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MARKET FORCES: THE BEST REGULATOR OF GLOBAL CAPITAL FLOWS

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The financial crises of recent decades have resulted not from market failures, but from governmental sins of both omission and commission. What many view as market failures, such as the U.S. savings-and-loan (S&L) crisis and the breathtaking scope of Asia's financial problems, are in fact the failure of numerous public policies. In effect, government, in its many forms, including central banks and the International Monetary Fund (IMF), is the primary cause of financial crises and therefore, with a few exceptions, not part of the solution to preventing future financial crises. Although seemingly inevitable in capitalist economies, these crises are entirely avoidable through the proper application of market-based economic forces.

Government, or more correctly the political marketplace, interacts with the commercial marketplace, including the financial markets, in two basic ways. First, governments create the legal environment, good or bad, within which the commercial marketplace operates. The legal environment includes contract enforcement, property rights, prevention of fraud, etc. Second, governments intervene, directly and indirectly, in the operation of the commercial marketplace. These interventions include tax and regulatory systems as well as more blatant interventions, such as attempts to influence interest rates or provide "administrative guidance" to private sector firms. Failure to maintain a productive legal environment constitutes a governmental sin of omission; governmental interventions in the commercial marketplace constitute a sin of commission.

This paper will first summarize the two broad categories of public policy failures underlying financial crises and then discuss the public policy failures caused by twenty different types of government interventions in the financial markets. It will close with a description of the very limited role governments should play in ensuring global financial stability.

The Public Policy Failures Underlying Financial Crises

The public policy failures underlying financial crises fall into two broad categories: the failure to create a productive legal environment and unwarranted interventions in marketplace activity.

A Productive Legal Environment

A productive legal environment is one in which all participants in an economy can function efficiently on a daily basis, with business being conducted in a commercially reasonable manner. A robust legal system is essential to a sound financial system because all financial products are legal contracts; accordingly, financial transactions constitute the creation or execution of legal contracts.

The two most important components of a productive legal environment and therefore a sound financial system are protection of property rights and highly reliable contract enforcement. Neither can exist, though, without well-developed statutory law and an honest, independent judiciary that enforces the law in an evenhanded manner while resolving disputes promptly and efficiently. Essential to an effective judiciary is an easily accessed appellate system that readily overturns capricious decisions while constantly modernizing the case law that fills the innumerable interstices of constitutions and statutory law.

Other aspects of a sound legal environment include appropriate protections against and effective prosecution of fraud and unscrupulous dealing; consumer disclosures and protections, comparable to fair weights-and-measures laws, that give buyers confidence in their marketplace dealings without imposing undue expense on sellers; antitrust enforcement that in fact promotes competition; and other legal protections that foster a fair, efficient commercial marketplace.

Although a productive legal environment does not guarantee the absence of financial crises, its absence cannot only create conditions that contribute to a crisis, but also impede or even worsen a crisis once it strikes. The balance of this paper is premised on a financial system operating within a sound legal system; for without the latter, the former is inherently unsound and reflective of a profound public policy failure. Therefore, this form of public policy failure will not be discussed further since a sound legal system is a given for a sound financial system.

Unwarranted Government Interventions in the Commercial Marketplace
Unwarranted government interventions in commercial markets represent the other broad form of public policy failure underlying financial crises. These interventions create a problem where none existed before or, in the rare instance of a true failure in the commercial

marketplace, exacerbates and prolongs that market failure. The heavier the intervention, the greater the magnitude of the public policy failure that then occurs. Twenty types of improper government interventions in the financial marketplace are described in the addendum of this paper (see page 126). They fall into three broad classes:

1. Pricing distortions in the financial markets, specifically mispriced credit (one to twelve).
2. Structural distortions within the financial services sector of the economy (thirteen to sixteen).
3. Delayed resolution of insolvent financial intermediaries (seventeen to twenty).

Public Policy Failures Caused by Government Interventions in the Financial Services Marketplace

Mispriced Credit

Mispriced credit is the principal public policy failure in the financial sector of most economies. Often executed under the guise of “monetary policy,” interest rates (the price for credit) deviate from what would be a true market rate of interest; that is, nominal rates of interest do not fully reflect an inflation premium or deflation discount, credit risk, liquidity factors, and other appropriate credit-pricing factors. Politicians usually prefer inflation to deflation (presumably there are more debtors in the electorate than creditors). Therefore, during an economic expansion, nominal interest rates are much more likely to be too low across an economy, or at least too low for the government and favored classes of borrowers. The first twelve forms of intervention discussed in the addendum plus one consequence of number 18 (mispriced deposit insurance) either create mispriced credit or attempt to neutralize the effects of its mispricing, usually with unintended and undesirable consequences.

Below-market interest rates are inflationary because they cause an economy’s credit supply to expand too rapidly, which in turn causes excess demand for goods and services, relative to domestic production capacity and labor supply, and sometimes an increased flow of imports; that is, credit is like any other economic good—the cheaper it appears to be, the more it will be demanded. Cheap credit (“easy money”) usually sparks lending booms, which inflate specula-

tive bubbles that inevitably burst, usually at great economic and psychological cost. Japan and Korea today greatly evidence both types of cost.

The emphasis here is on credit, not those forms of credit that also serve as money, because the money features, which conveniently serves as media of exchange, merely facilitate the occurrence of transactions—the moment in time when the ownership of a good or delivery of a service transfers from seller to buyer. Credit, however, serves the much more important role of giving purchasers the ability to make the purchase in the first place in those situations where the buyer does not already have sufficient assets to transfer to the seller. Hence, credit, and not the quantity of money or current income, operates at the margin to balance supply and demand within an economy. *Mispriced credit, therefore, unbalances the supply-demand relationship in either an inflationary or deflationary manner.*¹

Properly priced credit, *as determined by the financial marketplace, not politicians and government bureaucrats*, is absolutely essential to an economy's steady, noninflationary economic growth as well as its resiliency to economic shocks. This is the case for two reasons. First, the clearly opposed interests of debtors and creditors (debtors like inflation; creditors like deflation) will produce a nominal rate of interest that will hold credit growth to a noninflationary rate. As is increasingly recognized, low inflation is a prerequisite for sustainable economic growth.

Second, markets can adjust much more quickly to changing economic conditions, specifically supply-and-demand shocks, than can a government bureaucracy, such as a central bank. Financial markets now operate almost around the clock during the work week whereas central banks are very deliberative, due to their consensus decision making, and therefore are very slow in adjusting their interest rate targets.²

Fortunately, electronic technology increasingly frustrates the ability of governments and their central banks to distort credit pricing. Computers and telecommunications have greatly empowered the financial markets in their ongoing effort to price credit properly, specifically by permitting the quick, easy, and cheap movement of capital across national borders. Hence, creditors can, with increasing ease, flee units of account that government policies are misvaluing and where interest rates are mispriced. In effect, speculative capital

flows are tangible evidence of mispriced exchange-and-interest rates. Therefore, what some, such as Malaysia's Prime Minister Mahathir Mohamad, see as financial crises in fact trigger very healthy economic corrections.

The ongoing financial crisis in East Asia is just the latest example of financial markets very properly punishing governments for distorting the price of credit. The convergence of longer term interest rates over the last decade is another example of market forces disciplining errant governments as longer term rates drive down the inflation rate in countries with reasonably open money and capital markets. Governments still retain substantial ability, though, to distort short-term interest rates, which is why financial crises center on short-term credits, such as balances in bank accounts and short-term borrowings. These crises often spill over into other markets, such as the stock market and real estate. Fixed exchange rates magnify this problem by encouraging short-term borrowing denominated in other units of account, as was seen in the years leading up to the Mexican, Thai, Malaysian, and Korean currency crises. Once an exchange rate is broken, the interest and repayment burden of this external borrowing on debtors skyrockets.

The effect of government-induced credit-pricing distortions, which usually is inflationary, also undermines fixed exchange rates. But that effect only advances the date of the inevitable, which is the collapse of the exchange rate, often at great real economic cost. Exchange rate collapse, or adjustment, is inevitable since no form of price fixing can last in perpetuity. An inflationary increase in the credit supply, as would occur if the government forced currency into circulation, would accelerate that collapse. The unsustainability of various forms of gold and other commodity standards is further evidence that fixed exchange rates between any two economic goods or services cannot last. As with any other price-fixing scheme, the sooner a fixed exchange rate collapses, the better, because the after-shocks of the subsequent price adjustment worsen as the duration of the price-fixing scheme lengthens.

Structural Distortions Within the Financial Services Sector

Governments have interfered in the institutional structure of financial markets for a variety of reasons. U.S. bank branching restrictions, for example, were designed to protect local banking monopolies and

oligopolies. Many nations have likewise limited or even barred foreign institutions from operating inside their borders or have hobbled their ability to compete against domestic financial institutions. Governments also often restrict entry of new firms into the more heavily regulated financial sectors, specifically banking, by simply refusing to grant operating licenses or by setting capital and other entry requirements at uneconomically high levels.

Governments also have engaged in substantial compartmentalization of the financial services sector of their economies. Traditionally, governments have maintained a separation, for regulatory and supervisory reasons, between banks, insurance companies, securities firms (where they exist as such), and other financial intermediaries, such as finance companies. Often, this compartmentalization is reinforced by anti-tying restrictions that prevent the logical, economical bundling of financial products, such as credit and insurance.

Governments also have created specialized lenders to serve specific economic sectors or classes of borrowers. U.S. examples of such institutions include savings-and-loans (S&Ls), the Federal Home Loan Banks, the Farm Credit System, Fannie Mae, and Freddie Mac. It appears that every economy has had, at least until recently, a variety of specialized, government-sanctioned lenders.

As with credit pricing, electronic technology is rapidly freeing market economies from government structural distortions within the financial services sector in three ways. First, technology has made it increasingly easier for regulatory arbitragers, such as the money-market mutual funds and asset securitizers, to profitably execute end runs around heavily regulated financial intermediaries by creating new, technology-based channels of financial intermediation.

Second, technology has undermined the viability of specialized lenders by permitting other types of lenders to skim the cream from their customer base. This is why institutional distinctions among credit suppliers are rapidly disappearing as differentiated types of lenders invade each other's lending turfs. The near disappearance of the long-standing distinctions between U.S. commercial banks and S&Ls is just one example of this effect.

Third, and more recently evident, technology is rapidly eroding the distinction between banking, insurance, and securities products as specific products incorporate the characteristics of two or all three types of products. As products meld, institutional melding quickly

follows. This melding process is progressing rapidly despite substantial remaining government impediments, which are vigorously defended by the status quo—specifically those financial services providers, such as insurance agents, who fear that they will shrivel or disappear through this modernization process. Structural distortions of the financial services sector should largely disappear over the next decade as technology continues its relentless assault on the political marketplace.

Delayed Resolution of Insolvent Financial Firms

Although electronic technology is rapidly destroying government-imposed structural distortions within the financial services sector of the world's economies, government supervision of financial institutions is still deeply embedded, and consequently quite costly economically as well as systemically dangerous. Equally bad, or perhaps worse, the product warranty that accompanies this government supervision, usually called "deposit insurance," is badly mispriced, if priced at all, which contributes to mispriced credit, usually with inflationary consequences. The last four forms of intervention discussed in the addendum contribute to the delayed resolution of insolvent firms.

Government supervision of financial firms, specifically the older types of firms (banks and insurance companies), is primarily intended to prevent their insolvency. Insolvency is highly undesirable because (1) creditors, specifically depositors and insureds, suffer losses and (2) failures can cause systemic instability domestically and even internationally due to the highly networked and nearly real-time operation of financial systems. Given the great importance that governments traditionally have attached to preventing bank and insurance company insolvencies in particular, the blame for every failure of a highly regulated financial firm must fall on the institution's government regulator.

Partly because they lack the resources and frequently because they fear political embarrassment, government regulators often move slowly to close an insolvent institution, particularly a large one, or to come to grips with a large number of insolvent institutions.³ The U.S. S&L fiasco and the massive insolvencies in the Japanese banking and insurance industries are excellent examples of

the latter type of case; Credit Lyonnais is a good example of the former, a typical too-big-to-fail bank.

Delayed resolution of insolvent situations creates a serious moral hazard in that the managers of insolvent institutions are no longer risking stockholders' money; instead, they are betting with taxpayers' money, with the term *taxpayers* including healthy institutions that are taxed through such devices as deposit insurance assessments. Hence, the real moral hazard in deposit insurance and other creditor protection schemes is a regulatory: regulators fail to close failing institutions in a timely manner—before the point of insolvency is reached.⁴

If problems in a country's banking system become sufficiently severe, with much of the system effectively bankrupt, and these adverse conditions are magnified by large government debts and/or the consequences of an unsustainable fixed exchange rate, then the IMF may lead an international bailout of the entire economy. Effectively, these bailouts risk taxpayer funds of other countries; therefore, multilateral bailouts create the same moral hazard risks as do taxpayer bailouts of domestic financial institutions. It is arguable that the IMF-led bailout of the Mexican economy in 1995 increased the belief among international lenders and investors that they would be protected in future financial crises, such as has since occurred in Asia, by similar IMF-led bailouts.

Creating the Environment for Global Financial Stability

Fortunately, creating the environment for global financial stability is fairly straightforward because doing so largely consists of eliminating government-induced credit-pricing distortions, specifically the first twelve forms of government intervention listed in the addendum. Although it is hard to image a world without these pricing distortions, each form of intervention that is eliminated will improve the credit market's ability to properly price credit. Evidence of this fact lies in other deregulated markets, specifically agriculture, energy, transportation, and communications. Ending these interventions will not be a costless exercise, and therefore cannot be executed overnight, because so many business decisions have been based on mispriced credit. However, starting to phase out these interventions

should provide ample notice that reliance upon them should be reduced.

Increasingly, market forces are forcing the dismantling of these forms of intervention; not surprisingly, this dismantling is most evident in the more open and prosperous economies. Specifically, as noted above, financial innovators have used electronic technology to create new channels of financial intermediation, such as money-market mutual funds, and new types of financial products, such as asset-backed securities, to end-run costly regulations. However, rear-guard actions by status quo forces and their statist accomplices, including multilateral organizations such as the World Bank and the IMF, are retarding this dismantling. Likewise, as noted above, electronic technology is rapidly dismantling the structural impediments that governments have long sought to impose on the financial services sector, while facilitating the harmonization of the world's financial markets. Nonetheless, governments need to take positive steps to eliminate the credit pricing and structural distortions that they have imposed on their economies.

Although government intervention in the financial markets needs to be eliminated almost entirely, there are three areas where government *innovations* are needed.

First, and most important, the safety-and-soundness regulation and supervision of all financial institutions needs to be delegated to the private sector as well as all product warranty losses associated with privatized regulation and supervision. The global epidemic of failed government supervision of financial institutions is sufficient evidence that major innovation is needed in this arena. The cause of this epidemic, the abject failure of government financial institution regulation, is just one more example of the inability of socialist institutions to perform adequately. Further, because government regulation is especially hobbled for financial firms operating across borders and industries, a new, market-driven regulatory mechanism must be implemented that operates on a global basis without regard to national or industry lines of demarcation. The need for this broad, global capability is growing rapidly as globally active financial conglomerates emerge. In effect, financial institution supervision has become too critical to the health of the world's economy to leave in the hands of government bureaucrats. Specifically, a delegated or privatized regulatory mechanism must meet these criteria:

- It must unbundle the liability side of financial institution balance sheets so that all insolvency risk now borne by depositors, insureds, and other creditors (with few exceptions) is shifted to private-sector third parties who explicitly and voluntarily become guarantors of all but a few types of liabilities of these institutions. Protecting creditors against any loss in this fashion should their financial institution become insolvent nips the risk of financial crises in the bud for they have no incentive to run. This prophylactic measure effectively eliminates the need for a government-backed lender of last resort for the guaranteed institutions.
- Regulation must become contractual in nature, with each guaranteed institution negotiating a contract with its guarantors specifying how to calculate the premium that it pays in return for that guarantee. The guarantors under this contract will largely be other guaranteed financial firms, hence the term *cross-guarantee contract*. The contract also will specify the prudent business practices appropriate for the business strategy that the institution has developed. The guarantors will use one of several competing private-sector firms to ensure the institution's compliance with its cross-guarantee contract.
- Marketplace competition will force the cross-guarantee premium to become a component of the interest rates that the institution charges for its loans and investments, which will have the highly desirable macroeconomic effect of improving credit pricing. Risk-sensitive premium rates will therefore choke credit flowing into speculative, inflationary bubbles long before they became dangerous. Because of their risk sensitivity, these premiums will effectively eliminate the regulatory moral hazard inherent in government regulation and deposit insurance schemes. Since private-sector contracts can be negotiated and renegotiated much more quickly than government statutes and regulations, the cross-guarantee marketplace will be able to respond much more quickly and precisely to changing economic conditions and technology than can government regulators, particularly in cross-border and cross-industry situations.⁵
- Each cross-guarantee contract must, without exception, meet certain risk-dispersion criteria. Because of the mandatory nature of these risk-dispersion rules, they must be administered by government agencies. Hence, government's role in a world of

delegated financial institution regulation will focus entirely on ensuring the stability of the financial system through the enforcement of these rules. Properly structured risk-dispersion rules will permit the network of guarantors, as a whole, to absorb losses arising out of an economic catastrophe far worse than the Great Depression, particularly if the guarantors' risks are diversified globally.⁶ Because of their relative simplicity, it will be much easier for the nation-states to agree to these rules than to much more complex rules governing the safe-and-sound operation of financial institutions. Further, because of the credit enhancing and operating efficiency benefits of cross-guarantee contracts, all but the BCCIs of the financial world will elect to headquarter in countries that participate in a cross-guarantee system.

Second, the regulation of stock exchanges and other organized markets must focus exclusively on ensuring the competitive operation of these markets in a manner that is fair to all participants. Any market regulation beyond this point, such as favoring certain classes of investors, constitutes counterproductive intervention in the financial sector. All structural barriers within the financial services sector should be abolished as their continued existence is a threat to financial stability as well as a serious drag on economic efficiency. Likewise, governments should exit the payments system business. Because cross-guarantee contracts will explicitly guarantee all payment obligations to payment and clearing systems (payment obligations are comparable to deposit liabilities), there will be no need for central banks to risk taxpayer dollars by providing payment finality for large-dollar transfers or for other payment and clearing system risks. In other words, the cross-guarantee concept provides a device for fully privatizing the payments system risks that the world's central banks now impose upon taxpayers.

Third, and a seemingly minor point for nations with a substantial banking infrastructure, governments should pay as many of their bills as possible by check or electronic funds transfer, and therefore as little as possible with currency. When currency is needed to pay government bills, the government should buy that currency from private banks and immediately pay for it with funds previously raised through taxation or the sale of interest-bearing debt. Further, this cur-

rency must be fully redeemable in interest-bearing government debt at the market value of that debt. These steps will ensure that the quantity of government currency in circulation is entirely demand-driven, thereby eliminating currency-driven or monetary *quantity* inflations, even in countries with primitive banking systems.

Conclusion

Financial crises and price inflation have occurred almost without interruption over the last twenty-five to thirty years, a time of extremely heavy government involvement in the monetary and banking systems of the world. Electronic technology, however, by empowering the financial markets, is rapidly eroding the ability of national governments and their respective central banks to spark inflations and destabilize financial systems. The commercial marketplace is rapidly trumping the political marketplace.

The growing importance of the financial markets is already evident in the nearly worldwide decline in inflation rates. As the financial markets continue to wrest power over credit pricing from governments, inflation rates should continue to decline. Stable prices themselves are a powerful contributor to systemic stability and the absence of crises. Likewise, the financial markets increasingly control foreign exchange rates, as Malaysian Prime Minister Mahathir Mohamad learned to his discontent in 1997. This form of market discipline should lessen the viability of fixed and other forms of exchange-rate manipulation, which in turn will lead to greater financial stability.

Even with the growing, beneficial power of private, competitive financial markets, governments, usually through their central banks, still exercise some control over short-term interest rates, which causes distortions in longer term rates. Therefore, eliminating any government or central bank influence over short-term interest rates will further stabilize financial systems.

The final, and perhaps toughest, step in ending financial crises and maximizing financial stability throughout the world lies in privatizing banking regulation through the cross-guarantee concept or a similar method of delegated regulation for individual financial institutions. Only then will the world's economies have sufficiently rid

themselves of the destabilizing influences of government intervention in the financial marketplace. Central banks and the IMF can then be sent to the bureaucratic boneyard.

Addendum: Twenty Forms of Undesirable Government Intervention in Financial Markets

Undesirable forms of government intervention in the financial marketplace, which often occur even in the supposedly advanced, free-market economies, take many forms, including:

1. Interest rate signalling or outright fixing of interest rates, which is tantamount to price fixing. Rate signalling is the principal monetary policy "tool" that central banks use today. Market forces have largely limited government influence to the pricing of shorter term interest rates. Usury limits on loan interest rates as well as limits on deposit interest rates fall into this category. One such example is the infamous Regulation Q, enforced by the Federal Reserve, which formerly applied to interest rates paid on all bank and thrift deposits; it now applies only to corporate checking accounts.
2. Fixing the domestic value of a country's unit of account by guaranteeing currency holders (and occasionally bank depositors) the right to exchange the protected forms of media of exchange (money) into a commodity, such as gold or silver, or into media of exchange denominated in the unit of account of another country. The latter form of right of exchange usually is administered by a government-controlled currency board.
3. Government inflation of that portion of the credit supply that also serves as media of exchange. This inflation can take two forms: (1) the government forces currency into circulation by paying its bills and obligations with currency that it then refuses to redeem for anything else of equal market value and (2) the government forces the banking system to lend money to it. These loans can consist of noninterest-bearing reserve requirements or explicit loans on which the government pays no interest or a below-market interest rate. In either case, the governments can write checks that increase these loan balances, which can cause an inflationary increase in the credit supply.

4. Reserve requirements on deposits used to control the quantity of reservable bank deposits. Although the United States still has reserve requirements, they now are merely a tax on depositors, not a monetary control device.⁷ A few countries have even abandoned reserve requirements.⁸
5. Government borrowings that enjoy special tax advantages that lower the stated cost of government debt or provide a higher after-tax yield to debt holders. The tax-exempt status of state and local government debt in the United States is an excellent example of such a tax advantage as is the exemption from state and local taxes of interest paid on U.S. Treasury debt.
6. Favorable tax treatment and government credit guarantees for certain types of private-sector borrowers. U.S. examples of this favorable treatment of borrowers include the home mortgage interest deduction; the nondeductibility of corporate dividends, which effectively favors debt capital over equity capital in corporate capital structures; and Small Business Administration loan guarantees.
7. Direct government influence over domestic lending and other forms of credit creation. Usually, this direction takes the form of administrative "guidance" to private lenders, which serves to direct loans and other forms of credit to favored borrowers or classes of borrowers. Japan and Korea have been notable practitioners of guiding credit flows within their economies.
8. Government ownership of financial institutions. Apart from socialist, Marxist motivations, government ownership of financial institutions has been seen as a way to more directly control interest rates as well as to direct capital to favored sectors of the economy and politically privileged borrowers. Nominally private, government-sponsored lending enterprises also fall into this category. U.S. examples of such institutions include Fannie Mae, Freddie Mac, the Farm Credit System, and the Federal Home Loan Banks.
9. Nonprice distortions of financial products, such as forced lending requirements; favorable legal treatment of debtors vis-à-vis creditors, particularly for troubled debtors; distortions in the granting of insurance; and so forth. Specific U.S. examples of such distortions are the Community Reinvestment Act and foreclosure protections for delinquent borrowers.

10. Outright fixing or attempting to control fluctuations in foreign exchange rates. This practice has faded among the more prosperous industrialized countries, but is still seen as desirable among small and developing countries.
11. Government monetary reserves, usually held as gold, as well as securities and currency denominated in other units of account. The dollar, of course, is the principal unit of account in which monetary reserves are held. In addition to being an unproductive use of a country's savings, monetary reserves give a country the means to do something that itself is undesirable—influence the exchange rate of the country's unit of account.
12. Capital controls designed to regulate capital flows between a particular economy and the rest of the world. Capital controls usually are imposed in an attempt to neutralize the external consequences of earlier government interventions in the domestic financial marketplace.
13. Stock market and securities exchange regulation as well as regulation of other types of organized markets and exchanges, such as commodities exchanges, which have the effect of distorting the financial marketplace.
14. Discriminatory taxes levied on financial institutions, such as a bank stock tax, or on financial transactions, such as a transactions or turnover tax.
15. Entry restrictions, product and institutional compartmentalization, anti-tying restrictions, branching prohibitions and restrictions, and other restraints on the ability of financial intermediaries to organize and operate in the most efficient manner.
16. Operation of various payments system mechanisms, such as net and gross payments settlement systems, securities settlement, check processing, and clearing of electronic payments.
17. Government banking supervision, which presumably is designed to keep banks and other types of depository institutions, or at least the larger institutions, from becoming bankrupt. Similar government supervision exists for insurance companies and securities firms.
18. Government deposit insurance and comparable creditor protection schemes, such as state guarantee funds to protect the insureds of insolvent insurance companies. Deposit insurance and guarantee funds essentially are a product warranty to protect de-

positors and insureds when government supervision has failed to prevent the bankruptcy of an insured or guaranteed institution. If priced at all, deposit insurance usually overcharges healthy banks and seriously undercharges weak banks.

19. Governments, through their central banks, as lenders of last resort (LLR) to domestic financial institutions. Any funds a government or central bank lends as a LLR must be simultaneously financed by government borrowing from the public. This borrowing can take the form of an increase in interest-bearing debt or, in fairly primitive economies, an increase in the supply of noninterest-bearing debt (currency).
20. Taxpayer bailouts of financial institutions, such as the French government's bailout of Credit Lyonnais, and multilateral bailouts of entire economies, such as Mexico in 1995 and several Asian countries in 1997. In both levels of bailouts, taxpayer funds are used to protect various classes of domestic and foreign creditors.

Notes

1. The author has discussed the causes and consequences of mispriced credit in numerous articles and papers. See, for example, "Money Doesn't Count—Interest Rates Do: Market-Based Monetary Policy for the 21st Century," which is posted on the Internet at <http://www.cais.com/ely/mpin21st.pdf>. Other articles, papers, and commentaries by the author on monetary issues are listed at <http://www.cais.com/ely/monpolicy.htm>.
2. Bert Ely, "Is Monetary Policy Needed?" *The Banker*, Oct. 1995, 14–15.
3. Even the U.S. government acknowledges this phenomenon. A report published by the U.S. Treasury Department stated that "[m]arkets tend to be less forgiving than regulators, who may be more willing to give a troubled institution time to work through its problems." Robert Litan and Jonathan Rauch, "American Finance for the 21st Century," The United States Department of the Treasury, 17 Nov. 1997, chap. 4.
4. Bert Ely, "Regulatory Moral Hazard: The Real Moral Hazard in Deposit Insurance," a paper presented at the Southern Finance Association on 22 Nov. 1997. This paper is posted on the Internet at <http://www.cais.com/ely/sfa1197.pdf>.
5. The author has written numerous articles and papers about cross-guarantees that are listed at <http://www.cais.com/ely/bnkissue.htm>. Particularly important articles and papers are: "Cross-Guarantees: A Horse of a Different Color," (with Rep. Tom Petri, R-WI), at <http://>

- www.cais.com/ely/horse.pdf; "Better Banking for America: The 100 Percent Cross-Guarantee Solution," (with Rep. Tom Petri), at <http://www.house.gov/petri/banking.htm>. Also, by the author, "Bringing Market-Driven Regulation to European Banking: A Proposal for 100 Per Cent Cross-Guarantees," Centre for the Study of Financial Innovation, London, July 1995.
6. The risk-dispersion rules for a U.S. cross-guarantee system are spelled out in great precision in comprehensive legislation, H.R. 4318, that Rep. Tom Petri introduced in the House of Representatives in 1996. The bill can be accessed at <http://thomas.loc.gov/cgi-bin/query/z?c104:H.R.4318>. A synopsis of H.R. 4318 is located at <http://www.cais.com/ely/synopsis.pdf>.
 7. Bert Ely, "Time to Abolish Reserve Requirements," *The Golembe Report*, Vol. 1997-7, 27 Aug. 1997. This paper is posted on the Internet at <http://www.cais.com/ely/tgr82797.pdf>. See also by the author, "Pay Interest on Reserves? No Abolition Is the Answer," *American Banker*, 9 Dec. 1997. Posted on the Internet at <http://www.cais.com/ely/ab12997.pdf>.
 8. Sellon, Gordon H., Jr., and Stuart E. Weiner, "Monetary Policy Without Reserve Requirements: Case Studies and Options for the United States," Federal Reserve Bank of Kansas City *Economic Review*, Second Quarter 1997, 5-30.

THE POLITICS AND ECONOMICS OF THE INTERNET AND CYBERSPACE

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