Regulation and the Role of Law in Economic Crisis

by Ioannis Glinavos

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Abstract

This paper contributes to the current debate as to responses to the crisis and the role of law in paving a way out of recession, by highlighting the persistence of market centred theories that defined the state market relationship before the crisis. The paper begins by discussing the concept of regulation itself and discusses the extent to which the credit crunch has shaken belief in modern capitalism. The paper then offers a discussion on the relationship of deregulation to financial crisis, arguing that there is a direct link between the receding reach of the state and market instability, drawing analogies with previous instances of market failure, like the Great Depression. On the basis of this connection, a theoretical portrayal of perceptions of the role of law in modern capitalism is attempted, where the main message is that dominant modern perceptions of the state market relationship allow a role for regulation but still do not recognise the state as the legitimate author of such regulation, showing a preference for market-led solutions. The paper then tests these findings against state actions in response to the credit crunch and concludes by offering the suggestion that while the current financial crisis has shown the limitations of modern capitalism, and while it is possible that a fundamental rethink of the role of the state in the market may take place as a consequence, this rethink has not yet materialised in policy proclamations and government aspirations on a global scale.

Keywords
Law, Regulation, Great Depression, Recession, Capitalism, Credit Crunch

Table of Contents

Introduction..................................................................................................................................................2
Deregulation and Financial Crises...............................................................................................................3
The Role of Law in Markets.........................................................................................................................5
Regulatory Responses to the Credit Crunch ...............................................................................................8
Conclusion..................................................................................................................................................10
Bibliography...............................................................................................................................................11

* Dr. Ioannis Glinavos, City Solicitors' Educational Trust Lecturer in Contract Law, Kingston Law School, Kingston University, KT2 7LS, UK, i.glinavos@kingston.ac.uk
"This financial system is no more! It has ceased to be! 'It's expired and gone to meet its maker! It's a stiff! Bereft of life, it rests in peace! If you hadn't nailed 'it to the tax payer's perch it'd be pushing up the daisies! 'Its metabolic processes are now 'istory! 'It's off the twig! It's kicked the bucket, it's shuffled off its mortal coil, run down the curtain and joined the bleedin' choir invisible! THIS IS AN EX-FINANCIAL SYSTEM!!"  
(Willem Buiter, November 26, 2008)

Introduction

As a result of the credit crunch and the global financial crisis it has spawned, debates on the relationship of the state to the market and the role of regulation have once again become prominent. As evidenced in these debates, and especially in policy circles, there is a strong desire to use law as a response to what are perceived to be failures in finance and banking. The need to use law and expand regulation is strong as it shows activity on the part of governments in dealing with the crisis. However, apart from the need to make a political statement, regulation in the present circumstances is conceptualised in ways that may not threaten the established relationship of the state to the market. This paper examines perceptions of the role of law in regulating the economy in times of crisis. It explores regulatory responses to previous market collapses, like the 1929 crash and speculates on how law could be used currently to assist in overcoming economic difficulties.

The paper begins by discussing the concept of regulation itself and discusses the extent to which the credit crunch has shaken popular faith in modern capitalism. The paper then offers a discussion on the relationship of deregulation to financial crisis, arguing that there is a direct link between the receding reach of the state and market instability, drawing analogies with previous instances of market failure, like the Great Depression. On the basis of this connection, a theoretical portrayal of perceptions of the role of law in modern capitalism is attempted, where the main message is that dominant perceptions of the state market relationship allow a role for regulation but still do not recognise the state as the legitimate author of such regulation, showing a preference for market led solutions. The paper then tests these findings against state actions in response to the credit crunch and finishes by offering the suggestion that while the current financial crisis has shown the limitations of modern capitalism, and while it is possible that a fundamental rethink of the role of the state in the market may take place as a consequence, this rethink has not yet materialised in policy proclamations and government aspirations on a global scale. This paper therefore makes a contribution to the current debate as to responses to the crisis and the role of law in paving a way out of recession, by highlighting the persistence of the market centred theories that defined the state market relationship before the crisis.

The very concept of regulation is highly controversial. This paper sees regulation as the product of legislative action focused on enforcement, as binding sets rules that constrict behaviour backed by sanction of enforcement by courts. This type of regulation is in many respects the opposite of what the business community wants, which usually takes the form of guidelines and legislation facilitating standard creation by the market itself. Public proclamations in 2008 that criticised markets and laissez faire set off alarms for businesses that benefited from the lax and retreating regulation of the last 20 years. Even personalities with impeccable capitalist credentials sounded suddenly sceptical. No lesser an inside man than George Soros, the hedge fund manager, said:

"The system, as it currently operates, is built on false premises. Unfortunately, we have an idea of market fundamentalism, which is now the dominant ideology, holding that markets are self-correcting; and this is false because it's generally the intervention of the authorities that saves the markets when they get into trouble". (May 15, 2008)

Suspicion that a temporary popular anti-capitalist sentiment may translate into direct government control over financial activities considered till now the domain of market self-regulation, energised corporate interests in reinforcing the deregulatory mantra that we have become so familiar with over the last two decades. This took place despite the links of deregulation to the current economic crisis.
While recognising that efficient and effective regulation is a crucial part of heading off a future crisis, the business community argued that it would be dangerous for the state on national and international levels to retreat to prescriptive, rules-based regulation. Despite the fact that vague statements by officials in favour of state regulation did not seem to translate into policy and market preferred solutions to grave problems like the solvency of banks were pursued, a concerted campaign to pre-empt a return to a regulatory state commenced in earnest. The arguments put forward were along the lines that recognising the need for efficient regulation is not just about preventing further crisis, but also a question of creating efficiencies to underpin the competitiveness of the world’s financial centres (Dallara 2008:341). An illustration of this trend can be found in the 2007 report by Michael Bloomberg and Charles Schumer on Sustaining New York’s and the United States’ Global Financial Services Leadership, which warns against the loss in jobs and indirect revenues resulting from the decline in New York’s competitiveness in recent years, noting that achieving regulatory balance is one of the most important factors in maintaining employment and competitiveness. According to such thinking, the optimal combination of rules-based and principles-based supervisory approaches, with rules providing predictability and principles providing maximum freedom of business management are the best guarantee for a speedy exit from the recession. In fact the concession that regulators have a right to regulate the entire market place, is moderated by the proviso that rather than more regulation, what is needed is more consistent and thorough application of the regulation that already exists. In other words the 'business as usual' school of thought is steadfast in its effort to convince us that the failures of financial capitalism becoming very apparent in 2007 and 2008 are not elements of a systemic failure, but blips in an otherwise benign expansionary trend. And that one has always more to fear from regulation than from the market. In the words of the Financial Times:

“A clean-up is overdue. Yet, in cleaning up, we must remember deeper truths: human beings will always believe what they want to; and so regulation will always fail. We know, too, that nothing better than the market system is on offer, however flawed. Financial markets fail. They are also indispensable”.
(FT Leading article, 27/12/08).

The next section explains why things may not be as benign by demonstrating the historical links between deregulation and financial crisis

**Deregulation and Financial Crises**

There is considerable evidence to suggest that deregulation of financial services creates opportunities and preconditions for speculative bubbles. The absence of regulatory restrictions on the operation of financial firms and the sale of financial products lead to the explosion in the price of securities in 1927-28 and contributed to subsequent asset bubbles like the new technology bubble of the late nineties. Modern experiences of boom and bust suggest a direct correlation between liberalisation and market instability. The cyclical nature of growth in capitalism therefore is more strongly related to the nature and quality of regulatory frameworks, than assumed by market analysts.

Financial deregulation typically encourages banks to expand their involvement in the securities and real estate markets, and it also intensifies competition between banks and non-bank financial intermediaries. As a result, financial liberalisation tends to increase the vulnerability of the banking system to sudden collapses of asset values in the securities and real estate markets. For these reasons, deregulation has been associated with boom-and-bust cycles such as the one that lead to the Great Depression and banking crises in many countries since the 1970's. The experience of the United States in the 1920s and 1930s provides a great illustration of the links between deregulation, and financial instability. During the 1920's the desire of banks to circumvented statutory restrictions by organising affiliated corporations, which engaged in a full range of underwriting, selling and dealing activities involving both bonds and stocks greatly reduced their borrowing within the banking sector and made the securities markets the prime source for financing (Benton 2003: 101). The reason for this
preference for markets over customers can be found in the decline in bank's traditional corporate lending business. This decline made real estate and securities markets attractive new profit sources and offered incentives to push for and take advantage of lax regulation. The consequence of the subsequent explosion in the price of real estate and asset prices led to the speculative bubble that exploded in 1929, marking the beginning of the Great Depression, a phenomenon with global consequences.

Crisis can be a catalyst in developments in policy that can at times lead to rapid and wholesale reversals of policy directions. One such reversal was the expansion of regulation in the United States after the 1929 crash and the initiation of the New Deal by the Roosevelt administration. Regulatory responses to the crash and the ensuing Great Depression marked one of the most radical reversals of economic policy seen in the United States. As a product of pressure from various sources, the New Deal was grounded in no single coherent or systemic theory. Perhaps a single unifying theme was that the popular conviction that an unregulated free market guided solely by the invisible hand of private interest could lead only to the dispossession associated with the depression. The Roosevelt administration responded to this popular perception by offering the countervailing power of government, administered by disinterested expert regulators, in order to discipline the market and stabilise an economy that laissez faire had all but destroyed. The result was a stunning expansion of administrative authority both within and independent of the executive branch (Tomlins 2008:284). What is particularly interesting is that the state sought to set in place a regulatory framework that would prevent the re-emergence of circumstances that could lead to another bubble and subsequent catastrophic crash. One of the most important legislative responses to the economic crisis was the work of Senator Carter Glass, Representative Henry Steagall and other proponents of the Banking Act of 1933, known as the Glass Steagall Act. The Act's backers were convinced that banks had played a significant role in promoting unsustainable booms in the real estate and securities markets during the 1920's. As a solution to this problem it was suggested that commercial banks should restrict their operations to the acceptance of demand deposits and the extension of short-term, self-liquidating loans to finance the production and sale of goods by businesses. Banks therefore should be prevented from making unsound loans and investments that encouraged an overbuilt real estate market and an immense over-expansion of real estate values, Banks should also be discouraged from making investments in securities that undermined their solvency in stock market downturns and they should be restricted in making loans to finance the purchase of securities.

Liberalisation that removes the above restrictions has since been shown to produce a banking system that is more vulnerable to systemic risk. Admittedly, deregulated financial markets generally promote faster growth rates by providing more extensive financing to consumers and businesses during economic expansions. However, by encouraging a greater reliance on external funding, deregulation creates a higher risk that consumers and firms will become overextended and insolvent if external funding sources shut down during economic contractions (Benton 2003: 79). The problem is not so much enacting legislation immediately after a financial collapse, but ensuring that safeguards are maintained when memories of the collapse fade, and an appetite for risk returns. It could be said that regulation following the 1929 crash sought to protect against a non existent danger, as the appetite for risk that had fuelled the bubble was entirely dissipated after the crash and did not return for some 30 years. What the use of law after 1929 failed to achieve, was to set in place lasting safeguards that could outlive the memories of the crash, safeguards that could protect future generations, far removed from the Great Depression from repeating the mistakes of the 1920s. Deregulation from the 1980s till 2007, despite recurrent crises, albeit of a lesser severity that 1929, gradually removed those safeguards and allowed a financial community with an insatiable hunger for risk to stroke a bubble that lead to the credit crunch and current problems upon its collapse.

By 1998 regulators and the courts in the United States had allowed banks to make substantial inroads into the securities and insurance sectors by exploiting loopholes in the Glass-Steagall Act and the Bank Holding Company Act of 1956, both enacted with the memories of the Great Depression present in people's minds and considered strong legal barriers to bank entry into the securities and insurance fields. In confirming the return of universal banking powers to the financial holding companies, the Gramm Leach Billey Financial Modernisation Act repealed several depression era safeguards in 1999.
Unlike the system of finance established in the United States in the 1930s, the new model of finance allowed competition between commercial banks and investment banks for securities business. As a result opportunities for profit increased dramatically, encouraging the investment banks into ever more risky reliance on proprietary trading – speculating with their own capital to increase returns. Further, the model of finance to emerge after the repeal of the Glass Steagall Act was based on securitization, and became known as the 'originate and distribute' model. A securitization is a financial transaction in which assets are pooled and securities representing interests in the pool are issued. Under the originate and distribute model, financial institutions would create assets (such as loans) then repackage these and sell them to investors. The resulting funds would be used to originate more assets which in turn would be repackaged and sold, recommencing the cycle. This model of banking recreated in a way the institutional framework that had led to the crash of 1929, by allowing the banks to lend not on the basis of deposits, but on the strength of the money markets, the way was opened for the financial sector to depart from the fundamentals of the real economy creating a fictional wealth that enriched the few, but ultimately impoverished the many.

From the standpoint of financial institutions, the originate and distribute model had two benefits. First, it increased profitability by generating income from fees charged for origination rather than relying on interest repayments, in a low interest environment. Second, it reduced risks of any potential defaults because the originators did not own the assets originated; instead the resulting securities were widely distributed in the markets. From the standpoint of regulators, this model likewise had two benefits. First, banks were less risky because they were holding fewer loans and hence were exposed less to default risk in any future economic downturn. Second, by repackaging and distributing credit risks widely into the market, this brought down the charges which lenders had to charge borrowers, increasing home ownership and economic activity. Unfortunately, as Arner points out (2009:17-19) these benefits, when taken to excess, also turned out to be the greatest weakness of the new model.

The weaknesses of the new financial model were evident long before the credit crunch. The dot-com bubble and its subsequent collapse and recession at the beginning of the new century were based on much the same correlation between deregulation and excessing risk taking. In his book the Roaring Nineties (2003) Joseph Stiglitz argues that the dot-com collapse and ensuing recession should have been a final warning that deregulation had gone too far. He suggests that the state withdrawal policies of Reagan and the first Bush administration created an environment where the spread of financial services came to substitute investment in the real economy as a source of innovation and growth. The recession in 1991-1993 was a direct result of overexposure and weakness in the financial sector. However, lax regulation and opportunities for quick profits returned in the nineties and fuelled the technology bubble resulting in immense waste and record losses when the market realised that the magical profitability of new technologies would not materialise. The point however is not that this was an episode in the predictable cyclical movements of capitalism, but an exaggeration -of perhaps-cyclical trends, brought about by excessive deregulation. The successes of the Clinton administration in restoring balance in the budget after 1993 which helped release capital in the economy due to a combination of low interest rates and other incentives, helped mask vulnerabilities. The second Bush administration then continued on the deregulating path which led to the overexposure of the sub prime mortgage market that started off the current crisis. A crisis in which market participants and regulators were equally complicit, by exhibiting the remarkable lack of foresight and even modesty that had also defined the great crash of 1929.

The next section presents perceptions of the role of law in markets that preceded the credit crunch and inform to a great extent current interpretations of the state-market relationship and the role of regulation.

The Role of Law in Markets

As discussed in the previous section, one of the major contributors to financial crises historically has been the withdrawal of the state from the regulation of the economy, especially in the area of banking
and finance. While however, the level and extent of regulation can predict economic instability or at least the chances of rapid expansion and a subsequent recession, the use of law has been greatly restricted in what is considered the domain of the market since the early 1980s. The reason for this 'lack of law', evidenced in worldwide efforts at deregulation and privatisation, has been the dominance of free market ideology propagated primarily from the USA and the UK. According to Robert Wade (2008:34) the prevailing ideological climate that created the conditions for the expansion of the bubble that deflated in 2007-8 resulting in the credit crunch, was characterised by hostility to regulation. It gave rise to a laissez faire ideology that celebrated the unregulated areas of finance as demonstrating the validity of the efficient market theory of financial markets, suggesting that markets are self-adjusting and that competition plus light-touch regulation produces efficient, innovative, and stable financial markets. Aiming at the withdrawal of the state from the economy, a worldwide consensus in favour of liberalisation bearing the traits described above became common sense in both developed and developing economies. Extreme examples of the deregulatory consensus can be seen both in post communist transition states, like Russia, and in advanced markets, especially in the area of financial markets.

The preponderance of a market liberalisation agenda, throughout the 1980s in the US and the UK and from the 1990s globally, identified as key roles for law the definition, allocation and protection of private property and the enforcement of contractual agreements. Law was seen as having a key role to play as the guarantor of private property rights, for the market mechanisms and economic processes which lie at the heart of liberal democracy are premised upon the existence of private property. Policy discussions as a result tended to translate all human activity to transactions of property rights. Since the mid nineties however, especially in developing economies, economic reform choices moved on from a standard list of policies consistent with liberalisation (macroeconomic stabilisation, privatisation, trade liberalisation, property rights) to reforms that were seen as more context specific and more targeted to countries individual needs (Kikeri 2006:17).

As a result of these trends, along with institutions in general, law has become much more important in reforms aimed to promote development that have an ambit wider than the initial establishment of a market economy. The prevalence of law and institutions in modern development literature owes a lot to the work of Douglass C. North (1992), one of the founders of the ‘new institutional economics’ movement. His work explains why more law is needed in the context of a market economy, than market fundamentalists believed at times of economic expansion. North sees market-supporting institutions as extending from formal rules (laws, constitutions, rules), to informal constraints (conventions, codes of conduct, norms of behaviour), to effective enforcement (Brodak 1997). North argues that the belief that a minimal package of market supporting institutions (not much more than property rights and contract) can be enough to found a functioning free market, which once up and running, can take care of itself is mistaken because of the discrepancy between theoretical models that inform many economists and real life. North’s analysis, together with work by the World Bank also based on the new institutional economics suggests that to eradicate the problems associated with high transaction costs impeding economic growth, a series of regulatory interventions are needed which go beyond the mere establishment of private property rights and contract. Indeed, in many ways development is now being treated as a fundamentally legal/institutional reform project rather than a purely ‘economic’ one (Rittich 2004:206).

As a consequence, legal reform in a general sense – encompassing respect for the rule of law, institutional creation and the recognition of individual rights - has come to be seen as absolutely central to the achievement of development itself. Law therefore is not seen any more as a necessary precondition to market empowerment alone, but also as defining a ‘capable state’. The notion of a ‘capable state’ so prevalent in World Bank publications starting from the 1997 World Development Report implies a state that is not a direct provider of growth, but a partner, catalyst and facilitator. In order to keep an eye on social fundamentals, this capable state has, according to the World Bank, tasks additional to the usual list of market fundamentals. These tasks include the establishment of a foundation of law (Craig 2006:99).

However, in particular in the context of international development, a greater acceptance for law, and a
definition of the state as a ‘facilitator’ does not necessarily imply a greater acceptance of the state as a regulator. Commentators like David Kennedy note that the minimal state/ deregulating paradigm continues to be baseline common sense for development professionals with the result that laissez-faire remains a potent default proposal when governments are thought inept (Kennedy 2006:151). For example, while projects to promote the rule of law stress the commitment to equality, fairness, transparency, accountability, consistency and predictability, there is still a lack of specific means to achieve these objectives. While there is recognition that development requires more law, there is still doubt as to what role the state should play. The persistent desire to set outer limits to legal regulation has shifted the focus away from the state to non-regulatory and so-called mixed modes of governance so far as the achievement of social objectives is concerned. This is reflected in the emphasis on non governmental organisations, civil society and ‘soft’ forms of regulation.

However, the Bank, like other international financial institutions, has not altered to date its original position that the state ought to intervene as little as possible in the market and that market inefficiencies are more easily dealt with than state capture and corruption. This view serves to place limits on both the reach and purposes of legal reform, as the presumption of government failure often undercuts the case for state intervention even where it might otherwise be warranted in order to enhance efficiency. Consequently, even though there appears to be a shift in attitudes towards the role of law, the shift is limited by continuing scepticism about the state’s capacity to intervene effectively and a continuing belief that state interventions should be kept to a minimum. After all, the position of international organisations still is that growth is more likely to result from deregulation and liberalisation that encourage foreign investment rather than from government sponsored development policies, despite all the evidence to the contrary (Rittich 2004) and despite the historical link between deregulation and financial instability. This perception appears to even have survived the major failures of ‘light touch’ regulation in the banking and finance sectors in 2007-2008 as is evidenced from the insistence of the UK and US governments to seek private sector solutions wherever possible instead of nationalisation as a response to problems of solvency in banks. An example is the takeover of HBOS by Lloyds TSB in the UK in 2008, chosen as a superior way to rescue HBOS than nationalisation. Arguments put forward included the surreal suggestion that the government could not possibly find the ‘talent’ to run the bank if it were nationalised, so it was better to allow those who had proven their incompetence by bankrupting it, to continue to run it.

The debate as to the role of the state in the regulation of the economy however is not just a matter for law and economics. Regulatory interventions, or the lack thereof, can have severe consequences on the political economy of a state and changing popular perceptions of the functions of law can have direct effects on the democratic legitimacy of institutions. The substitution of state regulation by independent regulators is an example of the effects of depoliticisation of economic decision making on perceptions of legitimacy. Independent non-state regulators are meant to achieve the aims of market support without abandoning the (until recently) dominant perception of the market as self regulating. The creation of allegedly non political, independent institutions however means institutions isolated from the political and by extension democratic process. The European Central Bank (ECB) for example prides itself in not seeking or taking instructions from European Community institutions or bodies, from any government of an EU Member State or from any other body, in determining its price stability policies. Considering however the effect on the economy that the setting of interest rates has (or had before they reached the nominal levels of 2009) some degree of political input in the Bank’s decision making would be at least desirable, if not required. The institutional independence of the ECB does not improve public perceptions of the EU as a democratically deficient structure. Institutional independence therefore can have severe consequences on perceptions of legitimacy and on the link between democratic decision making and economic policy. At times of severe economic crisis and recession, selecting types of self regulation over political control can be a particularly politically dangerous route to follow.

The two most prominent features in programmes to promote institutional independence historically have been central bank independence and judicial independence. As suggested above, using the example of the ECB, central bank independence ensures that monetary policy is determined solely by ‘economic’ concerns. This ensures the pursuit of policies deemed good for the ‘investment climate’. It also,
however, dis-empowers governments; they are less able to control the economy or to pursue expansionary economic policies and wider social objectives (Watson 2002). It further contributes to the growing distance between the public and the political process. When elected representatives are unwilling or unable to deal with fundamental economic issues, there can often seem to be little difference between democratic and authoritarian government. This in turn creates a legitimacy vacuum which can damage people's belief in democracy. Further reforms aimed at addressing these problems often create a new set of difficulties, not least because they usually seek to build on structures which are little respected – such as, for example, the newly created and distributed property rights in post soviet states like Russia (Glinavos 2007). This risks a downward spiral that affects legal and institutional structures alike.

One legal reform meant to increase transparency and legitimacy is the creation of judicial systems distinct from executive power. The promotion of an independent judiciary as the solution to legitimacy problems however raises a new set of difficulties, as mentioned above. The main attraction of an independent judiciary in the international development setting is its ability to act as a check on the state and to constraint political interventions in the operation of private property rights. Within the constitutional framework of a capitalist state where the protection of property rights is elevated to a fundamental human and constitutional right -and becomes the principal goal of policy- a judicial system which is separate and distinct from the executive can help to ensure that alterations to the political regime do not affect the economic status quo. This also can be seen as a major political liability in times of crisis.

Overall, we can conclude that while there has been greater acceptance for law and regulation since the mid nineties, this has not yet taken the form of a wholesale change of attitude towards the role of the state in a free market. The dominant free market and deregulatory policy direction established in the 1980s in the US and the UK has survived modifications to perceptions of the state market relationship. What has emerged is an acceptance of law with a market supporting function beyond the establishment of a few market fundamentals, and an acceptance of the need for politically independent regulators. What has not emerged is an acceptance of the state as market regulator with a wide ambit. The current crisis will test this conclusion, but the initial reactions from governments suggest an acceptance of regulation from the same set of politically independent institutions, not a direct assumption from the state of an overseeing role over the economy.

The following section presents current and emerging regulatory responses to the credit crunch and the ensuing global recession.

**Regulatory Responses to the Credit Crunch**

Initial regulatory responses to the credit crunch seemed to share on the level of rhetoric, at least, the rationale behind the post 1929 changes. There seemed to be an expectation that governments would use law as a shield against future collapses. Apart from the uses of regulation as an immediate response to current problems, like the control of tax havens for example, what is still in 2009 foremost in the political agenda, is an effort to create on an international level safeguards against repeats of the present situation. This means that emerging regulation aims to prevent conditions that gave rise to the excessive and irresponsible lending that led to the credit crunch from reappearing. In this environment a rapid theoretical shift is ripe to take place, like it happened with the Roosevelt administration, away from market led solutions and laissez faire. While no desire to a return to state directed development is yet expressed, it is difficult to predict the consequences of the current trend towards re-regulation. As the shock of the collapse in the autumn of 2008 settled however, and developed economies prepared for a prolonged recession, public pronouncements in favour of concentrated changes to the way capitalism operates receded.

It is now generally recognised that the financial crisis of 2007-2008 was caused by excessive borrowing, excessive lending and excessive investment incentivised by a series of significant economic
and regulatory factors. Excessive borrowing and lending most directly arose in the context of the market for subprime residential mortgages in the United States, especially during 2005 and 2006. These excesses however, were not limited to the United States. They were reflections of global trends impacting almost every market and asset class (Arner 2009:2). By the end of 2006, real estate prices in the United States and a series of other developed countries had reached unsustainable levels. As central banks around the world began to raise interest rates to pre-empt inflationary pressures, weaker residential mortgage borrowers in the United States began to have difficulties meeting their obligations, and defaults on loans began to increase. At the same time, as the rate of new borrowers dropped, real estate prices began to decrease rapidly, triggering a downward spiral which ultimately impacted on most asset classes and lead ultimately to the systemic crisis in the U.S. and global financial systems of September and October 2008.

While the evolving crisis contained a series of potential risks to the real economy stemming from a collapse of confidence or a loss of value in substantial portions of the financial system (known as systemic risk), it was the bankruptcy of Lehman Brothers on 15 September 2008 which finally triggered a systemic financial crisis in the United States, causing a crisis in the financial system that is serious enough to have significant adverse effects on the economy as a whole. The US crisis in turn triggered a global financial crisis in the autumn of 2008. As a result of the crisis, the governments of the United States, the European Union and Switzerland, among others, were forced to intervene dramatically in order to prevent the financial crisis from becoming a financial collapse, that would have major adverse economic consequences capable of causing a prolonged recession and even a depression like that of the 1930s. It was this systemic financial crisis in 2008 that highlighted the need for significant changes in both domestic and global financial regulation to prevent future systemic financial crises (Arner 2009:8).

The current crisis is therefore interpreted as an opportunity to improve regulation and supervision. For example the OECD argues that the financial crisis has shown the need to strengthen financial market regulation, while however, resisting any temptation to revert to a too conservative banking system (Furceri 2009:41). The tendency is thus to address this crisis not by rethinking the purposes and reach of state power, but through the formal market-enhancing institutions of banking. By adopting the language of institutional economics, responses to the crisis therefore run the risk of failing to address the underlying social relations of power that shape changes to economic institutions (Marois 2009: 7). As Gerard Greenfeld (Panitch 2004) argues, there is a need to move beyond institutions and policy to examine underlying power relations and structures.

The commitments made by World leaders in the G20 (namely to take whatever action is necessary to stabilise financial markets and enable families and businesses to get through the recession; to reform and strengthen the global financial and economic system to restore confidence and trust; to put the global economy on track for sustainable growth) intend to rescue global capitalism and the place of finance therein and do not constitute a radical rethink of the state-market relationship akin to the one represented by the New Deal in the 1930s. Gordon Brown at the end of the G20 summit in London in April 2009 summarised the outcomes of the meeting highlighting the decision to reform the international financial institutions to overcome this crisis and prevent future ones, the need to promote global trade and investment and reject protectionism, to underpin prosperity. Principles to reform the global banking system agreed in the G20 included bringing the shadow banking system, including hedge funds, within the global regulatory net, new international accounting standards, regulation of credit rating agencies and a commitment to end tax havens that do not transfer information on request.

The summit communique stated that strengthened regulation and supervision must promote propriety, integrity and transparency, guard against risk across the financial system, dampen rather than amplify the financial and economic cycle, reduce reliance on inappropriately risky sources of financing and discourage excessive risk-taking. Regulators and supervisors it claimed must protect consumers and investors, support market discipline, avoid adverse impacts on other countries, reduce the scope for regulatory arbitrage, support competition and dynamism, and keep pace with innovation in the marketplace. It is clear therefore that more regulation is to be expected, at least to the extent that regulation and oversight will extend to all systemically important financial institutions, instruments and markets, including, for the first time, systemically important hedge funds. Also, some regulation over
levels of pay is now endorsed via the Financial Stability Forum’s (FSF) new principles on pay and compensation. These principles are meant to be implemented by firms and will be reinforced through supervisory examination and intervention at the national level. Authorities, working with the FSF are meant to ensure coordination and consistency of approaches across jurisdictions. The principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. They are not intended to prescribe particular designs or levels of individual compensation. However, as the principles aim to prevent compensation packages that encourage dangerous risk taking, they are not intended to address inequalities in compensation within and between firms and are not concerned about distributing corporate gains more equitably between employees. This is a small indication that responses to the causes of the credit crunch deal with making the existing system more efficient and stable, instead of addressing wider concerns touching on the legitimacy and equality effects of financial capitalism.

The G20 also agreed on the importance of resisting protectionism and promoting global trade and investment. Reinvigorating world trade and investment is essential for restoring global growth, the summit communiqué stated, and stressed that the world will not repeat the historic mistakes of protectionism of previous eras. The role of the IMF is to be crucial in the effort to restore growth by revising conditionality for its loans. Whether this will actually happen remains to be seen, especially considering the record of the IMF in pushing liberalisation, even after it claimed to have abandoned the policies of structural adjustment of the 1980s and 1990s (Onis 2006). The desire of the governments of the developed world to resist nationalisation, even when large financial institutions failed spectacularly and had to be rescued with public money, suggests that the trend towards private sector solutions is not seriously undermined by the rhetorical embrace of better regulation. The unfortunate consequence however of using the public purse in supporting the private sector, while allowing the private sector to reap the benefits where they occur, is that as many have stated over the last couple of years we find ourselves in a situation that losses are socialised while gains remain private, otherwise known in the worlds of Gore Vidal as socialism for the rich and capitalism for the poor (Reich 2008).

Overall, regulatory responses in the UK and the United States following the credit crunch, as well as the declarations of the G20 fail to give a clear picture as to a shift away from the market liberalising imperatives of the last two decades. Yes, regulation is meant to reach more areas of market activity. Yes, international financial institutions are meant to have regard to the social consequences of their actions. Yes, social responsiveness, sustainable development and legitimacy are present in policy communiques. Does this suggest a return of the state as the centre of regulation? Does this suggest an abandonment of the divide between politics and economics so carefully constructed during the depoliticisation decade of the nineties and the ‘independent institutions’ era that begun in the new century? The next session offers some thoughts in answering these questions.

Conclusion

The financial crisis that took the form of a looming global recession in 2008 has resulted in a sharp, but likely to be temporary, abandonment of what was considered till very recently economic orthodoxy. Very much like during the Great Depression, governments seem to have thrown away the free market textbook they had been carrying since the the early 1980s to do ‘whatever is necessary’ to prevent a massive collapse of free market capitalism in the developed world. Within such an apocalyptic environment, even the most strident advocates of laissez faire, now call for law to protect the market from itself. According to Robert Wade (2008), the efficient-market theory, which had justified the push for liberalisation, has been shown to be seriously deficient. If anything, the crisis shows the hazards of an economic growth model based on the growth of finance and housing, and on the international system’s tolerance of large external deficits. Competitive financial markets have generated temporarily profitable, but neither efficient nor stable financial markets. While the record of previous crises as discussed above shows that financial liberalisation is a leading indicator of future crisis, governments do not seem convinced that state-led law-enforced re-regulation is required. Re-regulation is unavoidable however when even sophisticated but light-touch regulatory systems, like the US one,
have been shown to be flawed in structure and functioning. Wade in fact suggests that some of the flaws are so obvious -like the conflicts of interest of the rating agencies- that one wonders why regulators did not act to correct them long ago. His answer is that the gigantic profits made in the financial industry prevented governments from reining in the market while the 'party' was in progress (Wade 2008:49-50).

It is also debatable whether public announcements from world leaders hinting to an abandonment of laissez faire will translate into concrete policy. It is important to remember that previous recent crises, like the recessions at the beginning of the nineties and at the beginning of the new century, while they have served to temper market fundamentalism with the growing influence of institutional economics, and via a renewed attention to something called 'the rule of law', they have failed to bring about a reversal to a largely constant deregulatory trend. Also, perceptions of the state-market relationship have not yet undergone a sea-change, like in the 1930s. It is entirely possible therefore, that while the credit crunch has offered concrete evidence of failures of laissez faire and of serious weaknesses in our current perceptions of the role of law and the role of the state in the economy, policy makers will attempt a return to 'business as usual', shying away from a radical rethink of the direction and operation of modern capitalism, no matter how necessary.

Even assuming that states will use law to assume a more direct control over the parts of the economy that have failed during this crisis, it is debatable whether this will take the form a temporary fix, or whether it will herald a more permanent change. The problem is that any regulatory responses to this crisis that seek to create future safeguards run the risk of meeting the same fate as regulation post 1929. Depending on the extent of the damage done by this crisis, policy makers will have forgotten in 5, 10 or 30 years why safeguards were put in place, and will in time dismantle them. The question of regulation can be divided therefore between concerns about current action and a meta-point as to our view of the future. The question is, first, should law be used now to curtail the behaviour of market actors in the long term future, and if so, is it likely to be effective? If both questions are answered positively, meaning that the current crisis has unearthed weaknesses in capitalism that need to be addressed to ensure the survival of the system, and that sufficiently strong regulation can be embedded in the legal system in a way that it prevents deregulation in the long term -perhaps through its embedding in constitutional structures- is such regulation going to change the nature of capitalism? To frame the question in a different way, even if greater involvement of the state in the economy is needed now to help avoid the repeat of financial meltdowns in the future, will it lead to a more democratically, ethically and socially acceptable version of capitalism? Or, is the current practice of entrusting regulation to politically independent, and democratically immune institutions likely to continue? Recent experience has shown that the independent central banks and independent judiciaries charged with preserving the status quo and effecting the separation of politics from economics, so trusted by liberal theorists, are at best ineffective at times of grave economic crisis. At worst, independent institutions can serve to undermine the legitimacy of democratic politics at times of crisis and open the way for an even less representative and responsive version of capitalism than the one operating today.

If a preference for market solutions survives this crisis, as seems to be the case currently, any regulatory intervention on the sidelines of a market dominated economy is likely to fail in the long term. Unless the credit crunch opens up debate about the nature of the state-market relationship, the role of law and regulation in the economy, and the relationship of democratic choice to market freedoms, any regulatory interventions now are likely to follow the trajectory of Depression era legislation. They are in other words likely to constrain behaviour while memories of the crash are still fresh, but fade into insignificance for the next generation allowing another round of deregulation to pave the way for the next systemic crisis in capitalism.

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