Unintended Consequences

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We live in a regulated world. A paradox of the present is that the vast reach of the information era, with its egalitarian sharing of news, entertainment, and learning, has become a treasure trove for regulators and authorities. For financial markets, the crisis of 2008 brought a deluge of regulations, oversight, lawsuits, fines, and media-triggered popular anger. Bankers became villains and banks became whipping boys treated like criminal enterprises. We believe the Dodd-Frank Act has done tremendous damage to the economy and to the industry. Compliance requirements alone create a cost that drains efficiency and stunts creativity. It should not be a surprise that central bank monetary policies do not get transmitted to the real economy, considering the whipping-boys are the conduit.

We and the media have written extensively about the ineffectiveness of central bank monetary policy. What has gotten less attention is the role regulators have played in choking a vital industry for the economy. After the crisis, regulators unleashed a vast array of actions against individuals and institutions seeking recompense for the damage they caused. The Justice Department pursued many executives, especially those connected to the housing crisis, without obtaining any convictions. Not wanting to be left empty handed, in what looked more like a shake-down than legal due process, the government obtained Federal Housing Finance Administration Settlements and DOJ "Task Force Settlements" of $17.2 billion and $41.0 billion respectively from the largest banks. Surely, these "Settlements" came with a laundry list of rules, oversight and threats which effectively curtailed the mortgage market.

In September, in a display of staggering insensitivity, with Task Force discussions still in process, a leaked report suggested the DOJ was seeking a $14 billion settlement from Deutsche Bank related to its role in the crisis. This leak occurred at a time the bank's entire market capitalization was about $20 billion and the institution was addressing other challenges. Global financial markets spent two weeks fretting over the possibility of another financial crisis triggered by none other than the Task Force charged with punishing the culprits of the last one.

The transmission mechanism of monetary policy via the provision of loans has been thwarted by new capital requirements and risk based measurements that reduce the ability and incentive for banks to expand balance sheets. Banks' withdrawal from trading in capital markets has impaired liquidity and, at times, clogged the free flow of capital. On October 14 a new rule went into effect splitting money market funds into "cash alternative" Government Funds and higher risk Prime Funds. The separation process appears to have proceeded smoothly, so far, although Libor rose significantly relative to short-term government bond rates as money funds prepared for the split. We do not expect any dislocations from the change, but an important source of working capital financing has become scarcer and more expensive.

Finance is not the only industry under regulatory assault. Most industries, even favored ones, are being pursued in the U.S. and abroad. What surprises us is the apparent lack of understanding that excessive regulation has deleterious economic consequences. The U.S. DOJ is looking to fine Volkswagen billions for facilitating faulty emissions tests. There seems to be a need to punish that rogue company for its egregious actions. Never mind that consumers dislike deceitful companies and stop buying the cars, which also, by the way, costs many workers their jobs. On August 30, 2016 the European Commission told Apple it owed $14.5 billion in back taxes to Ireland because of improper "special treatment." In a letter to customers defending its lawful compliance with Irish tax laws during its 26 year presence in the country, Tim Cook wrote, "The European Commission has launched an effort to rewrite Apple's history in Europe, ignore Ireland's tax laws and upend the international tax system in the process. The opinion issued on August 30 alleges that Ireland gave Apple a special deal on our taxes. This claim has no basis in fact or in law. We never asked for, nor did we receive, any special deals. We now find ourselves in the unusual position of being ordered to retroactively pay additional taxes to a government that says we don't owe them any more than we've already paid."

Technology and social media have altered the way people live and communicate. The benefits to society have been vast, but so have new problems catching the attention of regulators and censors. Take new businesses like Airbnb or ride-sharing. For individuals who wish to participate for financial gain, both of these seem innocuous and, arguably, personal endeavors. Yet hoteliers, taxi drivers and other competing travel industry workers require registrations and are generally subject to regulations.

Internet age activities will slowly, but surely, face interference because digital footprints make regulators and tax assessors salivate. In free societies this has already caused consternation because rights we hold dear are under assault. In others, underground networks proliferate even if they are under continuous pursuit by censors.

The balance between regulation and freedom is seldom struck in favor of freedom because governments believe they know what is best for society. The challenge is understandable considering, for example, how extreme political, social, and economic positions have gained a megaphone on social networks. Unfortunately, those venues serve to disseminate miss- and disinformation with impunity. If unregulated, unlimited airwaves can serve to feed false, or worse, deliberately distorted information. Still, people oppose incursions into their lives and privacy especially when presented to them as "in their best interest."

The irony of our current path is that as people's lives become more impinged they get unhappier and as companies get more regulated they become less efficient. The U.S. is less than one month away from a presidential election pitting two extremely unpopular candidates against each other. The electorate receives nearly daily revelations about distasteful actions or statements made by each. Ultimately, the country will have as Commander-in-Chief a person disliked by the majority of the population on the first day in office. Recently, people defied expectations and their governments in Britain and Colombia voting against what observers believed to be the preferable choice. We wonder whether this was anger, disaffection or maybe just a vote against excessive government.

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