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The paradox of regulation [1]

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Information in the economy is widely dispersed among a huge amount of consumers and businesses, which possess local information that enables them to set prices and determine quantities of goods and services to be bought and sold. The market price, aggregating billions of choices and decisions every single day, is the best way to express real value. No central regulatory body can do a better job, simply because they cannot physically posses all the necessary information.

The same line of reasoning is applied in the financial market. The complex matrix of information and market participants is somewhat smaller in the financial market and rather global (as the decisions and financial products are run globally) but they are far more complex than regular goods and services and are thus far more difficult to control and have oversight on. Even if the regulators fully understand the complex derivatives and quadrupled securitized loans they cannot process how market participants will react and sometimes cannot even see the obvious consequences of their own actions.

The current financial crisis is the best example of this. By steering banks into buying MBSs (Mortgage Backed Securities) [3], they were creating an artificial demand for these securities and henceforth an artificial demand for more mortgages which led banks into lowering their lending standards in order to create more and more AAA-rated MBSs.

The regulators need to understand the consequences their actions may incur on those being regulated, and should be able to anticipate their reactions, but have failed to do so repeatedly. They will fail again, as their desire for finding new safe assets may end up creating another asset bubble. There were some suggestions that new safe assets should be debt of businesses backed up by government guarantees (in order to have an AAA rating) and re-packaged into new types of securities.

Others have proposed to do the same with eurozone peripheral sovereign debt ? have highly solvent nations pull the debt into securities, back them up the usual way and sell them on the market, thereby creating new, huge, safe bonds and resolve the sovereign debt crisis in one blow. Some banks have already started to issue covered bonds (debt made up of high quality mortgages and loans) backed up by collateral and secured by bank?s other assets in the event of bankruptcy. No matter what the new safe assets look like, by exaggerating their use and forcing banks to recapitalize with these assets can only lead to another asset price boom, higher debt burdens (as these safe securities are in fact debt-tied securities) and consequently another recession.

As far as the impact on the current recovery, an increase of bank capital-asset ratios, even if announced at a future date (in the Basel III case this is 2019), due to negative future expectations, will work towards the decrease of lending, unprofitable business lines for banks that will drive costs for bank customers, and finally shift the businesses to seek support on high investment projects with the so-called ?shadow banking system? ? hedge funds, money market funds, SIVs, and investment funds. Furthermore, even if we disregard expectations of future contraction by the banks which may lead them to contract today, the European Commission (EC) plans to institute the 9% capital standard as soon as possible to prevent financial contagion from a Greek default, making the reaction on the lending market immediate.

The paradox of the regulatory oversight body arises in the following ? by striving to make the system stable, they end up increasing the systemic risk and fuelling artificial demand that can lead to an asset bubble. By creating incentives to invest in certain types of assets, the regulators send false signals about the demand for these assets and hence distort its prices. The effects of their actions are usually counterproductive and the reason this is so is because they think they posses enough data and information to control the market economy and the behaviour of market participants.

Never was this possible before and has always proved to have disastrous consequences, since the market will always have more information than a few individuals, defined by the term asymmetry of information. The regulators call upon the asymmetry of information in their desire to overcome it, but they paradoxically become its victims.

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