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Avoiding a Keynesian Rush to Regulate the Financial Markets

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In his address to Congress, President Obama vowed to "move quickly" to reform financial regulation. The next day the President met with economic advisors and Members of Congress to jump-start the effort—that's quick. There is little doubt financial regulation needs improving. But a rushed restructuring would almost certainly do more harm than good. There are at least three dangers in "quick fix" financial reform: differing emergency and long-term needs; improperly diagnosing the crisis; and, slowing economic recovery.

Reform cannot be postponed indefinitely, but taking the time necessary to plan a once-in-a-century regulatory restructuring would be time well spent. Further, this is not a partisan issue; no one disputes that an overhaul is in order. But first, the U.S. needs to understand clearly what went wrong and needs correction. A good way to start would be with Senator Johnny Isakson's (R–GA) bipartisan proposal for a Financial Markets Commission.[1] Giving such a commission a year to study financial market problems would still leave the current Congress ample time to adopt a comprehensive reform plan.

Separate Emergency and Long-Term Plans. Fed Chairman Ben Bernanke suggests that emergency mortgage aid is needed to deal with a situation akin to a fire in the housing markets.[2] Assuming he is correct, is the best time to write a new building code while flames are flaring? Should not America first put the fire out, figure out what started it, and then determine what might help prevent similar fires in the future?

Easy credit (too much leverage in finance-speak) was one cause of the market crisis, and some have proposed limits on certain types of borrowing. But whether or not new limits are justified in the future, right now leverage is not the problem. In fact, the opposite is true: Banks are reluctant to lend; markets are de-leveraging at historic rates without government encouragement. New borrowing limits (or poorly considered bank capital requirements with similar effects) could intensify the economic downturn. In the short run, credit is too tight and needs easing; in the long run the previous restraints were obviously inadequate. The very urgency of the current economic situation demands a more measured approach to long-term reforms.

While the President and his team continue to tackle the immediate crisis, a Financial Markets Commission can begin planning for long-term reform.[3]

Regulatory Keynesianism. One impediment to a proper diagnosis of the crisis is that too many policymakers think they already know the cause: deregulation. "Regulations were gutted for the sake of a quick profit," said the President. Factual evidence does not support this story line,[4] and even if it did, what sort of regulation would improve things? Would just any sort of regulation do?

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Keynesian economists assume throwing government money at the economy will make it better—any sort of spending will do. Some policymakers appear to be in the grip of regulatory Keynesianism: If there is a problem in markets, just throw some regulation at it—any old regulation will do, just as long as it is done "quickly."

Modern financial markets are a lot like rocket science: Incredibly complex mathematical calculations are involved and tiny mistakes lead to spectacular—and dangerous—explosions. There may be a case for certain types of regulations to limit the exposure of average investors and homeowners to financial blow-ups. But there is a big difference between blow-ups that affect certain institutions and investments and those that can affect the stability of the entire financial system. To provide real protection, regulators need to understand what causes different types of explosions, which need to be dealt with differently than they are currently, and what side effects different approaches to regulation would have.

The causes of the financial crisis are still being debated. Among the factors that may have contributed are over-investment in housing, excessive leverage (borrowing), and lax credit standards. In each case, existing regulations may have made matters worse. Governments world-wide encouraged housing investments. The "Basel" bank capital requirements, which intended to limit bank leverage, may have had the perverse effect of encouraging riskier lending practices. Securitization—assembling a large package of loans and selling shares to investors—may have contributed to poor credit standards for the underlying loans. But Fannie Mae and Freddie Mac were among the early promoters of securitization, and various other regulations encouraged the practice.

As with excessive leverage, securitization originated by private sector entities has contracted almost to the point of extinction. There is no need for immediate government limits. Reforms in securitization may be necessary in the future, but designing the right sort of reforms for this complex process will not be easy. It is worth taking the time to get the right balance in complex processes such as securitization, capitalization, and housing subsidies.

Poorly designed regulations may have encouraged, rather than curbed, excesses in private markets. A Financial Markets Commission could help identify how regulation may have contributed to market flaws and what sort of regulations might work better.

Avoid Mixed Messages. The financial sector is flat on its back. Government is working hard to revive it. A new dose of regulation and the uncertainty that it will cause is the last thing an ailing financial sector needs.

America's financial system has just suffered the equivalent of a major heart attack. In the long run, lifestyle changes are essential for the patient's future health. But the U.S. needs to get its financial sector out of the emergency room before insisting that it start doing push-ups. A Financial Markets Commission, operating independently of the emergency response team, can start planning needed changes right away. By taking adequate time to plan, America can make sure it has the diagnosis and remedy correct and avoid shocking the patient with an over-aggressive recovery program.

Chartering a high-level Financial Markets Commission would show that Congress and the President understand the importance of financial regulatory reform. A properly designed commission

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1. Financial Markets Commission Act, S. 298, 111th Cong., 1st Sess., at *http://thomas.loc.gov/cgi-bin/query/z?c111:S.298* (March 4, 2009).
2. Catherine Rampell and Jack Healy, "Fed Chairman Says Recession Will Extend Through the Year," *The New York Times*, February 24, 2009, at *http://www.nytimes.com/2009/02/25/business/economy/25econ.html* (March 4, 2009).
3. David M. Mason, "Why an Independent Financial Markets Commission Is Needed Now," Heritage Foundation *WebMemo* No. 2112, October 23, 2008, at *http://www.heritage.org/Research/Economy/wm2112.cfm*.
4. James Gattuso, "Meltdowns and Myths: Did Deregulation Cause the Financial Crisis?," Heritage Foundation *WebMemo* No. 2109, October 22, 2008, at *http://www.heritage.org/Research/Economy/wm2109.cfm*.

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could make essential contributions in diagnosing and designing a reform plan while allowing emergency conditions to abate. A commission would not be an excuse for avoiding reform or a cause of unreasonable delay. Rather, it could be an important tool for designing a genuinely improved and lasting financial regulatory structure.

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