BANKERS AND SCAPEGOATS

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ABSTRACT

It is commonly believed that banks are in special need of regulation to prevent financial crises, and the recent sub-prime crisis would tend to support such views. Yet it is clear that a series of perverse incentives exist in the banking industry. Incentives for bankers to take on too much risk lead to financial crises, and then a lack of a bankruptcy process for large financial institutions lead to massive taxpayer bail-outs. This chapter canvasses the issues surrounding the sub-prime crisis and explores arguments relating to regulation and the political economy of the recent crisis. As long as the political cost-benefit of having inefficient banking regulation dominates an economic cost-benefit of having efficient regulation, we can expect that perverse incentives will remain and financial crises will be a regular feature of the economic landscape.

And Aaron shall lay both his hands on the head of the live goat, and confess over it all the iniquities of the people of Israel, and all their transgressions, all their sins. (Leviticus 16: 21.)

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1. INTRODUCTION

Scapegoats are an ancient institution. They survive into the present, although it appears that a very important part of the process is now neglected. In biblical times, the sins of the people were transferred to the goat; it was guilty by proxy. Now, however, it seems the goat was guilty all along. Following the recent financial crisis, the banking system is being blamed for having taken on excessive risks and for being too greedy. Yet it is quite clear that in many instances bankers were responding to incentive structures that were established by the political process (this is especially the case in the United States). It is interesting to note that the same political process is now blaming bankers for the crisis – a clear case of scapegoating but without confession.

This chapter consists of four sections, which collectively canvas the issues surrounding the sub-prime crisis and explore the arguments relating to regulation and the political economy of the recent crisis. In Section 2 I round up some of the usual suspects, explaining why banks are said to be subject to systemic risks. Despite the recent crisis centering on the banking system and systemic risk, it is not clear that these sorts of argument explain the need for additional regulation of the banking system. I also examine some of the arguments that have been posited for the recent crisis. Those arguments that relate to bubbles, esoteric financial theory and sudden outbursts of greed, are particularly unsatisfactory. There may well be an argument about inappropriate regulation – poor incentive structures – that does go some way the explaining the crisis.

Section 3 examines modern theories of regulation. The economist’s toolbox usually contains a public interest theory and a capture theory of regulation. Recent theoretical work undertaken by Andrei Shleifer and various co-authors provides a richer theory and understanding of regulation. This institutional framework provides a better understanding of the costs and benefits of regulation. Empirical analysis is consistent with this institutional theory of regulation.

Section 4 makes the argument that bankruptcy is the appropriate discipline measure for failed banks. Here the political economy of the response to the crisis is examined. Bailing out failed banks are fraught with financial peril and moral hazard. To be sure, the notion that financially distressed banks should be provided with liquidity is the traditional response to problems in the banking system, but economically distressed banks should be allowed to fail. By subscribing to either the ‘too big to fail’ or ‘too big to discipline’ philosophies of banking policy makers ensure that poor
incentives remain in the banking system. Unfortunately, as policy makers derive political benefits from having inefficient banking regulations, it will be difficult to remove those inefficiencies from the system.

2. THE USUAL SUSPECTS

There appears to be a generalised view that banks and banking is somehow different from other sectors of the economy making it necessary for special attention. This view is difficult to justify; as Benson (2000, p. 188) indicates, ‘Firms that do not affect people’s health or safety or the defense (sic) of the nation rarely are regulated specifically. Why should banks be treated differently than these firms?’ In this section, I discuss some of the bank-specific arguments for regulation while discussing the general argument (asymmetric information) in the next section.

Although banks perform a multitude of functions on behalf of their clients, the core business of banking consists of borrowing money to lend it. Banks earn their profit by managing the mismatch of risks arising from the different preferences of borrowers and lenders. Although this activity might be considered risky, the basic business model is similar to that of any market intermediary. Banks and the services they offer are ubiquitous. Banks serve all other firms in the economy, and most individuals will have, at least, one bank account. An ongoing relationship between a bank and a particular client is seen as providing information to observers regarding the quality of the client’s income stream. Yet the same can be said for many other business relationships, and it is not clear that the kind of signalling that Fama (1985) emphasises is cause for public policy intervention.

The major argument that banks are somehow different is based on the notion that banks are subject to high levels of systemic risk. This is due to fractional reserve banking, high levels of leverage, and strong interrelationships between banks as they lend and borrow from each other. This leads to the view that a bank run could easily and quickly lead to a loss of confidence in the entire banking system. This, in turn, imposes very high costs on competitors, suppliers, consumers, and the economy as a whole. Benson (2000), however, suggests that these arguments are oversold. He divides those individuals and firms affected by a bank failure into two groups. First, those with a contractual relationship with the failed bank; Benson (2000, p. 190) makes the argument that these individuals should be well-placed to understand the risks of their relationship and should not get any greater protection than any other contractual relationship. Then there are those
who may suffer an externality due to bank failure. Here Benson (2000, p. 191) argues that attempts to prevent this sort of externality has had the perverse effect of increasing the risk of failure.

There are, of course, the macroeconomic effects of a systemic crisis in banking. The macroeconomic issue at hand is due to the interaction between the banking system and the money supply. A run on the banking system can cause the money supply to contract quite sharply imposing huge costs on the real economy. The problem here is in differentiating between solvent and insolvent banks. There is a large theoretical literature dealing with this problem – yet the empirical evidence suggests less of a problem. Kaufman (1994) undertook a review of theory and evidence and reports that banks are only slightly different from non-bank firms with respect to failure. Kaufman (1994, p. 143) does provide some argument that is worth quoting in full.

However, there is no evidence to support the widely held belief that, even in the absence of deposit insurance, bank contagion is a holocaust that can bring down solvent banks, the financial system, and even the entire macroeconomy in domino fashion. Indeed, losses to depositor creditors at failed banks, one of the major fears and causes of runs, are smaller on average than in nonbank industries. Even at its worst, as in the 1980s with deposit insurance, resolution of bank insolvencies appears far more efficient than resolution of nonbank firms through the bankruptcy process.

Benson (2000) concurs with Kaufman (1994) and suggests that even if banking crises could impact upon the macroeconomy, then the monetary authorities could quickly and easily intervene. He concludes (1994, p. 192) that protecting the macroeconomy is not a valid basis for regulating banks.

This sort of argument, however, would appear to be somewhat at odds with the events of the recent crisis period. It has been argued that financial markets and financial institutions are at the very centre of the recent financial crisis. Kaufman (1996, p. 41) has argued that bank failure can be associated with bubbles and that

The best protection against widespread bank failures and systemic risk is macroeconomic policies that achieve stability and avoid price bubbles that leave banks highly vulnerable to failure.

The idea that there was a bubble in the United States is widespread – indeed it appears that Krugman (2002) encouraged the US government, and the Federal Reserve in particular, to generate a real estate bubble to keep the US economy strong. To the extent this occurred and Kaufman (1996) is correct, it is unsurprising that a financial crisis occurred. One problem with this type of argument is that, while the idea that asset markets are prone to bubbles is very common, it is also unsatisfactory. It is unclear what is meant
by the term ‘bubble’ except that the user does not agree with or understand current asset pricing levels. As Eugene Fama said in an interview with John Cassidy (2010) of The New Yorker

[Cassidy] I guess most people would define a bubble as an extended period during which asset prices depart quite significantly from economic fundamentals.

[Fama] That’s what I would think it is, but that means that somebody must have made a lot of money betting on that, if you could identify it. It’s easy to say prices went down, it must have been a bubble, after the fact. I think most bubbles are twenty-twenty hindsight. Now after the fact you always find people who said before the fact that prices are too high. People are always saying that prices are too high. When they turn out to be right, we anoint them. When they turn out to be wrong, we ignore them. They are typically right and wrong about half the time.

A far more valuable exercise would be to examine fundamental factors within the market to understand how they may be influencing pricing.

Schneider and Kirchgassner (2009) suggest that economists were partly to blame for the financial crisis. Their argument is that financial economists had devised elegant and sophisticated models that masked their underlying assumptions and weaknesses. Users of those models, unaware of those assumptions and weaknesses, would have been taken by surprise when the models failed under real world conditions. According to Schneider and Kirchgassner (2009, p. 321)

These new models, which were rigorous and promised to provide ‘exact’ information emboldened market participants to believe that the additional leverage was safe since participants now used scientific techniques and were convinced that they could manage it.

This is an argument that neglects any understanding of the efficient markets hypothesis. That theory suggests that mechanistic approaches to asset pricing and trading are bound to fail – the route to superior returns is by taking on additional risk (however defined). If any user of sophisticated modelling ever thought that they had found a riskless path to riches, they deserve to have lost their money.

Other economists seem to be arguing that the efficient markets hypothesis itself is partially to blame for the crisis. Quiggin (2010), for example, suggests that an understanding of the efficient market hypothesis lead to a change in regulatory philosophy. Prior to the 1970s financial regulation had been restrictive, focusing on consumer protection and macroeconomic stability. Subsequently, however, regulation sought to facilitate innovation and be ‘light-handed’. It is not clear that the efficient market hypothesis caused a change is regulatory approach or whether an improved understanding of
regulation itself was the cause. Quiggin (2010), however, correctly argues that the term ‘deregulation’ when applied to the financial sector is misleading; no industry that ultimately is underwritten by the public purse can be described as being unregulated. The manner of the regulation may change over time, and it is those changes that may have perverse consequences.

It is clear, however, that US regulation played an important role in the sub-prime crisis. The usual argument along these lines is that inefficient deregulation occurred, but that view is difficult to sustain. Horwitz and Boettke (2009, p. 17), for example, indicate that over the period 1980–2009 there were four regulatory policies for every one deregulatory policy. Conversely, Schneider and Kirchgassner (2009, p. 320) argue that financial markets and innovation ran ahead of regulation, and there may be some merit to that story. But the real regulatory story must relate to the interaction between US housing policy and US banking regulation.

The US government has for decades followed policies that promote home-ownership. Although the United States is hardly unique in pursuing such policies, over the past 20 years or so, they expanded that policy dramatically. The US government pursued policies that effectively forced financial institutions to lend money to individuals that were poor credit risks. George Melloan (2010, pp. 365–366), former deputy editor of the Wall Street Journal describes the events leading up the sub-prime crisis as follows.2

The relevant interference began over a decade ago when Congress and the Clinton administration began forcing banks to make highly risky loans to advance home ownership for Americans whose ability to afford homes and pay off mortgages was marginal. Two government sponsored lending and loan guarantee enterprises, Fannie Mae and Freddie Mac, became a receptacle for most of these dubious loans and folded them into mortgage-backed securities of equally dubious quality.

The credit bubble created by the Federal Reserve Board in 2003–04 provided an environment for further irresponsible lending on a massive scale. Eventually it all came crashing down with a freeze-up in the $7.6 trillion mortgage-backed securities market that left several large players like Lehman Brothers and Bear Stearns insolvent.

If we agree that US government policy played an important role in contributing to the sub-prime crisis, then comments like this by Richard Salsman could be a good description of the situation.

If there is anything more tragic than our current banking crisis, it is that the crisis is being blamed on the wrong group, on the bankers, instead of on the primary culprit, government intervention. The tragedy lies in failing to identify the fundamental cause of the problem, thereby ensuring its continuance. Bankers are not entirely innocent of wrongdoing in the present debacle, but to the extent that bankers have been irresponsible, it has been primarily government intervention that has encouraged them to
be so. ... Government has created these banking crises – by making it nearly impossible
to practice prudent banking. Having done so, government has then pointed to bad
banking practices as sufficient cause for still further interventions in the industry.

The only problem with this quote is that it does not apply to the sub-
prime crisis. Salsman (1993, p. 81) wrote those words to describe the
previous US banking crisis – the Savings and Loans (S&L) crisis of the
late 1980s. In other words, it is very clear that the two crises have similar
origins. Government intervention in the market – even for the very best of
intentions – can have adverse consequences and very high costs associated
with those consequences. As Ludwig von Mises (1980, p. 295) indicates,
‘Imprudent granting of credit is bound to prove just as ruinous to a bank as
to any other merchant’.

The political solution to the S&L crisis was, as now, to blame bankers
for their greed and introduce regulation. A typical explanation along these
lines was provided by the minority report in an Australian Senate Inquiry
(Economic References Committee, 2009, pp. 49–50).

From the middle of 2007, financial markets began showing signs of considerable turmoil
as the realities of trade in exotic financial derivatives and the explosion in sub-prime
lending that had characterised the finance market boom became clear.

As subsequent events would reveal, inadequate regulation and greed on the part of
financial market players would set in train a sequence of events in the United States, the
United Kingdom and Europe that would culminate in the collapse, nationalisation or
government bailout of major banks, insurers and credit providers. These included
Citigroup, American International Group, Northern Rock, Fannie Mae, Freddie Mac,
Bank of America, Goldman Sachs, Morgan Stanley, Royal Bank of Scotland, Lloyds
TSB, HBOS and a number of major continental European financial institutions. The list
of institutions involved reads like a veritable Who’s Who of those who only months
earlier would have considered themselves ‘masters of the universe’. As we now know,
these emperors had no clothes.

The idea that financial markets had become unusually greedy appeals to
morality but is not a good economic explanation for the crisis. Regulations
to limit greed and executive compensation have been proposed in the United
States and in other jurisdictions such as Hong Kong. This notion, however,
was rubbished in a Wall Street Journal Asia (2009) opinion piece.

The idea that bankers caused the financial crisis is only credible with politicians and
unaccountable bureaucrats. It’s especially seductive in the U.S., where Wall Street firms
leveraged up to their necks and then took taxpayer money when they were bailed out.
But no such crisis happened in Hong Kong, where banks more prudently managed their
balance sheets.
The idea, too, that a public-sector bureaucrat can better align banker incentives than a competitive marketplace is laughable.

In addition to being ‘laughable’, the idea that bureaucrats can and should closely manage private institutions is inconsistent with the latest theory and evidence from regulatory and institutional economics.

3. AN INSTITUTIONAL THEORY OF REGULATION

The economics of regulation can be broken up into three strands. The first strand, generally associated with Arthur Cecil Pigou, is the ‘public interest’ theory and suggests that governments intervene to correct for externalities and other market failures. The second strand, associated with George Stigler (1972), suggests that industry seeks out regulation to create barriers to entry for new rivals and to maintain profitability. This strand of literature is known as the ‘special interest’ or ‘capture theory’ theory of regulation. The third strand, associated with Andrei Shleifer, sets out an institutional analysis of regulation that draws upon both the public interest and capture theories of regulation.

Shleifer (2005, p. 442) describes four broad general mechanisms to exert social control over organisations; ‘market discipline, private litigation, public enforcement through regulation, and state ownership’. The trade-off in distinguishing between these mechanisms is between disorder and dictatorship. Djankov, Glaeser, La Porta, Lopez-de-Silanes, and Shleifer (2003, p. 598) have provided an excellent definition and discussion of disorder and dictatorship.

The two central dangers that any society faces are disorder and dictatorship. Disorder refers to the risk to individuals and their property of private expropriation in such forms as banditry, murder, theft, violation of agreements, torts, or monopoly pricing. Disorder is also reflected in the private subversion of public institutions, such as courts, through bribes and threats, which allows private violators to escape penalties. Dictatorship refers to the risk to individuals and their property of expropriation by the state and its agents in such forms as murder, taxation, or violation of property. Dictatorship is also reflected in expropriation through, rather than just by, the state, such as occurs when state regulators help firms to restrict competitive entry. Some phenomena, such as corruption, reflect both disorder and dictatorship. When individuals pay bribes to avoid penalties for harmful conduct, corruption is a reflection of disorder. When officials create harmful rules to collect bribes from individuals seeking to circumvent them, corruption is a cost of dictatorship.
Market discipline is a very powerful force and should be considered as a regulatory default. It allows private decision making, consumer sovereignty and minimises the costs of dictatorship. Of course, it may well be the case that market discipline cannot control disorder. Shleifer (2005, p. 444) argues that the ‘case for public intervention relies crucially on the presumptive failure of market discipline to control disorder’. At this point the control strategy becomes private litigation. The rules of contract and tort law administered by courts of law now control disorder; the state begins to play a role. Courts are institutions of the state and are staffed by bureaucrats and judges. Courts of law exist, at this level, to enforce private agreements and to adjudicate disputes between private parties.

Courts themselves, however, are imperfect institutions. Shleifer (2010) has argued that courts cannot always resolve disputes cheaply, predictably and impartially. When this occurs, courts and private litigation do not control disorder, and the scope for regulation opens up. Regulation occurs when the state not only provides a dispute resolution mechanism but also writes the rules that govern economic behaviour and transactions. There is substantial variation in how government can enforce its regulations. It can, for example, allow bureaucrats to engage in a regime of inspection and verification with fines being issued for non-compliance. Alternatively, the state can provide a set of rules that are privately litigated or publicly litigated. Public litigation can consist of either civil or criminal charges. Similarly the regulatory agency can initiate litigation itself for breeches of the regulations or act once a complaint has been received.

State ownership appears to be an efficient response to those situations where the disorder costs are likely to be very high. Shleifer (2005, p. 447) gives the examples of prisons, police force, and military where this is likely to be the case. The costs of disorder resulting from private ownership here are potentially so large that government needs to maintain control over these institutions.

It is one thing to have a generalised argument for regulation as an effective control mechanism, it is quite another to advocate regulation for a specific industry. The argument for regulating financial markets appears to be strong. Financial markets face what economists call an ‘asymmetric information’ problem. Of course security markets are hardly unique in this respect. Friedrich von Hayek (1945) has written that asymmetric information is the economic problem to be resolved. This represents a classic case of ‘market failure’ and gives rise to the need for regulation under public interest regulation theory.
La Porta, Lopez-de-Silanes, and Shleifer (2006) investigate the impact of security laws on financial markets across 49 economies. In particular they investigate how security laws operate to protect investors and whether regulators with public enforcement or rules with private enforcement lead to better outcomes. After exhaustive empirical analysis, La Porta et al. (2006, pp. 27–28) report,

our findings suggest that securities laws matter because they facilitate private contracting rather than provide for public regulatory enforcement. Specifically, we find that several aspects of public enforcement, such as having an independent and/or focused regulator or criminal sanctions, do not matter, and others matter in only some regressions.

The upshot of this analysis is that legal rules matter, but that regulators do not always matter. So long as rules can be enforced in courts investors do not need to be protected by regulators. This is the very argument made by the Wall Street Journal Asia – investors do not need regulators to second-guess private decisions, they need a legal framework for decision making.

It would be easy to argue that the La Porta et al. (2006) is only generally true, but that banks and other financial institutions are different. Yet that is not the case. Barth, Caprio, and Levine (2004) find an analogous result in their investigation of bank regulation and supervision across 107 countries. They summarise their results as follows (Barth et al., 2004, pp. 245–246).

In terms of broad implications, these findings raise a cautionary flag regarding reform strategies that place excessive reliance on countries adhering to an extensive checklist of regulations and supervisory practices that involve direct, government oversight of and restrictions on banks. Instead, our findings are consistent with the view that regulations and supervisory practices that

(1) force accurate information disclosure,
(2) empower private-sector corporate control of banks, and
(3) foster incentives for private agents to exert corporate control,

work best to promote bank development, performance and stability.

Barth et al. (2004) are not using the same law and finance approach to interpret their results as the La Porta et al. (2006) paper does; yet the conclusions are remarkably similar. Regulations involving prescriptive behaviour and powerful regulators using public enforcement mechanisms are not the better techniques to employ for the purpose of social control. These sorts of results raise the important question of why governments pursue those types of regulation. Not only do they appear to be non-optimal from an economic perspective, they must be non-optimal at a personal and political level. Afterall, as the Wall Street Journal Europe (2009) points out,
'The bankruptcy of a systemically important bank is, necessarily, also a failure of the regulators who were overseeing it'.
The question to ask is why some commercial institutions are considered to be too big to fail or too big to discipline. Congleton (2009) has provided a public choice explanation of the political response to the crisis. He finds that a public choice explanation works reasonably well. He does not, however, seem to consider that calls for bank bailouts would themselves be part of a bankruptcy game. He makes the point that prior to September 2008 the United States seemed to be experiencing a standard recession and that many US financial institutions were actually bankrupt and not liquidity constrained. He then argues (2009, pp. 305–306) that former Treasury Secretary Henry Paulson employed stronger rhetoric than circumstances indicated to promote his bailout package.

There is some evidence that the ‘Great Depression’ rhetoric used to secure passage of the bailout bill exacerbated the credit problem and the recession. Because individual investors and firms naturally assume that Treasury experts have the very best data, the risk of another Great Depression apparently was ‘new news’ to many of them.

In the light of these arguments, it does seem puzzling that he does not give more weight to Stigler’s capture argument saying that the evidence for capture is unclear. Perhaps so, yet the greatest beneficiary of an argument that some institutions are too big to fail would be those very institutions. Swan (2009, p. 130) has no doubt the capture hypothesis is at work.

In effect, the U.S. government has now been captured by the recipients of hundreds of billions in taxpayer largess and must keep on upping the ante now that it has declared that all the banks with the one exception of Lehman’s are ‘too big to fail’.

Congleton (2009) finds in favour of the argument that bankruptcy procedures in 2008 were inadequate to deal with the financial crisis. That is, financial market innovation had outstripped regulators’ ability to regulate the financial system and bring about an orderly process to manage failure. This view suggests that there are potentially very high costs associated with existing bankruptcy procedures. White (1996) has provided an important framework for understanding those costs and the various trade-off associated with bankruptcy procedures. She makes the important point that the incentive effects created by the bankruptcy process are more important than the impact of the bankruptcy process on those firms that are actually distressed. Unfortunately, it is here that our understanding of the bankruptcy process is particularly poor – a point also emphasised by Smith and Stromberg (2005, pp. 261–262). White (1996) makes the point that delay costs can be very high, and Congleton (2009) also makes the point that bankruptcy needs to be expedited in the financial sector.
Financial crises and bank failure, however, are not rare events. Perhaps the extent of the sub-prime crisis was unusual, yet it does seem strange that no expedited bankruptcy mechanism exists for large financial institutions. This does indicate a gap in the regulatory framework. This gap could exist by accident or by design.

The argument supporting a regulatory accident suggests that regulators did not foresee a financial crisis of sufficiently large magnitude to require expedited bankruptcy procedures. Conversely, it might be the case that regulators do not know how to design and implement an efficient bankruptcy procedure for large financial firms. It is an open question as to how plausible that argument might be. It is not at all clear that the market economy has exceeded the limits of bureaucratic control.

Alternatively, it is possible that a regulatory gap exists due to deliberate design. Kroszner (1994, p. 423) makes the argument, ‘The demands of government finance have had a major impact on the financial regulations lawmakers adopt’. So why wouldn’t regulators, or more likely politicians, want an efficient bankruptcy procedure? The most basic argument would be that it is not in their interests for such a mechanism to exist. So long as a political cost-benefit analysis for inefficient regulation dominates an economic cost-benefit analysis public choice theory suggests that inefficient regulation will occur. This simple analysis may be represented as:

\[ \text{Political benefit} - \text{economic cost} > \text{political cost} - \text{economic benefit} \]

This framework begs the question as to the political benefits of inefficient regulation. Quite simply, inefficient regulation allows banks to take on too much risk. This could have, at least, two political benefits. First, it would allow politicians to pursue their social agendas, such as community housing, through the banking system. Second, by taking on too much risk, banks might become much more profitable than they otherwise would be, giving rise to high tax revenues to government that can be used to pursue other political objectives. An additional issue to consider is that misallocation of resources and waste can take many years to realise, and political horizons may be too short for those costs to be internalised by politicians. The absence of an efficient bankruptcy procedure in this instance could be a signalling device, indicating to financial institutions that they will be bailed out and not have to bear the full costs of failure as a consequence of their excessive risky behaviour.

The market system has a process for dealing with failure called bankruptcy. In the financial sector, this procedure works very differently than in most other parts of the economy. I have made the argument that this
may well be due to the incentive structures within public choice. This does raise the additional question, however, of why regulators attempt to scapegoat bankers when a major financial crisis occurs. It seems the costs of failure are enforced through the political process rather than the market economy. The question becomes whether the costs of failure are better enforced in the political process or through the bankruptcy process. While this is an empirical question, it does seem more likely that the costs would be higher in the political process. In the first instance, the political process is more likely to be arbitrary, have higher deadweight costs associated with it, and lead to greater government involvement in the economy. On the contrary, a market-orientated bankruptcy process would create incentives to reduce unnecessary waste. After all an objective to the bankruptcy process is to maximise the value of the firm’s assets despite failure. There is no such incentive in a political process.

5. CONCLUSION

Several scapegoats have been identified as having contributed to the sub-prime crisis: bubbles, financial economists, the efficient markets hypothesis, inefficient regulators, greedy bankers and the like. To be sure, there is enough blame to go around, yet the role that government and politicians play in establishing incentives for excessive risk-taking and the failure to provide an adequate bankruptcy mechanism has not yet been adequately understood. The efforts to create more prescriptive banking regulations and more powerful regulators is inconsistent with the latest research and understanding of effective regulation. Populist demands for greater regulation are almost certain to lead to poor policy implementation and perverse outcomes.

This chapter highlights the incentive that political decision makers face when designing a set of regulations to specifically ensure that banks take on too much as opposed to too little risk. The quid pro quo of such an incentive system is that government must stand ready to bail out those failed institutions that respond to those incentive structures. The cost of such a system is that the costs of failure are then enforced through a political process of scapegoating, as opposed to a market process of bankruptcy. The latter process includes the incentive to minimise those costs of failure, whereas the political process does not face those same incentives. For as long as politicians do not incur any failure costs as a consequence of policies they pursue in office, it is likely that these sorts of inefficiency will continue.
As Swan (2009, p. 131) asks, ‘are politicians in what has become effectively, a socialised banking system, the best people to be setting bank lending policies and making investment decisions on citizens’ behalf?’ To reduce the incidence of failure, the costs of failure need to be privatised and enforce where they are incurred. That implies less government intervention and greater use of bankruptcy to dispose of failed firms, including banks.

NOTES

1. Quiggin’s book is unpublished as yet, but a draft version can be found at http://zombiecon.wikidot.com/start
2. A more detailed discussion of US housing policy and its contribution to the sub-prime crisis can be found inter alia in Congleton (2009), Davidson (2010) and Wallison (2010). A recent special issue of Critical Review examines several arguments relating to the crisis. Stiglitz (2009) discusses irresponsible private behaviour, Jablecki and Machaj (2009) discuss the Basel accords, White (2009) investigates the role credit-rating agencies played, and Wallison discusses the contributions Fannie Mae and Freddie Mac and other features of the US housing market made to the crisis. At a more macroeconomic level Reinhart and Rogoff (2009) have provided an exhaustive history of boom and busts including the sub-prime crisis.
3. Strictly speaking those institutions should be described as being financially distressed, bankruptcy is a legal process.

REFERENCES


