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Nobel winners debate need for regulation

Economics laureates cite flaws in system; vetting products

BY JOELLEN PERRY

LINDAU, Germany—Some of the world's brightest economic minds agree the current financial crisis exposed major flaws in the system, but disagree about the role regulators should play in preventing a repeat.

At an annual gathering Thursday of economic Nobel laureates on a tiny, medieval island in southern Germany, three winners of the Nobel Prize in economics and one Peace Prize winner lamented the excessive risk-taking, lax management and impenetrable complexity at the heart of the financial system's current turmoil.

Many of the laureates' criticisms focused on the notion that banking has drifted from its fundamental purpose. Amid a rush to profit, "what's been lost is the idea that a banker has some responsibility to protect the client's interest," said Daniel McFadden, who won the Nobel Memorial Prize in Economic Science in 2000 for research focused on modeling individuals' decision-making processes.

While a market in which homeowners' mortgages can be packaged into securities sold to banks across the globe might be efficient, Mr. McFadden said, "the most efficient way to organize economic activity may also prove to be the most brittle. Congress needs to consider the costs of volatility and instability."

But a rush to regulation could have dire consequences, warned fellow laureate Myron Scholes, who took a Nobel Prize in 1997 for a method of valuing derivatives,

which are financial instruments whose price changes based on the value of related assets. Ticking off the financial systems' basic functions—including financing large-scale projects, facilitating saving and assigning prices to assets—Mr. Scholes attributed decades of economic growth to innovations that let institutions "perform these functions more efficiently."

Mr. Scholes, who also co-founded Long-Term Capital Management, a hedge fund that collapsed amid the East Asian and Russian financial crises of the late 1990s, said, "Sometimes, the cost of regulation might be far greater than its benefits."

One example, Mr. Scholes said, are the Sarbanes-Oxley accounting rules implemented after Enron's collapse earlier this decade. The rules have been criticized as undercutting the U.S.'s attractiveness as a base for investment.

Joseph Stiglitz, a professor of economics at Columbia University who won the Nobel in 2001, suggested misguided innovation itself caused the current turmoil. Noting that homeowners' most important risk assessment is the likelihood that they can retain their home amid market volatility, Mr. Stiglitz said, "These are the problems [financial markets] should have created products to match. But they created risks, and now we're bearing the consequences of this so-called innovation."

There were some areas of agreement. The stan-

dards that gauge how much capital banks should hold—called Basel II for the Swiss city in which they were developed—focus too tightly on managing daily risk and not enough on handling crises. "What happens most of the time is not important," said Mr. Scholes, noting the current financial turmoil comes on the heels of the dot-com bubble's bursting and the Asian financial crisis of the early 1990s. "We have to learn how to handle the shocks when they occur."

One idea that might prevent a repeat of the turmoil: a commission that would vet financial products before their release, akin to the U.S. Food and Drug Administration's evaluation of drugs before they are released to the market. Mr. McFadden said, "We may need a financial-instrument administration that tests the robustness of financial instruments and approves only the uses where they can do no harm."

But tinkering with a fundamentally flawed system may not be enough, said Muhammad Yunus, whose success in lending small amounts of money to people too poor for ordinary credit led him and his Grameen Bank to win the Nobel Peace Prize in 2006.

"Our banking is sub sub sub prime," said Mr. Yunus, noting his model requires no collateral, offers no insurance, and boasts "no lawyers." The upshot: "Our repayment rate is very high. Like 98 or 99%."