

# Simple Rules

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Forum for Innovation  
U.S. Chamber of Commerce Foundation  
February 26, 2013

for a  
Complex World



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# Complexity ~ Wealth

- division of labor
- specialization
- new products
- new technology
- multiplicity of diverse choices
- complex interactions yielding efficiencies and new ideas

Complexity Needs Simple Rules

# Information Is Key

Standardized Channels,  
Languages, Platforms, and Metrics

- Roads, railroads, shipping containers, Internet, universities, industrial clusters
- Meter, gram, volt, dollar
- English, TCP/IP
- Rule of law, property rights, currency value
- Competing standards allowed / encouraged
  - English vs. Mandarin / TCP/IP vs. UDP

# Good Rules

- are simple
- maximize degrees of freedom
- facilitate information flow, creativity, and error-correction
- do not interact with other rules in unpredictable ways

# Bad Rules

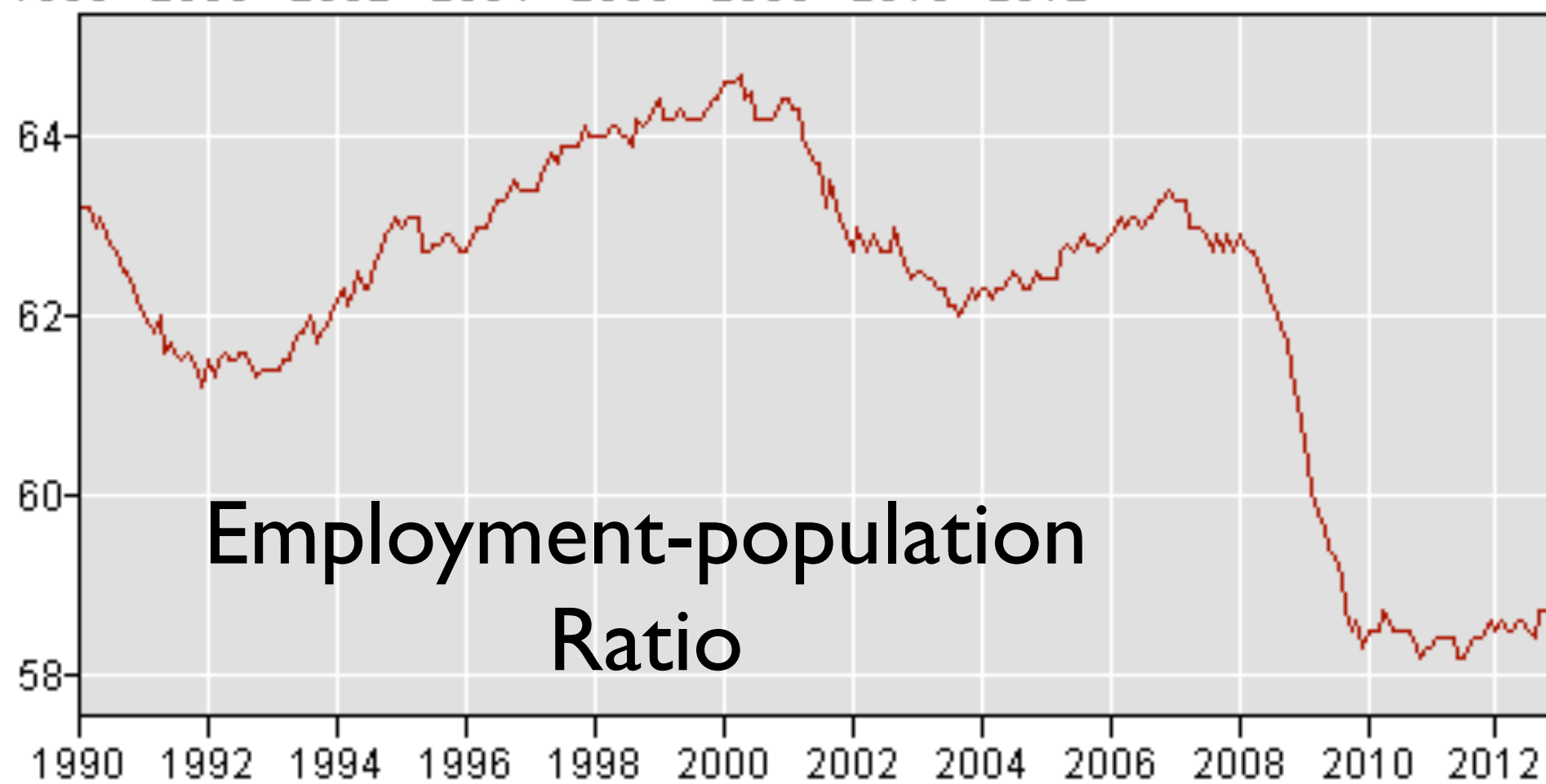
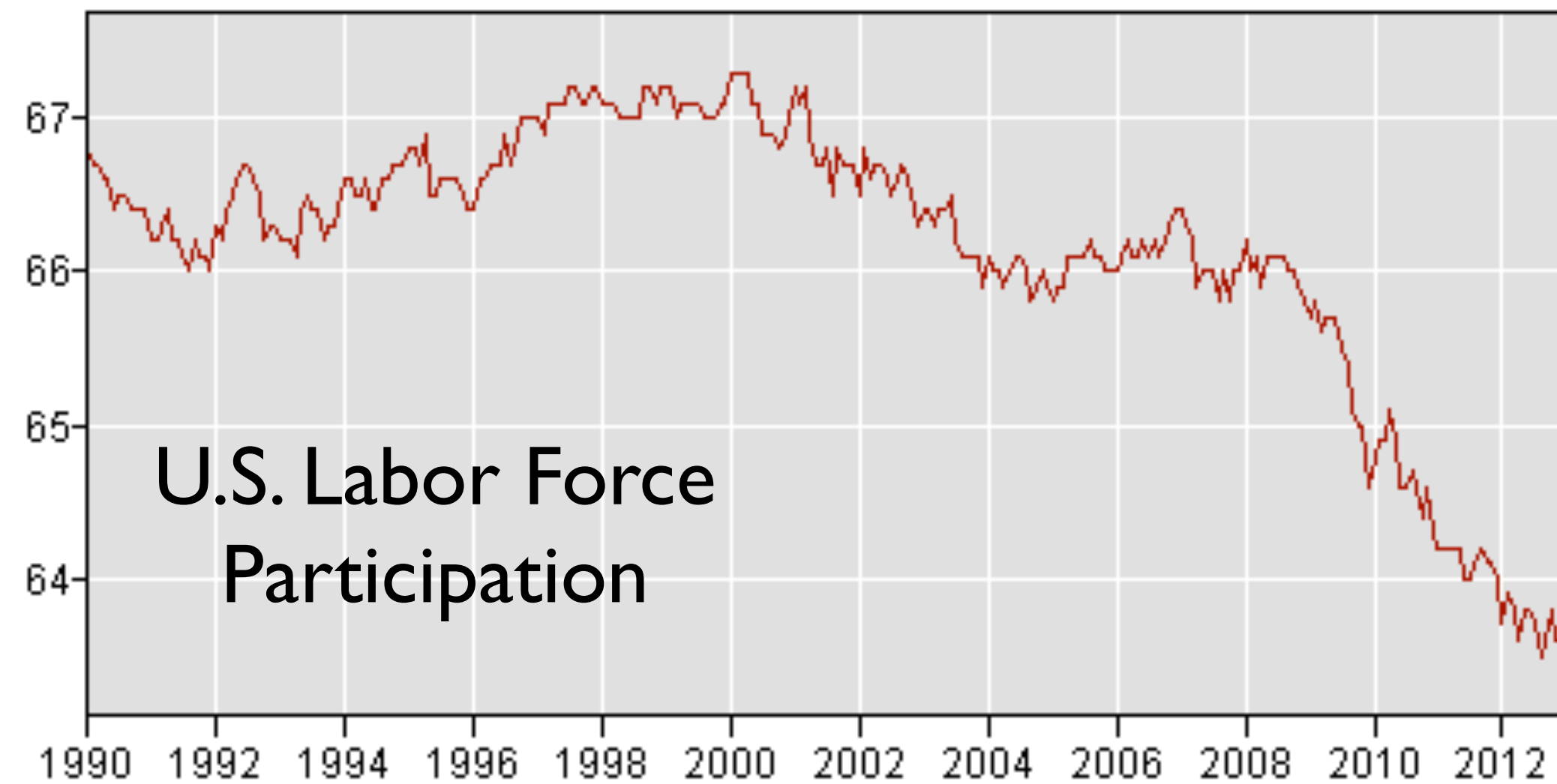
- are complex
- limit degrees of freedom
- impose overly broad uniformity and rigidity
- discourage information flow, creativity, and error-correction
- can interact with other rules in unpredictable ways

# Bad (Complex) Rules: Two Recent Examples

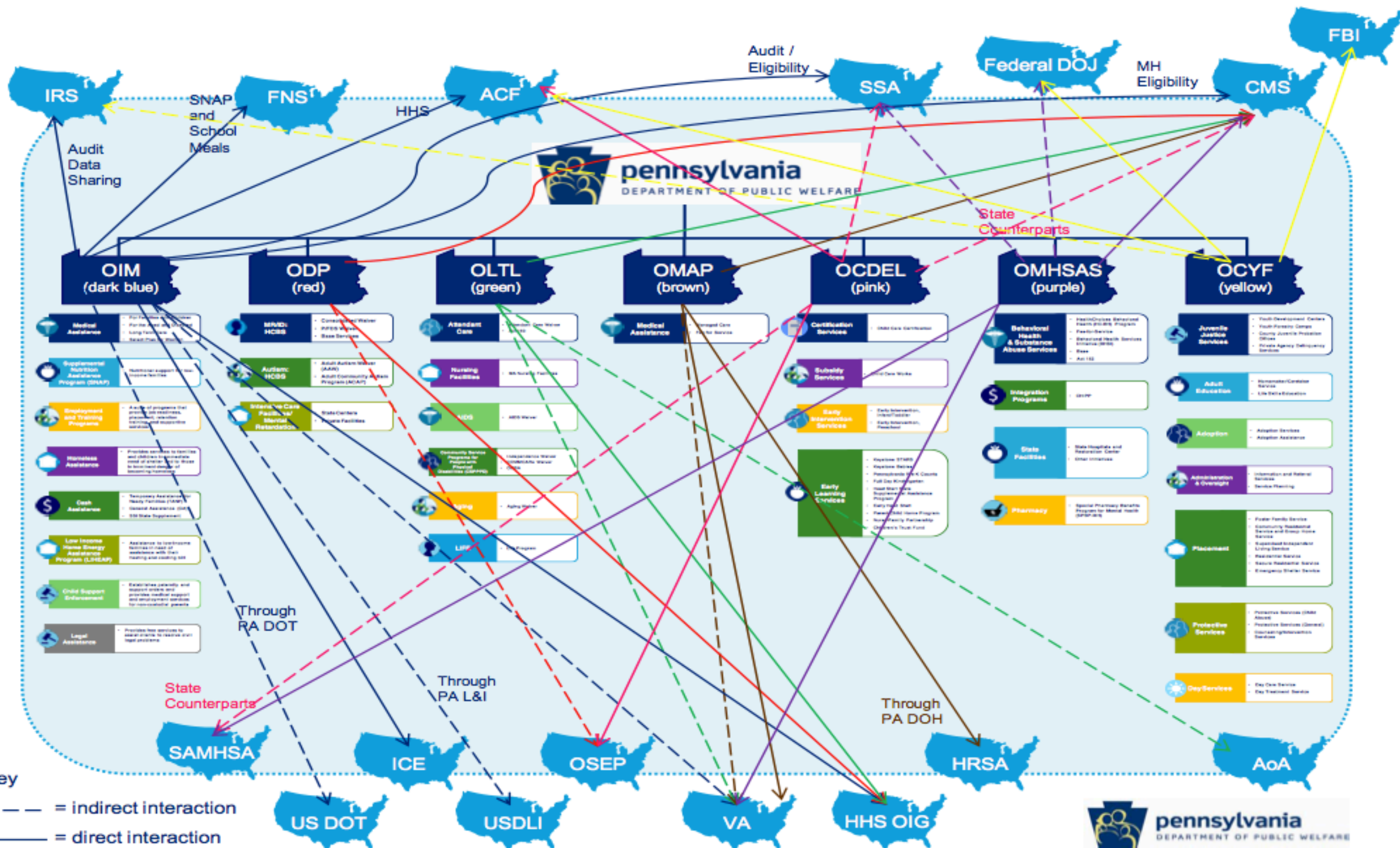
- Labor markets – unemployment and labor market contraction today
- Capital markets – Panic and Great Recession 2008-09

# Labor Markets



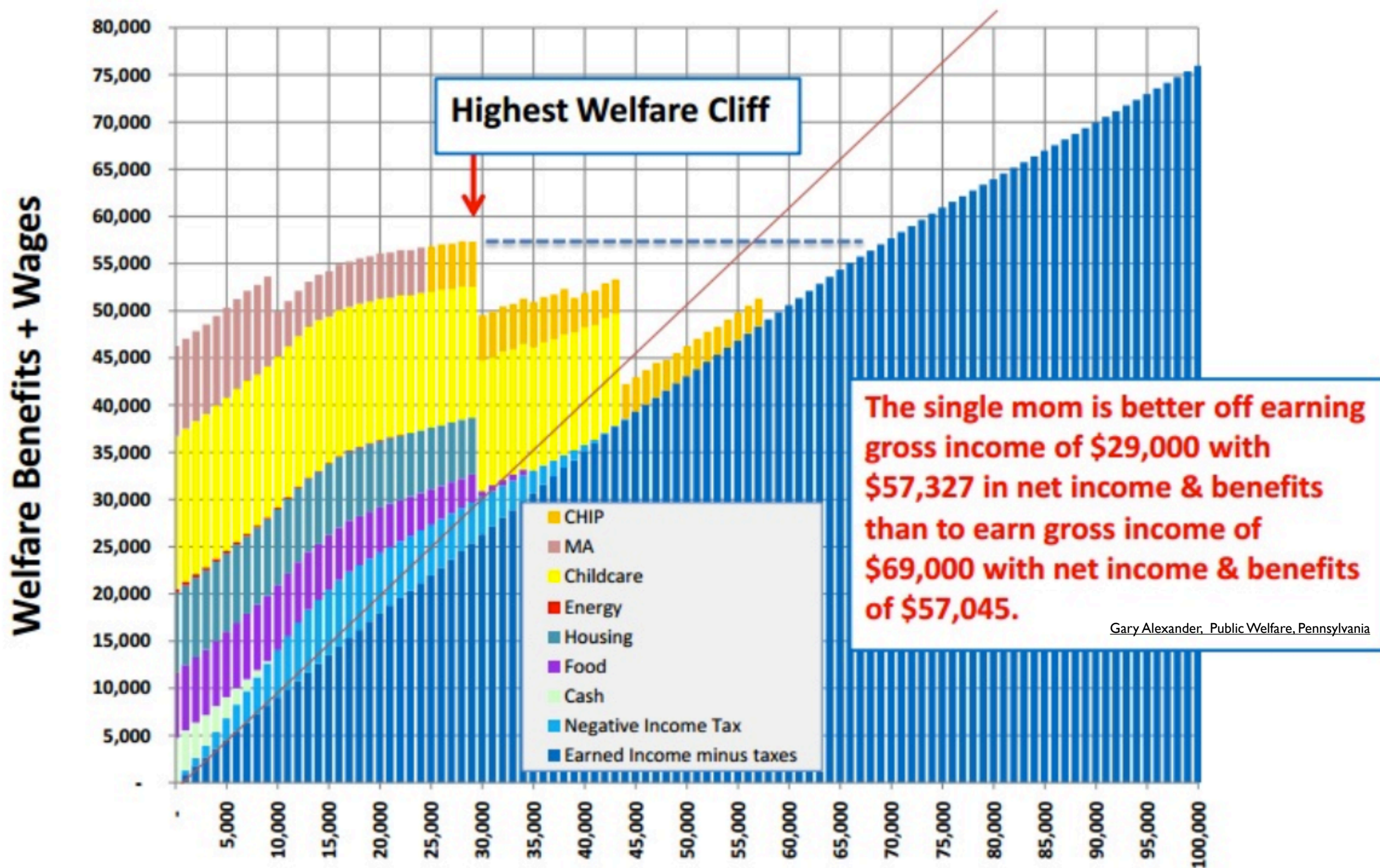


# “Chaos in the Federal-State Relationship”



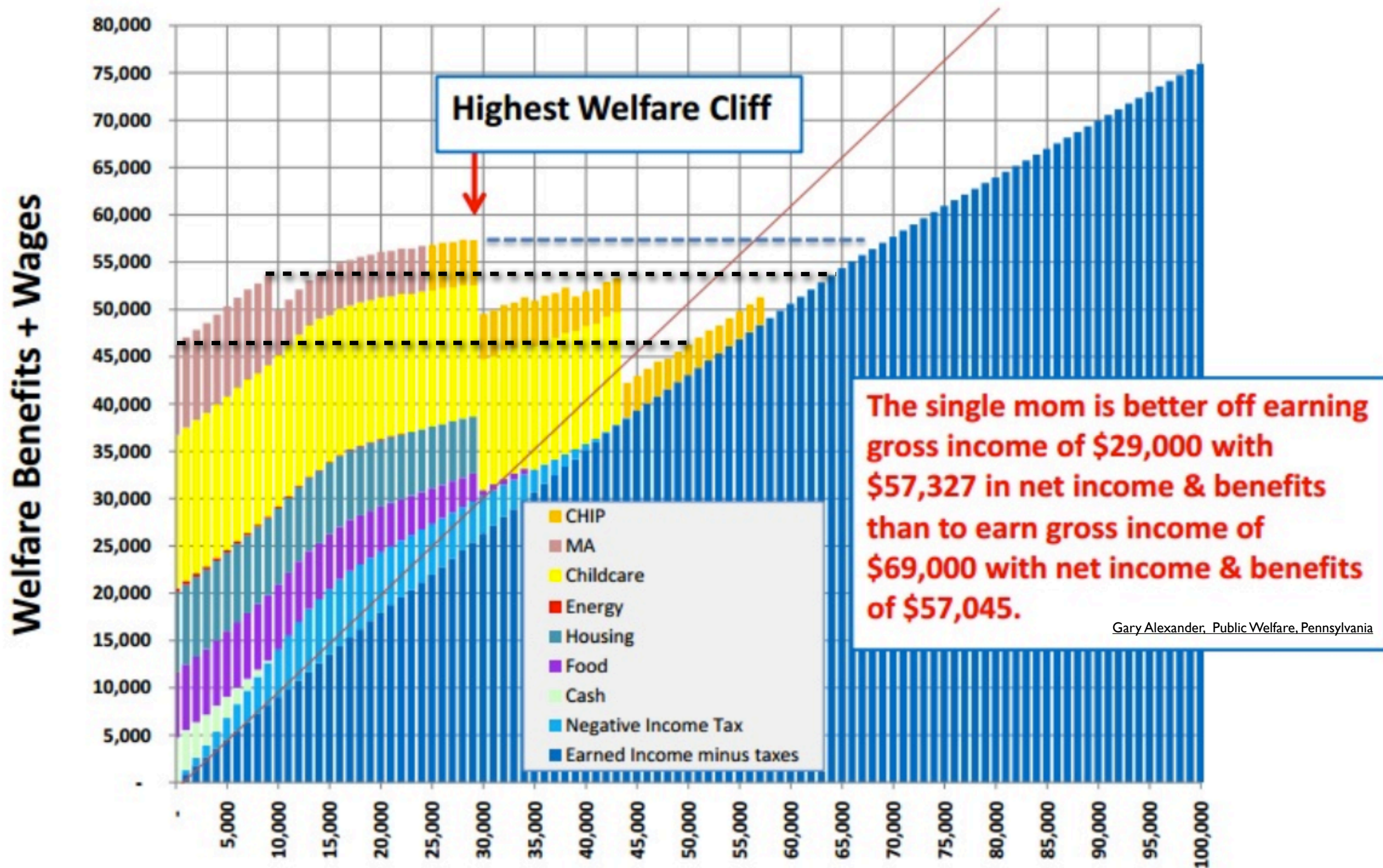


# Caught in the Anti-work Web





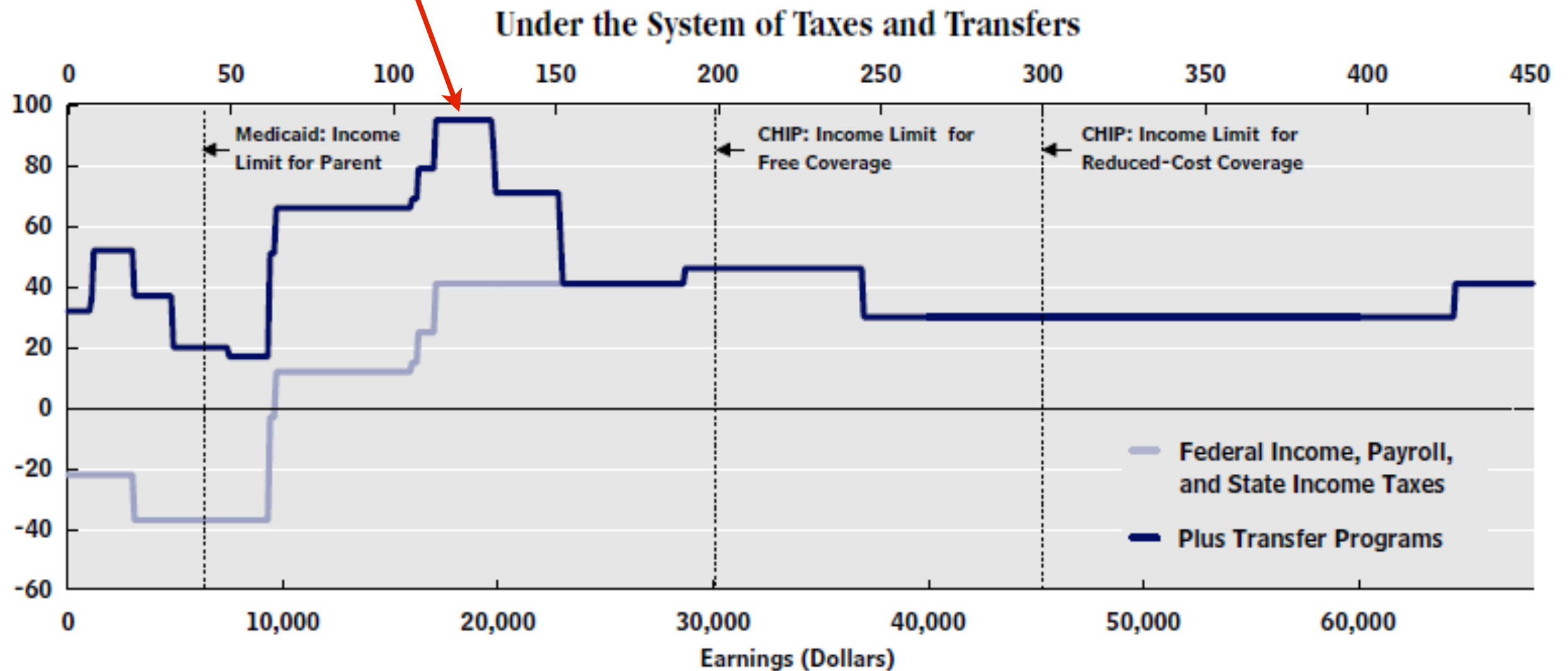
# Twilight Zone: \$0 > \$50,000





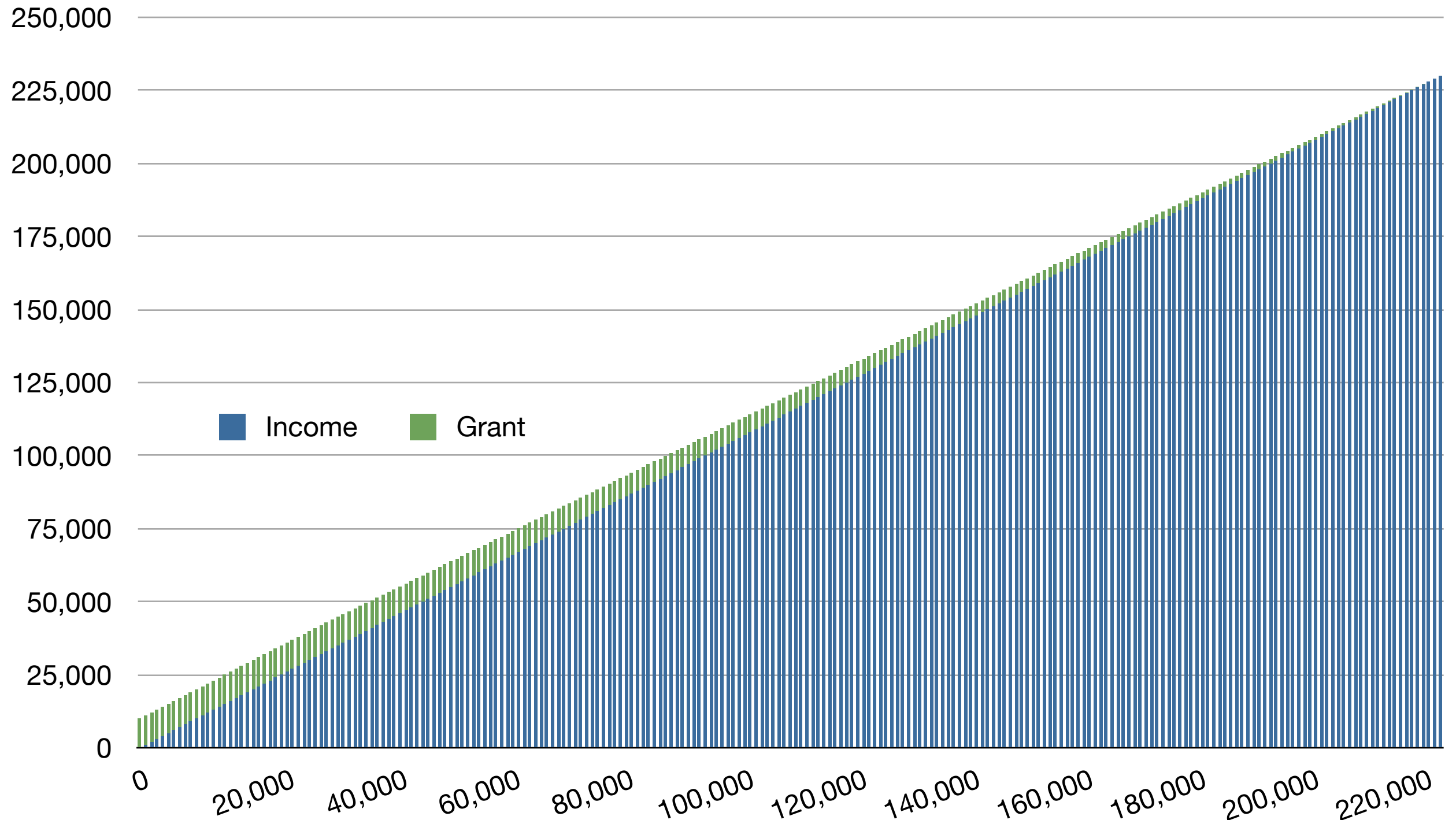
# New CBO Report

95% marginal tax  
rate at \$18-20,000

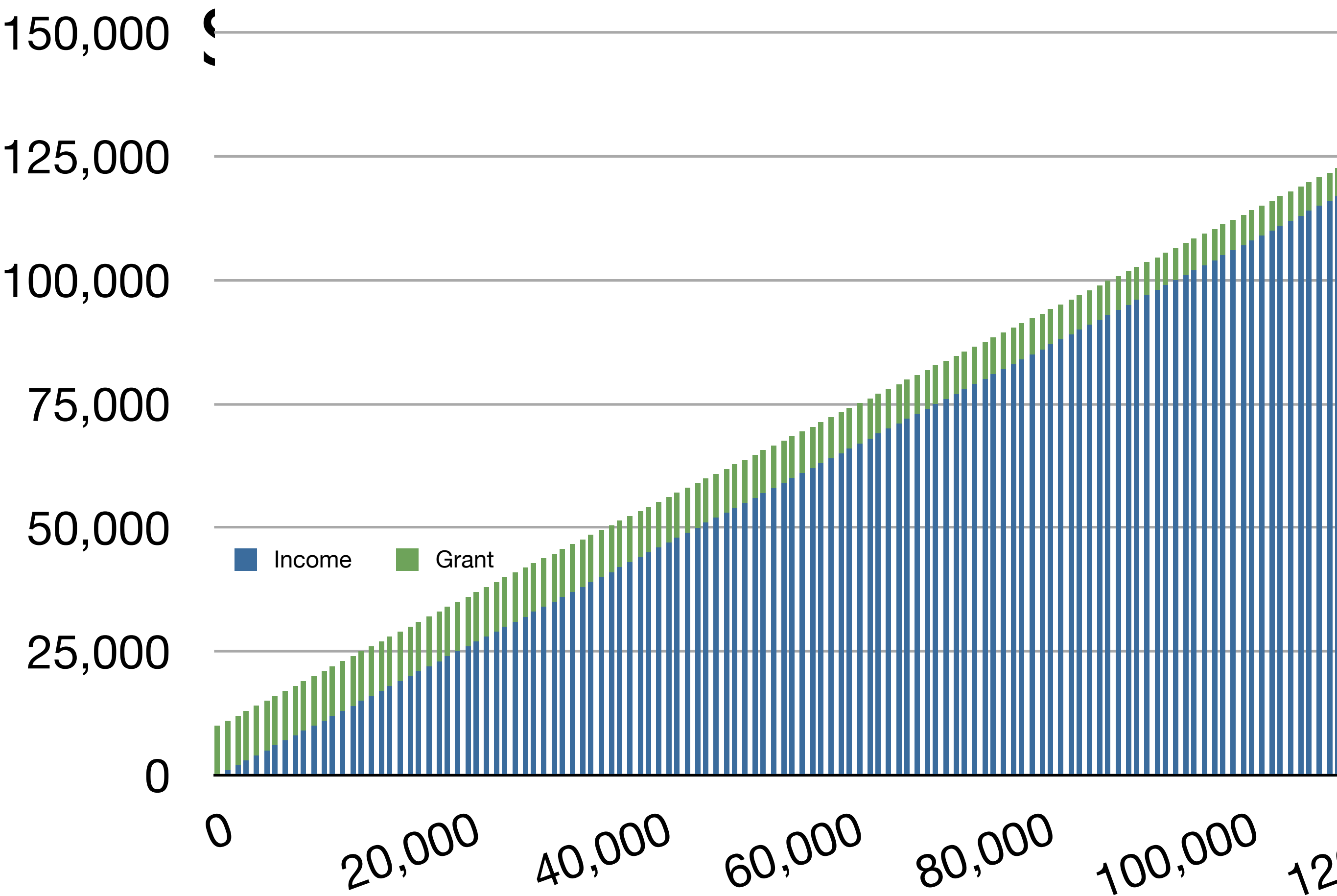


# Simple Safety Net Overhaul

Murray cash grant – \$10,000 per American citizen 21 – gradual taper







# Capital Markets



# Well-meaning policies, seemingly unrelated

- Fannie/Freddie/FHA meant to encourage home ownership
- Fed 1% rate / Treasury weak-dollar policy: meant to avoid deflation and help manufacturing economy
- Basel capital guidelines designed to encourage investment in “safe assets” and give banks healthy cushions
- Mark-to-market (fair value) accounting meant to encourage financial transparency

# Well-meaning policies, seemingly unrelated

- Fannie/Freddie/FHA subsidized irresponsible borrowing/lending
- Fed 1% rate / Treasury weak-dollar policy inflated hard assets (homes, oil)
- Basel capital guidelines created insatiable demand for “AAA” securities – MBS and ABS had attractive risk weights vs. raw mortgages or business loans
- Mark-to-market (fair value) accounting created opacity, detonated a panic



# Anatomy of a Panic

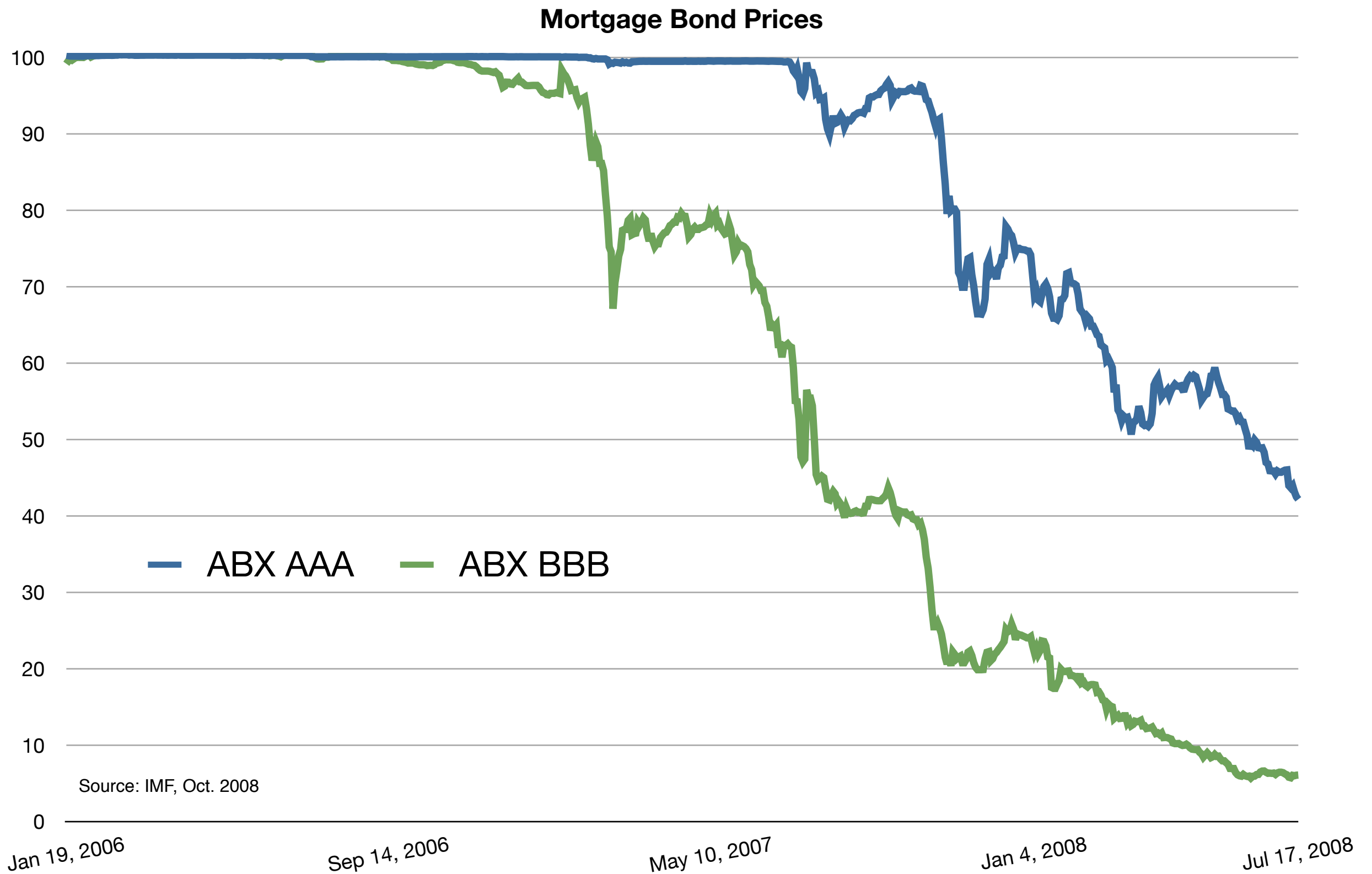
- Housing market peaked and began decline
- Margin calls on sub-prime in shadow banking system. CDS prices rose to reflect possible losses in MBS
- Mark-to-market (esp. FAS 157) said you must mark similar asset pools based on other “prices” observed in market / even price of CDS insurance
- Capital requirements – say 10% – forced selling as M2M prices reduced regulatory capital
- Capital requirements were supposed to be buffers. But what if you can’t touch buffer?
- Forced selling caused further M2M losses, forcing others to sell, more M2M losses, *ad infinitum*

# FAS 157

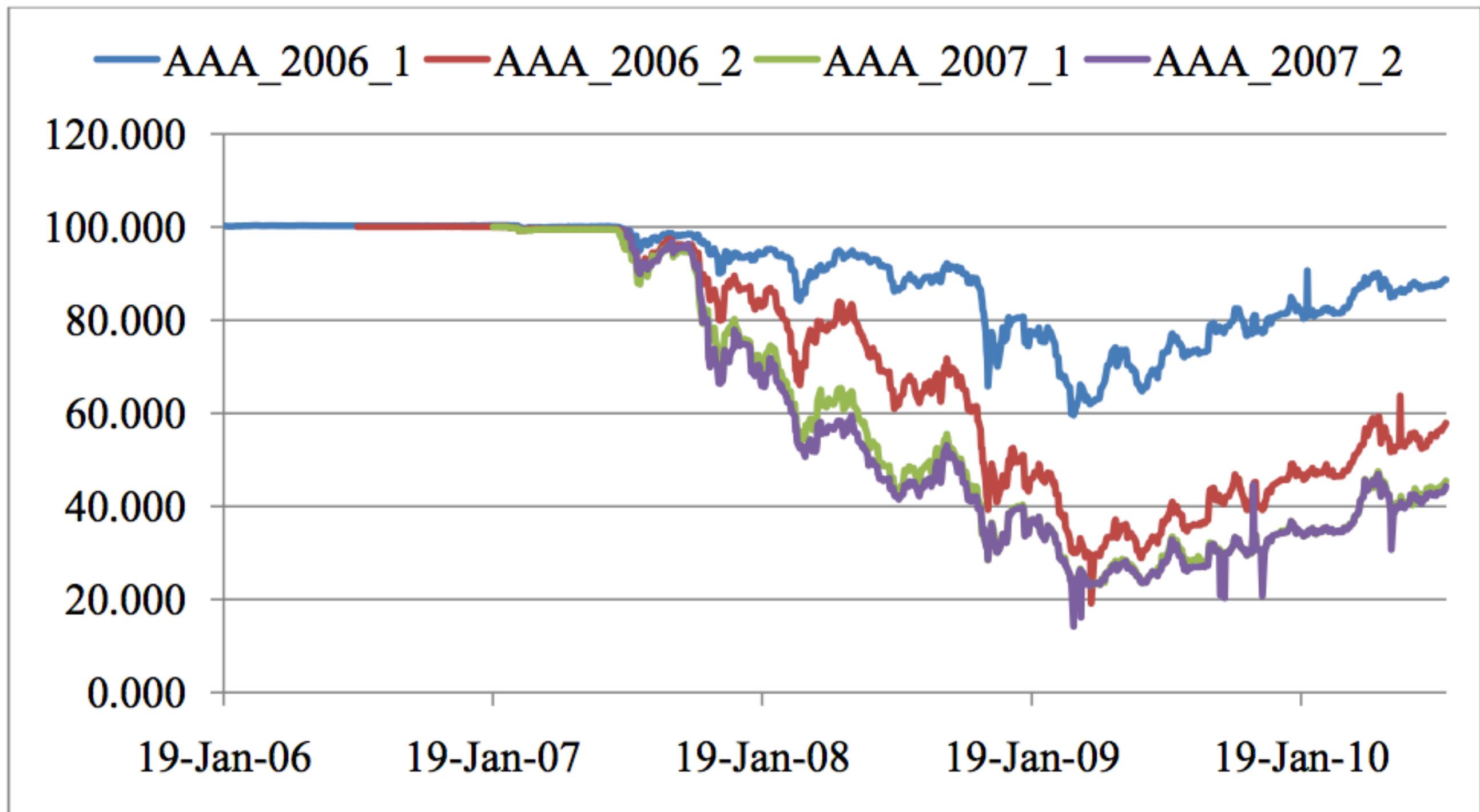
- FAS 157 went into effect autumn 2007. It said banks must mark assets at “observable” prices for similar assets even if there were no real price of the asset in question.
- “Thus,” write Friedman and Kraus, “the observable prices for CDS insurance on PLMBS were used to mark down the type of asset that they insured. Eighty-two percent [82%] of assets marked down by banks in an SEC study of [mark-to-market] were valued in this fashion, with only 11 percent marked against actual prices.”



# Mark to Mayhem



# Mark to Mayhem

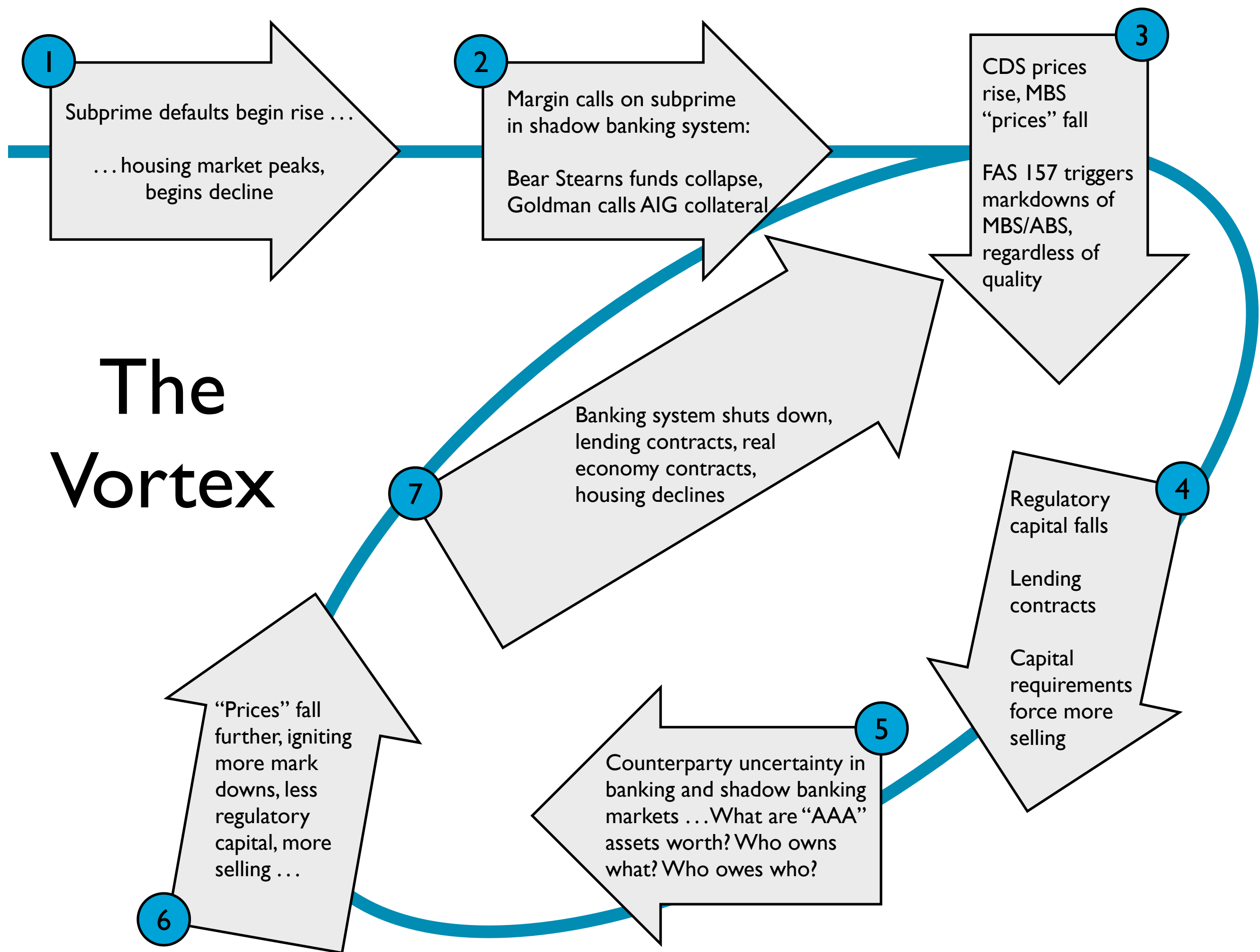




# The \$5-Trillion Feedback Loop

- ~ \$500 billion in MBS/ABS/ACP mark downs in U.S. could have, in principle, led to \$5 **trillion** in reduced lending capacity
- actual loan contraction not quite that bad, but still largest credit crunch since Great Depression
- new business loans, which have less favorable capital weightings, declined **67%**

# The Vortex



As mark-to-market drained the  
deep end of the capital pool . . .

. . . TARP attempted to refill the  
shallow end



"Although this could not be known in 2007, at the end of 2010 most of the triple-A tranches of mortgage-backed securities **have avoided actual losses in cash flow** through 2010 and may avoid significant realized losses going forward."

– *Financial Crisis Inquiry Commission*

"You know, the stock market goes up and down every day more than the entire value of the subprime mortgages in the country."

– *Ben Bernanke*

“Accounting systems should never drive economic activity. They should reflect it. Fair-value accounting significantly contributed to the collapse of liquidity in capital markets (in 2007-2009).”

– *John Allison, former CEO, BB&T Bank*



# How do we think these rules will turn out?

- Dodd-Frank = 2,319 pages and 243 new rules
  - Volcker Rule = 298 pages
- Obamacare = 904 pages and ~3 million words of new rules (so far)

# As world becomes more complex,

- the complexity (wealth) we've accumulated helps cushion downside ...
- it takes greater effort and intelligence to navigate ...
- it's more challenging to grow – to build new levels of complexity ...
- need more entrepreneurship to find new ideas, products
- thus we need simpler, not more complex, rules

# Diversity > Regulation

“Given what they knew at the time, it is hard to see how the regulators could have crafted a better rule. But by the very act of crafting any rule, they reduced market heterogeneity, making the financial system more vulnerable to a black swan. If the penalties imposed by a regulation have their intended effect, they homogenize the behavior of those who are subject to it, increasing the system’s fragility by reducing its diversity. The paradoxical lesson of the Recourse Rule is that regulation can create systemic risk even when the regulators are aiming at systemic stability.”

— *Jeffrey Friedman and Wladimir Kraus*



Good Rules	Bad Rules
simple	complex
information flow	information blocking
negative feedback	positive feedback
error correcting	error reinforcing
inert	interactive
principles	regulations
competing standards	one size fits all
bottom-up	top-down
cooperation	coercion
exit	no exit
promote accountability	promote ambiguity
promote heterogeneity	promote homogeneity
encourage new	lock in old
civil society	Administrative State
Commerce Clause	today's anti-Commerce Clause
Flat Cash Grant	today's Safety Net
Flat Tax	today's Tax Code



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ENTROPY ECONOMICS

GLOBAL INNOVATION + TECHNOLOGY RESEARCH

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