What is the purpose of Financial Regulation?

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This is a question that I've never seen asked, at least not in the popular press, but it seems important to me, and I've been thinking a lot about it lately. For one thing, how can you possibly write good regulation if you don't know what you are trying to do?

It could be that the question is so basic and obvious that everyone knows the answer: "It's to prevent bubbles or business cycles."

That can't be the correct answer.

Here's a great quote from David Brooks (HT to Greg Mankiw):

"The premise of the current financial regulatory reform is that the establishment missed the last bubble and, therefore, more power should be vested in the establishment to foresee and prevent the next one."

Right.

The problem with writing regulation to prevent bubbles or business cycles is that it can't be done. There is no theoretical reason or empirical evidence that regulators are any better at anticipating bubbles or business downturns than anyone else, and nobody is any good at it. So, why write regulation for that purpose?

That is not to say that there are no reasons to write financial regulation. I believe there are, but we've been doing it for the wrong one. Here are my proposed reasons:

- Minimize or eliminate direct losses to innocent bystanders
- Minimize the economic impact of a systemic financial crisis

That's just my opinion, and I can think of many people who might have more or better ideas on the topic. So, I'd love to see a serious discussion about the topic. The result would be better regulation.