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Governance in the Global Economy

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How New Will the Next Regulatory Regime be?

Robert Boyer

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ABSTRACT

The collapse of the American financial system following the sub-prime bubble and the ensuing global financial crisis have shown the fallacy of market fundamentalism. There is a now an urgent need to return to a more balanced view: modern capitalist economies are resilient precisely because they are mixed economies. This paper proposes a diagnosis of the various spillovers that generated the present crisis, and then discusses various options for new regulatory regimes. A light handed approach would use mainly monetary and fiscal policy, as well as limited macro regulation, in order to prevent financial instability from leading to major crises. A second and more ambitious strategy would redesign the whole financial system by changing accounting rules, building new risk assessment models and implementing less perverse remuneration systems. The social control of financial innovations, such as securitization and its successors, could offer a third avenue to be explored. Correcting the global imbalances that led to the crisis concerning international relations and power relations between firms, workers and finance could define a still more radical reform. Eventually, under broad but not very demanding international principles, quite diverse regulatory regimes will probably emerge, given the various different economic specializations and styles of governance found in each national economy.

1. TWENTY YEARS OF 'LAISSEZ-FAIRE' ORTHODOXY CHALLENGED

With the victory of the conservative governments of Mrs Thatcher and President Reagan and the triumph of the new classical macro-economy, the previous regulatory regimes for labour, goods and, in particular, for financial markets, were 'reformed' i.e. largely eroded or even dismantled. A new *doxa* diffused throughout the world, basically one where markets are self equilibrating, where state intervention is seen as the problem rather than the solution and one, therefore, where a light touch approach to regulation has prevailed. This has been especially the case within finance.

Following the collapse of the American financial system after the sub-prime bubble, the fallacy and dangers of such market fundamentalism have become clear. Firstly, financial instability and the recurrence of speculative bubbles have made an impressive comeback. Therefore ad hoc State intervention is again welcome in order to restore two of the primary public goods; namely financial stability and the credibility of money. Secondly, the replacement of self-regulation and light touch regulation with explicit surveillance and control of finance by public authorities is now under consideration. Thirdly, given the huge costs of bailing out so many financial entities, economists, analysts and politicians are beginning to reconsider their previous belief that it is impossible to prevent financial crises; and that hence public authorities should simply focus on crisis management rather than crisis prevention. So, are we witnessing a dramatic reversal of attitudes with respect to the regulation of finance?

2. STATE AGAINST MARKETS: A FALSE DEBATE

The history of economic doctrines as well as that of major crises would suggest that financial stability passes through wavelike cycles: one generation suffers from a quasi economic collapse due to the unleashing of market mechanisms and then sets regulations and institutions in order to prevent the repetition of such dramatic episodes. This configuration is at first successful, but it always ends up in some new form of crisis that a new generation tends to attribute to excessive regulation. Hence, a process of deregulation and quasi complete oblivion of the lessons of the past ensues, setting into motion a 'laissez-faire' regime that, in turn, encounters its structural crisis.

It is no surprise, then, to see the sub-prime crisis commonly interpreted as the revenge of the interventionists against the proponents of laissez-faire! Since Milton Friedman has been proved wrong about the stabilizing nature of speculation, ergo John Maynard Keynes was right! Unfortunately, the debate is not that simple.

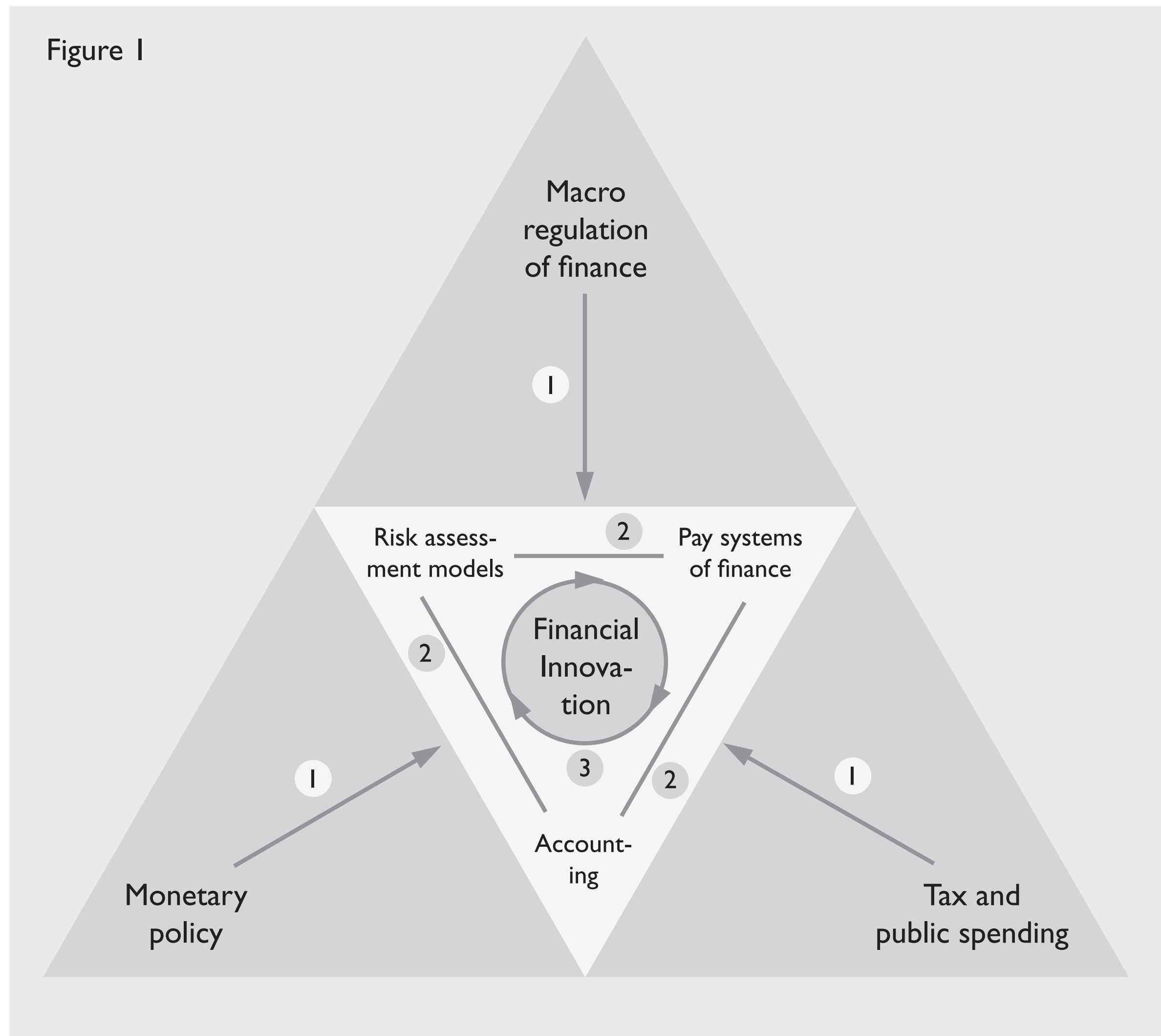
On the one side, especially in the United States, regulations are feared because they can negatively affect financial innovation and thereby the dynamism of the American economy. Implicitly, and sometimes explicitly, economists also fear that extensive regulation could lead to a US equivalent of the soviet *Gosplan*.

On the other side, a vocal minority of experts and policy makers hold a dissenting view about the origins of the financial crisis: namely that the public guarantee granted to Freddie Mac and Fanny Mae was at the core of a major moral hazard problem which led to frantic speculation. Privatize companies such as these and such an episode will not repeat itself.

These two opposite positions share a common, and false, premise i.e. that State and Market are alternatives and that each defines an exclusive coordination mechanism. The first position totally disregards the lessons of financial history. The Golden Age, for example, engendered unprecedented stable and fast growth and this was coupled with clear collective control over the autonomy of finance. Similarly, the second position misrepresents the involvement of Freddie Mac and Fanny Mae in the sub-prime crisis: indeed, it might well even be that the injunction to mimic the private sector exacerbated the speculative bubble. Last but not least AIG, a totally private entity, came close to collapse and was finally quasi nationalized for excessive risk taking in a search for extra profit. The causality is clear: financial crisis leads to public intervention but this does not mean that public intervention leads to financial crisis as has been assumed within the free market *doxa*.

De facto, adequate regulation is necessary for the viability of any market, especially financial markets, where promises to pay are particularly uncertain and require one form or another of 'convention'. Consequently,

Figure 1



the misleading struggle between the defenders of 'pure markets' and the proponents of state intervention should be replaced by a search for relevant complementarities between these two coordinating mechanisms. In this respect, between the mythical pure market economy and the caricature of a centrally planned one, a whole spectrum of *mixed economies* exist, combining to form a complex architecture of institutional arrangements.

The challenge associated to the sub-prime crisis can thus be encapsulated in the question: 'in what direction will the various national mixed economies evolve?' *A priori,* several paths are open for developed economies: 1) to establish a set et of complementary macro policies that counterbalance the built-in instability of finance, 2) to redesign the objectives, incentives and tools of finance in order to prevent severe and frequent crises, 3) to implement society-wide control of financial innovations (see figure 1).

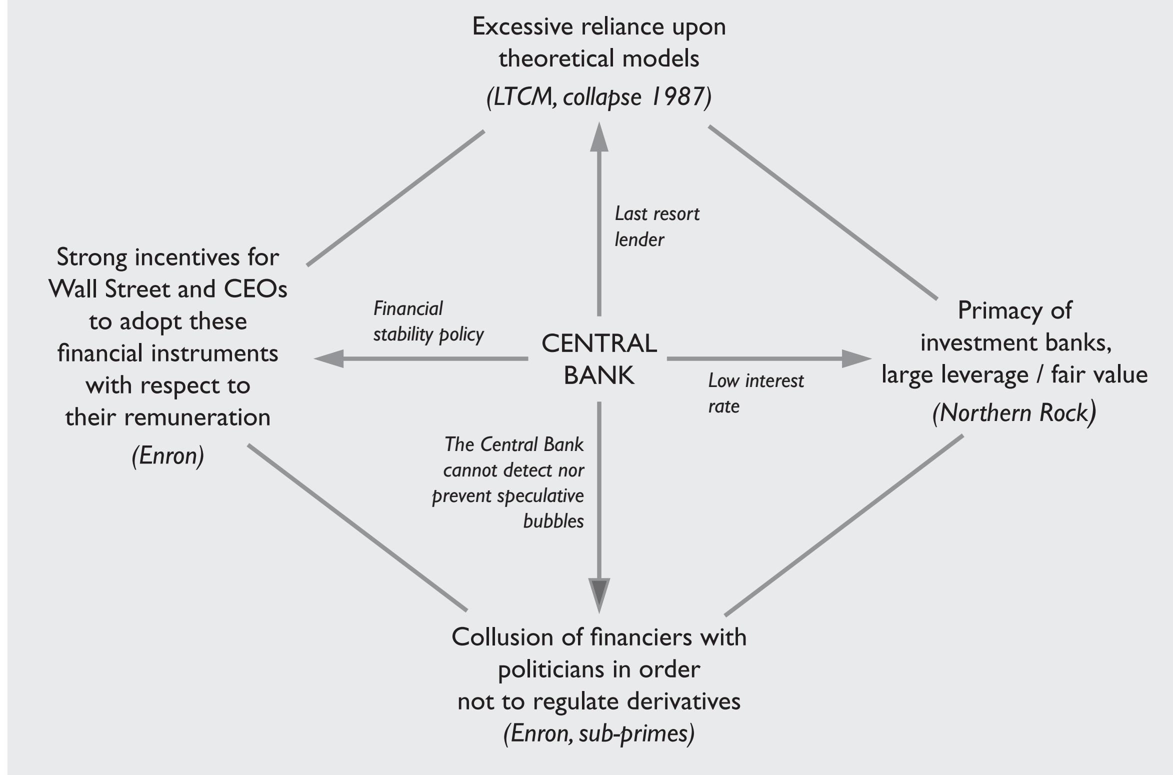
Before I turn to each of these possible paths for a new regulatory regime, I will briefly identify their common objective: to correct the structural imbalances that generated the sub-prime crisis.

3. A COMMON OBJECTIVE: CORRECTING THE STRUCTURAL IMBALANCES THAT GENERATED THE SUB-PRIME CRISIS

Far from being a pure accident that could not be anticipated (Boyer, 2008; 2009), the crisis came following many warnings that the American economy was entering a zone of financial fragility (figure 2):

- Firstly, the Stock Market crash of 1987 showed that individual optimal strategies for minimizing risk, when they are diffused to all actors, might well trigger a systemic instability. It was the first, and neglected, warning concerning the limits of *conventional mathematical finance*.
- The collapse of LTCM back in 1998 should have shown the danger of models that seem to entitle very *large leverage effects* for innovative, and therefore risky, hedge funds; at odds with the much more prudent strategy of typical commercial banks. Excessive credit is a major source of financial crises.
- *The remuneration* of the key actors in the financial system was indexed upon the total volume of activity. Given the underpricing of risk, this induced an explosion of quite exotic and complex financial products, and the new business model 'originate and redistribute' progressively diffused a high degree of irresponsibility among all the actors within the mortgage market. This feature was first detected when ENRON went bankrupt, and this particular collapse also unmasked the lax American *accounting system*.
- During all these episodes *the silence of the regulatory authorities* has been deafening, and this is not by chance. Actually, the new financiers were so rich and so full of promises that they easily convinced the administration and politicians that all these new financial products were stabilizing the economy and having a positive impact on efficiency. Any regulation, therefore, would be detrimental. Thus the financial laissez-faire was, paradoxically, strengthened. This is why the sub-prime crisis is so deep: all the previous imbalances had been piling up and this triggered a complete meltdown after the Lehman Brothers bankruptcy.

Figure 2. The origins of the sub-prime crisis: the spillover from various ill-judged mechanisms and strategies



Finally, *the Central Bank* was part of this process. It was the lender of last resort to overcome the 1987 Stock Market crash; it maintained a very low interest rate after its victory against inflation – measured by consumer prices but not asset prices – and thus allowed a speculative bubble to develop which it declared itself unable to detect. The financiers were reinforced in their belief that they were 'too important to fail': the FED and the Treasury would bail them out when the bubble burst.

According to this analysis the post September 2008 chaos was not at all the unexpected outcome of an adverse exogenous and external shock: it was, rather, the logical consequence of cumulative imbalances within the financial sector and the economy. Let us now explore various avenues for reforming this system.

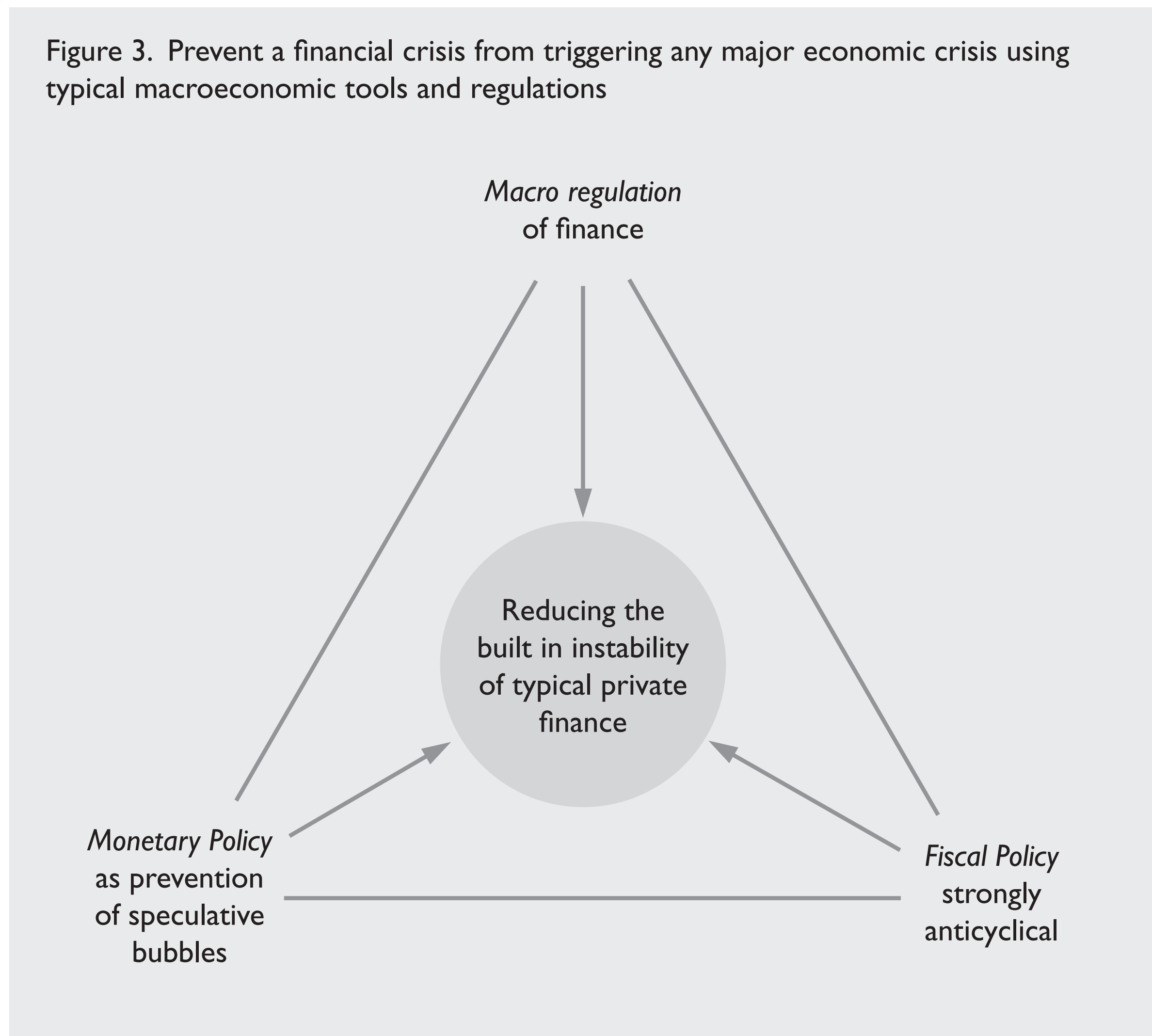
4. CONVERGING MACRO-ECONOMIC REGULATION AND MONETARY AND FISCAL POLICY: A POSSIBLE FIRST NEW PARADIGM

This proposal derives from two important premises. Firstly, that instability is a structural feature of finance that deals with uncertainty as well as risk. Furthermore, the entrenched power of contemporary financiers is such that it would be quite difficult for any government to interfere directly with the internal organization of finance. But this does not mean that public authorities are powerless at preventing crises: basically they may adopt strong *anti-cyclical* and *anti-speculation* policies that could be efficient enough

to drastically reduce the risk of a major economic crisis generated within the realm of finance (figure 3).

- On top of the existing regulations at the level of each entity and asset, the State should design a *macro prudential regulation*. A special agency should be in charge of making real time, stress tests of the resilience of the whole financial system in response to the mimetic diffusion of speculation and its outbursts, and/or adverse macroeconomic shock, affecting all the entities simultaneously. When facing a clear risk of financial collapse, this agency should be given the right to increase capital requirements at an early stage of the speculative boom, however unpopular this might be among financiers. In a sense, this amounts to no more than converting the stress tests made after the sub-prime crisis into a permanent and ex ante exercise, and complementing the international micro regulations of Basel I and II – themselves reformed – with a national tool adapted to each domestic macroeconomic juncture.

Figure 3. Prevent a financial crisis from triggering any major economic crisis using typical macroeconomic tools and regulations



- Of course, *monetary policy* also has a role to play. Ideally, the Central Bank should be given the objective of a maximum rate of inflation, measured synthetically by the purchasing power of money in terms of goods, services and assets. Therefore when an acceleration of asset prices not explained by a clear rise in real rates of return takes place, the short term interest rate should be raised, accompanied by a statement of the type: 'Given present information and analysis available to the Central Bank, there is an x% probability that the economy is entering into a speculative bubble. If this diagnosis is confirmed by future data it will be used to orient future decisions about the interest rate and refinancing of banks'. If authorities fear triggering unwarranted recessions due to false alarms, the Central Bank may continue to target consumer price inflation and move its interest rate policy accordingly, but it can increase the reserve ratio of the bank to remove the excessive liquidity that may trigger an asset bubble. Furthermore, these reserve coefficients could be differentiated in order to penalize speculative activities but not the financing of productive investment. Of course, there will be a need for coordinating this policy with the macro regulation by capital requirements previously mentioned.
- The third pillar of this macroeconomic approach relates to *fiscal policy*. In the American system the deduction of interest payments associated to mortgage credit generates a bias towards credit and away from saving and this may ultimately imperil macro stability when this device converts some households into 'Ponzi speculators'. This is also part of the story of the sub-prime crisis. There is, therefore, room for the following reform of the tax system: to cancel interest payment deduction and increase marginal taxation for those financial earnings which exceed a threshold for a normal rate of return in the rest of the economy. This would help to reduce the public deficits that are expected for a long period after the costly bailing out of finance. Another major change is required, namely that public policies that have tended to become more and more pro-cyclical should be reformed to converge again towards a typical *anti-cyclical* 'Keynesian' stance.

To sum up, this paradigm brings state intervention back into favour, without directly interfering with the incentives, tools and objectives of finance. This does not mean that powerful actors would easily accept such a drastic reversal of the policies of the last two decades. If there is going to be resistance in any case, why not go even further and reform the internal sources of financial instability themselves?

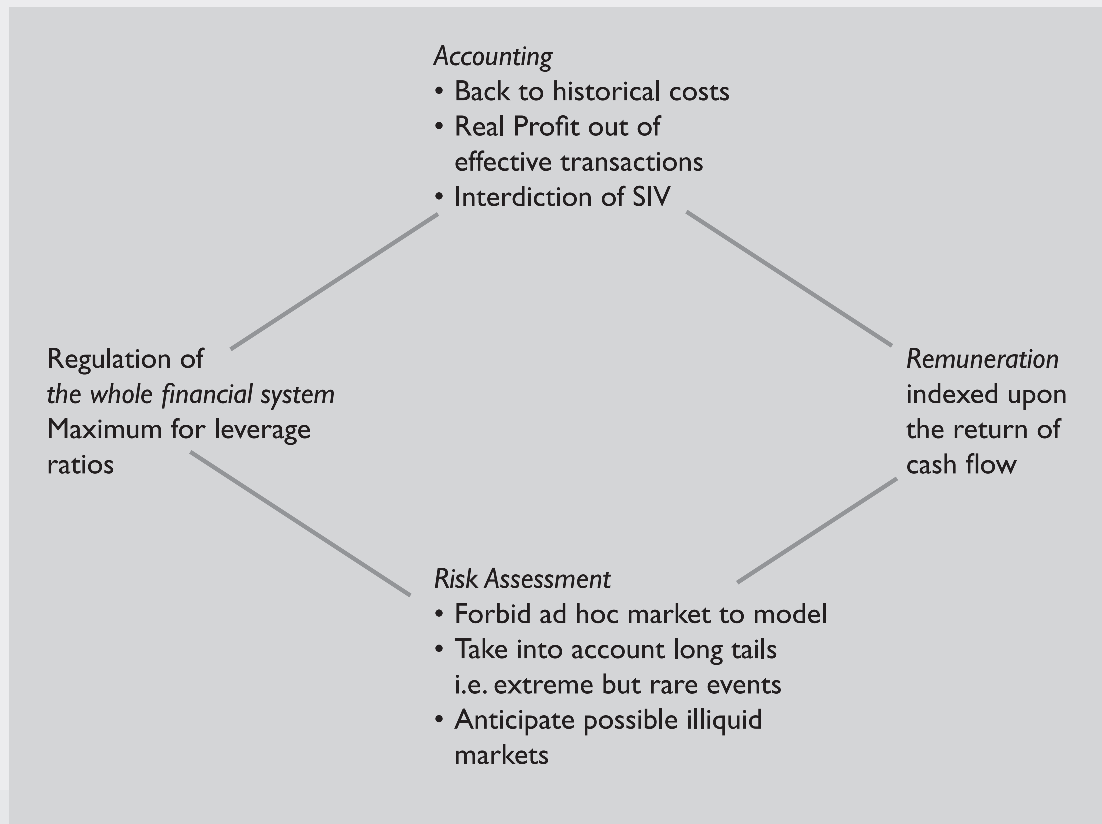
5. REDESIGN THE OBJECTIVES, INCENTIVES AND TOOLS OF FINANCE IN ORDER TO FOSTER A MORE RESILIENT SYSTEM: A POSSIBLE SECOND NEW PARADIGM

One of the cornerstones of this second approach relates to the *reform of remuneration* of all actors within finance according to the ex post medium term performance of related credit, assets or mergers, at odds with the previous system. For instance sellers of mortgage credit should be paid according to the reimbursement flows, thus taking into account the risk of default. One can expect thereby a greater moderation of credit. Similarly, stock options should be banned since they move

according to so many factors that are far distanced from a direct measure of the contribution to the performance of the firm, and typically promote excessive risk taking (figure 4). This seems far better than arbitrarily capping financiers' remuneration, without redesigning the very core of incentives.

- This calls for a drastic reappraisal of fair value *accounting principles*. They have a clear responsibility for the size of the bubble and, conversely, the collapse of so many banks since they introduced another acceleration mechanism on top of the well known financial accelerator. Furthermore it is meaningless to distribute virtual profits that would only be generated if the firm were to stop its activity and sell all its assets at current market prices! It is time to return to the conventional conception and measure of profit as value creation; to adopt a modernized version of historical costs once inflation has been drastically reduced. Similarly it is important to forbid all the Structured Investment Vehicles and other accounting tricks that allow losses and costs to be hidden and only inflated and invented profits to be put forward. It is time to learn from the ENRON scandal: that particular fraud took place in conformity with the general principles of American accounting!

Figure 4. Redesigning finance internally; incentives, accounting principles and models aimed at drastically reducing the frequency and severity of major financial crises



- The failure of risk assessment using the conventional models of modern mathematical finance calls for the rebuttal of firm specific model evaluation, and the elaboration of a new generation of risk assessment models that would correct their clear shortcomings, shortcomings which were evidenced during the sub-prime crisis: relatively high frequency of quite *extreme events, endogeneity* of bubbles, the need arising for anticipating a possible *freezing* of markets and access to credit. Financiers should no longer be entitled to build their own model of this new generation: one form or another of certification, hence standardization, should be welcome. In other words, risk assessment at the micro level is too serious to be left to the initiative of overconfident *quants* and their opportunistic deployment by top managers in the financial sector.
- Finally the growing interdependency between the typical activity of commercial banks and the dynamism and inventiveness of investment banks calls for an *integrated regulation* of the whole financial system. Since, in the US, Wall Street entities have now been incorporated into the common status of holding bank they benefit from the same access to deposit insurance, liquidity from the Central Bank and credit from the Treasury, and they have to comply with the same reporting rules, surveillance mechanisms, transparency and security for the public. The de-leveraging that has taken place since the Lehman Brothers collapse should converge towards a safer leverage ratio, just to prevent the repetition of an LTCM type crisis.

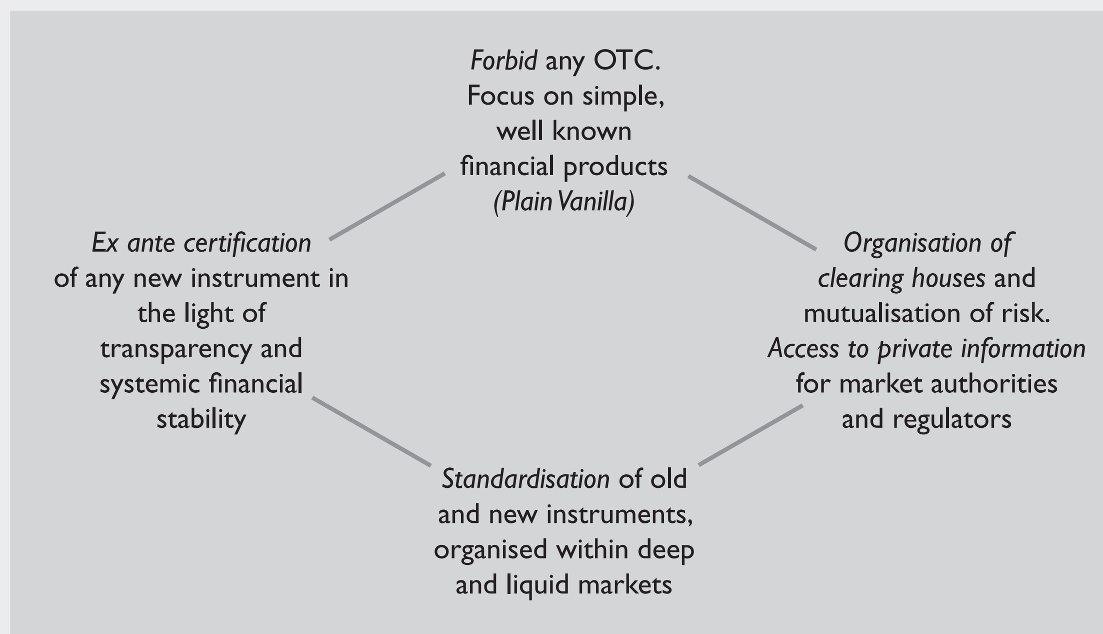
To be frank, this is far easier to propose than to actually implement since it assumes a drastic shift in the bargaining power of national governments and public administrations with respect to still powerful international finance. Thus a third strategy might be suggested.

6. A COLLECTIVE CONTROL OF FINANCIAL INNOVATIONS: A POSSIBLE THIRD NEW PARADIGM

This addresses one of the interpretations of the sub-prime crisis: that the *laissez faire* approach, applied to finance, has induced a wave of innovations so powerful that they have destabilized the whole economic system. In any other domain the public authorities have designed rules in order to prevent a given innovation from having a negative effect on the rest of the society. This is the case for medicine, transport security, equipment, work organization, construction etc.

In the domain of finance, it took nearly two centuries to design and implement regulations in order to prevent the bank runs that used to threaten the basic relation of any market economy: the resilience of the monetary system. *Mutatis mutandis*, the task of public authorities nowadays is to invent rules and mechanisms in order to prevent the collapse of modern financial systems under conditions of unexpected feedback from a group of powerful, but potentially dangerous innovations, such as securitization allied with complex derivatives (Boyer, 2008). The task is to invent for investment bank activity the equivalent of what has already been done for commercial banks (figure 5).

Figure 5. Collective control of private financial innovations, highly profitable innovations but ones which are powerful enough to destabilize the whole economy



How to prevent a repetition of the 2008 collapse? Firstly it has to be recognized that granting credit to people unable to pay it back was only a highly profitable idea for the originators because securitization was shifting the risk to less informed agents. A regulator should have forbidden such myopic risk transfer. When they did so, for example in Spain, the real estate bubbles were not prevented but no toxic derivatives have been able to worsen the crisis as prices have declined. Secondly, sub-prime holders were betting upon an unlimited rise in real estate prices; thus transforming themselves into 'Ponzi speculators' and it is well known that such a scheme is bound to implode. States whose governments maintained strict rules concerning mortgage credit, such as Canada or Germany, did not experience the same trajectory at all as did the US.

Consequently, a third regulatory paradigm would focus upon financial innovations and proposes an *ex ante* certification of new instruments; the standardization of a limited variety of these instruments; the organization of clearing houses with mutualisation of risk; real time access by regulatory agencies to the full information generated by deep and liquid markets and, finally, an interdiction on selling Over the Counter Products to badly informed agents.

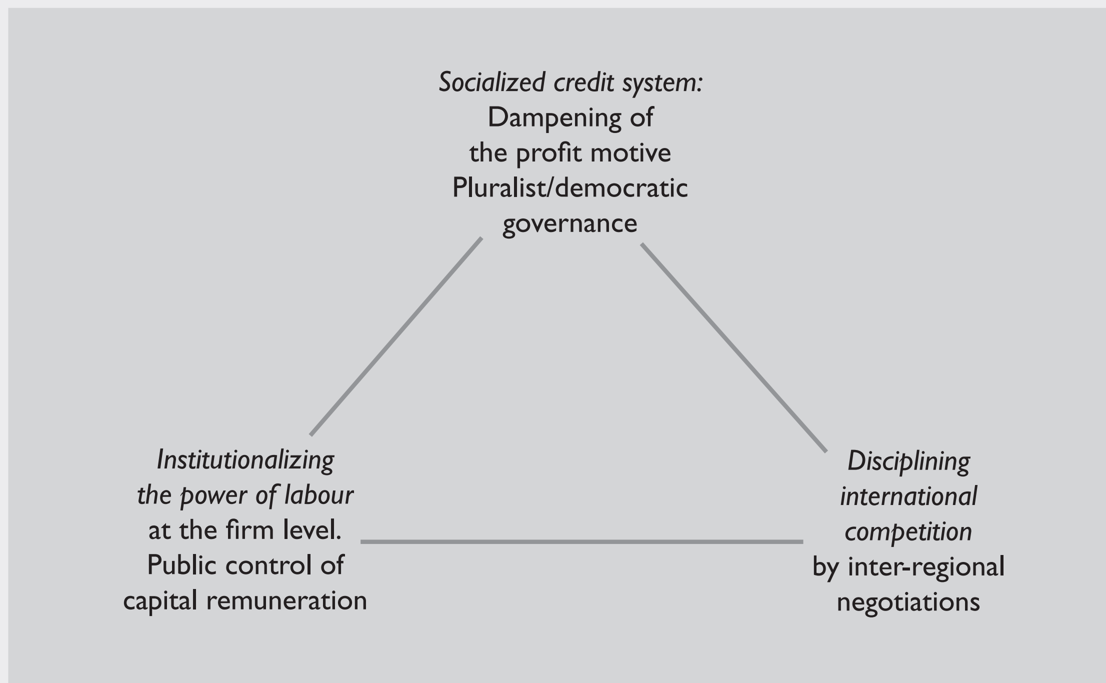
The purpose is again simple to set out, but hard to implement. What is required is to embed into any new financial instrument firstly the requirement of transparency for the buyer, and sometimes the seller, and secondly explicit mechanisms that would stop any negative externality in terms of systemic stability. This had been achieved for commercial banks but has yet to be obtained for the activity of investment banks.

7. THE SEARCH FOR A NEW INSTITUTIONAL ARCHITECTURE: A RESPONSE TO A SYSTEMIC AND STRUCTURAL CRISIS

The preceding analysis has focussed mainly on the domain of finance and its relation with public intervention. Nevertheless, the deep and long-lasting economic crisis that derives from the quasi collapse of the American financial system calls for a wider analysis (Boyer, 2009). Was not the sub-prime invention a trick to overcome the long term stagnation of the real income of the less privileged fraction of the population? Has not the global 2008-2009 recession shown how the international system has changed drastically under the opening up of most economies to trade, direct investment and finance? This constitutes an invitation to shift from a micro approach to *regulation* to a macro analysis of the role of different financial systems in the dynamism and resilience of growth regimes, i.e. *régulation* in the French sense of the term (Boyer, Saillard, 2001).

Clearly, the profit motive has a clear responsibility for the succession of financial crises, and the power acquired by finance through liberalization and globalization has induced predatory strategies in high finance. In a sense, this is a Polanyi type of crisis: the full commodification of finance has led to the collapse of its founding pillar, i.e. trust. Therefore a totally different conception of finance could emerge: the management of a public service would be delegated to the banks and other entities, with named access to credit and money (Lordon, 2009). Governance structures of finance should give a

Figure 6. Finance as a public utility, reinstituting some power to workers and a new deal for international relations



voice to each stakeholder (credit holder, depositor, wage-earner, citizen, communities, State etc) in order to mitigate the absolutism of the profit motive (figure 6).

Basically, credit should no longer be allowed to act as a substitute for poor and stagnating incomes. Consequently, the power of labour at firm level should be strengthened, either by a reform of the governance of non financial firms, or by public control of capital remuneration. Last but not least, the weakening of workers' bargaining power is itself an outcome of the pressure of foreign competition; the high mobility of capital and the productive overcapacity associated with the entry of China, India and other emerging countries into world competition. Disciplining international relations by interregional negotiations would open a new phase of internationalization; one more acceptable to workers and citizens than the present unintended effects of a high degree of interdependence without clear collective rules (Lordon, 2009).

Such a path is far from deriving automatically from the present state of the world economy, but the rupture of some of the past determinisms makes it less irrelevant than it has seemed in the past. Everything is in the hands of the collective actors in a position to initiate the exploration of such a reconfiguration of national economies and international relations.

8. FINANCIAL STABILITY HAS BECOME A GLOBAL PUBLIC GOOD BUT COUNTRIES STILL PURSUE NATIONAL STRATEGIES

The simultaneity of the 2008-2009 recession all over the world has evidenced an unprecedented interdependency among countries. Even those economies that have not been playing the game of financially led growth have been severely hit by the freeze of the American financial system. It is no surprise then that their governments are ready to impose drastic limitations on the autonomy of finance and its ability to generate structural/systemic crises. However, this is not fully in the interests of countries such as the US and the UK which have a definite competitive advantage in international financial intermediation.

De facto the initial responses to the financial crisis have been highly contrasting. The persisting lack of legitimacy accorded to fully fledged nationalization and strong control of finance in the US is striking. Conversely a clear reluctance to adopt any Keynesian reflation plan can be observed in Germany whereas in France, a broad acceptance of State intervention and a form of public control over finance prevails. In the UK there is yet another configuration: a pragmatic approach with an acceptance of partial nationalization but light touch regulation. The benefits of a typical social democratic approach to financial crisis are quite clear in Sweden (figure 7). The Chinese strategy meanwhile has been one of a brutal relaxation of bank credit, huge public spending, a slow but definite reduction of the purchase of US Treasury bonds and persisting control over the exchange rate.

The present state of globalisation displays an overwhelming paradox: rhetorical efforts by the G20 are in the direction of general and common principles for financial regulation and yet creeping protectionism is taking place in finance and trade, and we are seeing a search for typically national strategies (Boyer, 2009).

Figure 7. Ways out of the crisis: a matter of political compromises and national styles of policy making

	United States	*UK*	*Germany*	*France*	*Sweden*
Laissez faire fundamentalism	Republican experts and politicians ↓	Mervyn King initial statement ↓			
Keynesian spending + bad debt resolution funds	Paulson and Geithner Plans ↓				
Bank bail-out but no Keynesian plan			2008 strategy	Help to the banks and supply side plan	
Partial nationalization and active Keynesian policy	Obama 2009 plan	Gordon Brown 2009 plan			
Nationalization of core banks					Bailing out after 1990s crisis

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