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Law and Finance: A Theoretical Perspective

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Abstract

Finance is traditionally studied by lawyers as well as by economists from the vantage point of the premise that a market economy has, at its core, a single natural and necessary institutional form, expressed, for example, in the basic rules and doctrines of contract and property. The literature about "varieties of capitalism" has proved insufficient to challenge this assumption. A corollary of this view is the idea that, barring particular market defects, a market economy will channel the savings of society to its most efficient possible uses. The first task of regulation is supposedly to redress such localized flaws in the competitive allocation of resources.

This brief text outlines the rudiments of another way of thinking about finance. It does so in the form of a list of connected propositions. Under prevailing arrangements, finance has become increasingly decoupled from the real economy. The production system is largely self-financed on the basis of the retained and reinvested earnings of private firms. Financial intermediation is largely self-directed, oriented to asset trading and position taking by highly leveraged financial institutions, supported in good times and bad by favorable monetary and regulatory policies.

It need not be this way. A series of innovations in our present institutions and practices could greatly enhance the usefulness of finance and mitigate its dangers. Regulation, as conventionally understood and practiced, is not enough. Regulation better understood and directed is the first step toward institutional reorganization. The reorganization of finance should in turn be judged by the standard of its service to broader aims. One aim is the organization of socially inclusive economic growth. Another is the power of a national economy to participate actively in the global economy without accepting an unfavorable niche in the international division of labor or abdicating its potential for strategies of development that go against the institutional formulas favored in the world today.

A crucial test of every program of reform is success in forming the appropriate institutional vehicles for carrying its agenda forward. From this imperative arises the need to re-invent comparative law as a handmaiden of institutional innovation. The institutional details matter, and they exist only as law.

KEYWORDS: Financial crisis, contagion, regulation, reform, institutions, institutional change, globalization, development, comparative law, international law, law and finance, financial globalization, reform of the international financial order.

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.[1]

Theoretical underpinnings of the program advanced in the essay[2]

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.

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[1] 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 (variability, asymmetry, and the reorientation of global governance and global law.) 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.

[2] 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.[3]

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.

[3] The theme of the importance of broadening the policy space for economic and institutional experimentalism has been emphasized in the work of Rodrik, Wade, Sabel and Unger, 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 according to the principle or doctrine of "financial restraint"); the institution of the development bank in Latin America and in East Asia; and institutional experiments in the organization of domestic financial markets and in different forms of strategic integration of national and global markets, in the past thirty years, especially in the BRICs and other successful contemporary developing countries.

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 an 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.