Hypothesizing Regulatory Instability

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Erik Gerding, **Law, Bubbles, and Financial Regulation (2013)**.

Erik Gerding's recent book, Law, Bubbles, and Financial Regulation, is an ambitious and fascinating project that seeks to explain how asset bubbles—a perennial staple of economic history—lead to and, in turn, are exacerbated by financial regulation. Gerding makes it clear from the outset that his goal is to move beyond "fixing immediate symptoms" of a financial crisis and try to uncover the fundamental factors that explain how disasters happen. To this end, he advances what he calls the Regulatory Instability Hypothesis, a conceptual framework for explaining how financial markets (traditionally, a realm of private ordering) and financial regulation (the public sphere) get locked into a deadly spiral leading to a crisis. Gerding identifies five key dynamics that define this interaction: the regulatory stimulus cycle, compliance rot, regulatory arbitrage frenzies, pro-cyclical regulation, and promoting of investment herding. His Regulatory Instability Hypothesis holds that these five distinct dynamics pose danger to financial stability by undermining laws and regulations designed to protect it.

In my opinion, one of the most interesting and novel elements of Gerding's argument is his concept of the "regulatory stimulus cycle." Various scholars before Gerding wrote about the multiple causes and consequences of various deregulation campaigns, including privatizations of previously public functions and repeal of specific laws viewed as constraining private markets. In the aftermath of the latest financial crisis, in particular, many were searching for specific *legal* mechanisms that enabled unsustainable growth in risk and leverage within the financial system in the pre-crisis decades. For example, some scholars argued that the latest crisis could be traced directly to the partial repeal of the Glass-Steagall Act in 1999 and/or the passage of the Commodity Futures Modernization Act of 2000—the two most significant deregulatory legislative acts in recent times. Others (including myself) have focused on specific regulatory or legislative actions enabling financial institutions to conduct business activities that fed the pre-crisis asset bubble.

Gerding brings together all of these strands to construct a convincing and creative explanation of the entire complex of legislative and regulatory actions and failures to act, which form a single historical pattern that cannot be reduced to a simple notion of "deregulation." Gerding argues that asset bubbles and busts create similar cycles of "regulatory stimulus" (which encompasses "loosening" of various legal restrictions on bubble-conducive financial activities) and "regulatory backlash" (which inevitably follows an implosion of the bubble). He analyzes this phenomenon of regulatory stimulus through three theoretical lenses—public choice, behavioral economics, and social norms—and demonstrates the complexity and multiplicity of factors that create and reinforce pernicious regulatory cycles. Gerding's argument is original, thoughtful, and quite illuminating even for those of us who are well-versed in this subject-matter.

Gerding follows a similar approach when he examines the complex factors behind the other four aspects of his Regulatory Instability Hypothesis. He continues this densely packed discussion, which forms the bulk of the book, by applying his conceptual framework to the Panic of 2007-08. Here, Gerding shows his mastery of the rise and growth of the so-called shadow banking system, which he uses as a vivid example of the bubble-bust dynamics not only in financial markets but also in financial regulation.

The last part of the book lays out the author's vision of how to design a more effective and adaptive financial regulation that would be less vulnerable to the pernicious dynamics of regulatory instability. It's a sweeping but thoughtful discussion of high-level principles of regulatory design that could potentially alleviate specific problems he identifies earlier. While admitting "profound challenges" of trying to counter these deeply-rooted dynamics, Gerding methodically catalogues a wide range of measures aimed at redesigning regulatory institutions, with a view toward breaking the historical pattern of boom-and-bust cycles. Necessarily lacking in specificity, this forward-looking discussion nevertheless is very impressive and effective as a conceptual framework outlining the avenues for future policy work in the area.

As with any large-scale and ambitious work, Gerding's book may invite legitimate criticism on a variety of specific points. I do not agree with every statement, diagnosis, or recommendation for future reform that he advances in his book. I would even argue against some of his assertions (and, especially, some of his recommendations). If I were writing this book, I might have chosen a different theoretical device to construct the argument. Yet, none of these disagreements diminish the significance of the book. On the contrary, by defining the contours of the debate and creating a helpful vocabulary for discussion, Erik Gerding's new book provides a great benefit to the scholarly community. To be sure, this book is a dense read that requires an extra effort from its readers. Yet, the result if well worth the effort.

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