Title :Global Consequences of Financial Deregulation

.01 Deregulation and Intervention

The systems of regulation of banking and finance in the capitalist world have undergone great and rapid changes in the 1980's. The tendency has been to ease or relax-in some cases even to eliminate-regulations that tended to restrict competetion among institutions and markets and to widen both the assets and liabilities in which banks and financial markets deal. This deregulation is in part motivated by ideology. The belief that "The market outcome is best" is extended by faith to systems characterized by financial relations which violate the assumptions under which the standard theorems of economic theory, that point to the virtues of the market technique for organizing cooperation, are demonstrated. There is nothing in economic theory that demonststes that a free banking system would not break down into a chaotic situation. There are observations from history that make the case that the managemnt of financial arkets cannot be left to market forces.

Deregulation also reflects unsatisfactory experience with poorly designed or obsolete regulations. Regulations cannot be set in place once and for all. Regulators must be aware that the regulations in place if effective are foreclosing transactions that would be profitable in the absence of regulation. Just as taxation systems must be

constructed to recognize that avoidance and evasive actions will be taken by those impacted, so a system of regulation will induce market behavior that aims to circumvent the regulation. Furthermore the evasion may come from organizations that are outside the scope of the regulators authority. Eternal vigulence and awareness by regulators of the ways in which markets evolve is necessary if regulation is to be viable.

In addition to the deregulation that results from legislated or administrated change, financial dergulation has reflected the impact of new computing and communication capabilities and the effect ofchanging relative interest rates as well as their greater varience upon the profitability of banks, other financial institutions, and of various market tansactions .The deregulation that has taken place in the 1980's is as much or more a question of regulations adapting to changing markets as it is the result of legislated or administrative chcnges which removes barriers to market practices.

Even as deregulation was proceeding at a rapid pace, a series of crises in financial markets or of "important" units led to large scale interventions by the authorities that refinanced, restructured, and "paid off" the holders of liabilities of these various institutions. If we separate central bank activities into those which aim at demand

management -i.e. to affect income, employment, and the general price level- and those which are of a lender of last resort nature -i.e. designed to maintain the nominal value of assets and liabilities of financial institutions- in the 1980's the latter (lender of last resort) interventions became larger.

In various episodes it became clear that the first priority of central banks (broadly defined to include specialized agencies that guide,protect and intervene to support particular financial institutions) is as a lender of last resort.

A lyric in a famous musical GUYS and DOLLS goes "Marry the man today and change his ways tomarrow". So the central banks of the capitalist world are first committed to supporting and validating the financial structure. Only after this is done do they feel free to use their operations to affect the standard macro-economic variables. However refering back to the lyric I cited the Central Banks would presumably change the regulatory framework when they intervene so that the developements that led to the intervention would not happen again.

Regulation and intervention are similar in that they "prevent"outcomes from being what the underlying self interest determined behavior of economic units would generate. Regulations in finance and in other facets of economic life developed in response to felt needs either in

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terms of the behavior of indivdual units or the imputation of system malfunctioning to particular behavior of units. Certainly in the mid-west of the United States prudential regulation of banks through auditing and examination reflected the experience or the belief that "A bank charter is a license to steal".

Prudential regulation has an additional rationale: insofar as the Central Bank or other agencies have an insurance or contingent lending relation with the regulated organization.

Insurance and refinacing commitments by the authorities always have a moral hazzard dimension insofar as the protection by the insurance or refinancing commitment means that some depositing or financing units need not be as concerned with the performance and behavior of the unit they are financing as they otherwise would have been.

For those present decisions whose correctness will become apparent only in the future, even in the distant future, success can breed behavior that leads to failure. As I put it many years ago "stability induces instability".