Lecture 1. Introduction to the Subject

Definition: Regulatory economics is the economics of regulation. It is the application of law by government or regulatory agencies for various purposes, including remedying market failure, protecting the environment and economic management.

At its core, economic regulation aims to achieve economic efficiency, usually defined in terms of price, service quality, and support for competitive outcomes where possible. On the contrary, social regulation is ultimately focused on eliminating risks.

Economic regulation is an important instrument of government policy in market economies. We do not talk of regulating planned systems. Economic regulation involves the exercise of some influence on activities, other than total control. It is no accident therefore that the economics of regulation has become increasingly important in recent years as direct state ownership has declined. The perceived failure of central planning has not in itself discredited all government attempts to improve economic performance. Indeed, the idea that the provision of certain limited but crucial regulatory functions by the state is necessary for economic advance is a well-established part of classical liberal economic and political theory.

Regulation is not, however, a very precise term. Some forms of regulation are concerned with setting a framework of rules for people to follow in their dealings with each other. In this sense the law of contract or property would include part of the regulatory base of the economy. A financial regulation, for example, that all companies must disclose price sensitive information to the market by means of a public announcement within a specified time period would be of this rule setting type. The regulation applies to all market participants and is end independent in the sense that no one could possibly know exactly what would actually happen in every case as a result of introducing it. Although the detailed outcomes are not known, the regulation could be defended as a means of making the market process more efficient over the long term.

Other regulations are more prescriptive in form. They instruct people to achieve particular ends, often by the implementation of specified means. An example would be a regulation instructing a firm to install certain machinery in order to reduce pollution or improve safety. Measures of this type do not merely establish the rules governing the behaviour of transactors in the market; they attempt to determine the results or to restrict them within acceptable limits.

Distinction between regulation as the planning of collectively determined desired ends and regulation as the governance of a continuing decentralized market process is important. At the conceptual level it seems clear enough - as clear as the distinction between a referee who fixes the outcome of a game and a referee who simply enforces the

rules. In practice, of course, it is sometimes difficult to distinguish them from each other. Nevertheless, the conceptual distinction is at the heart of many of the disputes concerning the role of the state in a market economy.

What are the sources of regulation?

The sources of regulation include both domestic/national laws (laws that apply to activities within the jurisdiction of a sovereign nation) and international laws (agreements between sovereign nations).

What is the objective of financial regulation?

The main aim of the financial regulators is to maintain the stability and integrity of the financial system in the country. Financial regulation also influences the structure of banking sectors by increasing the diverse financial products available.

What is the basic principle of regulation?

- A firm must conduct its business with integrity
- A firm must conduct its business with due skill, care and diligence
- A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems
- A firm must maintain adequate financial resources