

Lecture 2: “Why does the law regulate financial markets?”

Theoretically, if the market is properly working, it is able to manage bad behaviours of the participants and obtain efficiency itself by exploiting perfect competition. It happens if and only if the participants follow the market discipline. As a consequence, regulation is not needed because the combination between contracts and market discipline is enough. But, in the real world it is not true: contracts and market discipline do not lead to the pursuing of a general interest and do not permit to reach the optimal equilibrium. As a consequence, the mechanism of a competitive market may lead to inefficient results, which are known, in economic term, as market failures.

The presence of market failures justifies government intervention to fix the problem. The law is the only solution to have efficient results because the existence of market failures does not permit it. The law is the only way to reach the optimal equilibrium.

According to Arthur Pigou (1932), we can distinguish between 4 different types of market failures:

1) Monopoly (or more generally market power).

Where one firm (monopoly) or a few firms (oligopoly or cartel) can profitably raise price above the competitive level, the market is not efficient. As a consequence, the competition dies out and the assumption on which the idea of markets being able to regulate itself is not realistic anymore. On the other hand, it is possible that one firm (a natural monopoly) can exist due to the high infrastructure costs necessary to build.

2) Negative externalities.

A negative externality can be considered a cost that is suffered by a third party as a consequence of an economic transaction.

In the financial system the action of an agent may have effects that spill over onto other parties than those explicitly involved in the exchange, when this happens we have a negative externality which can lead to a market failure.

Externalities commonly arise in situations where property rights over assets or resources have not been allocated or are uncertain. A negative externality makes the margin social cost (MSC) curve higher than the private marginal cost (MPC): for this reason, it involves overproduction and consequently a general welfare loss. Markets in general do not consider social costs and for this reason they are not able to reach the optimal equilibrium, which takes in consideration all the individuals. Law comes in, in order to internalize these externalities: it creates artificial costs which are able to shift the equilibrium from free market allocation to socially efficient allocation.

The systematic risk associated with the bankruptcy of a financial intermediary is the major negative externality we can have in a financial system. The failure of a bank affects not only its counterparts (which means its depositors) but also for all the other banks present in the system: it undermines market confidence and liquidity generating systematic problem (bank-run). Regulation is the way in which systematic risk can be managed: regulation aims at limiting the bank's exposure to risk by increasing the level of money need to set aside to limit their possibility to lend money. The reason why law tries to prevent banking crises is that the social costs are enormous and exceed the private cost to individual financial institutions.

3) Positive externalities (public goods).

A positive externality can be considered a benefit that is enjoyed by a third party as a result of an economic transaction. This occurs when the consumption or the production of a good causes a benefit to a third party. With positive externalities, the benefit of the society is greater than personal benefits, therefore the margin social benefit (MSB – Demand) curve is higher than the private marginal benefit (MPB): as a consequence, positive externalities lead to under-consumption and market failure. Law and regulation come in to increase the demand for goods with positive externalities and permit to reach the optimal equilibrium.

Public goods are the most important example of positive externalities. They are goods that everybody can use and consume without excluding other possible users but in which nobody wants to invest because the returns are very lower (a classic example is defence). Because individuals cannot be excluded from consuming a public good, those with high valuations will tend to understate their preferences and others will “free ride”. As a consequence, a competitive market may fail to provide an efficient level of public goods (underproduction) determining a market failure.

The most important positive externality in the financial system is trust. If banks are very good, people trust the financial system, but trust is a public good and therefore people could make free ride over the trust. The law

fixes the problem with a tool called authorization or license which is a way to screen out the “bad guys” and to avoid “bad guys” free riding over trust.

4) Asymmetric information.

Information asymmetries are severe and may give rise to opportunistic behaviour by the agent with more information (agency problem), generating excessive costs and adverse selection. The possibility of opportunistic behaviour by firms and financial intermediaries brings about both monitoring costs (on the investor’s side) and bonding costs (on the firms and intermediaries’ side) and may ultimately lead to impede the exchange.

In this case, the market failure is solved by the law through the use of mandatory disclosure in favour of the investors as a mean to avoid information underproduction.