rose by more than 70 percent after adjusting for inflation, creating more than US$8 trillion in housing bubble wealth.

There was no remotely plausible explanation for this increase in house prices based on the fundamentals of either supply or demand in the housing market. There was also almost no increase in real rental prices over this period, indicating that there had been no change in the fundamentals of the housing market. If there is a huge divergence from a 100-year long trend, with no explanation based on fundamentals, how could the run-up in prices be anything over than a bubble?

It was also extremely simple to calculate the magnitude of the bubble. At its peak in 2006, the difference between the bubble-inflated value of housing and the 100-year trend level exceeded US$8 trillion (US11$110,000 for every homeowner). It was inconceivable that the country could withstand this loss of wealth, plus the collapse of the housing sector, without enormous consequences for the economy.

The fact that this would lead to a serious financial crisis should have been apparent. Even in the best of times housing is a highly leveraged asset with homeowners typically buying homes with down payments of 10-20 percent. It was hardly a secret that lenders were accepting much lower down payments (often zero) during the bubble years. This meant that a plunge in house prices would put large numbers of homeowners underwater in their mortgages, leading to very high default rates and large losses for banks. All of this could be easily inferred from any quick analysis of the data, yet almost the entire profession could not be bothered with such details. If there are no professional consequences for being so completely wrong on such an important public policy issue, then there is little reason to expect that economists will perform any better in recognizing future crises.

It will not be possible to fully offset the pressures for conformity within the economics profession. But, it is important that these pressures be recognized so that they can be countered to at least some extent. This means maintaining more open doors for outside opinions.

In the current situation there is a very one-sided structure to the incentives in the profession. Taking issue with the prevailing views in the profession carries enormous risks. Economists who warned of the bubble and the threat it posed to the economy risked ridicule and jeopardized their careers. If these economists had been wrong—as it turns out, they were not—their future prospects in the profession would undoubtedly be seriously diminished as a result of foolishly raising such alarms.

On the other hand, when the consensus within the profession is wrong, there are no obvious consequences. None of these economists are losing their jobs. In fact, it is unlikely that many are even missing out on a scheduled promotion as a result of having failed to see the largest financial bubble in the history of the world.

It would be appropriate for public bodies to investigate the conduct of top economists in important policy positions and ask them how they failed to recognize the growth of the housing bubble and the threat it posed to the economy. This failure should be viewed as serious malfeasance and treated accordingly. It would certainly be appropriate to dismiss high level civil servants who failed to recognize and warn of the bubble given the enormous consequences of this failure, however at the very least these economists should have promotions and pay increases set aside.

There must be serious professional consequences for a failure of this magnitude, otherwise economists in policy positions will never have the incentive to do anything other than to just repeat the conventional wisdom. It is essential that making the same mistake as every one else not be accepted as an excuse. These people are being paid for their professional analysis, not just repeating what others have said on a topic.

It will not be possible to fully offset the pressures for conformity within the economics profession. But, it is important that these pressures be recognized so that they can be countered to at least some extent. This means maintaining more open doors for outside opinions. Ideally this will mean more support for economists who apply unorthodox approaches and who are outside of the economic mainstream, particularly when their analysis is supported by real events. Recognizing the pressure for conformity also means not accepting the excuse that everyone else made the same mistake.

Conclusion

It is important to have an effective set of rules for regulating the financial sector. However, even the best rules will be inadequate if the regulators lack the power to enforce them. The current crisis was brought about not so much because the rules were inadequate, but rather because the regulators, at key moments, did not have the political power needed to impose effective regulations.

In order to have effective enforcement it will be necessary to rein in the power of the financial industry. This essay raises three policy directions that can limit its power. This list is far from exhaustive, and following through on these principles will not be easy either politically or practically. However, it is essential that the public and policymakers recognize the need to place serious limits on the political power of the industry. If this crisis does not qualitatively reduce the financial sector's power in the political sphere, then we will inevitably see more financial crises in the not distant future

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