

Dr. Gertrud R. Traud
Chief Economist/
Head of Research

research@helaba.de

Editor:
Markus Reinwand, CFA

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Landesbank Hessen-Thüringen
MAIN TOWER
Neue Mainzer Straße 52-58
60311 Frankfurt am Main
Phone: 0 69/91 32-20 24
Fax: 0 69/91 32-22 44

Excessive Regulatory Zeal is Counterproductive

History shows that regulation is a cyclical phenomenon, and that there is often an overshooting in either direction. This suggests that we have not been able so far to find an “optimal dosage” of regulation that could allow for even growth. Against this backdrop, one should not place exaggerated hopes in supranational organizations. With a view toward asset values, excessive state interference in market processes mostly turns out to be counterproductive. Moreover, historical experience would argue that in spite of an expansion of regulation, it will hardly be possible to completely avoid periods of crisis in the future. However, a regulatory framework that securely establishes a fixed relationship between actions and liabilities could direct the risk behavior of market actors onto sounder tracks.

Markets need rules

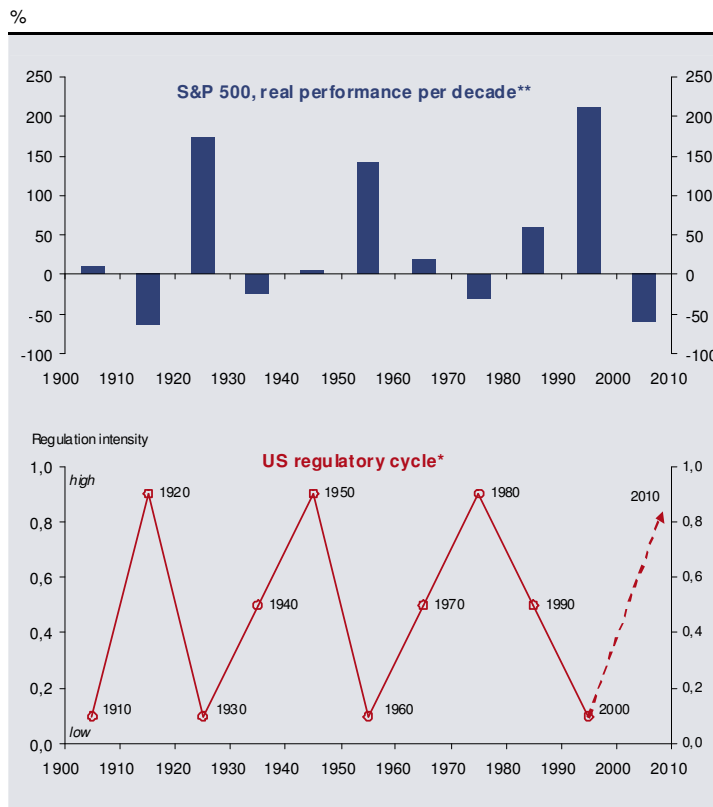
The biggest trouble spots seem more or less under control by now, and financial markets are beginning to stabilize. Now begins the cleanup. Around the globe, most recently at the G20 meeting in London, political leaders are currently pondering the question of how the “monster” of the financial markets can be tamed. Even if only faint outlines are visible of how this is to be done concretely, one thing seems clear: the financial markets must be regulated more strictly and in a globally coordinated fashion to prevent a crisis of this magnitude from happening again in the future. It is certainly true that absent – or better: poorly devised – framework conditions allowed the crisis to develop. However, it is far more difficult to find the right measure to, on the one hand, counteract developing excesses, and, on the other hand, allow sufficient leeway for the positive market forces to develop.

Regulatory cycle fluctuates between extremes

At a look at the past demonstrates that the regulatory process is subject to strong cyclical fluctuations: decades of deregulation and liberalization are regularly followed by decades in which the legislative power intervenes more strongly in the workings of the market. The regulatory cycle reached a first peak in the twentieth century in the decade between 1910 and 1920 as a reaction to the crisis of 1907 and the demands generated by the First World War. This was followed by a period of prosperity and deregulation in the twenties. The global economic crisis that began in 1929 then initiated a new era of comprehensive state interventions. The forties, too, in the face of the Second World War, were entirely under the banner of regulation. In the subsequent phase of rebuilding, the reins were loosened again and the economy boomed. Things were much more unsettled in the next two decades, the '60s and the '70s. This period saw, among other things, the Cuban Crisis, the Vietnam War, the end of the Bretton Woods system, and the first and second oil crises and the expansion of state influence that came with them. The change in economic policy began under the government of Ronald Reagan in the US and Margaret Thatcher in England. Un-

der the influence of the Chicago School and its best-known champion, Milton Friedman, extensive deregulation measures were undertaken especially in the Anglo-American countries. State enterprises were privatized, taxes were cut, and the power of the unions was pushed back. With the breakup of the Soviet Union, the Anglo-American version of the market economy then embarked on its triumphal march around the world. After the bursting of the New Economy bubble and the corporate scandals, on the one hand, and the attacks of 9/11 and the subsequent war on terror, on the other hand, the pendulum of government swung back again. Until now, the area of domestic and foreign security have dominated this trend. The upheavals in connection with the global financial crisis now give reason to expect a massive expansion of regulation also in the financial system.

Stocks suffer from regulation



* stylised trend derived from the number of regulatory agencies newly created in each decade or the number of employees in the regulatory authorities; ** until 2.28.2009
Sources: Ravi Batra, Weidenbaum Center, Helaba Research

Keeping expectations realistic

The pronounced fluctuations in the regulatory cycle during the last one hundred years are an indication that we have evidently not yet been able to find a balance between regulations to limit undesirable market results and the positive growth forces. In the process, we can see that in decades of growing state influence, stocks produced below-average inflation-adjusted returns, while above-average, real gains in stock prices occurred in phases of deregulation. Especially in light of the loss in asset values in the wake of the financial crisis, an excess of regulation would most likely prove counterproductive, that is, it would tend to delay the process of economic recovery.

Regulatory policy has right of way

This does not mean that the legislator is condemned to inactivity. However, since history never

repeats itself in detail, the next crisis will presumably have different causes. But what those causes will be is all but impossible to make out ahead of time. That is why the regulations should be kept in such general terms that they deal not merely with the symptoms, but instead with the fundamental causes of crises. One of the most important principles in this context is the unity of action and liability. If this principle is violated – that is, if it is possible to privatize profits but socialize losses – we can expect that market actors will take excessive risks. Especially the current trend toward a concentration in the financial sector therefore seems anything but in line with this goal of preventing future crises, since it might take the notion of “too big to fail” to an extreme. Moral hazard, even if through different mechanisms than in the current crisis, would thus be once again pre-programmed. The goal should therefore be to counteract the emergence of “system-busting complexes.” Only then can the free-market mechanism of sanctioning behavior through selection come into play and exert its disciplining effect. In spite of the much-invoked economies of scale, the motto must therefore be: diversity instead of size.

Some of this appeared as an opinion piece in *Die Welt*, 4 April 2009 ■

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