THE REGULATION OF EUPHORIA

The present condition of the world capital markets is related to the euphoria that preceded it. Asset values followed a strong upward trend in the period 2003-2007 and one cannot help thinking that policy was helping to cure the crisis of 2000-2002 by rekindling a euphoria that could get markets out of control. Self-feeding asset revaluation was supported by credit expansion.

Two policy elements stand out. Firstly, easy money offered license to lever up earnings, assets, corporate acquisitions. Abundant liquidity kept pushing values higher. Investors, including professionals, persuaded themselves, once again, that the maintenance of high returns, albeit disproportionate to *perceived* risks, was normal.

Secondly, supervisory coverage fell far behind market development, especially as abundant liquidity accelerated this development. It is held that after the crisis of 2000-3, regulation became stricter. In the US, SOX tightened audit controls. In Europe, the Market Abuse Directive represented a strong instrument for curbing illicit practices. These affected organized regulated markets.

Yet, activity in unregulated markets expanded enormously. Subprime lending is a case in point. Hedge funds and private equity firms spearheaded highly levered transactions. The rapidly disappearing species of investment banks were freed of capital requirements and trod the path of high leverage, high yields and risk underestimation. Commercial banks followed suit, aided by bulging equity values.

Complex products circulating in OTC networks, were valued without the safeguards of transparency, liquidity, and certification that are built into the operation of regulated markets. Now, a fierce debate is unfolding about 'fair value' of these instruments. But the failing may not be in the accounting principles at all, as some assert, but in the flawed organization of OTC markets. Valuation in organized markets is supported by capitalization and institutional safeguards that are not duplicated in over-the-counter networks.

The euphoria of 2003-7 was born in unregulated space. Regulators avoided intervention, feeling political pressure in favor of the boom. Enthusiasm for securitization was premised on the belief that risks would be widely dispersed through a market process. Yet securitization entailed huge misrepresentation of risks. Regulatory reluctance to limit hedge fund leverage, even after the LTCM episode, was proverbial. It was thought that hedge fund principals controlled their risks, which we know is wrong. The depth and structure of the present crisis is thus closely connected to the euphoria that preceded it. Overleveraging has reversed into deleveraging; excess liquidity has been succeeded by intense shortage.

Arguably, crisis intervention is now very important but insufficient. We must already contemplate the regulation of euphoria. Otherwise the global economy will settle in a deteriorating spin, where crisis will be temporarily relieved by euphoric episodes to be followed by harsher crisis.

How can one regulate euphoria? The answer requires analysis but several premises can be proposed: First, a connection must be established between choice of monetary policy and regulatory policy. Easy money should provoke increased vigilance on excessive risk taking by financial intermediaries. Second, market spaces must be integrated from a supervisory perspective. Regulation can be strict or lax, but monitoring and readiness for intervention must cover the entire market not just parts of it. Third, institutional safeguards on market integrity in OTC transactions must be imposed, including capital adequacy for risks. Fourth, banks and other intermediaries must apply reserve policies running contrary to the credit cycle. As equity values rise, reserves should slow credit expansion. Fifth, coordinated 'breaks' should be used to obstruct self-feeding price cycles. Capital requirements, capital gains taxes, margin requirements can become active tools of regulation, adjustable in response to euphoria. Sixth, the governance and internal design of unregulated financial firms (e.g. hedge funds) and of organizations that certify asset quality (e.g. credit raters) should become a legitimate concern of public interest and policy.

If market busts are organically connected to booms, then the regulation of euphoria becomes an indispensable facet of policy to rebuild confidence in global financial markets.

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