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January, 2012

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Available at: https://works.bepress.com/tamara_lothian/11/

Beyond macroprudential regulation: Three ways of thinking about financial crisis, regulation and reform

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Research Article

Abstract

This paper considers the debate about the 'macroprudential regulation' of finance in the context of a broader view of the relation of finance to the real economy. Five ideas are central to the argument. The first idea is that the two dominant families of ideas about finance and its regulation share a failure of institutional imagination. Neoclassical economists blame localized market and regulatory failures for the troubles of finance. Keynesians invoke the way in which the money economy may amplify cycles of despondency and euphoria. Neither current of thought recognizes that the institutions of finance in particular, and of the market economy in general, can take different forms, with different consequences for the organization of production and exchange as well as for distribution. The second idea is that, under present arrangements, finance readily becomes the master rather than the servant of the real economy and lays itself open to recurrent booms and busts. The third idea is that present arrangements can be reformed in ways that more effectively put finance at the service of the productive agenda of society. The fourth idea is that the regulation of finance, including what we now call macroprudential regulation, can and should be designed as initial moves in such an institutional reshaping. The fifth idea is that neoclassical and Keynesian conceptions are inadequate guides to the execution of this task. We can find in law and legal thought many of the intellectual and practical tools that we need.

Policy Implications

- Macroprudential regulation should be seen as the first step in the institutional reshaping of the financial system. The central principle of macroprudential regulation should be to hold finance to its central task of serving the productive agenda of society.
- Regulatory reform, operating at both the national and the supranational level, should incorporate the following elements: (1) repudiation of regulatory dualism; (2) heightened scrutiny of certain classes of financial transactions lacking in any plausible relation to the expansion of GDP and the enhancement of productivity; and (3) a series of international and multilateral rules giving pride of place to all forms of investment in the real economy, and providing restrictive treatment for short term portfolio capital.
- Comparative law and legal analysis, viewed as the study of actual and potential institutional set ups for different areas of social practice, including the area of finance, has a crucial role to play in expanding our understanding and imagination of alternative institutional strategies of reform.

A central topic of the present debate about finance, in the US and in the world, goes under the label of macroprudential regulation. The fundamental idea is that, in a world of increasing financial complexity and integration, traditional forms of financial regulation are not enough. Neither the self-interest of market agents nor traditional forms of microprudential regulation (designed to insure the safety and soundness of individual financial intermediaries) provides an effective framework for controlling risks that emerge from the operation of the financial system.

This topic is commonly treated as a technical subject of policy analysis, independent of any general theoretical or programmatic debate. The concept of macroprudential regulation, however, lacks conceptual precision. This idea distinguishes macroprudential regulation from microprudential regulation, as the basis of whether the problems are systemic rather than localized. However,

 doi: 10.1111/j.1758-5899.2011.00167.x
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systemic flaws can become manifest only in the vicissitudes of particular institutions. And, even more importantly, they can be effectively addressed only by measures that modify the 'system'.

The conventional discourse is unable to conceive such measures. Not only does it lack a view of alternative ways of organizing finance and its relation to the real economy, it takes for granted the idea that no such alternatives exist.

I argue here that this approach is misguided. The regulatory response to the financial crisis depends on a series of more basic assumptions about the market economy, its institutional organization, and the possibility of alternative arrangements. By failing to acknowledge and defend these assumptions, partisans in the debate today fail at the most basic task posed by the recent crisis: the task of understanding the nature and limitations of our existing financial arrangements and the possibility of alternative arrangements. Given the toll taken by the recent crisis, neither failure is acceptable.

I illustrate this argument by considering the debate about macroprudential regulation from the standpoint of three different views of financial crisis, regulation and reform. Two of these positions are well established: indeed, they dominate both the public and the academic discussions. The third position is barely present at all. Yet it promises greatly to advance both our theoretical insight and our practical response to the problems of crisis and slump.

The first position is the conventional, market fundamentalist ('neoclassical') view.[1] Everything that can go wrong with finance has to do with localized market failures (including asymmetries of information) and particular failures of regulatory response to such localized market failures.[2] According to this view, large scale financial institutions require heightened regulatory scrutiny not only because of their sheer scale, but because of their systemic connections with other financial and non-financial organizations.[3] Extra safeguards and shields are required to compensate for what is essentially an attenuation of the discipline of competition brought about by the practicalities of economies of scale in finance. Safeguards and shields are what, in this discourse, macroprudential regulation is about.

The second position is the Keynes-Minsky view.[4] This view sees the economy as beset by pervasive, unquantifiable uncertainty (not to be confused with quantifiable risk) and vulnerable to the swings of baseless euphoria and despair, greed and fear, boom and bust.[5] These cycles may be aggravated if the government permits moral hazard by giving the largest, most systematically connected organizations to understand that they will be rescued from whatever calamities they bring upon themselves. Macroprudential regulations are, in this discourse, to put preventative measures – brakes against euphoria – in the place of such fuel to moral hazard.

The third view, at best suggested but almost never developed in contemporary discourse affirms the thesis that there are different institutional directions that the organization of finance and of its relation to the real economy can take. Some loosen, others tighten, the relation to the real economy. Some loosen, others tighten, the relation of the former to the latter: the service that finance renders to the real economy.[6]

Macroprudential regulation is best understood as one of a number of preliminary moves in an effort to innovate in the arrangements that shape finance and govern its relation to the real economy, the better to ensure that it performs as the servant rather than as the master. A central concern of this piece is to develop, with respect to the revealing issue of macroprudential regulation, this thesis.

In the third view, law and legal thought play a fundamentally different role from the role they perform under the other two approaches. For the first two views, law, with respect to macroprudential regulation or to any other domain of finance related policy and regulation, is no more than a collection of technical devices, deployed in the service of an independently stated economic program. In the third view, however, law is of the essence. It is internal to the statement of the economic program because the heart of this program is the reshaping of institutional arrangements that exist only as law.

The central claim of this piece is that the third, institutionally reconstructive approach provides a superior alternative to both the market fundamentalist and the Keynes-Minsky approaches to finance and to its regulation. The keynote of this approach lies in the promise that the institutional arrangements, expressed in law, decisively shape the nature and the degree of the service that finance renders to the productive agenda of society. In so doing, they also increase or decrease the threat that crises originating within finance may threaten the real economy.[7]

The present arrangements governing the relation of finance to the real economy produce a result that is only apparently paradoxical. Finance remains relatively indifferent to the real economy in good times: the vast amount of capital assembled in the capital markets in all the major market economies of the world bears an oblique relation to the financing of productive activity.[8] Yet major disturbances do arise within finance. They arise all the more readily because the ties of finance to the real economy remain so loose, not just because of the swings of euphoria and despondency on which the Keynes-Minsky school of thought sets such great store, nor just because of the localized market and regulatory failures that have been a characteristic target of the market

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fundamentalists. When they do arise, they can wreak havoc, as we have recently seen.

An implication of the view proposed here is that the debate that goes under the label 'macroprudential regulation' should be rethought and redirected.[9] It is not enough to multiply regulatory buffers against the supposed psychological cycles of the financier or to redress particular flaws and asymmetrical information in the established market arrangements or in the regulatory response to those defects. It is necessary to design regulatory policy in a way that anticipates, in gradualist and fragmentary form, institutional innovations designed to tighten the relation of finance to the real economy and to ensure that finance is the servant it is supposed to be, rather than the master it has often threatened to become.[10]

Two main premises underlie this position. The first assumption is that no watertight distinction exists between regulation and institutional reorganization. Regulation is, by its very nature, a first step of institutional organization or reorganization. When it is not the refinement of established institutional arrangements – in the case of the topic we address, the arrangements governing finance and its relation to the real economy - it is the prefigurement of alternative institutional arrangements. It thus touches on the main vocation of legal thought: to work out in detail the institutional context of economic, social and political life.[11]

A second presupposition of the argument is that we can and should distinguish between a desirable financial deepening and an undesirable financial hypertrophy.[12] Financial deepening is the multiplication of links between finance and the real economy, channeling long term savings to long term productive investment. Financial hypertrophy is the expansion of the financial sector (measured by the proportion of talent, as well as resources and profits that it absorbs) without regard to the service extended to the real economy.

The argument develops in four parts. Part one considers the problem of macroprudential regulation from the standpoint of the market fundamentalist position. Part two considers the problem of macroprudential regulation from the standpoint of the Keynes-Minsky view. Part three considers the problem of macroprudential regulation from the standpoint of the third, institutionally reconstructive view, emphasizing the existence of alternative institutional arrangements and the importance of reconstructing existing arrangements. Part four concludes by returning to the debate about macroprudential regulation posed at the outset of the piece, in light of the intervening discussion.

I analyze each position along three dimensions: (1) a general view of the market economy and its institutional organization; (2) the purpose of financial regulation; and (3) the project of macroprudential regulation and reform.

Part one: the market fundamentalist position

Consider first the problem of macroprudential regulation from the standpoint of the market fundamentalist position.

The market fundamentalist position is the one associated with the dominant neoclassical synthesis in economics as well as with conventional policy discourse.[13] Until the recent financial crisis, this view appeared to be the only view, established in theory as well as practice. Even today the idea continues to hold sway in academic and policy circles around the world. Yet its flaws are severe and increasingly recognized by policymakers and financiers.

View of the market economy and its institutional organization

The first and most basic idea is a general view of the market economy and its institutional organization. According to this more general view, the market economy has a single natural and necessary legal-institutional content, including e.g. the established regimes of contract, property, corporate governance and financial regulation. There are variations, represented in ideas about anomalous property and contract rules as well as in the literature about the 'varieties of capitalism'. But the variations are relatively minor. The broad movement is, supposedly, toward legal-institutional convergence typically explained on functionalist grounds in a quasi or pseudo-Darwinian discourse.[14]

In the area of finance, this idea translates into the view that financial markets, intermediaries and arrangements arise spontaneously, against a background of accepted legal-institutional arrangements.[15] These arrangements are thought of as the natural and necessary arrangements – or form of organization – for the market economy, including the natural and necessary arrangements for organizing the relation of finance and the real economy. The arrangements governing finance are supposedly the outcome of a continuous testing, in historical experience, of what works or fails to work.[16]

A central claim of the market fundamentalist position is that all defects in the workings of finance must arise either from localized market failures – e.g. imperfect competition, asymmetries of information, principle-agent problems – or from localized failures in the regulatory response to the localized market failures.[17] Within this point of view, a threat accorded special weight goes under the label 'too big to fail'. Certain organizations, by virtue of their size and their strategic location, have great power to disturb the workings of the capital markets and thus to jeopardize activity in the real economy. The strategic location has to do with the density of their links to other financial organizations.[18]

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What this view fails to recognize is that the power of disturbance that such large and strategically placed financial organizations exercise is never merely a function of size and strategic position. The power of disturbance exercised by large financial organizations always depends on at least two additional factors: first, the extent to which finance is effectively mobilized in the service of the productive agenda of society; and second, the broader institutional setting in which financial activity takes place.

Consider, for example, the problem of serial default(s) among major Wall Street banks in fall of 2008. Proponents of the market fundamentalist view attribute the failure of Lehman and other players to a series of well known factors: for example, excessive leverage and maturity transformation within the financial system; reliance on short-term credit in wholesale markets to finance extraordinarily large and complex pools of mortgage backed securities and CDOs; the concentration of trading and investment activities within the shadow banking sector, with limited oversight and regulation. Lehman could engage in these risky practices, the argument goes, because it operated at the margin of the traditional banking sector. In this setting, the ordinary discipline of the market broke down. Neither counterparties nor regulators had levers to see or control the vast buildup of liquidity and solvency risk, whether at Lehman or in the market more generally.[19]

There are two problems with this account. The first problem is that none of the factors identified above provide an explanation for the sudden preeminence of broker-dealers within the financial system, or the explosive growth of complex securities and trading strategies among the leading Wall Street banks. Credit expansion and maturity transformation have long been the province of the banking system. But neither of these factors alone can account for the structural transformation of the financial markets implicit in this buildup of risk.

The second problem is connected to the first. There is a tendency to attribute the immediate causal background of the crisis to a series of relatively accidental mishaps, for which there was insufficient regulatory vigilance; thus the emphasis on Lehman and on certain classes of asset based, derivative securities. Yet, as Shleifer[20], Turner[21] and others have shown, the trouble was much more generalized. It affected, for example, the market in commercial paper, the most prosaic of all financial instruments. These studies support the larger purpose of the argument here: the diffuse trouble is the manifestation of financial hypertrophy.

In other words, the key, in each of these cases, has to do with the institutional setting in which the financial activity takes place. Neither the size of a financial organization or even the structure of a trading regime add up, necessarily, to a fragile financial system, or to a fragile market economy. What matters is the link between finance and the real economy, as well as the broader institutional setting in which the financial activity takes place.

View of regulation

Three implications follow from this general view of the market economy, and its built in legal and institutional foundations.

First, absent localized market imperfections and/or regulatory mistakes, finance allocates capital to its most efficient use.

The second and chief implication concerns the scope and justification for financial regulation. The market economy in general – and the organization of the relation of finance to the real economy, in particular – may suffer from particular, localized flaws, such as imperfect competition, rigid prices, or asymmetrical information. The role of regulation is to address these localized market flaws.

The view of macroprudential regulation

The third implication concerns the task of macroprudential regulation. The task of macroprudential regulation is to address localized market flaws that have the potential for putting the entire financial system at risk, by virtue of the size, centrality or density of the affected markets or intermediaries.

This view may be reformulated in terms of a contrast between macroprudential regulation and institutional reconstruction. Simply put, the perspective of market fundamentalism implies that macroprudential regulation is both necessary and sufficient to address the problem of systemic risk. Institutional reconstruction is neither feasible nor desirable. Systemic risk may put in jeopardy macroeconomic stability, prosperity and growth. But this does not, in itself, suggest the need for institutional reconstruction. Indeed, on this view, the very idea of institutional reconstruction makes no sense. There can be no systemic flaws because there are no systemic alternatives.

Part two: the Keynes-Minsky view

Consider next the Keynes-Minsky view.[22] This view is sometimes seen as the only possible alternative to the market fundamentalist conception. But it is not the only possible alternative. We see this as soon as we consider in any detail the actual policies and arrangements embraced by this second view.

As in the earlier discussion, we can explore the Keynes-Minsky position along three dimensions: (1) a general view of the market economy and its institutional

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organization; (2) the purpose of financial regulation; and (3) the project of macroprudential regulation and reform.

View of the market economy

A central aim of Keynesian economics and economic policy was to take money seriously: that is, to refuse to see money as merely a transparent veil, as if the real economy were simply a barter economy.[23]

However, the chief role of money in Keynes' economics (extended in the writings of Minsky and others) is to serve as the vehicle of certain psychological drives.[24]In this respect, Keynes and his disciples continued the dominant tradition of Anglo-American political economy, with its tendency to sacrifice the institutional to the psychological in the explanation of how economies work. The key concepts in his system all have a psychological character. It was a tendency maintained despite Keynes' interest in the institutional idiosyncrasies of particular corners of the market economy, such as the stock market.[25]

View of regulation

The view of regulation that follows from the overall scheme of Keynes' economics is that its mission is to provide a series of buffers that attenuate the excesses of despondency and euphoria. In so doing, these regulatory restraints make it relatively more likely that economic activity will find equilibrium (within the view of multiple equilibriums) at a point of full or fuller employment.[26]

In such a way of thinking, regulation will be much more important as an antidote to euphoria. The favored response to despondency is stimulus, especially in the form of public spending. Constraints on financial speculation, imposed by the regulatory authority, will dampen financial euphoria by starving it of instruments. Regulation is thus the counterpart to macroeconomic, and specifically, fiscal stimulus, accomplishing in the high moments of the cycle what the latter achieves in the low moments.[27]

What is denied in this view is precisely what is central to our argument that the design of regulation can foreshadow and initiate moves that tighten the linkages between finance and the real economy, making it more likely that finance will operate as the servant rather than as the master.

View of macroprudential regulation

What approach to macroprudential regulation results from the logic of this position?

Certain financial organizations may become so large, and above all so centrally connected to other financial organizations, that their troubles may threaten to disrupt the workings of the capital markets and by so doing, to threaten the real economy. The result is to put the government in the dilemma of either rescuing them (at public expense) or allowing them to fail despite the damage that may ensue to activity in the real economy. This is the famous 'too big to fail' problem.[28]

In this way of thinking, the derivative task of financial regulation – derivative from the primary task of counteracting the excesses of speculative euphoria – is to prevent any financial organization from attaining either the dimension or the strategic location on the basis of which it can place the state in such a dilemma. That is the task of macroprudential regulation.

What this analysis reveals is that the conventional understanding of macroprudential regulation is largely an expression of the Keynes-Minsky view rather than of the market fundamentalist or neoclassical position.

Everything happens, in the realm of ideas and of public debate as if the market fundamentalist view were the economics of normal times and the Keynesian view, the economics of crisis and recession. Fiscal stimulus and macroprudential regulation, conceived as restraints, respectively, on despondency and on euphoria would then count as its two chief instruments. It is an intellectual circumstance in conformity with the so called 'neoclassical synthesis' in economics, which treats Keynesianism as an addition to the economics resulting from marginalism, rather than as an alternative to it.[29]

What this approach fails to recognize is that a basic source of trouble lies in the triumph of financial hypertrophy over financial deepening: that is to say, in institutional arrangements that enable finance to use the transactions and projects of the real economy as pretexts, for its self-regarding activities.

There is no way in the Keynes-Minsky account to gain a foothold for the idea that I take to be paramount: that institutional arrangements can either tighten or loosen the linkages of finance to the real economy. The abandonment of financial euphoria occurs and matters in an institutional context that leaves finance dangerously disconnected from its mission of serving the productive agenda of society. Yet neither Keynes-Minsky nor the market fundamentalist is able to see or appreciate how existing arrangements might contribute to this dynamic, or how alternative institutional arrangements might alter the relative weight of financial deepening and financial hypertrophy, and thus the course and effect of financial upheaval.

The exploration of this idea takes us to the third position we here examine and embrace. This third view does not deny the validity of the considerations adduced by the first two views. The localized market and regulatory failures adduced by the first view are real. Any way of organizing the relation of finance to the real economy will remain susceptible to the effects of these localized

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deficiencies. However, the degree of susceptibility is not a constant; it is a variable. A financial system becomes more vulnerable the more finance loses the discipline not simply of regulatory monitoring but also of institutionalized service to the real economy (financial hypertrophy as distinguished from financial deepening). Moreover, the significance of crisis and slump depends on the extent to which it represents turmoil in the midst of ascent or of stagnation.

The cycles of euphoria and despondency, emphasized in the Keynes-Minsky view, are also real. However, their consequences depend on the institutional setting in which they occur. Keynes-Minsky not only fails fully to take account of this setting – and of the chance to rebuild it; it also reduces the repertory of policy to regulation (rigidly separated from reconstruction) and to fiscal or monetary stimulus (not understood or designed as a forerunner of such reconstruction). By failing to alter arrangements, the policy leaves in place the deeper sources of instability.[30] The shallowness of the explanation is directly reflected in the narrowness of the policy response.

Part Three: the third, institutionally reconstructive view

On this third view, the debate that goes under the name of macroprudential regulation can and should be reinvented. It is not enough to redress localized market failures or localized regulatory responses to such failures, as the market fundamentalist view desires. Nor is it enough to prevent any organization from achieving a measure of influence (or a potential of damage) that undermines the regulatory campaign against the excesses of financial euphoria. It is necessary to deal with the short term in the perspective of the long term: that is, to say, to redress those localized failures or to prevent those usurpations of powers in ways that also affirm the interests of financial deepening over the perversions of financial hypertrophy.[31]

View of the market economy

Central is the idea that the market economy can be organized in different ways, with different consequences for the arrangements of production and exchange as well as for the distribution of advantage and disadvantage.

This idea gives a positive turn to the past negative insight into the institutional indeterminacy of the market economy.[32] It does so by providing insight into the historically contingent character of existing arrangements and the possibility of alternative arrangements.[33] Legal doctrine and legal theory, seen in historical context, provide the conceptual materials required to understand and evaluate existing arrangements, and to develop alternative arrangements.

Consider, for example, the structure and development of US financial markets in the closing decades of the twentieth century. Three main features distinguished the new model of US finance. The first was a radical increase in proprietary trading and position taking among highly leveraged financial intermediaries. The second feature was a decline in traditional bank based financial intermediation, and a concomitant rise in securitization and derivatives trading as central activities of finance. The third distinguishing feature was the rise of shadow banking.[34]

Two sets of fateful changes in the closing decades of the twentieth century converged to enhance the peril of these three events. The first was the hollowing out of the New Deal financial reforms, especially in the area of banking and of the mortgage market. The second was the reliance, not only of the government but also of the society at large, on easy money and easy credit as a surrogate for a strategy of socially inclusive growth and redistribution.

On the demand side, a pseudo democratization of credit, made possible in part by overvaluation of the housing stock as collateral, took the place of the property owning democracy that was never given adequate practical reality. On the supply side, the gateways of access to the advanced sectors of production and learning remained narrow even as Fordist mass production ceased to be the keynote of economic growth. Hobbled by this narrowing of access and opportunity, the country simply stopped producing enough of the goods and services that the rest of the world wanted, and tried to avoid or to postpone, by the false premises of easy domestic and foreign credit, the impoverishing and inequality deepening consequences.[35]

It is important to understand the difference between the view of law developed here and the view of law implicit in contemporary economic analysis and policy discourse. Much of the most influential thinking in this area looks out on law throughout the world and asks which legal traditions, doctrines, and rules are more or less useful to the implementation of some preconceived idea of the institutional logic and content of a market economy. The characteristic outcome is, in the first instance, a battle of intellectual straw men: stereotypes of particular bodies of national law (for example, 'French based code systems') or whole legal traditions (notably the entire tradition of the civil law) that any well informed jurist will dismiss as misleading.[36]

More serious yet is the failure to grasp the immense potential significance of legal analysis and comparative law in the attempt to redress a central defect of much of established economics: its blindness to the theoretical and practical implications of the legal/institutional

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indeterminacy of a market economy. The institutional alternatives do not matter simply for distribution; they matter for everything that touches on the organization of economic life: the organization of all economic activity and opportunity, and thus as well the direction and form, as well as the distributive consequences of economic growth.

The argument developed here addresses some of these failures of vision not in the abstract but rather in the context of the recent crisis and slump. In so doing it points to a much more intimate and more equal interaction between legal and economic theory than has yet been established.

The point is easily summarized. In the perspective shared by both market fundamentalists and Keynes-Minsky, finance and development take place against a background of accepted institutional arrangements. These arrangements are thought to inhere in the very concept of a market economy. By contrast, I emphasize that the market economy has radically different institutional forms, expressed in law, with distinct consequences for the path of economic growth as well as for the distribution of wealth, power and income. Within this perspective, a discourse about localized market flaws and remedies for such flaws is incomplete. The issue is always also: which market economy do we want, and what way of solving the problems of today will help us move toward it.

View of regulation

Conventional approaches to regulation – not just of regulation of finance but also of regulation in general – take the present institutional arrangements of the market economy for granted. If there are localized market failures, there must be localized regulatory responses to those localized failures. If finance is a field propitious to vast and recurrent waves of enthusiasm and of fear about the future, then there should be regulations designed to act, counter cyclicality, as buffers against such frailties.

However, the problems lie neither just in localized market failures nor in intractable psychological impulses. Market economies can be organized in different ways. The institutional variations that exist today in contemporary economies provide points of departure for further variation. This untapped institutional diversity, expressed in the details of law rather than in ideological abstractions, and in areas of law beyond those ordinarily considered germane to the effective operation of financial markets, acquires vital importance in relation to a structural goal that figures centrally in the argument of this piece: the reorganization of finance so that it becomes less likely to use the real economy as a pretext for its self-regarding transactions and more likely to serve the interests and needs of the system of production.[37]

A very different understanding of the task of both micro and macroprudential regulation follows from this view of the market economy and its legally defined institutional arrangements. On the view defended here, neither the idea of shields and safeguards, nor the belief in the importance of bumpers (as in speed) provides the necessary formulation. Instead, we must always ask, what particular institutional direction should a market economy – and financial system – pursue; what policies and arrangements are required to get us from here to there; and then given this, how should we conceive of and create a regulatory framework capable of getting us from here to there.

The commanding aim of regulation should be to ensure the predominance of financial deepening over financial hypertrophy. The management of avoidance of systemic risk – the focal point of the conventional debate about macroprudential regulation – should be incorporated into a broader set of legal and institutional innovations designed to make finance the servant, rather than the master, of the real economy.[38] Thus, regulation assumes its proper role as a first step in the program of institutional reconstruction. This program, in turn, gains force and authority when it forms part of an effort to innovate in the legal and institutional arrangements defining the market economy to the end of achieving an institutionalized broadening of economic opportunity: more access to more markets to more people in more ways.

What do these guiding aims imply by way of the specific content of a regulatory program in the US (and, by analogy, other advanced democratic market economies) today?

Micro and macroprudential regulation

The guiding principle of both micro and macroprudential regulation should be to hold finance to its central task of serving the productive agenda of society. Among the major corollaries of this principle are the following:

1. Regulatory dualism – the contrast between a thickly and a thinly regulated sector of finance – should be decisively repudiated. No type or domain of finance largely unregulated by government should be allowed to exist.
2. Classes of financial transactions lacking in any plausible relation to the expansion of GDP and the enhancement of productivity should be subject to heightened scrutiny and often prohibited. An example may help make the point. Short selling of commodity futures in organized exchanges may contribute to liquidity. However, short selling of complex derivatives by financial intermediaries in over- the-counter markets may make little or no

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contribution to liquidity in the underlying cash markets. Indeed, to the extent that such trading increases volatility, without any compensating increase in the production of information or dispersion of risk, such trading may deserve to be banned.[39] The objection is not to financial speculation, which may help generate information and organize risk allocation. It is to speculative finance decoupled from the real economy.

3. No financial organization should be allowed to place bets with capital that is in any sense insured by the state (for example, federal deposit insurance), except in the sense that a commercial loan represents a bet on the credit worthiness of the debtor.[40]
4. On the other hand, however, financial organizations that do not take government insured money should be allowed and even encouraged to hold equity stakes in productive initiatives and to undertake the work of venture capital in novel forms. Such initiatives may take both tax and regulatory form.[41]
5. The actual or potential contribution that a failing financial organization could make, if turned around, to investment in production should be the most important criterion of whether such organizations should be turned around rather than allowed to fail.[42]
6. Capital made available by the state for such turnaround (or 'bailout') should take the form of an equity stake rather than of a loan. Such stakes should be held by quasi state entities, managed independently, competitively, and professionally, in the manner of the New Deal GSEs.[43] They should mimic, in unfamiliar forms, the work of venture capital.
7. As part of the commitment to repudiate and replace regulatory dualism, while distinguishing between the treatment of classes of financial activity according to the level and nature of their function in the real economy, information about financial transactions should be made available, in real time, to the regulatory authorities to a much higher degree than it has been made in the past. This calls for an end to opaqueness – traditionally associated with banking – and the generalization of standards of transparency to market based credit transactions.[44]
8. A special class of large and strategically placed financial organization should be identified and subject to closer monitoring and supervision. However, even with respect to such organizations, a distinction should be made between activities regarded as suspect and presumptively forbidden (because without plausible relation to the expansion of output or the enhancement of productivity) and activities that because they are related to production and productivity, trigger precautionary safeguards rather than presumptive prohibitions. The sensitive and large organizations that are identified to be heavily present in the first class of activities should be subject to expanded standards of regulatory vigilance. The turnaround or liquidation decisions should be informed by the previously stated considerations.

This national regulatory program has a counterpart in the international and multilateral regulation of finance. The national and supranational programs reinforce each other. The international program should include the following elements, among others[45]:

1. The establishment of international and multilateral rules and procedures distinguishing between the restrictive treatment of short-term portfolio capital and the accommodating treatment of all forms of investment in the real economy.
2. The development of international rules and procedures designed to supplement national arrangements for the orderly turnaround of those failing financial institutions that are judged (by national and supranational actors) to have a continuing potential of contribution to the real economies and productive agendas of the countries in which they operate.
3. Institutional reconstruction of the international trade system, especially but not limited to the rules pertaining to the free movement of financial services to make them compatibles with 1 and 2 above.
4. The decoupling of a global reserve currency from the monetary and financial policies of a single country.

Part four: the debate about macroprudential regulation in light of these three ideas

This piece has argued that the debate about macroprudential regulation must be placed in the context of the larger debate about alternative conceptions of finance and financial reform in relation to the productive agenda of society. I distinguish three different perspectives: market fundamentalism; Keynes-Minsky; and a third approach, which I refer to as the view of institutional reconstruction. Each of these views implies a distinctive approach to the project of macroprudential regulation. Each of these views provides an alternative account of the role of finance in our democracy and in our economy.

From the standpoint of this larger conception of the social purpose of finance, each of the first two positions provide a trivializing and reductionist tilt to the problems of macroprudential regulation.

By contrast, the view of institutional reconstruction and reform provides us with a language in which to address these larger issues. It does so by viewing the

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debate about macroprudential regulation as a first step in the project of reorganization. This project in turn allows us to pursue the link between finance and the real economy, and between recovery and redistribution.

Two main implications flow from this third, institutionally reconstructive perspective. The first implication is that the concept of systemic risk must be reconsidered. The problem is not just that some organizations can hold the state hostage because they are 'too-big-to-fail.' The real issue becomes: what is finance for? Who does it serve?

The second implication is that we need to engage in a much broader debate about the social responsibilities of finance.

The problem, to make a long story short, is not that financial organizations have become too big to fail and, as a result, acquired the power to blackmail national governments. The problem is that under present arrangements finance has been allowed to serve itself rather than to serve the productive agenda of society. All other forms of instability acquire their power to damage the real economy from this basic fact. The overriding task of the regulation of finance is therefore to address the immediate and visible problems in the perspective of solutions to that more fundamental failure: to regulate and to reform in ways that help make finance the servant it should be rather than the master it threatens to become.

Notes

1. The basic tenets of the neoclassical position are described in Turner (2009) and Schularik and Taylor (2009). See, also, Samuelson (1948) and Arrow and Debreu (1954).
2. See Atkinson and Stiglitz (1980), Stigler (1971), Greenwald and Stiglitz (1993) and Stiglitz and Weiss (1981).
3. See discussion below at page 3.
4. See discussion below at page 5.
5. The distinction between quantifiable risk and unquantifiable uncertainty is associated with Knight (2009). Kindleberger and Aliber (2005) apply the Keynes-Minsky perspective to a series of historical case studies.
6. The concept of an institution is defined in note 37 below. This third, theoretical perspective is developed in Lothian (2010) and Lothian and Unger (2011).
7. See discussion below at page 6.
8. The separation of finance from the real economy has been a growing theme in recent policy and academic discussions, often under the rubric of 'financialization.' See, for example, Epstein (2005); Turner (2010); UNCTAD (2011) and McKinsey Global Institute (2010).
9. Skepticism about the adequacy of the conventional policy response to the crisis has been a persistent theme of the debate. See, for example, Turner (2011); Tarullo (2010); and UNCTAD (2011).
10. This claim typically takes the form of the need for structural, rather than merely regulatory reforms. See, for example, D'Arista (2009); Ash, et al. (2009) and Levy Economics Institute (2011).
11. See Lothian (2010).
12. The concept of financial hypertrophy is developed in Lothian (2010) and elaborated further in Lothian and Unger (2012).
13. See FSA (2009), Turner (2010) and Brunnermeier et al. (2009b).
14. The idea of convergence is criticized in Rodrik (2007) and Serra and Stiglitz (2008).
15. The classic treatment may be found in Diamond (1984). See, also, Beim and Calomiris (2001).
16. See the discussion of the imminent structure and development of the institutional organization of emerging financial markets and economies in Beim and Calomiris (2001).
17. See Brunnermeier et al. (2009), Group of Thirty (2009) and US Department of the Treasury (2009). See, also, World Bank (2009).
18. There is a vast literature discussing the problem of TBTF in the context of modern financial markets. Examples include: Scott (2010); Schwarz (2009); Wilmarth (2011); Johnson and Kwak (2010); and Tarulllo (2010).
19. The events are summarized in Brunnermeier (2009), Diamond and Rajan (2009), and Johnson and Kwak (2010).
20. Shleifer (2010).
21. Turner (2011).
22. The view developed here is a composite view, drawn from the main works of both thinkers. For Keynes, relevant material includes: The General Theory of Employment, Interest and Money (1964), A Treatise on Money (1965) and the occasional writings collected in Essays in Persuasion (2009). For Minsky, see Stabilizing an Unstable Economy (2008a) and John Maynard Keynes (2008b).
23. A schematic overview of Keynes' theory is developed in Lothian and Unger (2011). The theme of the non-neutrality of money is discussed extensively in the literature. See, for example, Minsky (2008b), Skidelsky (2009), and Tobin (1989).
24. Both the psychological and institutional themes are treated in chapter 12 of the General Theory.
25. See Skidelsky (2009).
26. This point is implicit in much of the debate over the nature and limitations of Keynesian policy tools. See, for example, Turner, (2011) and World Bank (2009).
27. See the discussion of TBTF in Levy Economic Institute (2011).
28. See Johnson (2009) and Johnson and Kwak (2010).)
29. See Levy Economic Institute (2011) and Papadimitriou and Wray, editors, (2010).
30. See Lothian (2010b) and Lothian and Unger (2011).
31. See Lothian (2010a).
32. See Unger (1996).
33. See Turner (2009) and (2011).
34. See Lothian and Unger (2011).
35. The use of credit as a surrogate for a real growth strategy has been criticized from different ideological perspectives. See, for example, Krippner (2011) and Rajan (2010).
36. I refer here to the conventional law and finance literature, represented in its early phase by Glaeser and Shleifer (2002) and by La Porta, et al. (1998).
37. I understand and use the concept 'institutional' to designate all rule bound arrangements for the organization of any domain of social life, under the aegis of a conception that is both descriptive and normative. Thus, the concept has three elements: (1) conduct shaped in a particular area of social life; (2) pertinent rules, especially as established in law; and (3) an underlying conception, at once descriptive and prescriptive, of desirable practice in that domain.
38. The link between macroprudential regulation and the institutional reconstruction of financial markets is subtle, but

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important. The focus of so much of the present debate on macroprudential regulation depends largely on the assumption that there is no other direction of systemic institutional change that would more effectively place finance at the service of the real economy. This piece rejects that assumption, and thus leads to a very different approach. The emphasis is on how existing ideas and arrangements, including those that go under the label of macroprudential regulation, can be rethought and revised, in the service of the larger project of socially-inclusive growth and institutional reform.

39. The Commodity Exchange Act of 1936 denied legal enforceability to futures traded off-exchange. Dodd-Frank gives the newly empowered CFTC authority to impose restrictions on a wide range of derivative transactions.
40. The separation of commercial and investment banking was, of course, a hallmark of the New Deal reforms. The effort to prohibit federally insured banks from participating in speculative activities finds expression in the Dodd-Frank reforms, through, for example, the Volcker Rule (prohibiting federally-insured banks from engaging in proprietary trading), and the 'push out' provision applied to swap and other derivative transactions. See, generally, Wilmarth (2011).
41. Tax and regulatory incentives have long been used in the US to encourage venture capital. The proposal here would expand the range of entities eligible for such benefits.
42. This principle is obviously at odds with the new special resolution regime contemplated by Dodd-Frank. The emphasis on 'living wills' implies a radical distinction between the interests and prerogatives of private law financial intermediaries, and the society these intermediaries are supposed to serve. The principle defended in this item goes a little way toward the effacement of this distinction.
43. The hollowing out of the New Deal approach to the organization of the GSEs played a key role in the increasing hypertrophy of the financial system in the years leading up to the crisis.
44. The provisions of Dodd-Frank increase transparency and disclosure throughout the financial system. They nonetheless fall short of the principle described above.
45. This part of the proposal is included merely to indicate the natural extension of the discussion to the international and multilateral regulation of finance. Many of the items on the list are already included in debates about the future of global governance.

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