

Title: Regulating Financial Innovation without Apology

Abstract:

This paper views the housing and credit bubble 2001-2008 in a stylized manner, namely as a sequence starting with a financial innovation in 2001 followed by the superimposition of other financial innovations leading to the prevalence of uncertainty in Knight's sense and ending in the last quarter of 2008 with both market failure and regulation failure. This 'debt bubble sequence' is just a slice of a dynamic process of stupefying complexity involving ignorance in a fundamental way. Few analysts would deny that a financial innovation, namely the sub-prime mortgage, combined with market participants' ignorance about the size and location of the risk underlying complex financial products was a critical factor conducive to the financial meltdown 2007-2008. To the extent that financial innovation does bear the blame, the most obvious question is whether anything can be done to help reduce the degree of public's ignorance about financial innovations and to prevent destabilizing innovations from entering the market. The main claim of this paper is that society should be involved in exercising directive intelligence through an appropriate institutional arrangement over the intricacies and technicalities inherent to financial innovations. Specifically, the paper proposes a new institutional arrangement conceived with the aim of strengthening financial system reliability and breaking the 'government regulation-financial innovation' vicious circle.