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PANEL SESSION:
"FINANCIALIZED ECONOMY, IMBALANCES AND PUBLIC ACTION IN THE AGE OF UNCERTAINTY AND SYSTEMIC CRISIS"

STABILIZING ENDOGENOUS INSTABILITY: A CONTRADICTION IN TERMS? PROPOSALS FOR AN INSTITUTIONALIST REFORM OF FINANCIAL REGULATION

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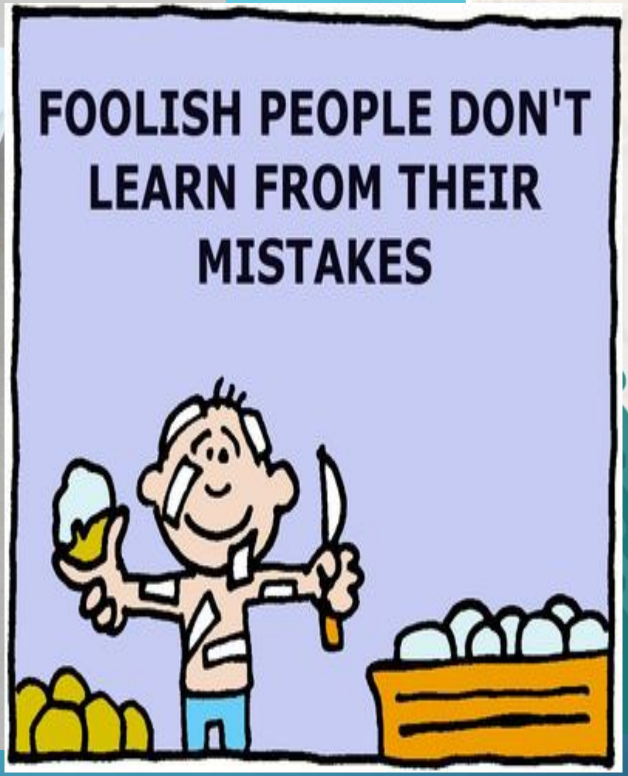

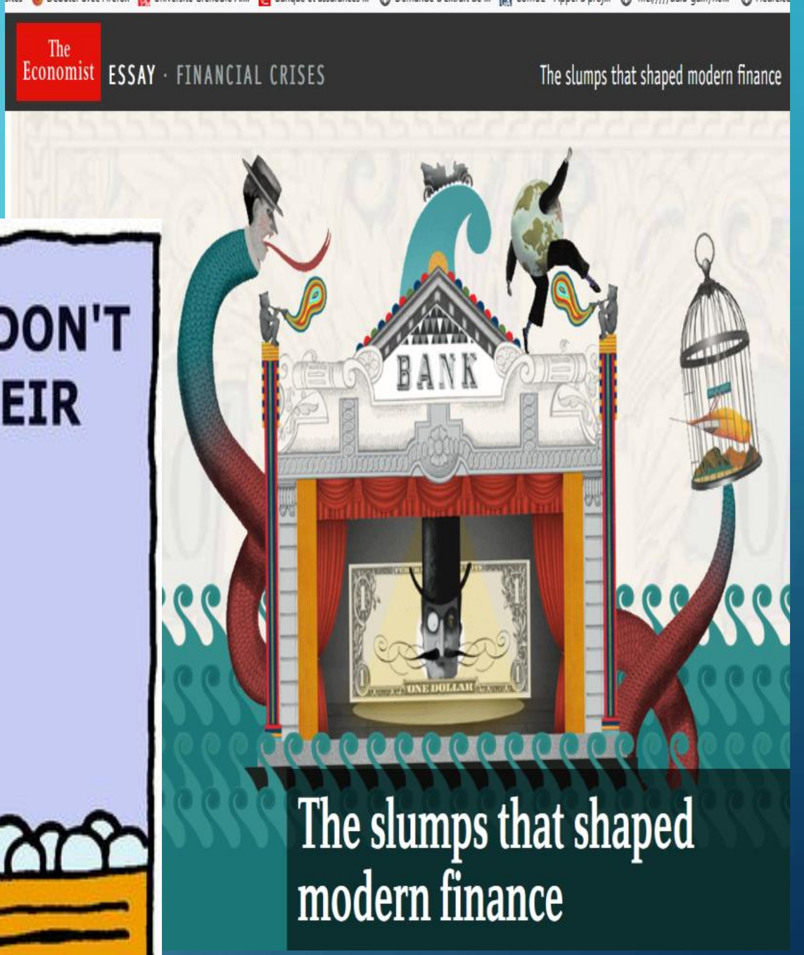

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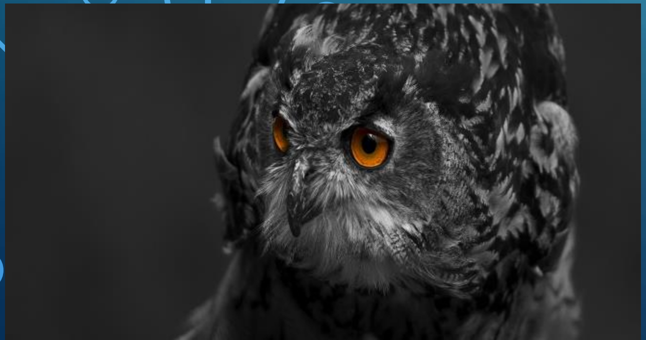
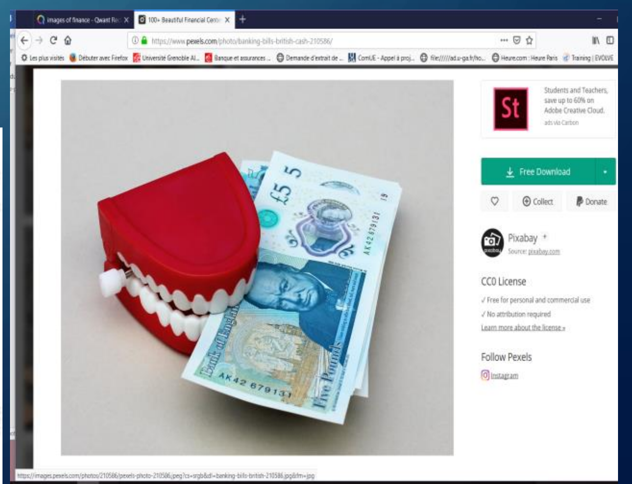




WORK PLAN

1. Some crucial observations about financialization
2. Characteristics of a monetary economy and financial paradox (Finance as a double-edged sword)
3. How to deal with the recurrent instabilities? An alternative financial regulation framework

1. Some crucial observations about financialization

- Observations:

Recurrent crises of financialized economies since the 1990s raise doubts as to whether the liberalized financial markets are apt to allow economies to evolve on a sustainable macro stable path.

- Context:

Financialization of economies enlarged uncertainties that have huge impacts on the final (mal)adjustment of economic imbalances.

Dominant beliefs in support of financialization :

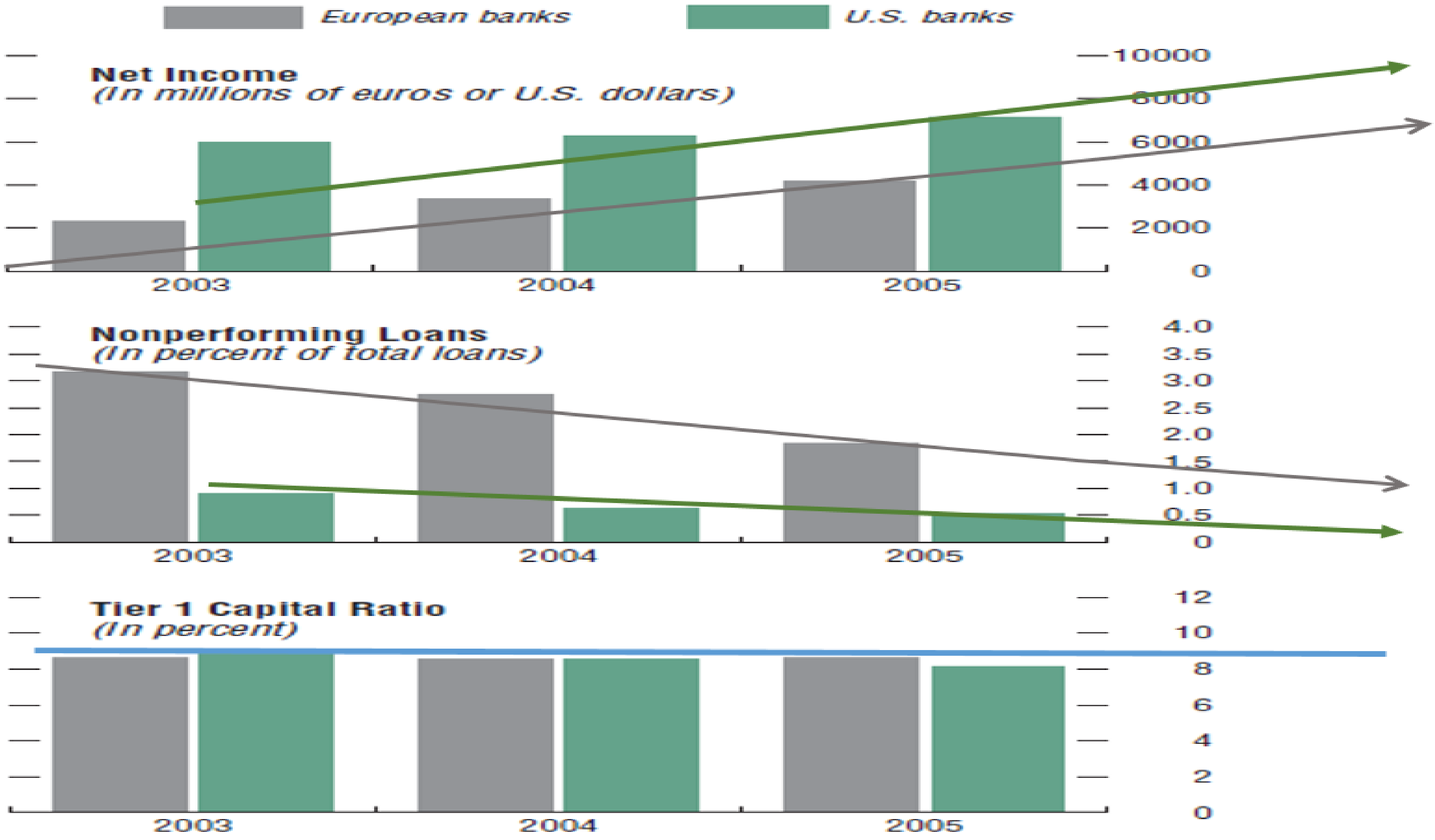
In its *Global Financial Stability Report* (GFSR) of April 2006, more than one year before the beginning of the 2007-2008 financial turmoil, the IMF maintains that:

"the global financial system recovered from various shocks, including the bursting of the equity bubble in 2000–01 and the debt crises in a few emerging market (EM) countries".

The IMF then argues that structural changes have made financial intermediaries much stronger:

"The positive assessment contained in the September 2005 GFSR that "the global financial system has yet again gathered strength and resilience" has been validated by recent developments." (p. 1).

Figure 1.1. Financial Indicators for U.S. and European Banks



Source: IMF staff estimates.

NB: Curves added by the Author.

- Asserting that “globalization and financial innovations have advanced the scope for capital markets to channel credit to various users in the economy” (Ibid.), the IMF report asserts that “A wider dispersion of credit risk has “derisked” the banking sector” (Ibid.) even though it also points to some risks and challenges that would include a lower level of information about “the distribution of risk to and among the nonbank financial institutions, which increases the potential for unpleasant surprises from the less regulated market segments.” (Ibid.)
- Greenspan (2005) argued that: “These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago”.

If these facts do not provide authorities with relevant information about the soundness of the financial system,

What alternative analysis?

➔Focusing on the monetary characteristics of a capitalist economy

➔Drawing upon the institutionalist understanding of how a capitalist economy operates (financialization and systemic stability)

Core assertion:

Financial self-regulation that rests on market incentives often results in macro instabilities that threat the viability of the entire economy.

• **VALUE ADDED:**

PROPOSALS FOR STRUCTURAL CHANGES IN FINANCIAL REGULATION AS A SERIOUS ALTERNATIVE TO NEOLIBERAL ECONOMICS.

Proposal:

Public authorities should frame an *EXTRA-MARKET PREVENTIVE FINANCIAL REGULATION* through the rule of precaution as a relevant policy guide in the cases where significant societal damage may occur.

A classical problematic: Financial stability is a public good that could not produced by the market mechanisms (Societal advantages>private returns)

2. CHARACTERISTICS OF A MONETARY ECONOMY AND FINANCIAL PARADOX

WHAT IS MONEY? A "THING"? A PHYSICAL/CHEMICAL STUFF? A TECHNICAL TOOL? A FACILITATOR OF REAL EXCHANGES? NONE OF THAT!!!!!!!!!

- DECENTRALIZED INDIVIDUAL DECISIONS AND MARKET-BASED MONETARY ECONOMY WORKS THROUGH A *PAYMENTS SYSTEM*

- ***PAYMENTS SYSTEM = MONETARY SYSTEM:***

A SET OF RULES, MECHANISMS, LAWS, INSTITUTIONS (PUBLIC/PRIVATE) WHICH GOVERN THE PROCESS OF:

1) CREATION/ISSUANCE;
2) CIRCULATION/TERMS OF USE;
3) ANNULMENT (REIMBURSEMENT/REPAYMENT) *OF PRIVATE DEBTS that rest on decentralized private individuals' expectations about an uncertain- future.*

- ➔ THOSE DEBTS COME FROM THE FINANCING PROCESS OF ENTREPRENEURIAL EXPECTATIONS (mainly) BY BANK CREDIT
- ➔ THEY CONTINUOUSLY FLOW INTO THE ENTIRE ECONOMY AS GENERAL MEANS OF PAYMENT AND SETTLEMENT:
- ➔ i.e. AS MONEY WITH GENERAL PURCHASING AND DEBT-SETTLEMENT POWER (SOCIETY-WIDE ACCEPTANCE/USE)
- ➔ HENCE MONEY APPEARS TO BE A SOCIAL INSTITUTION BUT AT THE SAME TIME IT RELIES ON PRIVATE (DEBT) OPERATIONS SINCE IT COMES INTO THE PICTURE THROUGH THE PRIVATE FINANCING PROCESS.

THEREFORE MONEY IS AMBIVALENT AND TRANSVERSAL

→ Ambivalent:

Money is a private creation (individual, decentralized, private decision and action system);

BUT at the same time,

Money has a pure public character (Money is also THE general means of settlement).

→ Transversal:

Everything and everyone are everywhere directly/indirectly involved in monetary (debt) relations and then affected more or less by the evolution of money and financial markets.

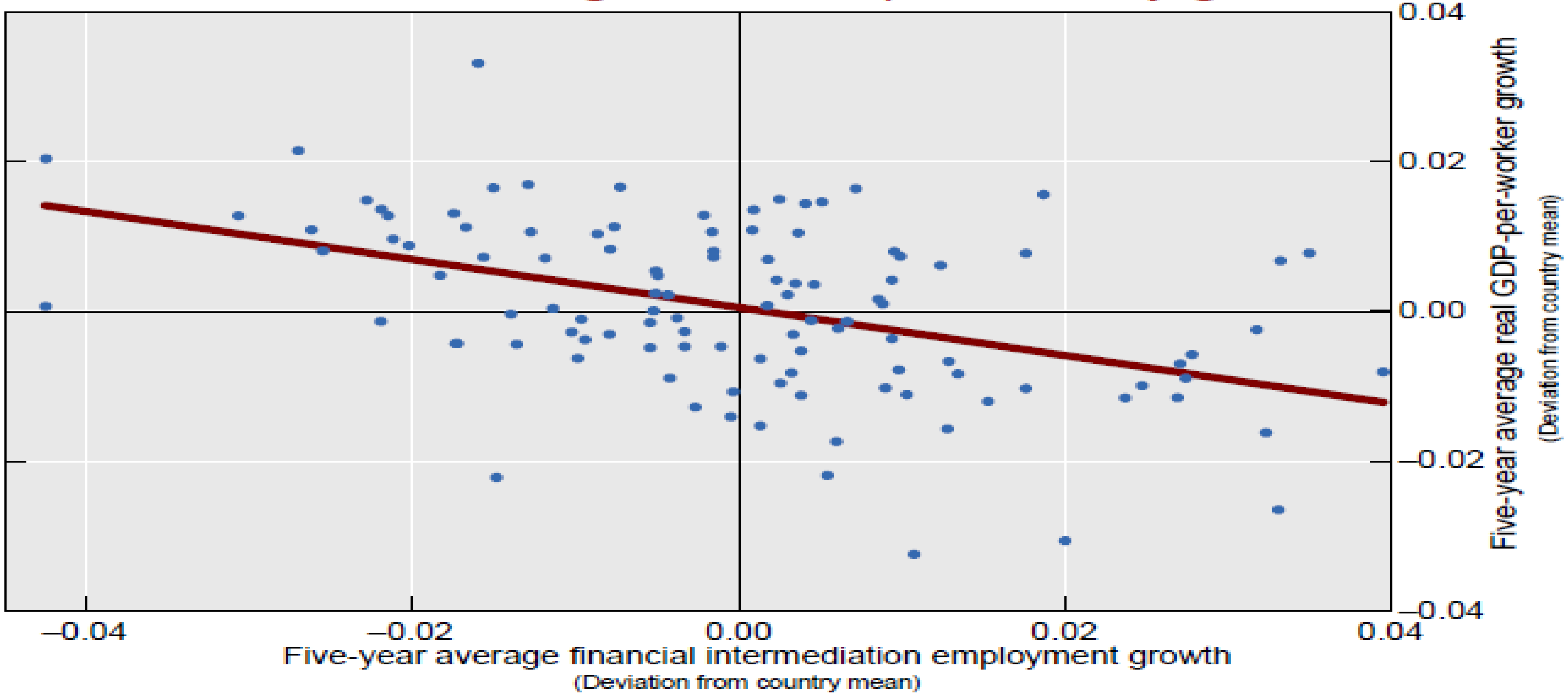
FINANCE AS A DOUBLE-EDGED SWORD

→ **Capitalist accumulation needs finance (bank credit, financial markets funding)**

→ **But at the same time when financial markets become free of any related real economy need and inflate through a speculative expansion of returns, capitalism collapses.**

- "First, the growth of a country's financial system is a drag on productivity growth. That is, **higher growth in the financial sector reduces real growth**. In other words, **financial booms are not, in general, growth-enhancing, likely because the financial sector competes with the rest of the economy for resources**. Second, using sectoral data, we examine the distributional nature of this effect and find that credit booms harm what we normally think of as the engines for growth – those that are more R&D intensive. This evidence, together with recent experience during the financial crisis, leads us to conclude that there is a pressing need to reassess the relationship of finance and real growth in modern economic systems." (Cecchetti and Kharroubi, 2015: 24).
- See Figure below (Ibid, p.2)

Graph 1
Financial sector growth and productivity growth[1]



[1] Graphical representation of $\Delta y_{i,t+5,t} = \alpha_i + \gamma\Delta fd_{i,t+5,t} - \delta y_{i,t} + \varepsilon_{i,t}$ for a sample of countries over the period 1980–2009, where $y_{i,t}$ is the log of output per worker in country i in year t; $\Delta y_{i,t+5,t}$ is the average growth in output per worker in country i from time t to $t+5$; $\Delta fd_{i,t+5,t}$ is the average growth in financial intermediation employment share in country i from time t to $t+5$; β_i is a vector of country dummies; and $\varepsilon_{i,t}$ is a residual. Country sample: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Korea, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

Sources: Cecchetti and Kharroubi (2012), Graph 5.

Unfortunately, this has not been admitted before the 2007-2008 world-wide turmoil since the system-makers did repeatedly asserted the advantages of free financial markets.

Policies implemented from the late 1970s resulted in a generalized financialization of major economies.

FINANCIALIZATION:

*** A "pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production." (Greta Krippner)**

*** The ascendancy of shareholder value as a mode of corporate governance or the growing dominance of market-based financial systems over bank-based financial systems (Gerald A. Epstein, 2006)**

* "the increasing dominance of the finance industry in the sum total of economic activity, of financial controllers in the management of corporations, of financial assets among total assets, of marketised securities and particularly equities among financial assets, of the stock market as a market for corporate control in determining corporate strategies, and of fluctuations in the stock market as a determinant of business cycles" (Dore 2002)

*** Expanded role of financial motives, financial markets, financial actors and financial institutions in the operation of domestic and international economies.**

3. HOW TO DEAL WITH THE RECURRENT INSTABILITIES? AN ALTERNATIVE FINANCIAL REGULATION FRAMEWORK

A complex issue: how to design and to implement an alternative regulatory reform in a global economy somewhat controlled by large multinational financial firms that regards financial regulation as a set of constraints and restrictions and not as a relevant framework that would let them adopt healthy strategies in order to get back sustainable outcomes through time.

This issue is also related to the design good institutions that would be consistent with the characteristics and prerequisites of a given economic and financial system.

Institutions are the rules of the game of society or, more formally, the humanly devised constraints that shape human interactions. [. . .] Institutions reduce uncertainty by providing a structure to everyday life. They are a guide to human interaction, so that when we wish to greet friends on the street, drive an automobile, buy oranges, borrow money, form a business, bury our dead, or whatever, we know (or can learn easily) how to perform these tasks. (Douglas North, 1990: 3–4).

"Economic institutions determine the incentives of and the constraints on economic actors, and shape economic outcomes. As such, they are social decisions, chosen for their consequences. Because different groups and individuals typically benefit from different economic institutions, there is generally a conflict over these social choices, ultimately resolved in favor of groups with greater political power." (Acemoglu et al. *2005: 386-387*).

What is it?

An alternative regulation should be a set of incentives-sanction mechanisms that should rely on slow-motion financial innovations that would be tested and checked before a possible system-wide implementation.

This could prevent financial markets' dynamics from generating huge imbalances and accumulated risks and reduce the likelihood of fast chain reactions in markets that often result in systemic crises.

This would require a specific and reformed institutional framework able to permit a tight public supervision and regulation that could shape financial markets' strategies so as to ensure macro-stability and societal viability.

What an alternative financial regulation should sound like?

- From an institutionalist perspective, it is obvious that a relevant and systemically consistent regulation should be relying on public institutions that seek at framing financial markets to lead them to adopt macro-coherent behavior.

- The latter means that market working must be compatible with the characteristics of a capitalist economy and its monetary and financial mechanisms.

- As the latter, usually, display by their own nature unstable evolutionary dynamics (see Hyman Minsky's *financial instability hypothesis*, a coherent organization of financial markets requires specific extra-market institutions (agencies, tools, mechanisms) that must seek to design and implement rules in order to increase the likelihood of systemic viability.

SOME DIRECTIONS

1. Publicness of financial stability

Public goods (a specific neoclassical concept that might be meaningful to think of the market malfunctioning):

Public goods belong to those cases of market failures that often call for public intervention (Sobel, 2004).

Two distinct criteria can be used to assess the publicness of an economic variable:

1) Non-excludability and non-rivalry of the good (Samuelson 1954, Musgrave 1959, Olson 1965, among others)

2) Societal criticalness of the need for such goods that cannot be efficiently addressed by private optimization plans.

Musgrave (1959: 44): a public good: whose inherent quality requires public production.

Ostrom (1990, 2003: individuals would all benefit from the provision of but cannot realize it at their individual level given its production costs.

When it comes to global issues, in an interdependent world: “if problems arise for **global public goods**, such as global warming or nuclear proliferation, there is no market or government mechanism that contains both political means and appropriate incentives to implement an efficient outcome. Markets can work wonders, but they routinely fail to solve the problems caused by global public goods.” (Nordhaus, 2010: 1)

The solution relies then on the possibility of collective provision-collective action of the good/activity but raises the question of how to do it in a relevant manner to give the expected results.

2. The concept: Macro-prudential regulation

Macro-prudential regulation must be substituted for micro-regulation schemas ➔Macro-prudential regulation deals with: systemic risk and aims at limiting the likelihood of a generalized failure.

It regards system outcomes as endogenously determined by the overall markets while

➔Micro-prudential dimension considers those outcomes as exogenous to the individual institutions.

➔**Incompatibility between micro decisions and macro stability**

→ The former relies on individual institutions' freedom of action without relevant global view while

→ the latter requires non-market-dependent, tight and regular public supervision.

- 3. The proposal: THE PREVENTIVE ACTION

A Macro-prudential PREVENTIVE approach to financial regulation: that rests on forward regulation: ***players must provide the proof of harmlessness of their expected financial activities***

A no-private-interests-related checking process: ***regular reporting by public regulators under the supervision of nonmarket public authority*** in order to prevent confusion between the socially-needed-systemic-stability and profit-seeking-activities-related assessment procedures (for instances, private agencies' ratings and banks' internal ratings based procedures);

- **Prevention of conflicts of interests:** ***separation between regulator and regulatee*** (rating and advising activities must be insulated from each other and rating agencies must be prevented from confusing both activities).