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After the Crisis: Institutional Innovation and the Alternative Futures of American Finance

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AFTER THE CRISIS: INSTITUTIONAL INNOVATION
AND THE ALTERNATIVE FUTURES OF AMERICAN FINANCE

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After the crisis: institutional innovation and the alternative futures of American Finance

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Introduction

The financial crisis of the past two years has given rise to two distinct conversations. One of these conversations is familiar. The other has barely begun, and continues to lack a language.

The familiar conversation is about market imperfections, regulatory mistakes, and the financial breakdowns to which these imperfections and mistakes contribute. The method and the language of this conversation are those that prevail in practical, policy-oriented economics. The view of the task is to regulate more and better, so that it won't happen next time, not at least in the same way.

The second and less familiar conversation is about the reshaping of the institutional arrangements that govern the relation between finance and the real economy, and finance and production. The focus is on structural limits, not just localized market imperfections and regulatory mistakes, and therefore, as well, on institutional alternatives: different ways of organizing the relation of finance to production; different ways of organizing the relation between government and financial markets. Here the toolbox of the conventional policy-oriented economics proves insufficient. Legal analysis can supply the missing tools, but only if it decides to do so. A broader task, a reconstructed method, and a different language are all necessary.

This piece represents an initial attempt to contribute to this second conversation. I begin with a series of concerns located squarely in the first conversation. But I then develop an argument about American finance and the regulation of finance, in the context of the current crisis that then moves toward the second conversation.

I develop the argument by focusing on two central themes. The first theme is the development in the US and elsewhere in the latter part of the 20th century of a form of financial intermediation that might be called, quite simply, hedge fund finance.

I use the term “hedge fund finance” to refer to a form of financial practice associated with the triumph of speculation over enterprise, of short-term trading of speculative positions, rather than the channeling of long-term savings to projects of long-term productive investment.

These practices have often been justified as indispensable to the achievement of a greater good. But the experience of the past three years suggests that this attitude is doubly mistaken. It is mistaken, first, because it fails to appreciate the nature and magnitude of risks posed to society as a whole by unqualified financial speculation. It is mistaken in a second sense because it fails to understand the degree to which we can reduce the harms associated with speculation by reinventing the institutional arrangements used to define financial markets, rather than by simply suppressing the practice of finance.

The second theme is the relative narrowness of financial development in the United States today, notwithstanding its reputation for being a leader in the world of finance.¹ The development of deep and liquid securities markets in the US in the post-war period has often been taken as a sign of the inherent genius of American finance. But this experience has largely been limited to a single area of the American financial system - the American secondary mortgage market - together with the various practices and arrangements used to define and extend the mortgage market.²

The irony in this situation is clear. The extraordinary dualism created today by the combination of financial sophistication and financial shallowness represents one of the most striking deficiencies of the American system of finance. Because of this dualism, the country could both attract and squander enormous quantities of global finance, independent of the strength, vitality, or opportunity to be found elsewhere in the American economy.

If the only alternative before us involved choosing to embrace or reject financial markets as understood and organized today, then the willingness to tolerate the conditions above might make some sense. But as I argue in the pages that follow, this choice represents a false dilemma. The choice is not whether to accept or reject either markets or globalization. It is to choose among alternative versions of market-oriented reform and globalization. Moreover, the choice does not present itself as an “either/or” decision to be determined once-and-for-all in exceptional moments of historical openness and experimentation. The process of structural change and transformation is a permanent feature of our experience. The more conscious we are of the choices we make in different areas of social practice, the more capable we will be in choosing for ourselves socially-useful forms of market-oriented reform and financial globalization.

Several implications flow from these preliminary observations. One implication is that the acceptance of our modern “hedge fund finance” as a necessary incident of financial development represents a double failure.

Another implication is that the reduction of sophisticated financial engineering to the American mortgage market makes even less sense. No country can continue to grow and develop in the absence of a more fully developed financial system. Moreover, the acquiescence in this situation creates an even greater risk. As the global financial crisis

¹ See comments by Phelps and others, lamenting the absence of business finance and the insignificance of the US venture capital industry – not in terms of quality or contribution, but in terms of scale – not enough for the country as a whole. This comment should be placed in the context of the comparative approach developed later in this piece, noting that government involvement and legal and institutional innovation have been essential to all successful experiences of post-war financial development and reform. Note also – that the argument has two sides, the negative and the positive. The negative- the control of speculation via institutional and structural reforms, not merely a commitment to the principle of financial regulation; the positive sense – the kinds of policies and arrangements required to support growth and innovation in the mobilization of savings for productive investment. This point has frequently been understood in theory, only to be cast aside in practice.

² Add references to empirical and policy literature showing the dominance of mortgage finance in every major segment of the US credit and banking system, including cash, structured credit and derivatives market.

has shown, an increase in global savings “naturally flows” into the organized part of the financial market. Unless the markets are themselves expanded, excesses of all kinds build up, leading to speculative bubbles that are bound to burst, creating untold suffering and destruction.

Financial rescue and reform in the domestic market and the strengthening of each country’s ability to participate actively in global markets

There is also a third conversation that will increasingly occupy our attention in the years ahead. This conversation links the discussion of the relation between finance and the real economy within each national economy to the discussion about broadening the room for maneuver of each national economy and national government vis-à-vis international finance. I explore this third conversation in a series of pieces, parallel to this article, about finance in the contemporary emerging -and especially – Latin American economies.

The concern driving this third conversation is straight-forward: to enjoy the room for maneuver required by domestic institutional experimentalism in the realm of finance a country must be able to pursue policies and arrangements that seem promising whether or not they conform to the prejudices and interests of global financial markets. In other work, I discuss the restrictive effect of a range of policies and institutional preferences that have often represented in today’s world a functional equivalent to the gold standard of the late 19th century. These policies and institutional preferences, including acquiescence in a low level of domestic saving, openness to international capital flows, and an emphasis on reductions in government spending rather than increases in the tax take, effectively diminish the room for maneuver in the design and implementation of the institutional innovations that could better mobilize long-term saving for long-term productive investment. There is a reciprocal link between institutional innovations in the area of finance and the institutional innovations that allow for more integration of the national economy into the world economy with less subordination of national economic policy making to the interests and prejudices of international finance.

Until recently, the United States has been widely regarded as invulnerable to these concerns. However, we have increasingly come to understand the limits of this invulnerability.³ Circumstance has demonstrated that the US is no longer immune to the problems associated with excessive dependence on foreign capital. So, too, we increasingly appreciate our common interest with other countries in the world in broadening our understanding and ability to respond to problems that have been high on the global agenda for years: problems such as the global imbalance in savings and investment; the volatility of global financial markets, and the relative scarcity of legal and

³ US exceptionalism in the area of international finance has traditionally relied on its status as holder of the world reserve currency, and on its ability to borrow in its own currency. The former is now under attack and the latter may become more expensive in the short-term, even if the prerogative itself remains.

institutional tools capable of responding to these problems, whether on a global or regional basis.

Some preliminary methodological observations

To advance in each of these areas requires more than a willingness to confront new issues in the context of changing times. We also need to experiment with different forms of legal analysis, especially comparative law and legal analysis. The reason is straightforward. It is one thing to entertain conventional policy discussions that take the established domestic and international institutional framework of finance for granted. It is another thing to seek refuge from those discussions and that framework in the abstractions of traditional ideological dispute, such as neo-liberalism, capitalism, or market fundamentalism. To explore alternative approaches to existing financial arrangements we need to combine the exploration of structural alternatives, domestic and international, with an imagination focused on legal and institutional detail. Only the development of a revised practice of comparative law and legal thought can make such a combination possible

Main questions addressed in this essay

This essay explores these issues in the context of considering three questions:

The first question is to understand how and why the US in the post-war period came to deviate from the path in which finance would serve the real economy and in which independence from international finance would not rest solely on possession of the international reserve currency.⁴

The second question considers how the global financial crisis revealed the nature and price of this deviation

The third question concerns how the US can embark on a trajectory of institutional innovation that can contribute to the twin goals of service of finance to the real economy and of greater independence of the national economy from global finance.

⁴ I explore the scope and limits of US financial reform in the post-war period in an accompanying piece, Note on Fannie Mae and Freddie Mac as a truncated experiment in the deepening of links between finance and the real economy.

Preview of the main substantive claims

It may help at the very outset to summarize the main substantive results of the analysis. I advance three central claims. The first claim is that the financial crisis of 2008 should be understood, at least in part, as the result of a breakdown in the arrangements connecting finance to the real economy, in local and global markets. The financial crisis that began in a tiny corner of the US mortgage market was never simply a problem about mortgage finance. It reflected as well the transformation of the US financial system as a whole, and the way this system had become increasingly detached from the kinds of projects and arrangements that contribute to shared prosperity, innovation and growth.

The second claim concerns the specific policies and arrangements that would contribute to this transformation, creating the conditions for financial breakdown in both local and global markets. Although many factors were involved, I focus here on four key developments in American finance and financial regulation: first, the resurgence of primitive financial ideology, manifest in the weakening of regulatory oversight and the rise of the shadow banking sector; second, privatization and deregulation of the federally-sponsored mortgage market; third, the decline of traditional bank-based financial intermediation, a decline noticeable from the 1960s on but taking on new and added significance during the decade of the 1990s; and, fourth, increasing dependence on short-term portfolio capital, both foreign and domestic, to fund government spending, domestic consumption and recurrent trade deficits.⁵

The third claim is that it is both possible and desirable to define and to implement an alternative approach to financial organization and regulation in the context of the current US and global financial crisis. It is commonplace to note that financial crisis is often the handmaiden of structural change. But this change never happens automatically, and there is no guarantee that the kinds of changes we need will be the kinds of change we get. We have a better chance of getting things right if we begin by asking the right questions.

This essay represents an attempt to contribute to this effort, in the hope that the broadening of debate in the US and elsewhere over alternative approaches to financial reform may lead to a broadening of discussion more generally over the alternative futures

⁵ A fifth and related tendency is the failure to create, in the aftermath of the banking crisis of the 1980s, a new set of legal and institutional arrangements capable of supporting the banks and the capital markets in activities unrelated to the origination, packaging and trading of mortgage-related loans, securities and derivatives. Here, as in other countries, one of the key – and even embarrassing facts – of the recent cycle of boom and bust is the fact that so much capital has been channeled into the mortgage market. One reason for this is as obvious as it is overlooked: huge amounts of domestic and foreign capital moved into the American secondary mortgage market because the mortgage market existed. As one prominent financial economist noted in an early discussion of the financial crisis, “Where else could all that money go?” (Rajan, “A View of The Liquidity Crisis.”) The American system of mortgage finance is the largest and most liquid credit market in the world, surpassing even the US Treasury market. As such, it was the only large-scale market available for USD-based investors searching for a pick-up in yield above US Treasuries. The situation would have been different had other financial markets existed. This simple – and apparently banal fact – has been important in many different episodes of financial crisis and reform. For a discussion of this point in the Chilean setting, see If Texas were Chile (noting the failure of the Chilean savings and loan industry during the decade of the 1970s, after the return of reserves from the Chilean central bank, but before any corresponding changes had been made to the kinds of financial markets and instruments made available to the Chilean thrifts.)

of finance and the alternative futures of democratic market economies, both here and in other countries.

Outline of the discussion from here

The outline of the piece is as follows. Part one considers the financial crisis of 2007/8 in its distinctive legal and institutional setting. Part two considers the US government's response to the crisis so far, from the initial efforts of 2007 to the more recent and sweeping initiatives undertaken by both Treasury and the Federal Reserve. Part three uses the arguments and analysis of parts one and two to propose an alternative approach to financial rescue and reform in the US setting. Part four concludes the argument by making explicit the central ideas implicit in my explanatory and programmatic discussion.

Part two

The financial crisis of 2008 reconsidered

To understand the financial crisis of 2008, it is necessary to grasp the structure and development of US financial markets from the New Deal to the present.

Two main themes have characterized this development. The first theme – most prominent during the New Deal period of reform - is the importance of structural reform to the deepening of financial markets, especially financial markets capable of mobilizing long-term savings for long-term productive investment. The New Deal began what could have become a model for the development of American financial markets in general. It did so by experimenting with new forms of public and private partnership to organize different areas of finance, especially the area of mortgage finance. Had the model been generalized, the financial system today would look very different than it does. But because the model was not generalized – i.e. because the idea of public-private partnership remained limited to the mortgage market – the example ended up overtaking the idea, and the idea itself remained vulnerable to historical set-backs and reversal.⁶

The second theme is the resurgence of primitive financial ideology in the closing decades of the 20th century. The term “primitive financial ideology” is used here to refer to the ideas and arrangements associated with what I have called the “first conversation,” i.e. the idea that financial market crisis and collapse can be understood as the product of localized market failures and regulatory mistakes, rather than structural deficiencies or systemic limitations in the organization of financial markets. The ideology would become manifest in two different ways: first, as the justification for the weakening of regulatory restrictions on finance; second, in the attack on the public-private partnership maintained in the area of mortgage finance. Together, these developments would help create the conditions for the financial breakdown of the past two years.^{7 8}

As many observers have noted, the privatization of the mortgage market and the deregulation of financial markets more generally can be understood at least in part as the outcome of interest-group politics.⁹ But the interest groups could succeed as well as they did only in the absence of an understanding of the nature and limitations of existing arrangements, and the possibility of alternative arrangements. This, in turn, revealed both a failure of understanding in the present and a failure of understanding in the past. To

⁶ See the discussion in Shiller (*Animal Spirits*) criticizing as inadequate most contemporary economic analyses of the financial crisis and citing as a major reason their failure to understand the importance of “legal and institutional detail” in the organization and performance of financial markets.

⁷ Note also recent work by finance and corporate finance specialists on the importance of historically-specific legal and institutional detail (Shiller, Bernanke, Feldstein, Gorton and others – who emphasize the nature and diversity of the institutions of finance, but do so in isolation from the core analytical framework applied by modern finance theory and macroeconomics.)

⁸ My emphasis here on the importance of historically-specific legal and institutional arrangements in the development of the financial crisis should not be taken as a rejection of other possible explanations and contributing factors, including, for example, monetary and exchange rate policies or structural imbalance in the global economy.

⁹ See, for example, Simon Johnson, *The Quiet Coup*; Martin Wolf, *Is the US the next Russia?*; Joseph Stiglitz, *Free Fall*, and Jeffrey Sachs, various pieces, commenting on the influence of the financial sector in US financial policy.

overcome this failure would require a return to what I have termed, the “second conversation”: the conversation about structural deficiencies and limitations, introduced during the period of the New Deal reforms, only to be abandoned in the decades that followed.¹⁰

The New Deal emphasis on structural reform

For much of the post-war period, U.S. banks and securities markets operated within the legal and institutional framework established during the decade of the 1930s, in response to the Great Depression. Two key principles animated these reforms. The first principle was the commitment to a comprehensive framework of financial supervision and regulation, designed to stabilize and strengthen the banking system, in part by insulating the banks from the risks associated with underwriting and position-taking in speculative financial markets.

The second principle was a belief in the importance of structural reform, not just to dampen financial speculation, but to deepen financial markets and to provide through this deepening the institutional and material support for the New Deal program of socially-inclusive economic reform. For the architects of the New Deal reforms, no effort was more important than the effort to redress by government action the perceived deficiencies in existing financial markets and arrangements. Without a supportive financial setting, the New Deal agenda would be compromised from the very outset, starved of resources and arrangements required to move forward.

This idea of activist government policy was, of course, a hallmark of the New Deal reforms. But nowhere was this approach more fully or successfully deployed than in the area of mortgage finance. For the architects of the New Deal, re-organization of the mortgage market was fundamental for two different reasons. First, the pre-reform model of housing finance was widely perceived to be at the heart of two great evils of the time: economic insecurity and financial instability. Second, the broadening of the mortgage market was considered an essential pillar of broad-based recovery and reform. For the Americans – as well as for Keynes – the area of housing and mortgage finance provided an especially promising channel for the reactivation of economic activity and the stimulation of aggregate demand.

Three key features would characterize the New Deal reforms in the area of housing and housing finance. A first feature involved the use of state-owned banks and investment funds to purchase and restructure a large portion of outstanding mortgage obligations. A second feature was the creation of a series of federally-sponsored mortgage agencies and auxiliary institutions. For the New Deal reformers, it seemed obvious that the traditional banks and securities markets were incapable on their own of creating a stable and expanding system of nationwide mortgage finance. To do this, new resources and arrangements were required. Thus, a series of new entities were created – the FHA, FHLBS, Fannie Mae under the RFC - not to supplant the traditional banks – but to

¹⁰ This theme is further developed in Annex 1 of this essay.

complement and extend them, by creating access to long-term funding, and by providing a series of risk management tools that would enable the thrifts and the banks to originate and hold in portfolio the new long-term mortgages that the system was designed, in part to support.

A third important feature of the New Deal housing and financial reforms was the strengthening and expansion of the public law framework for monetary policy and financial regulation. In our own day, it is commonplace to separate the discussion of monetary policy from financial policy and the institutional organization of the financial system. But the central bank and auxiliary institutions play a crucial role in the structure and development of financial markets and their relation to production. Here – as in other areas – organization matters.

In the context of the 1930s, two innovations of the new monetary regime would play an especially important role in the post-war development of the financial system. A first innovation consisted in the centralization of monetary and banking authority in the newly-created Board of Governors of the Federal Reserve. Prior to this transfer of power, monetary and credit policy were effectively under the control of the private bankers, acting on their own initiative through a series of regional organizations, often at cross-purposes.

A second major institutional innovation was the creation of the federal system of depository insurance (the “FDIC”). As many have noted, this system was remarkable in two respects. First, the new system of government-sponsored depository insurance eliminated the most basic source of systemic risk in 19th and early 20th century American finance: runs on the bank by retail investors fearful for their life savings. Second, and of even greater interest today, the FDIC would pioneer a variety of new techniques for the restructuring of failed institutions. The so-called “special resolution regime” established as part of its charter, would serve as a laboratory for the development of different forms of reorganization, including, in later years, different forms of public and private partnership designed to preserve assets and institutional resources capable of contributing to economic development in community and regional centers.

Until recently, most commentators have focused on the regulatory aspects of the New Deal financial reforms. But the New Deal program of structural reform would prove equally – or more – important in at least two respects. First, the new federally-sponsored system of housing and mortgage finance would contribute to the broadening of home ownership and expansion of the construction industry throughout the post-war period. Second, the New Deal system of housing and mortgage finance would contribute to the deepening of every part of the financial system. The banks and thrifts would thrive within a framework of federally-sponsored and insured deposits and a host of public institutions providing liquidity for the mortgage market. Securities firms would benefit as well, first by the steady issuance of government and agency securities, and later, by emulating the practices of the federally-sponsored mortgage agencies, especially in the area of securitization.

For a time, the system worked very well. The development of a the New Deal system of money, banking and credit would help to create the deepest and most sophisticated financial market in the world, contributing to an unrivaled period of shared prosperity, innovation and growth during the first few decades of the post-war period. Nor would the characteristic pathology of the pre-war markets return with the new prosperity. The combination of financial deepening, socially-inclusive growth, and government sponsorship and coordination would contribute to a period of unrivaled macroeconomic and financial stability in the US and elsewhere.¹¹

Yet from the very outset it was also clear that the system was subject to two great limitations. One limitation was financial localism: the organization of a national banking system made up thousands of unit banks, each confined to a relatively small geographical area and prohibited by law from interstate branching or functional affiliation.¹² Although this system could succeed in channeling savings to firms and households in the community, it would do so without benefit of economies of scale or diversification. As a result, the community banks and thrifts of the post-war period were inherently fragile. Their ability to perform even the most basic financial services depended on a series of special conditions, which would soon disappear.

A second limitation was the selective nature of the financial deepening that was achieved. For all the ingenuity and institutional creativity applied in the area of mortgage finance, the model of public and private partnership underlying the new mortgage market would remain the exception rather than rule. Within the mortgage market, public and private collaboration would create the basis for a vast expansion of both housing and housing finance. But beyond the mortgage market, in areas denied the same apparatus of government-sponsorship and support, local banks would remain what they had always been (at least in the United States until then): primitive and underdeveloped, cut off from the world's leading financial centers, whether in the US or anywhere else. Capital markets would remain equally remote: accessible to government and blue chip firms (and the occasional start-up favored by Wall Street and venture capital); but having little or nothing to do with vast majority of small and medium size firms which would form an increasingly important part of the US and other countries in the post-war period.

Neither of these problems was insuperable. Indeed, the very framework put in place by the New Deal model of financial reform would suggest many different points of departure for further institutional innovations that would tap the productive potential of savings in ways appropriate to a national market economy in the historical era of globalization. For example, the development of more sophisticated forms of fiscal and financial federalism could have provided a platform for an on-going process of collective learning and experimentation by the country's regional and community banks. The generalization of the "tertiary sector," i.e. the sector of government-sponsored funds, insurers and financial intermediaries could have served as a continuing source of both

¹¹ The US financial system is generally recognized as the most developed financial system in the world. There is also increasing recognition that the institutional transformation of the financial system in the closing decades of the 20th century has contributed to increasing macroeconomic and financial instability.

¹² Refer to the polemic in US financial history over the nature and significance local, unit banks, especially in comparison with universal banking, which is regularly taken as the sole alternative.

stimulus and support for the deepening of local markets and their integration with global markets.¹³

Had this subsequent progression occurred, financial localism – the most significant American experiment in the organization of finance up to the early decades of the twentieth century – could have been the first in a series of steps serving to strengthen and enhance the country’s uniquely decentralized system of banking and credit. It could have served – and could still be made to serve – as an emblem of what is necessary today to create a nationwide system of entrepreneurial finance, rooted in local communities, firms, and regions, but equipped financially, technologically and organizationally to move up the economic ladder and compete actively rather than passively in the global financial system.¹⁴

But this progression did not happen. Instead, from the 1970s on, four mutually reinforcing tendencies would derail the kind of forward motion necessary to support an ongoing process of financial deepening, in the service of growth with social inclusion.

Weakening of regulatory oversight and the emergence of shadow-banking

The legal framework for the regulation of finance was progressively eviscerated from the 1970s on. This hollowing out took place in two waves.¹⁵

The first wave involved the emergence of financial institutions in the 1970s free from the New Deal restrictions. Examples include: money market mutual funds; lightly-regulated finance companies; a burgeoning commercial paper market.

The second wave involved a restatement and rationalization of the system that arose from the continuing growth of the shadow market into a generalized framework of regulatory dualism. Regulatory dualism is the combination of a thinly-regulated sector and a thickly-regulated sector. The term is used here to refer to the increasing growth, formalization and integration of a two-tiered system of financial regulation, both in the US and in other countries.

Of course, the very idea of shadow banking has been part of the US financial system for years. The rise of money managers and non-bank banks in the immediate post-war period

¹³ Add references to the series of essays on venture capital, industrial policy and other arrangements of “economic and financial experimentalism” in developing countries.

¹⁴ Students of comparative finance and political economy have explored the contribution of government-sponsored financial development in many different settings. Note, also, that this kind of partnership responds, at least in part, to the concerns raised by proponents of universal banking in the US (Calomiris, among others). For a discussion of the role of publicly-sponsored venture capital and commercial credit as institutions of development contributing to the organization of new forms of enterprise and industry in advanced and peripheral economies, see the writings of Sabel, Gilson and Black, CM and KP, and essays in Rodrik, *In Search of Prosperity*.”

¹⁵ It is widely acknowledged that these national developments interacted with the deficit driven system of international trade and the enormous imbalances between major economies that arose in the decades following the collapse of the original Bretton Woods regime in August 1971. See, for example, *The Turner Report* (2009); Martin Wolf, *Fixing Global Finance* (2009); Richard Duncan, *The Corruption of Capitalism* (2009); and Eichengreen, *Globalizing Finance* (2d edition).

was a central tendency of the time, endlessly studied and debated by academics and policymakers. But beginning in the decade of the 1990s, the shadow sector would take on new and added importance as the primary venue for private label securitization. Thus, the new non-bank financial intermediaries would include: conduits and special purpose vehicles, in addition to hedge funds and private equity firms. Collateralized debt obligations (“CDOs”) and credit default swaps (“CDS”) would provide the instruments of choice for securitizing sub-prime mortgages and related exposures. The development of new money and funding markets outside the traditional banking sector would provide funding to the special purpose vehicles at the heart of the shadow market¹⁶.

For students and observers of the financial crisis, the arrangements described above are, by now, easily recognizable. But, according to the conventional account, the trends represent the spontaneous response to increased complexity and sophistication. By contrast, the account offered here suggests an entirely different perspective. The more closely we observe the historical trajectory of reform, the more clearly we are able to see that what appears, at first, as “spontaneous financial innovation” is, in fact, a product at least in part, of changing rules and regulations (conceived against the background of ideas available at the time and themselves subject to an ongoing process of criticism and transformation).

Reorganization of the US system of federally-sponsored housing and mortgage finance

This point becomes even more obvious when we consider the development of shadow banking in relation to the reorganization of the US system of mortgage finance. This second wave was reciprocally connected with a radical reorganization of the unique US system of mortgage finance.

Like the development of shadow banking, the transformation of the mortgage market would occur in two stages. The first stage consisted in the restructuring of the federally-sponsored mortgage agencies and the introduction of securitization for GSE-sponsored mortgage pools. Beginning in the 1970s, the newly-chartered GSEs would begin to securitize GSE-sponsored pools of residential mortgages. The new secondary mortgage market, based on securitization, would evolve from the simple pass-through structures of the 1970s to the more complicated CDOs, including multiple tranching and credit enhancements.

The second stage involved the development of “private-label securitization” – a parallel system for the origination, pooling and securitization of residential mortgages that failed to meet the standards established in the GSE segment of the market (thus, the label “subprime” mortgage market).

¹⁶ The new funding vehicles would include: CDs; federal funds; tri-party repo; auction-rate securities and asset-backed commercial paper. For a discussion of the distinction between money and funding markets, see the work of Brunnermeier, Shin and colleagues. The distinction has also been used by Secretary of the Treasury, Timothy Geithner in his speech to the New York Economics Club, Summer, 2008. At the time Secretary Geithner was President of the Federal Reserve Bank of New York.

Critics of securitization today emphasize the “inherent” deficiencies of this form of financial practice. What the critics fail to understand is that the market imperfections and regulatory mistakes revealed by the recent crisis are themselves products – not of securitization in general – but of the hollowing out of securitization that occurred during the decade of the 1990s as it evolved in the shadow market.

There was no intrinsic reason for the new markets in credit risk transfer to develop in this manner. As the earlier experience in the US had shown, securitization and derivatives, if managed properly, could, contribute in many ways to the socially-useful deepening and development of financial markets, in the service of economic growth and innovation. Yet the emerging legal and regulatory regime established by US and international authorities created both the opportunity and the incentives to expand these markets in the shadow sector. Only in time would the country come to realize the consequences of this shift and the effect it would have on the development of the financial system and its relation to real economy.

Breakdown of traditional bank-based financial intermediation

Two main consequences flowed from these developments. First, the slow but steady breakdown of traditional bank-based financial intermediation. For much of the postwar period, banks remained what they had always been both here and in other countries: the primary agents of financial intermediation, channeling savings to households and business, typically out of funding from their depository base.¹⁷ But from the 1980s on, this, too, would begin to change. Big banks, already buffeted by the tendencies described above (e.g. mortgage securitization, loss of deposits to money market mutual funds, loss of primary corporate customer base to the commercial paper market) would increasingly adopt the business model of their competitors: increasing emphasis on proprietary trading and position-taking in derivatives and publicly-traded securities; origination and securitization of mortgages and other standardized assets; and the provision of liquidity and risk management tools to players in the shadow market (especially those parts of the shadow market highlighted above).

Increasing role of capital markets in the intermediation of finance

The counterpart to the breakdown in traditional, bank-based financial intermediation was the increasing role of capital markets in the intermediation of finance, and financial activity more generally in the United States. As the new markets and arrangements took hold, the capital markets would become the leading sector of finance, outpacing and displacing the banks that once served as the heart of the mortgage market.

For comparative finance theorists, this move from “banking” to capital markets has often been seen as part of a natural evolutionary tendency, in which “institutions” are increasingly replaced by ever-more-perfect “markets”. As a descriptive matter it was

¹⁷ Add references to policy and empirical literature on changing structure of banking and financial markets in the US [ref to Shin and associates, together with Turner Cass Lecture again]

certainly true that many of the traditional loans and financial instruments formerly originated and held at the banks would – in the United States – be transferred to the money and capital markets. But the idea that markets were replacing banks – and through this replacement, contributing to a process of socially-optimal risk diffusion, was wrong in at least three respects.¹⁸

First, there were many reasons to believe that the “market” that began to emerge in the US from the middle of the 1990s might be less rather than more efficient than the bank-based model of financial intermediation from which the new model emerged.

Second, as the crisis would soon make clear, the fact that credit in the US financial system increasingly took securitized form did not mean that the banks were any less involved in the structuring or distribution of credit risk.

Indeed, in many ways the banks would become more not less involved in the process of credit intermediation. For one thing, many of the new securitized instruments would remain on the balance sheets of the banks; for another, many of the conduits and specialized investment vehicles involved in securitization either belonged to commercial banks, or were guaranteed or supported by them.

Third, the new shadow banking system – especially that part of the shadow system populated by conduits, special purpose vehicles and other non-bank financial intermediaries that had come to dominate US credit markets - instead of providing a haven for financial innovation in the service of enterprise, growth and risk-diffusion, would become little more than a venue for the trading of speculative positions by and among (mostly private) financial institutions, thoroughly disengaged from the real economy which the financial markets were supposed to serve. This last point requires further comment.

Ever since Keynes we have understood the ambiguity in the nature of financial speculation. Speculation can represent a concrete prediction of what will happen in the real economy and in doing so, fulfill two important functions: the organization of risk-taking and the generation and dissemination of information. But speculation can also turn inward and involve nothing more than the trading of speculative positions, with little or no contribution to the management of risk or the production of socially-useful information.¹⁹

This distinction between different forms of speculation would have little or no practical effect if the difference, in the end, were nothing more than a psychological fact; such is the tendency is much of the theorizing today, a tendency that itself goes back to Keynes.

¹⁸ Add references and citations, to BIS, Greenspan, Bernanke and others – on the presumed efficiency of the new “market-oriented” financial system. The argument is based on the idea that the new securitization and derivatives markets represented a form of market completion.

¹⁹ For the development of this theme in the context of the domestic market, see recent speeches and testimony of Geithner, Bernanke and Tarullo; see also, Turner and King. For the development of the theme in relation to global markets, see Krugman and D’Arista (discussing the significance of the “carry trade” for sudden changes in global currency and money markets).

But it is not a psychological fact. In fact, there are different ways to organize financial markets, especially financial markets designed to facilitate the organization and management of financial risk through the exchange of securities and derivative contracts.²⁰ Some ways promote socially-useful financial trading; other ways allow and even encourage what financial regulators, practitioners and observers increasingly consider socially-useless forms of gambling, with little or no social benefit.

In the period leading up to the financial crisis, there were many reasons to believe that the new emphasis on proprietary trading and portfolio investment among US financial intermediaries had become an exemplary illustration of the second, socially dangerous form of financial speculation. A large empirical literature would testify to the build-up of finance-driven asset bubbles, generating gains on paper as the markets went up, only to lose them when the markets went down.²¹

Note the irony in this last situation. The development of securitization and derivatives markets during the decade of the 1990s was hailed by many of the leading policymakers and central bankers of the time as financial breakthroughs of the highest order. Together, the two frontiers of high finance would stabilize and support an increase in growth as well as stability in global markets, by facilitating the diffusion of risks through new markets, intermediaries and instruments, increasingly available in every region of the world economy. But this is not, in fact, what occurred. Instead, the new financial markets of the 1990s would expand in scale, scope and turnover largely within the financial sector (and having little or nothing to do with the needs of the real economy). Thus the stage would be set for recurrent cycles of booms and bust, fueled by global liquidity, external debt, and the increasing proliferation of credit-driven asset bubbles.

The net result was to build into the very framework of the new global financial market seeds of its own destruction, creating the conditions for a market crisis unrivaled since the Great Depression. The vast creativity and ingenuity of late twentieth century financial engineers would succeed in creating mechanisms for financial deepening without development and expansion without social value; an endless cycle of boom and bust, built into the very framework of the new market-oriented” model of US and global finance.²²

The flaws of the hollowed-out system become manifest: the subprime crisis of 2007/8

²⁰ Refer here to the discussion of the Brazilian rules, prohibiting naked shorting of stocks and other forms of “purely speculative financial market transactions.” Chile provides an even clearer example of the use of the distinction between speculative and hedging transactions to discourage certain forms of trading deemed to be socially harmful.

²¹ Add references to Turner and others; plus the debate over different forms of derivatives trading and the extent to which these new forms of finance would or could harm or help the development of finance

²² Add references to Wade, Duncan, McKinsey Global Institute, Turner, King, Krugman, Volker, etc., documenting this trend. Compare the concern as it has begun to emerge in the aftermath of the current crisis to the concern shared by many in the 1930s, in response to the instability of the interwar period (Eichengreen); the financial crisis of the 1930s (Keynes, Brenner, etc.) and fears informing the post-war reconstruction, ultimately embodied in the original Bretton Woods regime (references include: Eichengreen, Heillner, Bernanke, Tarullo, etc.).

Nowhere would this dynamic of financial deepening through decoupling be revealed as clearly and as painfully as in the subprime crisis of 2007, and the global crisis of 2008. This story is, by now, well known. The purpose of the following account is merely to highlight the part of the story that remains obscure and will continue to remain obscure until placed in its broader legal and institutional setting.

The rise and fall of the subprime mortgage market

Consider first, the rise and fall of the subprime mortgage market as an exemplary illustration of the new era of financial decoupling and the increasing emphasis placed on the practice of speculative finance.

For much of the post-war period, the federally-sponsored mortgage market had served the country well, providing stable and steady growth in both homeownership and home finance. The market did so, at least in part, on the strength of the institutional and regulatory safeguards provided by the New Deal reforms. But from the mid 1990s on, the structure and composition of the US mortgage market would change. The market in subprime mortgages would account for an increasing portion of the mortgage market overall, especially the securitized part of the market. The proportion of simple pass-through structures involving agency standards and guarantees would decline, and the more complex, highly structured CDO and CDS instruments, originated and traded as part of the private label market would increase in prominence and effect.

At first these developments were well received. American central bankers and policymakers would celebrate innovation in the mortgage market as a sign of the alliance between ingenuity and democratization. For proponents of unfettered markets, the development of this new frontier seemed to confirm the central argument made all along: that financial markets and practitioners could be trusted to create value and monitor risk for the benefit of society as a whole. The best form of regulation was self-regulation, guided by the discipline of the market.

Yet, from the outset there were reasons to doubt this view of the facts. For one thing, the kinds of loans being made were questionable on their face. The self-regulating character of financial markets required transparency, full disclosure and sound management of risk. Yet little in the subprime market reflected either transparency or prudent risk management. Indeed, the very structure of the subprime contracts made clear what critics had noted all along: that the new mortgage contracts made sense only in a world in which housing prices only went up. The famous NINJA loans with teaser rates and little or no down-payment could only possibly perform if housing markets never fell and loans never suffered from market disruption.

For another, the changing structure of the mortgage market would itself reveal a widening gap between theory and practice. If the original model of securitization worked, it did so because of a series of safety and soundness provisions imposed on the system of housing

and mortgage finance. These safety and soundness provisions were more than mere trimming; they were absolutely essential to promote stability, integrity and transparency in public securities markets. The hollowing out of the institutional protections left the market prey to the kinds of pathologies characteristic of American finance in the period leading up to the Great Depression. As in the 1920s, the private label securitization market would become a game of insiders, structured for the benefit of the sponsoring banks, rather than the hapless investors dependent on rating agencies for protection.

Collapse of the shadow banking sector

For a time, the market seemed to work well. The self-reinforcing character of the credit bubble and housing boom would be in full bloom in the middle of years of the decade of 2000s. But as the US housing market began its inevitable descent beginning in the fall of 2006, a series of striking developments would reveal how far the financial system had drifted from its earlier moorings in the New Deal legal and regulatory regime.

An early indication of this transformation could be found in the sudden breakdown of money and funding markets beginning in the summer of 2007. A second indication could be found in the serial bankruptcies, bail-outs and rescues that would begin in the months following this market debacle.

For economists and policymakers, these events were stunning: markets are supposed to be self-correcting. But they should not have been stunned. The new forms of financial intermediation had made the world more risky and unstable. Growth in the shadow market was invisible and chaotic.

Leveraged losses, Wall Street banks and the financial panic of 2008

But by far the most stunning indication of the transformation of US finance would appear with the systemic breakdown of September, 2008. The collapse of the leading US investment banks in a period of less than a month was both unprecedented and unimaginable.

According to modern finance theory, none of this should have happened. Derivatives and securitization, viewed primarily as mechanisms of risk diffusion, were supposed to stabilize financial markets, not render them more unstable.

But in the conditions of the time, neither derivatives nor securitization would serve as true mechanisms of credit risk transfer. One problem had to do with the hidden ties of continuity and obligation linking different players in the financial market. For example, originators of residential mortgages could use derivatives or pooled asset-sales

(securitization) to reduce balance sheet exposure, or to obtain favorable regulatory treatment for assets and liabilities to which the firms might nonetheless remain exposed.

Another problem had to do with the enormous build-up of leverage and concentration of risk within the financial sector. On the eve of the sub-prime crisis, the leverage ratio for the country as a whole (i.e. total outstanding US debt as a percentage of GDP) had grown to an astonishing 350%, more than twice the level of 1980.²³ The majority of new debt was both (a) concentrated in the financial sector; and (b) linked to the real estate market, especially the residential real estate market. Indeed, the channeling of so much credit into the real estate market would produce what insiders would easily recognize as a reverse pyramid of obligations (or a giant ponzi scheme). In other words, the primary mortgage market was narrow; the secondary mortgage market, more general; and the successive layers of derivatives piled on top of each other (or to the side, through the trading of synthetic exposures) would create a chain of liabilities beyond the control and comprehension of financiers.

In this setting, the very concept of intermediation would take on new meaning. Intermediation was supposed to involve the channeling of savings from households and firms to productive investment (or long-term consumption) within the real economy. Yet the growth in credit and asset markets in recent years would remain heavily oriented to the banks themselves. Relatively little of credit allocated during the height of the recent bubble would even leave the financial system.

Domestic weakness, illiquidity and instability in global markets

Consider, finally, the spread of the crisis to global markets. Just as US finance would become increasingly a game of asset trading among highly leveraged financial institutions, created to benefit the “market” itself, so the spread of the crisis to the world as a whole would reveal how the new logic of speculative trading had come to dominate global markets.

Recall the many developments that had taken place in the world economy from the time of the Asian crisis. The world as a whole had become “awash with liquidity” prior to the global crisis. Growing imbalances in the world economy would increasingly correspond to the recycling of surpluses from developing to developed countries, especially the United States. At the same time, many of the most successful developing countries would be recipients of large capital inflows from abroad. Indeed, the increasing amount of cross-border investment was interpreted as a sign that the global economy was thriving, under the aegis of open markets and a regime of free trade.

²³ Source: Various Federal Flow of Funds reports; see also the Turner Review (March 2009) and the Turner Lecture at Cass, March 17, 2010.

According to the standard view, financial deepening in global markets should have been, on the whole, for the good. Financial liberalization, it was generally believed, should lead, automatically, to the efficient allocation of capital around the world.

Yet the very great turbulence in global markets triggered by the financial crisis in the US would provide a new perspective on the development of global finance. The accentuation of instability in the global capital market would now appear strikingly similar to the dynamic in the US market. The same tendencies apparent in the US market would reappear in the global market. These would include: a stunning increase in leveraged cross-border capital flows; the creation of a vast and parallel “shadow market” in global markets; increasing volatility within this market, and the enormous scale of capital reversals triggered by bursting of credit bubbles and declining asset values.

The financial crisis of 2007-2009 and its legal and institutional setting

Before going on, let us pause and consider the essential difference between this analysis of the dynamic of the crisis and the standard view that has informed public discussion and public policy. The key difference is in the crucial role I attribute to the distinctive institutional framework generated by what I have called the hollowing out of the New Deal regime. Although the outcome was organized under the aegis of a generalized regulatory dualism, it was not – apart from the contrast between a highly regulated and a thinly regulated sector – a system at all. It had no logic: no rhyme or reason. It was the contingent result of a series of surprising compromises among powerful forces. Everything happened as if the resurgent financial pseudo-orthodoxy of the late 20th century had been powerful enough to gut the New Deal settlement about finance but not powerful enough to replace it with a coherent alternative, suited to its own interests and vision.

American failure and global collapse

In retrospect, three key factors would prove crucial to the US and global financial crisis.

First, a breakdown in the relation between finance and the real economy. In the first few decades of the post-war period, American finance and financial regulation served the country reasonably well. It did so by mobilizing savings in the domestic market, and channeling those savings to the real economy, in both local and global markets.

But from the decade of the 1970s on, the structure of finance and political economy in the US and other countries would gradually unravel. The US would move from surplus status to become the world’s leading debtor. Moreover, the new US vulnerability to volatility in global markets would occur together with a change in the structure and composition of its

international investment position, rendering even more precarious the country's new dependence on foreign credit.²⁴

Among the many contributing factors leading to increasing fragility of financial structure were the importance of internal structural and institutional limitations: e.g. the failure to maintain the integrity of the mortgage market and the various segments of the financial system increasingly dependent on the mortgage market; the failure to extend the organized part of the financial system beyond the mortgage market; and in the failure to restrain the continuing flow of money into the mortgage market – money that had no where else to go.²⁵

This failure would have two effects: first, the disintegration of the mortgage market; and second, the increasing exposure of every other part of the financial system to the inevitable downturn in the housing market, leading to financial collapse.

This failure was in turn related to a second, systemic deficiency: the failure of the government to use the tools of legal and institutional innovation to encourage new forms of domestic savings, or new mechanisms capable of channeling savings to long-term investment, or new policies and arrangements capable of moderating financial instability and/or responding to financial crisis. Policymakers and theorists would increasingly understand the limits of inherited strategies of stabilization and adjustment. Full employment, innovation and inclusive growth would require something more than prudential regulation. They would require the development of new forms of finance, not merely regulation.

Consider, finally, a third key element in the explanation: a breakdown in the relation between US and global markets. For much of the postwar period, the US could do what it wanted to do, both at home and abroad, with little fear from global markets. The combination of global leadership in finance and trade, together with the broadest and deepest securities market in the world, provided the room for maneuver in pursuit of its own interests and ideals. That the country was also possessor of the world's reserve currency served only to amplify these other advantages.

But by the end of the 1980s, this cushion, too, would be gone. Mounting deficits in the balance of trade, together with reliance on global capital would lead to a change in the US' position vis-à-vis global markets, bringing the country closer to the position shared by many other countries in the world.

²⁴ Id, at ()

²⁵ See, for example, Rajan, "A View of the Liquidity Crisis." These factors have been exhaustively surveyed and analyzed in the policy and empirical research over the past few years.

The conversation about institutional alternatives retaken

The preceding account of the institutional genealogy of the financial crisis of 2007-2009 illustrates the contrast between the two conversations invoked at the beginning of this essay. I can now restate the contrast between these two conversations more fully. Here are three complimentary statements of that contrast.

One view sees the crisis as a mere threat. The point is to respond to the threat –and then to get back to business as usual. with only such legal and institutional reforms as could enhance the resistance of the established financial and economic system to the recurrence of similar crises. The opposing view – the one I take here – sees the crisis as an opportunity to place finance more squarely at the service of the real economy and to contribute an important piece to a broader project of democratizing economic opportunity.

One view finds the origin of the crisis in localized market failures such as asymmetries of information. The programmatic antidote is to correct those episodic market failures by a reinvigorated practice of regulation. The opposing account – which I here embrace – insists on the existence and the importance of alternative institutional approaches to the organization of finance and of its relation to the real economy.

We are accustomed to think of institutional alternatives in the idiom of large, indivisible systems, like “feudalism” or “capitalism”. We then imagine that failing a substitution of one system for another, the task is to correct, through regulation and compensatory redistribution the flaws of the established system. The problems and transformative opportunities of contemporary finance exemplify the inadequacy of such an approach. There are institutional alternatives, and the choice among them has decisive consequences. However, the institutional options are not properly represented at the level of abstraction or generality of concepts like capitalism. They are best described at the level of legally-defined institutional detail in which I here couch my argument. For that very reason they suggest an agenda for comparative legal analysis.

One view complains about the inordinate influence of high finance on law and public policy, made possible by its success in capturing, for its own benefit part of the apparatus of the state.

The other view, which guides my argument, acknowledges this influence but insists on the decisive power of legal and institutional ideas in shaping its power and effects. The absence of a practical and powerful discourse about institutional alternatives for the organization – not simply the regulation of finance - and for the definition of its task in the real economy speaks more eloquently and exerts a greater effect than all the countless words about financial excess that have been spoken in the wake of the recent crisis. To break this silence should, in this domain, be our chief concern.

Part three

Interpretation and criticism of the US project of financial rescue and reform

Three main lessons flow from this analysis of the financial crisis of the past three years. First, unless the project of reform addresses the major structural problems identified in the earlier discussion, it is unlikely to succeed. Second, to address these structural issues requires more than mere face-lifting of balance sheets with bad assets. It requires changing the basic rules of the game: the policies and arrangements that have led to the systemic problems at the heart of the financial crisis, including not only the internal organization of the financial system, but the legal and institutional arrangements linking government to financial markets. Third, this commitment to structural reform implies neither an abandonment of the entire system of post-war financial policies and arrangements; nor repudiation of the very concept of market-oriented financial reform and globalization. Instead, it requires a commitment to cumulative legal and institutional transformation, in the service of broad-based recovery and reform, with finance at the very center.

In an effort to work out an alternative, I begin by considering the US government's response to the financial crisis. For the government and its economic stewards, no effort has been more important than the effort to stabilize and rejuvenate the existing system of finance. In its efforts to achieve this agenda, the government has engaged in the largest and boldest program of financial rescue and reform since the decade of the 1930s.

This section argues that this strategy is well-intentioned, but incomplete. There are two main problems with the approach. The first problem is that the government's efforts at financial rescue and reform have remained focused almost entirely on preserving the existing order of financial markets, especially the big bank or Wall Street component, to the exclusion of almost everything else. Thus, the program reinforces what it should correct, rendering even more intractable the current framework of financial vulnerability and distress.

The second and deeper problem stems directly from the first. In focusing all its efforts on the maintenance and preservation of the existing system of finance, the government has squandered the opportunity and resources required to pursue an alternative approach. In squandering this opportunity, the government puts at risk the development of markets as well as democracy in richer and poorer countries.

I develop this argument in three steps. First, I consider the structure and limitations of the original program of financial rescue and recovery, as embodied in the Financial Stability Reform, and accompanying acts and initiatives. From the very outset the government has claimed the mantle of transformation. Yet it has done so without ever calling into question the existing structure of financial markets or their established legal and institutional framework.

In the second part of the discussion, I address the policies and arrangements that the government could have and should have but failed to pursue. I emphasize three main frontiers of reform that the government failed to cross, but could have: (a) maintaining the conventional strategy of regulatory dualism; why regulatory dualism is a mistake; (b) failing to give new life, form and direction to the American tradition of local finance; (c) more generally, failing to conceive and to implement institutional innovations in the service of finance to the real economy and of greater independence of the national economy from global finance.

For the government and its supporters, any argument that it could have and should have done more represents a failure to acknowledge the very real constraints confronting the country in its darkest hour. Thus, the officials have repeatedly claimed that they deal in the realm of the possible, even when the possible is less than desirable. But an examination of the actual policies pursued illustrates the many choices actually made in the course of combating the crisis. If the government failed to respond to the crisis in a manner compatible with further reform, it did so less from objective constraint than from a failure to imagine alternative paths of legal and institutional transformation.

In the third part of this discussion, I develop this general point further by considering a series of contrasts and comparisons with the New Deal program of financial reform. The present government has frequently invoked the comparison to FDR and the New Deal reforms. Yet the government's approach to the financial crisis today has been far more modest than the approach pursued in the 1930s. A comparative review of the New Deal reforms provides yet another illustration of what collective will and imagination can achieve when freed from the self-imposed limitations apparently active in the minds of our leaders today.

I conclude the section by returning to a central theme of the essay as a whole: namely that the government's room for maneuver is larger than it thinks or has been willing to assume, and that this belief in itself represents one of the largest constraints on effective reform today. In pursuit of a smaller agenda, the government has committed resources and taken risks larger than those assumed eighty years ago. These risks and resources can be better used. All we need is a better direction, which I develop more fully in the following section.

What the US government has done: finance-friendly rescue of Wall Street firms together with money and funding markets

Consider first what the US government has done in response to the current crisis. The main outlines are easily summarized. Both the analysis and policy response have remained almost entirely within the "first conversation," taking as the primary subject restoration and recovery of the existing financial system. Relatively little consideration has been given to the broader structural themes highlighted in the earlier section.

Three main sets of initiatives would carry the US program forward:

First, bailout of the banking system, meaning rescue and support for the largest banks (together with their various non-banks cohorts and counterparties) through a combination of capital injections, asset acquisitions, public subsidies and guaranties.

Second, a massive program of government-provided liquidity to the wholesale funding and money markets on which the American economy (or at least its wholesale financial sector) had come to depend. Together, the Federal Reserve, Treasury and FDIC would organize a series of special funding, liquidity and guarantee programs designed to restore the functioning of credit markets, and to prevent their wholesale collapse.

Third, provision of targeted credit through the newly renationalized mortgage agencies, Freddie Mac and Fannie Mae. Though heavily criticized before the fall for their dominant presence in the mortgage market, the federally-sponsored mortgage agencies would play an even greater part after the collapse of the subprime market. Recent studies show that the GSEs have once again become the preeminent providers of liquidity to the US mortgage market, accounting for nearly 100% of all new and refinanced mortgage facilities in the US since the outbreak of turbulence in the summer of 2007.

Criticism of the approach

There were two main problems with this approach. The first and most obvious objection had to do with the task of the government itself. The entire focus of the government's efforts was directed to preserving the status quo: bailing out the Wall Street banks at the heart of the current crisis. The second problem was intimately connected to the first. In dedicating itself – at times heroically – to the task of bailing out the existing banks, the government would squander both the resources and opportunities required to pursue any alternative approach.

Consider first the banks and non-banks at the heart of the government bailout. For the government and its economic advisors, it seemed obvious that the rescue of the largest banks would create the conditions for economic and financial recovery. Yet the banks at the heart of the economic and financial collapse would account for relatively little of the credit that continued to be made in commercial and industrial markets.

To be sure, the large banks would continue to play an active role in supporting the capital markets. They would do so both directly and indirectly, (x) by originating and repackaging loans; (y) by serving as central players and counterparties in currency and derivatives markets; and (z) by providing back-up lines of liquidity and other forms of credit enhancement to the shadow banking sector. But these markets had become increasingly suspect in the wake of the financial crisis.

Indeed, the very nature of the financial crisis would suggest that much of the earlier capital markets activity was irrelevant, and, at times, even harmful. From this

perspective, efforts to restore the functioning of existing markets to their pre-crisis level would prove both foolish and unfeasible. Foolish: because a market irrational on its face neither could nor should so easily be restored. Unfeasible: because conditions had changed and arrangements for supporting the fallen markets would need to be rebuilt.

At the same time, access to credit and risk capital for small and medium-size firms would become increasingly scarce. The sector Schumpeter had once described as containing the country's "Lilliputian banks" – the thousands of thinly-capitalized and narrowly-focused community and regional banks - continued to provide the bulk of credit made available to small and medium-size businesses. But this sector controlled a decreasing share of assets and deposits nationwide. And their balance sheets, too, remained excessively concentrated in residential and commercial mortgages, which would only worsen with the recession.²⁶

What the government now proposes to do through its “comprehensive program of financial regulatory reform”

Consider next the current proposal for financial regulatory reform. Both the project of regulatory reform, and the policy discourse within which the reform proposal(s) have taken place, seem, at first, to be very ambitious. But on further reflection, they are not. Understanding the nature and limitations of the proposals and the discourse takes us to the heart of the dilemma posed today in the debate over financial regulation.

The current project of financial regulatory reform is best understood as the combination of four different features. Each feature may be given different form. But the main outlines of the proposed agenda are – by now – established, shaped by discussions among elite policymakers in the US and in global forums.

Four different features make up the US proposal:

1. The classic New Deal regulatory reform agenda, including the determination to separate proprietary trading from government-insured deposit-taking (as embodied in the Volker rule) and a commitment to expanding the perimeter of regulation.
2. A new macro-prudential agenda, complementing the classic Basel reforms (see below) and focusing on the twin powers of enhanced supervision and resolution authority, in response to the problem of “too big to fail.”
3. The classic Basel agenda, emphasizing capital adequacy, additional restraints on leverage and a renewed concern with liquidity issues.
4. A new consumer protection agenda, as exemplified by the proposal to create a new Consumer Protection Agency in the domain of the capital markets.

²⁶ Acknowledge the changes currently being proposed in the US debate over financial regulatory reform. I discuss these measures at length in a companion piece to this essay.

Taken as a whole, the proposed reforms certainly seem ambitious. However, from the standpoint of the earlier discussion, it is clear that they fall far short of the structural reform(s) required in the US and other countries. The first and most basic problem is that the new proposal for financial regulatory reform does little or nothing to address the main structural flaws and deficiencies revealed by the financial crisis.

The point can be summarized in a single sentence. Instead of viewing the financial markets and arrangements we have against the mirror of what we need, the new regulatory reforms would simply extend the perimeter of regulation to areas that should never have been allowed to develop in the first place.

Viewed in this light, even the most ambitious of the recent proposals for financial regulatory reform fall short.²⁷ To the cries of the people, small business and community banks, the proposed legislation is silent, preserving rather than correcting the practices and arrangements at the heart of the earlier breakdown in finance.

What's missing – what the government should do going forward

To see how far away from real progress this is, consider the kinds of reforms we need to address the problems of finance today. Recall the earlier discussion. The initiatives with which the government addressed the crisis left unresolved and even unconsidered three problems that I have claimed in my earlier argument to be central.

The first is the problem of regulatory dualism: the strategy of regulation based upon a stark contrast between a thinly regulated and a thickly regulated sector of finance. The second is the problem of financial localism: the existence in the United States of a nationwide network of local banks, originating in the nineteenth century, with remarkable potential to support broad-based economic growth, but now abandoned and unequipped because starved of access to adequate resources and capabilities. No one has asked the obvious question: how could this unparalleled structure be reconciled with the imperative of economies of scale and brought up to the front line of advanced financial practices and skills?

The third problem is the most general: the tenuous link between finance and the real economy. As the earlier discussion has shown, the post-New Deal reforms rendered even more precarious the ability of the financial system to fulfill its most basic social function. Thus, what has always been important is today imperative. It is now vital to develop arrangements capable of more effectively mobilizing savings for productive investment, creating new instruments for the management of risk, and broadening access to the economic and cultural resources required to participate effectively in the global economy.

For the financial reforms to have lasting effect, they would need, at the very least, to address these structural problems. Yet neither the original emergency measures nor the program for regulatory reform debated in the US today even mentions, much less

²⁷ List the leading proposals produced in the past two years, in Europe, the US, and leading international forums.

establishes the conditions for new forms of production and new strategies of socially-inclusive growth.

Indeed, if anything, the proposed regulatory reforms would make these matters worse: As I have already noted, the emergency measures, partly through design and partly through neglect have compounded the very problems they were meant to address, by identifying the national interest in financial reform with preservation of existing markets, intermediaries and arrangements at the heart of the financial collapse.²⁸

Defenders of the emerging consensus are quick to point out that the US government acts today under severe, even debilitating conditions. But it is mistaken to claim that the federal government enjoys no margin to develop alternatives, on the ground that its whole course of action has been shaped by intractable and determinant constraints. In fact, the policy that, together with the central bank, it has pursued, is, in many respects a bold and surprising response to the crisis. My argument here is that it is nevertheless a response that fails to take advantage of the transformative opportunity presented by the crisis.

Rather than seeing the course of policy as the ineluctable consequence of the established constraints, we should interpret it as a choice – in many respects a mistaken choice – informed by ideas – in many ways inadequate ideas.

The bold (although misguided) and chosen chapter of the government's response to the crisis is manifest in three domains. First, it is expressed in the design and development of the bail-out of the banking system. For example, the government opted to commit vast resources to the turnaround of some of the largest of the nation's financial firms without either acquiring a decisive (albeit temporary) stake within these institutions or forcing a fundamental change in the way they do business. At the same time, it did almost nothing to enhance the capabilities of the nationwide network of small local banks, which represents the country's most important and most distinctive asset in the organization of finance.

A second realm of policy in which the constructed, non-automatic character of the government's response has been made evident lies in the jurisdiction of the Federal Reserve. It is the design and development of a program of "quantitative easing" or monetary liquidity that is as imaginative and creative as any attempted over the last thirty years. Such technical virtuosity and administrative audacity could have been put to many other uses.

A third area in which the government can be shown to have opted for a direction rather than to have one forced upon it by circumstance is housing and foreclosure. Here, too, the government has made choices that could not have been inferred mechanically from the structure of the situation in which it has acted. It has, for example, put the New Deal mortgage finance GSEs (Fannie Mae, Freddie Mac) under the banner of state receivership without reversing the post New Deal developments that rendered them – and

²⁸ Add references to the various reports of COP, making this point over and over again, in many different times and places.

the secondary mortgage market – subservient to a speculative finance relatively disconnected from the productive agenda of society. It has also launched an array of detailed anti-foreclosure initiatives without embracing a single decisive course of action that would do for small homeowners (or small businesses for that matter) anything comparable, in the generosity of rescue, to what it has proposed to do for big banks.

Each of these cases reminds us of a point that should have been obvious all along. In choosing to salvage or restructure our existing financial markets, there is no neutral baseline. There is no hypothetical point at which the market “as it is” ceases to exist and becomes the product of “political intervention.” The choices that we make are no better or worse than the assumptions we bring to the table. In each particular act of reconstruction or renewal, we broaden or narrow the field of constraint by acts of will and imagination.

The point can be generalized. There are always alternative ways to respond to a practical conflict, opportunity or dilemma. In the area of finance, some ways contribute to the stabilization of existing markets, and some ways contribute to the creation of new market orders, for example, by deepening the resources and arrangements made available to finance long-term, productive investment, or by innovating in the mechanisms of collective response to financial crisis and stagnation. The challenge is to identify and to work within the area of overlap between two different social objectives: increasing the capacity for innovation in the organization of savings, production, and investment; and increasing the mechanisms of response to external shock, for the sake of socially-inclusive growth at home and stability in global markets.

Comparison and contrast with the New Deal materials

To see how such a course is possible, even or especially in times of great crisis, consider once again the New Deal reforms in the area of financial markets. As many have noted, the crisis of the 1930s would serve, in many ways, as a precursor to the crisis today. Yet, two key differences would distinguish the government’s response to the Great Depression from the government’s response to the crisis today: (a) the willingness to use the federal government as an agent of structural, not merely regulatory reform; and (b) the willingness to innovate in the policies and arrangements used to organize the domestic (and global) financial system.

We see this difference manifest in the very first acts of the New Deal banking reforms. The famous banking holiday declared in the opening days of FDR’s first administration set the tone for the program of reform that would follow. This program was marked from the very outset by a commitment to combining governmental activism and structural reform in the service of an ideal of making finance subservient to production and turning the task of economic reconstruction into an occasion for providing personal security and opportunity for the broad mass of individuals and households.

Consider next the many new legal and institutional innovations undertaken in the service of this objective. The architects of the New Deal reforms experimented over and over

again in the effort to identify and establish policies and arrangements that would safeguard the individual against insecurity – in particular against the effects on the individual of major instability in the level of economic activity – and at the same time curb the speculative excesses of finance, particularly with regard to other people's money.

Consider, finally, the combination of these two themes in the programs developed in the area of housing and mortgage finance. The essential points are, by now, well known. The policies and arrangements devised at the time would do more than add a patina of support to the private restructuring of mortgage contracts. Instead, the federal government would develop policies, tools and resources to restructure outstanding obligations (for example, by establishing the HOLC to purchase distressed debt on the secondary market) and then use its new tools to restructure the system of mortgage finance. Together with the many anti-foreclosure initiatives initiated by state governments, the efforts of the federal government would provide immediate redress to millions of homeowners and at the same time contribute to broad-based reform, both within and beyond the housing and mortgage market. These reforms could not be reduced to a choice between state and market. They would involve, instead, the institutionalized broadening of the financial market in an effort to reshape the relation between finance and the real economy, in the service of the larger project of socially-inclusive economic growth.

Three further points are suggested by the discussion of the New Deal reforms.

The first point is that the New Deal reforms set out to deepen rather than diminish the scope of private enterprise and decentralized initiative. The second point is that this effort required an on-going practice of legal and institutional innovation in the organization of the market economy, especially in the area of finance. The third point is that our characteristic contemporary concerns were entirely absent from the earlier debate. The reformers did not hesitate to challenge existing practices and arrangements, out of deference to the interests of the financial sector; nor did they confuse the established arrangements of finance with the inherent requirements of market order. Instead, they experimented without a plan, in the service of what appeared at the time to be the most promising line of transformation.

Lessons from the New Deal approach to economic recovery and financial reform

We are now in the position to understand and evaluate the US program of financial rescue and reform. The main problem with the US response to date is that it fails to understand the main problem and seize the main opportunity. The main problem, I have claimed, is a weakening in the link between savings and productive investment, and between finance and the real economy. The main opportunity, until now largely squandered, is using the crisis of the past three years to develop a series of small-scale legal and institutional innovations to re-regulate finance in an effort to reorganize the relation between finance and the real economy so that the former becomes more useful –

and less dangerous – to the latter. To do so – I have argued here- requires rejecting the settlement of the past three decades as the horizon of our collective ambitions.

To reject the current settlement does not require that we return to the earlier New Deal project of financial reform. It does, however, command that we make better use of the institutional and conceptual materials at hand, to fashion a new way forward in the service of the two key goals: linking finance to the real economy, and broadening access and opportunity. In this task, nothing is more important than the alliance of will and imagination, in breaking free from preconceptions of how market-oriented financial system are or can be organized; in trying out new and more promising approaches to the organization and regulation of socially-useful forms of finance.

The discussion in the following section provides one illustration of what it would mean to pursue this tack.

Section 4: An alternative approach: responding to financial crisis and reinventing financial markets

This part develops an alternative approach to the project of financial rescue and reorganization. The approach is not a blueprint. Nor does it purport to express a single, imminent logic, inherent in the very concept of our existing “private market economy.” It provides an example of how we may begin today to respond more effectively to our immediate situation, by reimagining and reinventing our financial markets and arrangements.²⁹

Two main themes underlie each of the following proposals. The first theme is the need to reverse the priorities of the past thirty years – priorities that first sponsored and then acquiesced in a reorientation of finance reminiscent of the period leading up to the Great Depression. In each case, our country has allowed and at times, encouraged a move away from socially-responsible finance, to socially-unanchored financial markets. The results have been predictable: an increase in speculation over enterprise, requiring increasing amounts of government support, in the form of bailouts, rescues and subsidies. The cost of this move is incalculable; its effects are not only material but spiritual, denying the country both practical and conceptual resources needed to construct a better future. We need to reverse this slide. An initial step involves recognizing the slide for what it is. *Fin de siècle* haute finance may appeal to the corridors of power connecting Washington, Wall Street and Cambridge, but they satisfy few other interests and have triumphed at everyone’s expense.

The second theme is the need to complement changes in finance and financial regulation with changes in the institutional arrangements connecting government and financial markets. For too long, meetings between Treasury and “industry” have slanted the policy of this nation. The development of TARP and its progeny (especially in the programs adopted at the end of the Bush Administration) exemplify both the process and its perversion. The distortion occurred at two levels. First, the entire focus of the bank rescue program was entirely misconceived. Instead of asking, “what banks and financial markets we need to turn the country around,” and how can government involvement – in resources and arrangements – help spur the needed development – we asked, “do our largest banks have the capital they need to survive any further downturn,” as if the economy were the problem getting in the way of healthy banks, rather than the other way around. To pour trillions of dollars into insolvent banks that have become insolvent because of bets made with capital that should have been channeled to enterprise, innovation and growth, while at the same time standing idly by as hundreds of thousands of people become unemployed – is beyond immoral. Like the torture memos of the

²⁹ The introduction to this section will be revised in the final editing of the piece to emphasize three central themes: (1) the need to broaden the range of concern, from merely preventing financial instability, to the deepening of financial markets. The relation between the two themes at a deeper level. (2) One priority of the programmatic proposal developed here – making finance subservient not just to production (the post-Keynesian theme, or the theme given greatest emphasis by the post-Keynesians) but to innovative production. This point leads into a broader discussion of the nature of post-fordist production, and its preconditions, including both educational innovation and innovation in the system of finance. (3) How an emphasis on the deepening of finance in this sense requires more than mere regulation; it requires new forms of finance.

earlier administration, the very notion that this is ok suggests how far we have strayed from our moral foundations.

This problem will not be solved overnight. But it must be seen for what it is – not merely a problem in economic mismanagement, requiring a shift in strategic direction, but a problem for the democracy as a whole, which needs to renew its spirit by reinventing its arrangements, for the sake of the ideals we collectively share and the energy we will release by holding true to them once again.

Schematic overview of an alternative approach

This section develops an alternative approach to finance and the institutional organization of the financial system. The proposal advances four main initiatives: (1) creating a nationwide system of entrepreneurial finance rooted in community and regional banking; (2) reinventing the GSEs; (3) a new approach to financial regulation; and (4) restructuring as experimental reinvention

The first two initiatives are designed to support a nationwide system of entrepreneurial finance capable of supporting the productive agenda of society in a historical age of globalization. The third and fourth initiatives include policies and arrangements required to support an ongoing practice of financial innovation, restructuring and reform.

The basic premise of the discussion is that regulation can be radically different because financial systems can be radically different. This point becomes clear as soon as we make two moves: first, the move from the first to the second conversation; and second, the development of a new understanding of regulation, not as a neutral and apolitical “infrastructure” of a single best practice approach to market-oriented financial reform, but as the frontline in the development of an alternative approach to finance and the institutional organization of the financial system.

Creating a nationwide system of entrepreneurial finance rooted in community and regional banking

Any effort to reform the financial system must begin with the recognition that the nation becomes weaker rather than stronger when it “dissipates” its banks. The financial dualism that we have allowed has served neither banks nor country well. At the same time, the traditional solution to this problem has been deleterious to economic development and financial deepening as a whole, providing small-scale subsidies and support for consumer and community banking, but little access or connection to sophisticated markets, funding and risk-management tools.

One historical strength of the US financial system has been its unrivalled network of local banks. The system developed in the 19th century both before and after the Civil War. It helped to promote economic development throughout the economy by putting savings at the disposal of producers as well as consumers in every region and every state.

This system is commonly criticized as incompatible with requirements of scale and sophistication. According to this view, the US would have to follow the path of “universal” large-scale banks. But this is an unfounded prejudice. With the right institutional innovations, the network of local and regional banks can be revived. They can be revived by gaining access to the instruments, ideas and opportunities created in the vanguard of financial practice and required today to participate actively in the opportunities offered by innovative forms of production, in both national and global markets. The aim is to combine decentralization, flexibility and proximity to the local producer, with scale and sophistication.

For purposes of this proposal, we can distinguish three different forms of finance capable of contributing to the two objectives of scale and sophistication: first, public venture capital: the extension of long-term investment in new and emergent businesses, whether in vanguard or rearguard sectors of production. Second, restructuring, whether in finance or beyond finance (see below). Third, the development and application of new risk management tools, including derivatives and structured credits.

In the present setting, the proposal to extend the instruments of market and credit risk transfer may seem the height of folly. After all, these instruments played a crucial role in the financial turbulence of the past few years. But the problems had less to do with the instruments themselves, than with the social and institutional context in which the instruments were traded. The point of the proposal here is to change both the content and the context of the new practices of finance, the better to serve the needs of broad-based innovation and growth.

As part of this initiative, the government would work with local banks through the instrumentality of new GSEs (see below) to allow local banks to participate in, and develop new forms of venture capital, enterprise restructuring, and risk management, broadly conceived.

That this is possible as well as desirable is proven by countless historical experiences. In the nineteenth century, government-sponsored land grant institutions collaborated with local producers in the design and development of new forms of credit. State-level governments encouraged the development of local banks and infrastructural projects through the awarding of corporate charters, the development of local securities markets, and the raising of capital on international markets to fund railroads and canals. In the early twentieth century, government collaborated with farmers and manufacturers to stabilize and expand production through the creation of new forms of finance (for example, installment loans and agricultural cooperatives).

In our own day, the forms of finance required to expand opportunity and innovation in different regions of the national economy are likely to be very different. The challenge of economic organization and development today is less a matter of gaining access to capital (although this part of the financial package remains important), than gaining access to practices and opportunities at the frontiers of finance and production. In this process, collaboration and strategic coordination between outsiders (i.e. local producers and

banks) and insiders (firms and financial institutions in the vanguard of finance) is likely to be crucial.

The purpose of the new GSE (considered at greater length below) is to create the social context in which new practices and arrangements can flourish beyond their established domain(s).

This initiative retakes the enduring achievement of finance-related innovations in the two periods of greatest innovation in US history. The uniquely decentralized character of American economic development and organization in the first half of the 19th century could not have taken place without the support of the national government and its willingness to create a national monetary and financial system capable of facilitating the flow of money, credit and banking from one end of the country to the next. The rise of big business and modern industry at the end of the 19th century was supported in a different way: by creating legal and regulatory frameworks capable of reconciling the advantages of scale and scope with service to the real economy.

It is commonplace today to view financial development and reform in quasi- natural or pre-political terms. But this is almost always an error. History offers many different examples of government-sponsored financial innovation. What appears to be the natural unfolding of decentralized economic activity, led by purely private initiative, is almost always the result of an earlier period of institutional innovation led by government and collective action.

Indeed, the very example explored above – the New Deal re-engineering of the residential mortgage market - provides an illustration of how government-sponsored financial organization and development can lead to the deepening and democratization of finance, by broadening access and inclusion to economic and cultural opportunity through the creation of new forms of finance.

As already mentioned, the New Deal represented, in part, an effort to achieve this “leveling up,” but it did so narrowly, for the mortgage market. The task today is to generalize the experiment, putting advanced techniques of capital allocation and risk management at the disposal of local firms and networks of firms in different regions across the country, the better to inspire and support the development of a vibrant national economy.³⁰

Reinventing the GSEs

Any effort to tighten the links between finance and the real economy and to democratize finance requires the development of new forms of strategic coordination between government and firms. These forms should be market-creating rather than market suppressing. They should be pluralistic, participatory, and experimental.

³⁰ For purposes of this discussion, “bringing high finance down to earth (again)” may be given two separate meanings: (1) linking the high finance of wall street to the needs of production and exchange in an entrepreneurial economy, in an era of globalization; and (2) pursuing each of these tasks in association with local and regional banking centers

The purpose of strategic coordination is to create the context for socially-inclusive growth and reform, with finance at the very center. For finance to be more than a zero-sum game, local banks must be given access to the knowledge and practices required to disseminate sophisticated forms of finance among firms and communities at the local level. The idea would be to create both the agents and the instruments of “financial best practice,” reconciling the twin goals of (continued) localism with scale and sophistication.

Two main premises underlie this part of the proposal:

The first premise is that contrary to common view, these problems cannot be solved spontaneously by delegating the tasks to existing capital markets. They require a new cast of financial agent. The purpose of this item is to imagine who those agents might be, what tasks they would perform, through what forms, under which specific policies and arrangements.

The second premise is that the government can – and should – act as catalyst in the design and development of these agents. The reason is very simple. Only the government has the capacity, authority and resources needed to help spearhead the development of the new intermediate organizations.

A reinvented GSE (as described more fully below) would serve as the vehicle for the new form of decentralized strategic coordination.

The governmentally-sponsored enterprises³¹ were part of the institutional machinery developed by the New Deal to make possible a mass mortgage market. Fannie Mae, FHA and the FHLB were the most salient examples of the uniquely decentralized form of government sponsorship and support pioneered in the US setting.

Two distinct ideas converged and sometimes clashed in the original conception of the GSEs. One conception was corporatist: to create a structure parallel to government that would coordinate economic activity and, to that extent, displace the market. The other conception can best be understood not as corporatism but as a democratization of the market economy. Here the idea was to use the power of government to create a new market or new markets, open to more people on more terms.

The second conception was more innovative than the first. The substitution of the independent public corporation, originally devised to do this work, by the new legal vehicle of the GSE was the formal expression of the institutional innovation.

³¹ The term, “government-sponsored enterprise” is used here in a non-technical sense, to refer to any business-oriented entity organized by a government or sub-governmental entity to fulfill a commercial purpose. Fannie Mae was originally organized in the 1930s as a government-owned corporation. Fannie Mae was reorganized as a “government-sponsored enterprise” in 1968 as part of the more general reorganization of the federal-sponsored mortgage system. See, for example, ()

The trouble is that the innovation occurred only in the domain of mortgage finance as an enclave that could be first isolated and later, with the resurgence of primitive financial ideology in the late twentieth century, undermined.

The GSE entities have resonances in nineteenth-century American history. For example, many of the institutions devised in the 19th century to organize roads and railroads and canals, or family scale agriculture, on the basis of what today would be called strategic coordination between government and the family farmers (in turn joined together by a network of cooperative competitions) could be seen as precursors to the GSEs of the twentieth century.

The example should be preserved. The GSE concept can and should be reshaped and used today in the service of a program of the reorganization of finance: for example, in the form of institutions that would support the enhancement of the country's remarkable system of local banks by facilitating their access to advanced financial practices and by helping to reconcile the advantages of a decentralized financial system with the imperatives of scale.

Such organizations might take on a role beyond finance. They might, for example, be instrumental in the development of a new style of industrial policy concerned not to "pick winners" but rather to propagate successful local practices in industry. In this way, they could help "pre-Fordist" enterprise jump to the level of "post-Fordist flexible specialization" without having to pass through the supposedly necessary intermediate stage of rigid Fordist industrial mass production. The reinvention of the GSEs, for the purpose of financial reform can thus help further a broader program of economic opportunity and reconstruction.

The new GSE outlined above represents a continuation of the characteristic American approach to government-sponsorship and support for firms and financial markets. In contrast to the European and Japanese experiences in the post-war period, and, more recently, the experience of leading developing countries (especially the BRICs), the US has always favored pluralism and decentralization in lieu of a top-down, bureaucratic approach. Examples include: community development banks and development funds, favored with tax incentives and other supports, yet organized by private initiatives; regional members of the Federal Reserve, FDIC, and Federal Home Loan Banking system, designed to provide decentralized oversight and engagement in the formulation and administration of federal financial policy. Indeed, the FDIC provides an especially interesting point of departure for the reinvention of the GSE.

In working with small and medium-size business, there are always three subjects: (a) credit; (b) technology; and (c) practices and knowledge. The new GSE should not simply facilitate access to (a). It should also facilitate combinations of (a) with (b) and (c).

From the regulation of finance to its reorganization

A major concern of the program is to tighten the link between finance and the real economy and to prevent the productive potential of savings from being squandered. A second objective is to create public policies and institutional arrangements favorable to socially-inclusive economic growth.

This part of the program rests on two premises:

The first premise is historical or descriptive. The premise is that under present arrangements, finance and production have come to occupy entirely different worlds. I have already discussed the decoupling of finance from production in the US setting. In the closing decades of the twentieth century, the vast amount of capital channeled through banks, non-banks and financial markets would have increasingly less to do with the world of production, and increasingly more to do with asset bubbles, credit booms and speculation among highly leveraged financial institutions.

The second premise is that it need not be this way. The degree of connection or disconnection between finance and the real economy is susceptible to and dependent upon institutional arrangements.³²

The program has three parts:

The first initiative involves a concerted attack on regulatory dualism.³³

The second initiative involves two parts: first, regulatory and tax changes designed to discourage the disconnection between speculation and the real economy; second, tax and regulatory changes designed to encourage the connection between finance and the real economy. Once again it is important to emphasize that the problem is not speculative trading per se, but the separation of speculative trading from the real economy. The best example of the latter is the development of synthetic CDOs, designed to enable side-bets on already existing pools of derivatives and securities. Examples of the former include commodity futures and other risk management tools, traded on public exchanges by producers and trading companies involved in the real business of commodity production and exchange.

The third initiative is to do the work of venture capital far more broadly and deeply than it is now done. According to the standard theory, venture capital should be a central activity in financial markets. Yet it accounts for a miniscule part of financial practice in every country of the world.³⁴

³² A useful summary of the alternative theoretical traditions relied on to formulate this part of the proposal may be found in UNCTAD [Annual Development] reports, 2009-2010.

³³ See earlier discussion, *infra* at ----

³⁴ See the discussion of Phelps and others, *infra* at (). The effort to develop venture capital in both advanced and developing countries has become a central project among international financial institutions in recent years. See, for example, a summary of the experience of the IFC at (). The theme has attracted widespread interest in recent years

Here is a brief list of potential convergent initiatives going in such a direction. first, create new institutional vehicles. For example, establish new GSEs to work with local banks. Second, establish targeted credit and credit-enhancements as part of a broader effort to accelerate economic and financial recovery in countries most battered by the recent crisis. Third, create a publicly-supported venture capital fund, to complement the many other financial facilities created by Treasury and the Federal Reserve, as part of the recent effort to restore short-term funding mechanisms for small and medium-size businesses.

The current crisis has provided numerous opportunities to use the tools of sophisticated financial engineering for the benefit of society (as well as bankers). A major goal of an alternative approach to the reorganization of financial markets should be to put these inventions to work for the benefit of society as whole and the project of national recovery. In this, the techniques discussed above – venture capital, risk management, structured credit and securitization – should form part of the broader effort to put finance at the service (again) of economic opportunity and social inclusion. The financial crisis has demonstrated the enormous power of financial innovation to do harm as well as good. The task now is to shift the balance by creating policies and arrangements capable of supporting financial experimentalism in the service of the social good.

Restructuring as experimental reinvention

Consider, finally, a fourth element in the development of an alternative approach to financial reform. The fourth element involves an alternative approach to the project of restructuring. In one sense, of course, the reorganization of finance already embodies a new form of restructuring: restructuring conceived as any effort to do more than preserve existing social arrangements. But the concept of restructuring may be given further definition: the idea of restructuring as experimental reinvention.

We can think of restructuring in two senses. Restructuring in the narrow sense arises today in the context of discussions over expanding the government’s “resolution authority.” The debate has been narrowly focused on the turn-around (or liquidation) of failing financial institutions. But restructuring may also be defined in a second and larger sense: restructuring as an element in the larger task of industrial reorganization. In this second sense, it is clear that we are concerned not merely with failing financial firms, but with all firms; and that financial firms are relevant in both cases, i.e. as the object or material of turn-around; and as an agent of turn-around in the larger sense of industrial reorganization.

In the US setting, this point has been among the most controversial. The effort to understand and resolve the controversy allows us to see what is truly at stake in the effort to reframe the debate over financial reform and the alternative futures of finance.

among academics and policymakers interested in generalizing the practice of “high finance” in advanced and developing countries.

The controversy over what to do when a financial institution fails stems from the universal recognition that the organization of finance is peculiarly subject to the problem of confidence: the problem that the loss of faith in the ability of any particular financial institution to make good on its commitments might lead to follow-on effects or shared infirmities extending to other financial institutions. The problem arises because of the central role of confidence in the viability of any financial organization. Financial institutions always trade in the double coin of money and trust.

The classic response to this problem is to combine the regulation of financial activity with rules that protect the public. For example, by insuring the deposits of deposit-taking banks but preventing them (through regulation) from taking unreasonable risks with other people's money and allowing them to fail (after the fact) if they make the wrong decisions.

But the conventional toolbox is much too small. Existing arrangements typically offer a choice between two equally unacceptable alternatives: bankruptcy or bail-out; failure or nationalization; restructuring under the aegis of a bankruptcy court or special resolution regime, according to formal criteria unrelated to their function in the real economy.

In either case, the decision has two prejudicial characteristics. First, it is dominated by short term considerations. Second, the decisions made, whether by the firm, its creditors, or the bankruptcy or resolution regime are too narrow. They fail to take into account the effect of the decision on the structure of production, or the economy more generally, or the prospects of different categories of stakeholders whose lives and fortunes may intimately depend on the fate of the failed (financial) institutions.

Thus, the toolbox needs to be expanded. In developing a solution here, two main criteria should guide our efforts. First, minimizing taxpayer cost is not enough. A central criterion should be usefulness to industrial and economic reorganization. At the same time, we must also take seriously the problem of moral hazard. The most palpable, significant aspect of this concern is the "too big to fail" argument. Companies won't be allowed to go under, a la Lehman, but they can be taken over and restructured.

To simplify the discussion, it may be helpful to distinguish among three different aspects of the problem: first, the problem of third-party effects (i.e. the effects on depositors, creditors or other customers of failed financial institutions); second, the problem of the scale of the financial organization; and third, the problem of the impact of actual or imminent failure of a financial institution on the surrounding economy or structure of production.

With respect to the third-party effects of failed bets: require the financial system as a whole to finance its own insurance of the public against third-party effects of all types – not just the failure of deposit-taking banks. The mechanism would be (a) a special corporate tax on all financial organizations; (b) an insurance fund into which this tax would be paid; (c) a board representative of the finance industry with purely consultative authority indicating to the regulatory authority categories of financial innovations or

transactions that should not deserve such insurance against third party effects and therefore should not be allowed, because their risk is too greatly related to their function in the real economy and (d) a regulatory authority empowered to develop the body of law and policy in the light of this advice and of these objectives.

With respect to the scale of financial institution: reverse the presumption that scale is good, and impose limits on the size of financial institutions, which could be expanded by regulatory permission when (a) there is proof of a substantial efficiency gain in service rendered to the real economy and (b) some assurance that the organization has not become “too big to fail” and cannot hold the regulatory authority hostage.

With respect to actual or imminent failure of financial organizations: develop a third category between bankruptcy and nationalization: government-financed turnarounds to produce, as spin-offs, smaller financial organizations, directed to particular functions in the real economy. Such turnarounds would need to be informed by collaboration between the regulatory authority and consultative boards of financial specialists, able to tap into deep implicit knowledge in each turnaround context. And they might be supported by some of the new GSEs I earlier proposed. Some of these GSEs would either undertake the work of turnaround themselves or seek to widen the range of firms able and willing to do the work.

The cumulative effect of these expansions and enhancements of the toolbox of “regulation plus insurance” would be to move us toward a wave of reform that would combine, in a fashion suited to the realities of contemporary finance, the emphasis on accountability and security characteristic of the New Deal financial reforms with the emphasis on experimental decentralization and localism – placing finance at the service of the local producer – characteristic of the financial reforms of the Jacksonian and post-Jacksonian periods.

Three final considerations provide support today for this conception of restructuring as experimental reinvention.

First, in developing the conception here, I rely on the many recent experiences of experimental restructuring growing out of the recent crisis. Examples include: (a) innovations in the special resolution regime administered by the FDIC in the effort to preserve value and community resources, in the midst of a banking failure; (b) the many public-private partnerships formed by Treasury, the Federal Reserve and FDIC in the effort to stabilize and restore credit markets; and, finally, (c) the American institution of Chapter 11 bankruptcy, which provides firms in trouble with a second chance to overcome the prospect of business failure.

Second, the American experience of financial experimentalism in the 19th and early 20th centuries, discussed in earlier sections of this Essay.

The third consideration is that the United States, like all the advanced industrial economies, now faces two tasks simultaneously in economic and particularly industrial

reconstruction. The more familiar task is to accelerate and to broaden the movement beyond Fordist mass production – the large-scale production of standardized goods and services, on the basis of rigid machines and production processes – to post-Fordist forms of production, which combine cooperation and competition in the same domains, and increase the extent to which production is undertaken as ongoing group learning. The problem is: who is in on this new world of productive experimentalism and who is not.

The second more demanding task of reconstruction is to organize in many sectors of the economy and society a direct passage from pre- to post-Fordist types of production: from a world of undercapitalized rearguard small and medium-sized businesses to a world of frontline innovators.

These three considerations converge to suggest the significance of the role of a reconstructed financial system in the democratizing reconstruction of the market economy. My thesis is that a financial system reshaped along the line for which I have argued and able to rely on the expanded toolbox for its occasional turnaround of itself, will be much more useful than it now is to such a reconstruction of the market economy. It will be in a vastly improved position to tap implicit knowledge and to work with a broadened range of stakeholders in the part of its work that has to do with the turnaround or restructuring of non-financial firms.

Such a reshaping of finance will not solve magically the problem of broader social access to the new advanced sectors of production: the broadening of access to these sectors depends on wider mastery of key educational and economic endowments. It depends as well on the development of institutional arrangements allowing for a reoriented practice of industrial policy. Such a practice would not require governments to “pick winners” or to subsidize losers. Instead, it would enlist government in the work of propagating successful local experiments and giving more economic agents more access to more markets – and credit, technology, and knowledge, in more ways. Nevertheless, a financial system reshaped, disciplined, and equipped in the ways for which I have argued will be better able to reinforce inclusion rather than to undermine it. The experimental reinvention of finance, tested by failure and crisis, can serve the experimental reinvention of the market economy.

Conclusion: From Wall Street to Main Street (again): the financial crisis of 2008 and the alternative futures of US finance

I have argued that two distinct conversations have emerged in response to the financial crisis. The first conversation adopts the language of conventional policy debate, emphasizing localized market imperfections and regulatory mistakes, and the financial breakdown to which these imperfections and mistakes contribute. The second and less familiar conversation emphasizes an entirely different theme: the reshaping of the institutional arrangements that govern the relation between finance and the real economy, and the mobilization of savings for productive investment. The focus is on structural limits and deficiencies, rather than market imperfections and regulatory mistakes.

This essay represents an attempt to contribute to the development of the second conversation. I try here to expand understanding and debate about the alternative possible futures of finance and financial regulation, in the US and global markets.

The task is important for two different reasons. It is important, first, for the development of insight into the nature and limitations of existing forms of market-oriented financial reform and globalization. The task is important as well for a second reason: to develop the practical and conceptual tools required to re-imagine and recreate existing forms of finance, for the sake of new forms of production, and, as part of the larger effort to imagine and support new strategies of socially-inclusive growth and participation in global markets.

The argument has implications for three different sets of debates: (a) the debate about the alternative futures of finance in the US and global markets; (b) the debate about the policies and arrangements required to support socially-inclusive growth and globalization in the area of financial markets; and (c) the debate about the role of legal thought in the interpretation and critique of existing forms of finance and the possibility of alternatives to them.

I recognize how odd this standpoint must seem today, after thirty years of celebrating a particular style of market-oriented financial reform as the very essence of globalization. But it may seem less odd when placed in the context of two earlier traditions of progressive reform: the tradition of Jacksonian democracy, with its emphasis on localism and production; the tradition of the New Deal and FDR, with its acceptance of centralism and mass consumption. The normative conception defended here seeks to combine the strengths of these traditions, while aiming for something more: a new form of flexible centralization placed in the service of local reform, generalizing the privileges and prerogatives enjoyed today by a diminishing number of people.

Finance has traditionally been viewed as a constraint narrowing the range of the possible; but it can become instead a front line in the reinvention of the market economy. And legal thought – instead of being the chorus of fate can become the present voice of a different future.

Attachments

Annex I: Law and finance: a theoretical perspective

Annex II: From financial crisis to economic reform: Three projects for the reorganization of finance and its relation to the real economy

Annex I Law and finance: a theoretical perspective

My approach to the understanding of the financial crisis and to its use as a point of departure for the institutional reshaping of the market economy has been driven by a few ideas about law, finance and production that have broad theoretical and programmatic application. I provide below a summary of the ideas together with a series of comparative and historical examples used to motivate the programmatic discussion. I conclude by considering some points of departure in the US setting today for the advancement of this endeavor.³⁵

Theoretical underpinnings of the program advanced in the essay³⁶

One of the assumptions of this five-part program is a view of the institutional variability of the relation between savings and production. I explore this theme in greater detail in accompanying work. For purposes of this discussion, consider in highly abbreviated form the content of the underlying conception.

1. The main theoretical argument: contrary to what has been generally assumed by neoclassical and Keynesian economists, the channeling of savings to productive investment is not automatic, is not automatically provided by the market; its failure can't be understood as a consequence of short-term, market imperfections.

In fact, there are different sets of market-oriented financial institutions, differing in the extent to which they contribute to – or work against – the task outlined here. The earlier discussion of the post-war experience of US financial policy and reform provides a series of examples of this.

2. The universally shared advantages of high local savings under circumstances of contemporary globalization are as political as they are economic and as applicable to first world countries as they are and have been to the third (such, at least, is one of the more important lessons of the financial crisis in the past two years). The ability to maintain a high level of savings - both public and private - and at the same time effect a tighter link between savings and productive investment increases the room for maneuver among national governments and political economies within the global economy, and creates the possibility for active rather than passive integration in the global trading and financial regime.

³⁵ The underlying theoretical conception is presented here in summary fashion in the form of seven theses. The first three describe an approach to the understanding and organization of finance and financial regulation within national economies. The second two conjectures describe the counterpart to this approach in the area of global finance. The last two theses connect the emergent view of finance and financial development to the program of socially-inclusive growth, globalization, the institutions of finance and the method of legal thought.

³⁶ Three main sets of ideas underlie this and accompanying work: (a) the relation of finance and development at the level of national political economy, and the possibility of reconstructing this relationship; (b) the relation between broadening each country's room of maneuver to experiment with different strategies of development and projects of reform and the reconstruction of the global financial regime; and (c) the method of comparative law and legal thought.

3. This fact has been partly obscured for the US due to the special circumstances of the US possessing the world's reserve currency. However, this may now be changing in light of two circumstances:

1. The degree of structural imbalances has reached a point where it is now recognized as unsustainable. (See the discussion in R/R as well as in many other places.)
2. There is an increasing belief that USD will no longer be the reserve currency forever; that different monetary arrangements will evolve, including either (a) a basket of reserve currencies; or (b) quasi money drawing rights.

As always, changes such as these may evolve in different directions and have different effects. For the US, the question becomes what to do now that the status of the USD is no longer taken for granted and has become an item on the world agenda rather than a fact on which the country may continue to rely.

4. One corollary to the above: the universal interest in securing the conditions of economic sovereignty and experimentation, both in the choice of development strategies and in the formulation of projects of institutional reform.³⁷

This point may be given more general formulation. The comparative experience of development in the post-war period suggests that the most successful developing countries experimented with alternative forms of financial openness and integration. They did not blindly follow the institutional recipe of the day. Japan, Germany and the East Asian tigers – to name the most obvious examples – relied on capital controls, dual currency regimes, and other “heterodox” policies and arrangements in an effort to mobilize domestic savings for long-term productive investment. These same countries combined these “pro-growth” policies and institutional preferences with other policies and arrangements designed to curb speculation, stabilize capital inflows, and dampen volatility in currency and derivative markets.

These experiments and initiatives cannot be understood in terms of a simple contrast between market and bureaucratic ordering. They may be seen, instead, as efforts to promote a deeper reconciliation between economic and financial experimentalism at home and active rather than passive participation in global markets.

³⁷ The importance of broadening the “policy space” for economic and institutional experimentalism has been emphasized in the work of Rodrik, Wade, Sabel and RMU, among others. Relevant comparative and historical experiences are treated at greater length below. They include: US, German and Japanese examples from the 19th century; post-war experiences in advanced and developing countries, including: the East Asian tigers (mobilizing savings for long-term, domestic investment, referred to by Stiglitz and others as “financial restraint”); the institution of the development bank (interpreted by Amsden as the distinguishing contribution of late developing countries in the twentieth century); and the experiences and experiments in the organization and integration of national financial markets among the most successful contemporary developing countries, including, most recently, the experiences of the BRICs.

5. The thesis of alternative globalizations

The financial crisis of the past two years has highlighted differences in the ways countries participate in global markets, not just in terms of quantitative measures (for example, levels of de jure or de facto openness or closure, or flows of trade and investment in relation to domestic GDP) but in qualitative terms as well. Much of the research has focused on a relatively narrow set of policies and arrangements – for example, whether and under what circumstances to use capital controls, or to permit foreign portfolio capital to move freely in and out of national economies. But the choice transcends questions of narrow, technical detail and is of great consequence for politics as well as finance.

The same idea applies to the institutional organization of global finance. Just as countries differ in the arrangements adopted to organize finance and development within the national economy, so global regimes differ in the nature and extent to which they support rather than subvert our collective interest in the universal deepening of financial markets in richer and poorer countries, for the sake of development in particular countries and stability in global markets.

At the most general level, we can identify three different sets of conditions required to promote the project of economic and financial development in richer and poorer countries. An initial set of conditions involves expanding the “policy space” enjoyed by all successfully developing countries in the post-war period. A second set of conditions involves the mobilization of domestic savings made available to long-term productive investment. Still a third set of conditions is cultural: the broadening of access to education and economic opportunity to citizens in every country of the world.

In the closing decades of the 20th century, orthodox financial openness and integration was often viewed as synonymous with the project of economic growth and globalization. But the financial crises of the past 30 years, including the financial crisis of the past two years, have shaken the belief in this assumption. We now recognize that there is little empirical support for the thesis. Instead, heterodox policies and arrangements in the area of global governance and financial integration – for example, policies and arrangements associated with the original Bretton Woods regime - are increasingly viewed as more favorable to the project of financial deepening and development in richer and poorer countries.

The thesis of alternative globalizations applies the same critical and constructive method to the institutional organization of global financial markets as it does to the institutional organization of the domestic financial system. Just as there is no “single best practice form” of market-oriented financial organization, so there is no “single best practice form” of an open international financial system.

6. Socially-inclusive growth, globalization and reorganization of the global financial regime

The contemporary debate has emphasized the importance of coordination to preventing instability in global finance. This approach is too narrow, and leads to the wrong approach. The emphasis should be on universal financial deepening in the service of broadening economic opportunity in the world as a whole.

One by-product of the second or alternative approach to globalization is the prevention of instability at a deeper level, by preventing the world economy from collapsing in a deeper way. The first approach may also lead to greater stability, but in a much more superficial way. The alternative defended here proposes institutional minimalism in the service of deeper globalization, meaning more contact, collaboration, and connection without the imposition of a single set of financial arrangements.

This proposal stands in stark contrast to ongoing efforts to find a “single best practice approach” in the area of financial reform and regulation. Although chastened by the recent crisis, the belief in a single “best practice approach” continues to inform many of the most influential proposals today for the reform of the global economy. The argument of this piece rejects that idea. Instead, I advocate a return to the spirit (but not the arrangements) of the original Bretton Woods regime: institutional minimalism in the service of deeper globalization; universal financial deepening within each national political economy, for the sake of greater freedom of maneuver to experiment with alternative strategies of development and projects of reform, in richer and poorer countries.

7. Socially-inclusive growth, globalization and the revision of legal thought

My analysis of the financial crisis differs from the standard view chiefly in the crucial role I attribute to the distinctive institutional framework generated by what I have called the hollowing out of the New Deal Regime. This analysis relies on and implies a distinctive conception of law and legal analysis. I thus conclude the essay with a series of remarks on the nature and significance of this conception and its relation to the traditional approach to comparative law and legal thought.

Conventional comparative law has often degenerated into a purely descriptive exercise comparing alternative doctrinal systems: for example, civil-law and common law traditions, and their histories. Many non-lawyers have accepted this doctrinal analysis (e.g. LLSV) and claim to find great practical significance in it.

But the use of functional analysis in the late 20th century comparative law (e.g. Arthur von Mehren, John Dawson) has undermined the significance of this conventional comparative approach. It has done so by showing that the same doctrinal system can be used to achieve contrasting results and that the same results can be achieved by contrasting doctrinal systems. The outcome is to leave comparative law without a mission.

But comparative law does have a mission. The mission has two parts:

The first part is to analyze the nature and range of different models of social organization in different areas of social life. Thus, one topic would be the arrangements governing the relation between finance and the real economy.

The second part is to expand the range of available models, in the service of our interests and ideals.

This essay should be read, among other things, as a practical example of this work in legal analysis. It shows, in the particular domain of finance, how we can begin to supply the conceptual component of the task of reorganizing the market economy and of redirecting the project of globalization.

Annex II

Three projects for the re-organization of finance and its relation to the real economy (especially in the context of crisis): New Deal; Current Deal; Better Deal

	Basic institutional framework	Extending the institutional framework: quasi – governmental organizations	Preventing and managing crisis	Putting finance at the service of the real economy	From regulation to reorganization
New Deal	Strict separation between C/I banking; utility banks, disclosure regime; state polices boundary conditions (domestic and global markets)	Creation of public banks, investment funds; secondary mortgage market; GSEs; FHA; provision of liquidity and ins facilities for mortgage and banking system	RFC, HOLC, expansion of gov emergency powers; strengthening of federal reserve (new instruments monetary policy and LOLR); new regulatory regime and depositary insurance (FDIC and special bank resolution regime)	Use of federal agencies and GSEs to create new financial markets; use of tax/legal/regulatory tools to improve functioning of private credit markets	Regulation as the first step toward reorganization, in the service of the real economy
Reversal of the New Deal Agenda	Relaxation of restrictions on finance; rise of shadow banking creation of links between formal/shadow banking and between local/global markets	Privatization of GSEs & secondary mortgage market (securitization); delegation of sov to rating agencies, industry groups, internatnal banks, b/d's via emphasis on internal risk-management	RTC, regulatory forbearance (S&L crisis) consolidation and extension of regulatory framework; extension of LOLR to shadow banking	Reorganization of GSEs; elimination of New Deal restrictions; creation of legal channels connecting official banks to shadowy sector	Incorporation of shadow banking thru generalized system of regulatory dualism
Current Deal	Bailout of big banks and systemically imp non-banks; little banks allowed to fail	Reorganization and capitalization of GSEs; creation of new specl purpose funding & liquidity facilities thru Fed, and FDIC	Bailouts, nationalizations, debt-buybacks & guaranties; swap lines, new liquidity facilities, exp of L/ILR and access to discount window	Creation of funding and liquidity facilities by Treasury/Fed FDIC; TALF; targeted credit thru GSE	Regulation as an alternative to reorganization

	Basic institutional framework	Extending the institutional framework: quasi – governmental organizations	Preventing and managing crisis	Putting finance at the service of the real economy	From regulation to reorganization
Better Deal	Rejection of regulation; reorganization of big banks, little banks, non-banks, and relation to real economy	Public private partnerships, agents of restructuring and innovation, linking global/local, big/little; sophisticated/local finance	Reintroduction of limits on financial speculation; break-up of big banks w/o a purpose; temp and contingent controls on capital; restructuring as experimental reinvention	Reinvention of GSEs; GSEs as agents of strategic coordination & decentralized access to vc; risk management experimental restructuring; participation in global markets	Regulation as first step toward reorganization of finance and its relation to real economy: Finance as subservient to the creation of new forms of production and new forms of finance