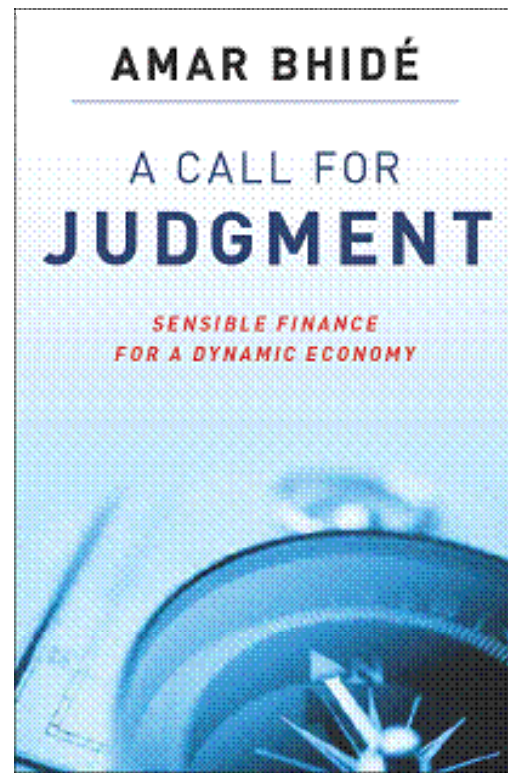


Tufts University

A Call for Judgment:
Sensible Finance for a Dynamic Economy

Amar Bhidé
www.bhide.net

**Thomas Schmidheiny Professor
The Fletcher School of Law and Diplomacy,
and member
Center on Capitalism and Society**



Misinterpretations of crisis

Too broad

- "The entire system of capitalism is defective"

Too narrow

- "Financial system fine ... but regulation had fallen behind"

My thesis

Real economy capitalism sound

- Inclusive innovation game has delivered the goods

Financial system severely flawed

- Undermines real economy
- Unstable

Defects deep and long standing

- Financial theory
- Misregulation

Innovation-finance conflict

Venturesome (real) Economy



Modern Finance

Conflicts with

**Decentralized judgment
coordinated by**

- Prices
- Dialogue
- Relationships

Tied to real responsibility



Highly centralized/concentrated

Mechanistic models

Limited communication

**No responsibility for
bad outcomes**

Today's talk

How modern finance undermines dynamism

- Critical features of an innovative economy
- Implications for a good financial system
- A dangerous and dysfunctional divergence

What made finance pathological

Radical and retro proposal

Inclusive innovation – a “massively multiplayer” game

Widespread prosperity requires widespread productivity improvements

- Development and effective use of innovations
- Multi-level, multi-faceted advances
- Many contribute and benefit

How capitalism organizes multi-player innovation

Decentralized, case-by-case, forward looking judgment

- Advantages of “on-the-spot” decision-making (Hayek 1945)
- Innovation requires imaginative, forward-looking choices
- Also favors decentralization

Limited by some coercive and voluntary controls

- Scale
- Externalities

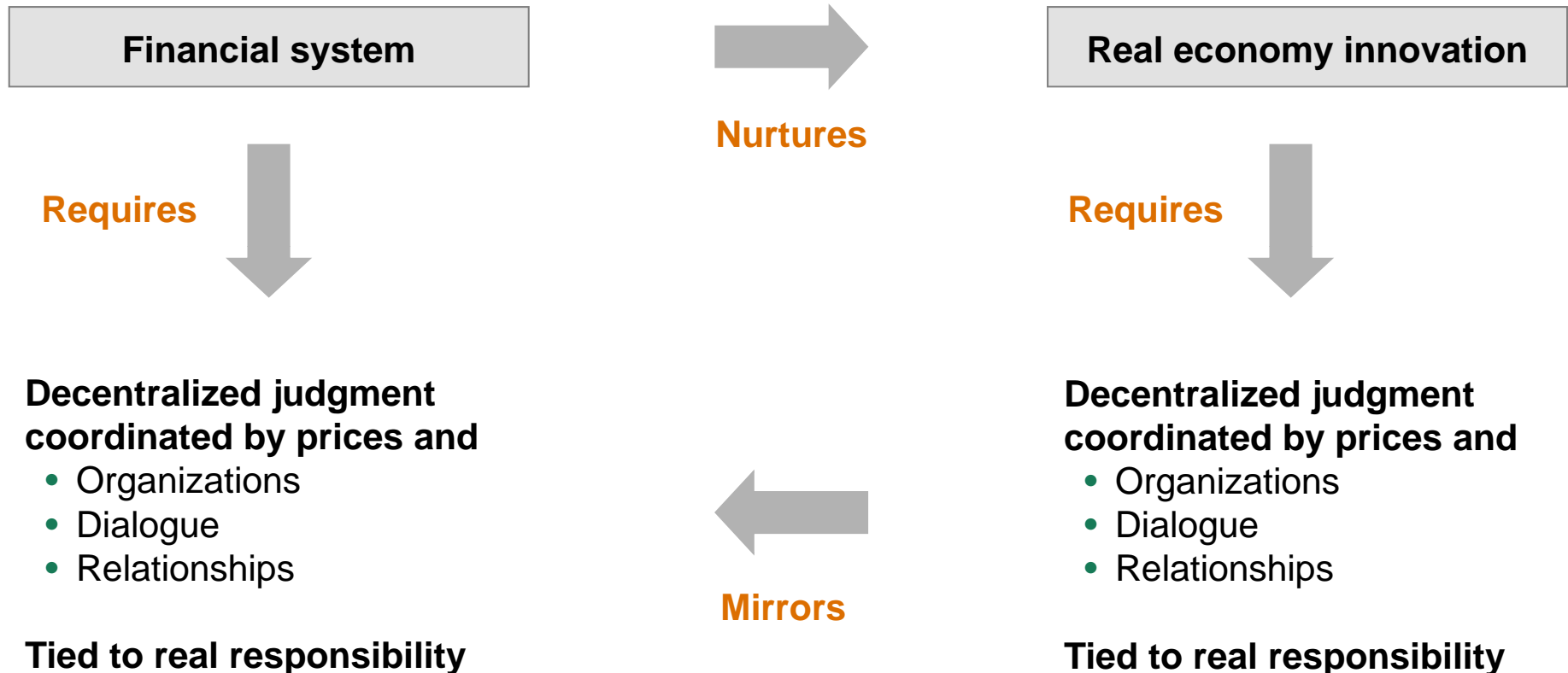
How capitalism organizes multi-player innovation

Coordination of decentralized judgment through

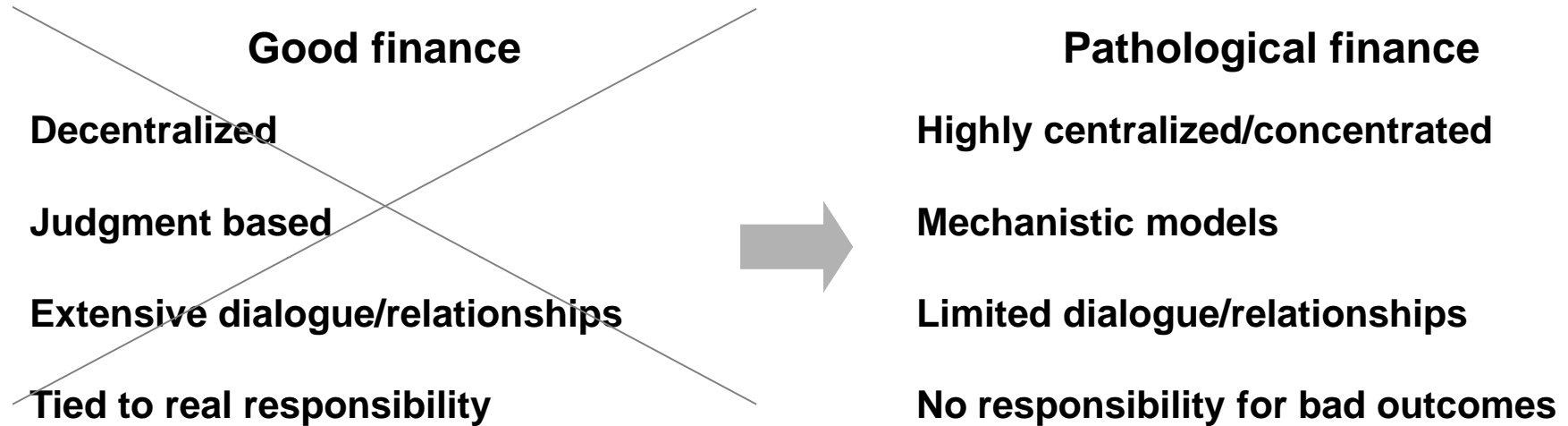
- Prices
- Organizations
- Dialogue
- Relationships

Tied to real responsibility

Finance should nurture and mirror dynamic real economy



Good finance displaced by pathological finance



Manifestations of pathologies

Mass-produced, judgment free explosion of

- Asset backed securities
- Complex derivatives

Concentrated in mega-firms

- Ineffectual top-down management
- ... and regulatory oversight

Consequences: The Establishment's Assessment

More, cheaper credit

- Financial innovations have produced “beneficial, real effects, increasing lending, entrepreneurship, and growth rates of GDP, while reducing costs of financial transactions (Rajan 2005)

... and better risk management

- Derivatives enable “risk and return to be divided and priced to better meet the needs of borrowers and lenders” (Kohn 2005)
- “banking organizations of all sizes have made substantial strides over the past two decades in their ability to measure and manage risks”... “concepts such as duration, convexity, and option-adjusted spreads” provide better risk returns to stockholders and “greater resilience of the banking system.” (Bernanke 2006)

Downside of robotic centralization

Misallocation of Capital

- Elimination of crucial case-specific factors
- Neglect of real enterprise

Instability

- Vulnerability to a few mistakes
- Increased herding and correlations?

Jeopardizes legitimacy of capitalism

Causes

Enabled by theories that ignore

- Multi-faceted, unquantifiable uncertainties
- Differences of opinion
- Dynamism

Mis-regulation

- Securities laws too tight
- Banking rules progressively weakened

What now? The establishment's diagnosis

“Regulation fell behind”

- “Old institutions cannot adequately oversee new practices.” (Obama 2008)
- Financial innovation continues to be “a tool for making our financial system more efficient” as long as regulators are “more alert to its risks.” (Bernanke 2009)
- “credit default swaps and derivatives are not in themselves a bad thing.” (Blair 2010)

The Insider Cure: “Modernize”

Dodd-Frank Act

- 2,300 pages
- The Financial Stability Oversight Council
- SEC and CFTC authority to regulate over-the-counter derivatives
- code of conduct for all registered swap dealers
- federal standard for all home loans
- New assets threshold for federal regulation of investment advisers
- Office of Credit Ratings

Skeptical “outsider” analysis:

Regulatory catch up futile and pointless

- Personnel issues
- Continuation of failed “top down” approach
- Not worth the effort.

Retro-radical alternative

Case-by-case enforcement of broad rules

- 'On-the-spot' examination, not top-down edicts
- Common-law model

But labor intensity limits effective scope

- Focus on sound depository and payment system
- Will also provide credit within prudent bounds and contain speculative manias

A modest quasi-libertarian proposal

Depository institutions ('banks') severely circumscribed and regulated

- Simple loans and hedging operations
- Standard: what a college-educated regulator can understand
- “Prudent lender” rule
- Shut down money market funds
- Reassert full government monopoly over money?

Unregulated hedge funds/investment banks ...

- No additional oversight
- No credit or counterparty exposure wrt regulated institutions

Conclusion: Focus on what is really broken

Deep seated pathology of centralized finance needs to be attacked

- Stabilized status quo-ante is not the answer

Protect and nurture decentralized innovation—the ultimate source of modern prosperity and 'good life'