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***Defending the Progressive Idea***

**Session 10: Perspectives on Emergent Financial Systems (E5, E6)**

**Paper Session**

**Sunday, Jan. 5, 2020 8:00 AM - 10:00 AM**

**Manchester Grand Hyatt San Diego, Cortez Hill A**

**Chair: Matías Vernengo, Bucknell University**

Paper 1: “An Institutionalist Framework for a Consistent Financial Regulation.”

**Faruk Ülgen, University Grenoble-Alpes**

Paper 2: Income Distribution, Household Debt and Growth in Modern Financialized Economies

**Mario Seccareccia, University of Ottawa & Orsola Costantini, Institute for New  
Economic Thinking**

Paper 3: “The Limits of ‘Progressive’ Institutional Change: Migration and Remittance Experiences.”

**Eugenia Correa, National Autonomous University of Mexico (UNAM)-Mexico City  
Alicia Girón, National Autonomous University of Mexico (UNAM)-Mexico City**

Paper 4: “Public Knowledge and Financial Regulation: Two Post-Crisis Periods

**Wesley Marshall, Metropolitan Autonomous University (UAM)-Iztapalapa & Gregorio  
Vidal, Metropolitan Autonomous University (UAM)-Iztapalapa**

Discussants:

**Felipe Almeida, Federal University of Paraná & Matías Vernengo, Bucknell University**

Faruk ÜLGEN<sup>1</sup>

*AN INSTITUTIONALIST FRAMEWORK FOR A CONSISTENT FINANCIAL REGULATION*

**Abstract:**

In the light of recurrent systemic crises that financialized market economies have been experiencing since the 1980s, this article seeks to determine the conditions required for a regulatory framework apt to ensure financial stability. Drawing upon an Institutional Minskyian endogenous financial instability approach, the article studies the fragilities of liberalized finance and points to some policy alternatives able to lead to an alternative financial regulatory model that is consistent with macroeconomic stability. It argues that in a weak regulatory environment financial markets naturally generate instabilities that could turn into systemic crises. The analysis maintains that in order to deal with such crises, a tight supervision should be framed under the aegis of public authorities, and suggests some rules to develop a relevant regulatory system through an open and democratic decision process. Two points then deserve particular attention: a macro-prudential approach that regards instability as a systemic (non-individual) issue, and a preventive approach that aims at preventing systemic-risk generating activities from taking control over the markets.

**Keywords:** Central banking, Financial instability, Financial supervision, Institutions, Regulation

**JEL Classification Codes:** B52, E61, G01, G18

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## **Introduction**

From the 1980s, major advanced economies implemented institutional reforms, liberalized their markets and replaced public constraints on financial activities by market-relying self-regulation mechanisms. This transformation led to the financialization of economies and generated recurrent instabilities that resulted in a systemic financial crisis in 2007-2008.

From a critical perspective on such a process, this article develops an Institutional Minskyian analysis of a capitalist economy with regard to the fragilities of liberalized financial markets and suggests common rules for an alternative regulation to achieve stronger macroeconomic stability. In this aim, the first section focuses on the endogenous instability of capitalist finance and the role of the prevailing institutional environment. It argues that when public supervision is relaxed, the potential for systemic financial instability increases. The second section maintains that self-regulation-based financial supervision cannot ensure systemic stability because of two basic features of monetary economies: the characteristics of the products (monetary debts-related financial positions) sold in the markets and the environment required for systemic stability. The third section shows that stability requires extra-market public supervision under the aegis of the central bank acting as a lender of last resort. A few basic rules are then suggested: a macro-prudential approach that regards instability as a macroeconomic issue, and a preventive approach that should reduce the scope of systemic risk generating activities in markets.

### **I. Financial instability and institutions**

In a capitalist economy, financial markets may *endogenously* generate instabilities that could transform into systemic crises if public regulation/supervision is loosened. Three specific characteristics of a monetary economy have to be highlighted (Ülgen, 2019):

- 1) A capitalist economy relies on continuous debt-creation operations between various agents (banks, financial intermediaries, enterprises, individuals, etc.);
- 2) These operations allow entrepreneurs to finance their plans and achieve accumulation. Parallel to wealth accumulation, debts also are accumulated;
- 3) However, each debt must be repaid. This recurrently generates pressures over the continuity of economic relations and might threaten systemic viability.

Drawing upon such a *credit view of money*, and studying a capitalist economy with expensive capital assets and sophisticated financial system, Minsky (1986, 1992) argues that financial instability is an endogenous phenomenon, a normal outcome of decentralized market operations. This Minskyian Financial Instability Hypothesis (FIH) states that when the boom is supported by further debt-creation without paying attention to the evolution of the whole system, debt positions become unbearable with regard to potential burst tendencies.

The evolution of the speculative housing bubble in the US economy was based on the increasing financing of debts whose solvency relied on the continuous inflation of the bubble<sup>2</sup>. Houses and associated derivative securities left both households, banks and financial intermediaries over leveraged. In a way, speculation on the continuity of speculative gains fueled speculation itself in line with market rationality even though major market players were aware that the market could not keep inflating indefinitely.<sup>3</sup>

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<sup>2</sup> Bernanke (2010) reports that U.S. house prices began to rise rapidly in the late 1990s growing at 7-8 percent in 1998-1999, and 9-11 percent over 2000-2003. The most rapid price gains were in 2004/2005, when the rate of house price appreciation was between 15-17 percent.

<sup>3</sup> The former Citigroup chief executive, Chuck Prince, notes: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing” (quoted in Sanati, 2010).

However, such a rationality does not allow the system to operate in a coherent and stable way at long-run in the absence of a non-market organization able to restrict market operations in the event of systemic risks. This issue is closely related to the institutional framework on which the market operations are built up. In an institutionalist vein, Minsky (1982) places the emphasis on the consistency of institutions with regard to the aims of society that should underline rules to shape suitable market operations.<sup>4</sup> Institutional regulations determine the options of market players with regard to given constraints, and shape the efficacy of market contracts.

As Wray (2011a) notes, the dominant theory of finance rests on efficient markets hypothesis that leads to economy-wide de-supervision and financial liberalization allowing banks to enter into speculative activities and develop transactional banking and securitization. However, such an evolution does not result in higher efficiency. Philippon (2012) assesses the efficiency of US financial markets through the measure of the cost of financial intermediation. The size of the financial sector is given by the share of the total compensation<sup>5</sup> of financial intermediaries as a fraction of GDP= $\text{Income of Finance Industry} / \text{Total Income}$ . The cost of intermediation grows from 2% to 6% over 1870-1930. It shrinks to less than 4% in 1950, grows slowly to 5% in 1980, and then increases rapidly to 9% in 2010. In a similar way, Cecchetti and Kharroubi (2015) document that financial boom does not result in higher economic growth and might be resource consuming through recurrent fragilities. Litan (2012) points to the inability or unwillingness of the US authorities to regulate subprime lending in a relevant way, but also to the excessive reliance by regulators on credit ratings as the main facilitators of the systemic crisis.

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<sup>4</sup> Thus the concept of “institutional-time inconsistency” does mean that the rules and mechanisms in force are not consistent with systemic viability.

<sup>5</sup> profits, wages, salary and bonuses.

## II. Economic regulation: self-regulation *versus* systemic stability

Economic regulation is the way a given institutional framework shape, support and fix the market operations. It is usually defined as a (binding) set of rules aiming at protecting and benefiting people, businesses and the environment, stabilizing markets and addressing market failures to support growth (National Audit Office, 2014).

The rationale for public regulation is usually related to market failures such as monopoly/oligopoly power. The regulation is then regarded as a way of achieving optimal prices, quantities and profits when markets cannot efficiently work and may provoke high costs and loss of welfare<sup>6</sup>. Joskow and Rose (1989: 1450) distinguish between economic regulation (administrative regulation of prices and entry into industries) and social regulation (environmental, health/safety practices, tax and tariff policies). Braithwaite (2005) focuses on the constraining character of regulation such that regulators would steer regulated actors' activities.

Following Posner (1974), Den Hertog (2010) presents two broad traditions with respect to the theories of regulation. The first (*public interest theories*) assumes that regulators have sufficient information and enforcement powers to effectively promote the public interest. The second (*private interest theories*) argues that regulators do not have sufficient information and can only imperfectly promote the public interest. It is argued that industry sometimes sets out its own standards seeking a sustainable and durable image in the economy and consumer confidence, and does not call for government regulations.

Self-regulation rests on the belief that market players might have system-consistent behavior thanks to a variety of rewards and punishments. Although understandable for some industries, self-regulation is not relevant to ensure supervision over every kind of activity. For

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<sup>6</sup> Stigler (1971: 3) views the issue in terms of allocative efficiency: "The central tasks of the theory of economic regulation are to explain who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources."

instance, King et al. (2011) describe the difficulties and promises of self-regulation as a mechanism to address environmental problems. Reynolds (1981) points to the weaknesses of the neoclassical approach resting on the efficiency of the regulatory framework in force.

The stabilization scope of self-regulation is very weak when it comes to *financial markets that may potentially generate externalities not only in the industry but also to society* because of the characteristics of monetary/financial operations.<sup>7</sup> First, banks are dealing with money and make possible the working of society on the basis of private credit-debt relations. Money is a private debt-engagement resting on decentralized expectations of debtors. It relies on non-social projects and targets. Second, these debts flow through the entire economy to let people access to society-wide economic communication/relationship in a decentralized way. Third, once registered in individuals' accounts by banks and flowed through society, money becomes the only society-wide general means of settlement of debts while it is originally a private debt. This is the ambivalent nature of money; privately created and publicly accepted and used.<sup>8</sup> Fourth, financial markets are the mechanisms that allow people to lend, invest and reimburse debts (related to productive as well as speculative purposes). Financial markets involve all the debt positions within market operations and make the future of society dependent on expectations shaped by these operations and related rumors.

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<sup>7</sup> Ülgen (2019) suggests a public good approach to financial system's stability through an analysis of the specificities of financial markets.

<sup>8</sup> It is worth noting that no debt can be repaid by itself. However, money –related to private debts– is used as a general means-of-settlement of debts thanks to the public power-based rules of the payments system. The role of the central bank as the lender-of-last-resort is therefore crucial for system's working through time.

Last but not least, self-regulation provokes conflict of interests<sup>9</sup> since it rests on a confusion between assessors and assessed parties<sup>10</sup>. There is no spontaneous systemic regulation that markets could spontaneously generate to prevent critical engagements. European Parliament (2013) states: “An effect of the financial crisis has been that there is over-reliance by investors, including IORPs, UCITS, and alternative investment funds (AIFs), on credit ratings to carry out their investments in debt instruments, without necessarily conducting their own assessments of the creditworthiness of issuers of such debt instruments.” European Parliament (2010) also states: “Financial stability is a precondition for the real economy to provide jobs, credit and growth. The financial crisis has revealed important shortcomings in financial supervision, which has failed to anticipate adverse macro-prudential developments and to prevent the accumulation of excessive risks within the financial system.”

It is obvious that even though policy makers cannot obviously identify bubbles in advance, they could be better focused on asset-price increases that are financed with debt since they can stand back and look objectively at the problem, *if they are not involved within the game as an interested player.*

### **III. Institutional framework for an alternative regulation**

The fragilities of our financialized economies call for extra-market regulation that consists in a macro-regulatory and preventive supervision to reduce the potential of systemic crises. In this aim,

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<sup>9</sup> Conflicts of interest refers to a set of conditions that lead to confusion between a primary-interest related professional judgment (such as balance-sheet soundness) and a secondary interest (such as financial gain). See MacKenzie and Cronstein, 2006.

<sup>10</sup> Banks’ own Internal Ratings Based models (IRBs) and Credit Rating Agencies evaluations, all related to private-interest-based and profit-seeking strategies.



identification of systemic riskiness of speculative, financial efficiency-based activities is a first step. But the core question is how to design and implement such a framework to address the root causes of disasters without overweighting public supervision in markets.

In institutionalist approaches this question gives rise to the studies on the social control of market activities in parallel with social welfare objectives. The design of financial institutions, i.e. of an alternative institutional macro-framework for stronger systemic regulation that contains systemic fragilities and dampens instability is one of the main policy problems in the institutionalist agenda (Ülgen, 2014). In a loose institutional environment, speculative finance transforms market operations into Ponzi schemes à la Minsky (Minsky, 1986) and turns out to be a debt-leveraging bubble through the rise of prices. Speculation becomes the main helm of economic decisions and leads to the Minsky's *money manager capitalism* (Wray, 2011b).

Minsky's FIH and institutionalist social control theory (Ülgen, 2014) can then be used to understand the working of a capitalist economy and its implications regarding the necessary public intervention. In such an approach, public institutions must act as social organizers of markets. Beyond its crucial role as lender-of-last-resort in case of systemic distress, and as provider of valuable information about the evolution of markets through interest rates changes, central bank must aim at organizing monetary/financial systems to support sustainable economic development.

Through the visible hand of the public power, this alternative calls for more rigorous financial supervision/regulation that must be designed and implemented at the systemic level to directly monitor and discipline banks and financial institutions in order to improve and strengthen financial stability. The latter is a collective concern which must be produced and managed through macro-regulatory frameworks.

To cope with crises and their destructive consequences and give markets a positive role in economic evolution, macro-prudential regulation must be substituted to micro-regulation and take into account various facets of the supervision process such as economic regulation (market

structure), conduct regulation (private actors' behaviour), social regulation (consumer protection) and societal regulation (collective objectives) to tame speculative short-sighted finance.

The ultimate challenge for regulatory policies is to make market actions socially consistent with the wellbeing of citizens in a sustainable way. A possible macro-regulation calls for consistent rules in order to cut markets' speculative ardours down, for instance, by separating the financial intermediation and the traditional productive system-financing bank activities. This requires a formal distinction between "Finance to finance" and "Finance to produce" (Ülgen, 2014). Beck (2012: 4) argues that financial markets development is not a goal in itself, rather it is a tool for economic growth: "While financial liberalization in the 1980s might have helped in structural transformation and economic development of the UK over the past three decades, the focus on the financial sector as a growth and export sector in itself, with a consequent regulatory bias and an implicit safety net subsidy, has not only contributed significantly to the current crisis but might also have exacerbated its extent. It is time to focus again on the facilitating rather than self-serving role of finance."

The design and implementation of such an environment obviously necessitates supra-individual transparent and democratic governance beyond local and group interests. In this case, errors and poor results can be discussed and adjusted together whatever the responsibilities of policymakers involved in the process such that regulation would not appear as a restrictive external constraint over free individuals but as a means to strengthen society's cohesion with respect to common objectives to prevent out-of-control strategies of financial institutions. Aikman et al. (2018) then point to a work in progress: "There is a debate to be had, an analytical debate, about the appropriate degree of discretion to confer on regulators, to ensure they retain the flexibility they need to respond to events while ensuring their decisions are clear, transparent and unpolluted by behavioural biases and time-inconsistency problems."

The rules might be elaborated together with the market actors that might have some specific, technical and experimental knowledge about the difficulties they have to deal with in the

exercise of their profession. However, regulation as a checking-and-supervision process of market activities according to a previously given set of collective objectives must remain out of conflicts of interests, i.e. out the reach of players' individual power. A possible direction might rest on the rule of involving financial institutions' responsibility in the crisis-prevention. Financial institutions could be called upon to contribute to a "security fund" depending on the degree of systemic risks of their operations such that the more risky the activities are, the higher the security tax charged. Also, on the principle of prevention, operators should provide an accurate assessment of the risk potential of their activities, and until proof of the non-systemic scope of the products/processes is provided, the planned activities would not be authorized. This twofold constraint should reduce the incentive to take risks that could generate systemic crisis. Acharya et al. (2017: 35) then maintain: "Unless the external costs of systemic risk are internalized by each financial institution, the institution will have the incentive to take risks that are borne by all. An illustration is the current crisis in which financial institutions had levered up on similar large portfolios of securities and loans that faced little idiosyncratic risk, but large amounts of systematic risk."

Bieri (2011:333) maintains that: "the principal regulatory lesson is twofold. First, at a micro-prudential level, the regulatory perimeter needs to be strengthened and extended. Indeed, it was excessive risk taking by global financial actors outside this very perimeter that lies at the origin of current crisis. Going forward, this implies both expanding the scope of regulation of institutions (...) and a tighter regulation for markets and individual financial products (...). At the same time, macro-prudential regulation ought to incorporate the fact that systemic risk is an endogenous component of the global financial system (...)."

Monetary and financial problems are no longer individual or sectoral. They are often systemic. Therefore, possible responses require coordination at the global level that could be designed and implemented by systemically powerful public institutions. Such a task calls for system-wide tools in order to fight against all odds to ensure that macro-stability will be achieved for the survival of the system.

## Conclusion

The crucial question of a relevant systemic financial regulation is “How to ensure that the bright side of finance (finance-growth nexus) prevails over the dark side of financial fragility?”

Even if many reforms and new regulatory rules have been set up and reframed the face of the public supervision in the aftermath of the 2007-2008 crisis<sup>11</sup>, Tarullo (2019: 61) warns that: “the current regulatory framework does not deal effectively with threats to financial stability outside the perimeter of regulated banking organizations, notably from forms of shadow banking. Moreover, with the political tide having for the moment turned decisively toward deregulation, there is some question whether the resiliency improvements of the largest banks will be preserved.”

Without denying remarkable contributions recently provided for the understanding of the roots of current financial instabilities, it seems necessary to call for an awakening of economic theory in order to change the way we look at the functioning of financialized economies. The 2007-2008 crisis points to some limits of the prevailing financial structure:

- \* The inability of loosely regulated financial systems to function in a stable way;
- \* The non-reliability of models advocating virtues of liberalized finance;
- \* The incapacity of self-regulation to keep the economy in a sustainable evolution path;

This article argues that a capitalist economy is a monetary economy whose working relies on continuous debt operations allowing entrepreneurs to achieve accumulation. Parallel to the wealth accumulation, debts also are accumulated. This recurrently generates pressures over the continuity of economic relations in markets and might threaten systemic viability. In other words,

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<sup>11</sup> Like the US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the European system of financial supervision in 2010, and the following regulatory reforms still in progress (see at : [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-reforms-and-their-progress/progress-financial-reforms\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-reforms-and-their-progress/progress-financial-reforms_en)).

the economy needs debts; debts must be reimbursed but they cannot be totally repaid. This is the “genetic” paradox of such an economic society; its food is her own poison and the cure is a public regulatory framework to keep capitalism safe even under an oxygen tent in case of systemic crisis.

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