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**Democracy, Law and Global Finance:
A legal and institutional perspective**

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A legal and institutional perspective**

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ABSTRACT

Finance has become more a problem than a solution to what the world most wants: socially inclusive growth. It has become a source of crises that threaten the development of the real economy. It has escaped accountability to democratic institutions and often helped, instead, to influence and corrupt them. Its potential to contribute to broad-based opportunity-expanding growth has been largely and massively squandered.

In this piece I seek to understand not only how this failure manifests itself in some of the major countries and regions of the world, but also, how it can be corrected.

The intellectual and policy response to the crisis in its American and European epicenters has almost entirely suppressed discussion of two themes of immense importance: the link between redistribution and recovery and the connection of finance to the real economy. My analysis recovers these suppressed themes by relating them to a third theme: the deficit of democratic accountability that lies at the root of many of these problems.

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Introduction: finance and the progressive imagination

Finance has become more a problem than a solution to what the world most wants: socially inclusive growth. It has become a source of crises that threaten the development of the real economy. It has escaped accountability to democratic institutions and often helped, instead, to influence and corrupt them. Its potential to contribute to broad-based opportunity-expanding growth has been largely and massively squandered.

In this piece and in a developing body of writing, I seek to understand not only how this failure manifests itself in some of the major countries and regions of the world, but also, how it can be corrected. One of the positive programmatic outcomes should be a toolbox of legal-institutional arrangements to use and organize finance in the service of socially inclusive growth.

These innovations do not amount to a confining, universal blueprint. They are nevertheless applicable, with suitable adjustments, to a wide range of contemporary economies. Moreover, we can develop them with conceptual and institutional materials that are already at hand, in contemporary experience. To identify these resources for legal and institutional innovation through comparative analysis, thus forms another goal of the intellectual agenda.

My method of analysis gives pride of place to institutional alternatives and innovations, expressed in the detailed materials of law. It is comparative law turned into a practice of micro-institutional analysis. We expand our sense of institutional alternatives as we begin to grasp the institutional variations already at hand. From small variations, we may begin to imagine larger variations, informed and inspired by a progressive programmatic imagination.

The intellectual and policy response to the crisis in its American and European epicenters has almost entirely suppressed discussion of two themes of immense importance: the link between redistribution and recovery and the connection of finance to the real economy. In the face of regressive redistribution, mass consumption came to rely increasingly on an extraordinary expansion of household debt (made possible in part by overvaluation of the housing stock as collateral).¹ Finance increased its size (as a proportion of GDP and as a drain on talent) while weakening rather than strengthening its service to the productive agenda of society.²

My analysis recovers these suppressed themes, in part by relating them to a third theme: the deficit of democratic accountability that lies at the root of many of these problems. Instead of being made accountable to democratic institutions, finance in the most advanced economies has gained inordinate political influence and become the star example of "capture" of government by powerful private interests. Corruption becomes then simply the most salient aspect of a whole system

¹ The use of credit as a surrogate for a real growth strategy has been criticized from different ideological perspectives. See, for example, Krippner (2011), Rajan (2010) and Turner (2014).

² See Greenword and Sharfstein (2013) and Philippon and Reshef (2013).

of collusion that undermines the vitality of democratic institutions, even as it squanders the potential for reform presented by the crisis.³

Such an account places familiar issues of corruption in a broader and more revealing, institutional context. It suggests both how and why transparency and accountability of finance within the economy require changes beyond the economy: in the constitutional organization of the state and in the legal organization of the surrounding society.⁴

The approach to law and finance

This project builds on earlier work in which I develop a new perspective on law and finance in the context of a broader view of the relation of finance to the real economy. Five ideas are central to this conception. These ideas may be summarized in the following manner:

1. The market economy does not have a single natural and necessary legal-institutional form. The form it now takes in the rich North Atlantic economies is inadequate to ensure the achievement of the widely professed goal of socially inclusive growth except when and where this goal has been accomplished by a long prior history of efforts to broaden economic and educational opportunity (e.g. the pre-history of Scandinavian social democracy). The institutional reorganization of finance and of its relation to the real economy should be understood as part of the larger project of reimagining and remaking the market economy.
2. Under present arrangements, finance readily becomes the master rather than the servant of the real economy and lays itself open to recurrent booms and busts.
3. The present arrangements can be reformed in ways that more effectively put finance at the service of the productive agenda of society.
4. The regulation of finance can and should be designed as an initial move in such an institutional reshaping.
5. The fifth idea is that neoclassical and Keynesian conceptions are inadequate guides to the execution of this task. We can find in law and legal thought many of the intellectual and practical tools that we need. The reason is straightforward. The ways of organizing a market economy now on offer in the world exist as a legal repertory; the detailed institutional alternatives exist as legal alternatives. Thus, the expansion of the repertory must take the

³ For explanations emphasizing the problem of regulatory capture, see Johnson (2009) and Johnson and Qwak (2010).

⁴ See Lothian (2012 a) and references cited therein.

form of institutional alternatives that are alternatives expressed in law. Existing and historical variations in the organization of the market economy, and in the relation of finance to the real economy, in particular, provide possible points of departure for the design and construction of the kinds of arrangements we need to secure socially inclusive growth.

Structure and democracy: the theoretical horizon

The basic thesis explored in this essay is the centrality of structure and structural variation. By structure, I mean the basic arrangements and ideas that shape different areas of social organization. By structural alternatives, I mean largely institutional alternatives and alternative ways of thinking about institutions.

The idea of structure in social life has traditionally been associated with the idea of a blueprint, either a universal or local blueprint. But this association is unnecessary. Structural alternatives do not come as pre-packaged sets of ideas and arrangements. Programmatic thinking does not involve pre-defining all possible worlds and trajectories of reform. What matters is the direction and the first steps, given the material at hand.

My working assumption is that the relevant legal-institutional structure needs to be depicted at a much greater level of detail or concreteness than that associated with the traditional ideological debate.⁵ At this level, it ceases to appear as a recurrent and indivisible type, which conforms to certain laws of change and has a preset Institutional content.⁶

A structure, in the sense assumed in this essay, can exert a decisive influence and be recalcitrant to change and nevertheless represent a hodgepodge, capable of being explained only in the light of its particular history, full of accident and suppressed transformative opportunity.

Two main corollaries flow from this idea. The first corollary is that structural understanding and reform is path dependent. It depends on the existing repertory of institutional ideas already established, either in our own experience, or in experience known to us, whether through contemporary or historical knowledge. These materials serve as points of departure for the development of programmatic proposals. The repertory of institutional alternatives develops through recombination and analogical extension.

The second corollary is that there needs to be a method, a practice or a process - experimentally to advance and reconstruct such alternatives, given the absence of a blueprint. That method is democracy.⁷

⁵ For a concrete illustration of this approach in the American setting, see Lothian (2010).

⁶ The approach to institutional innovation, transformation and structural change illustrated in this essay forms part of a larger movement of thought across the social sciences today. Examples include: Blyth (2002), Hall and Soskice (2001), Rodrik (2007), Streek (2009), and Streek and Thelen (2005).

⁷ The conception of democracy as a practice of institutional experimentation is developed further below. See also Lothian (2010) and (2012) (a). The theme of “democratic experimentalism” is given fullest expression in Unger (1998). See also Dorf and Sabel (1998).

From here, my argument advances in three simple steps: (1) A conception of the larger intellectual and practical issues at stake; (2) An analysis of two different experiences of financial crisis, regulation and reform from the standpoint of the conception and agenda outlined above; and (3) A working out of the implications of this conception and this analysis for the issue of financial regulation

Part 1

Elements of a conception

Finance is important, above all, because it represents the economic surplus used to build the future. Under present arrangements, this task is carried out imperfectly. There has been an enormous increase in financial activity in recent years. Yet little of this financial activity has contributed to the process of long-term savings, investment and growth. In advanced and developing countries, the vast bulk of productive investment still comes from retained earnings of firms. Traditional banks and securities markets continue to play an important role in the channeling of savings to firms and households. But the bulk of this external finance has had little or nothing to do with funding of resources for long-term investment.⁸

For a while, at least, it was possible to believe that this vast increase in financial activity helped to create the conditions for growth and increasing prosperity. Yet the financial crisis of 2007-2009 would reveal that few, if any, of the new modern markets had, in fact, functioned according to plan. Financial innovations would lead to concentration rather than diffusion of risk; privatization and deregulation would lead to involution rather than growth; and the policies and arrangements used by governments to stabilize and promote development would have only limited effect. This third point would be the most damning: growth and development claims associated with the universal project of the time – opening and integration of markets through a process of globalization and deregulation – had led to asset booms and busts, rather than any increase in the economy’s long-term growth potential.⁹

Two main views have informed the intellectual and policy response to the crisis. According to the dominant, neoclassical view, the problem lay in a series of localized market imperfections and in the failure of equally localized regulatory responses to these localized market imperfections. By redressing these localized market and regulatory failures, we can make private returns converge to social returns. According to this view, there was and is no systemic problem in the regulation of finance or in the organization of its relation to the real economy; only an ill-advised and long-standing relaxation of regulatory vigilance, particularly with respect to new markets in financial derivatives and to the shadow banking sector that proliferated alongside the standard, regulated banks.¹⁰

⁸ See sources listed in notes 3 and 4 above.

⁹ The empirical evidence is reviewed in Rodrik (2011) and in Schularick and Taylor (2012).

¹⁰ The basic tenets of the neoclassical position are described in FSA (2009) and in Schularick and Taylor (2009).

According to the second, “Keynes-Minsky” view, financial markets, and markets in general, were vulnerable to cycles of euphoria and despondency. There was a permanent danger that the oscillations of financial markets would amplify, rather than attenuate, the instability of the real economy. In this respect, the Keynes-Minsky position continued and magnified the psychological, anti-institutional bias of Anglo-American political economy. The task of regulation, according to this view, is to provide buffers and counterweights to dangerous disturbances of the financial markets, the better to attenuate cycles that we cannot hope fully to suppress or avoid because they are rooted in the bearing of certain psychological constraints on the workings of any market economy.¹¹

This piece takes a different view. I advance two ideas. The first idea is that the relation of finance to the real economy can and should be reshaped. The second idea is that the regulation of finance can and should be a first step toward reorganization of finance and the institutional structure of the financial system.

To appreciate the nature and significance of this alternative view – and the way it differs from the prevailing view and the prescription that view implies – consider its implications for the debate about regulation. According to the standard, neoclassical approach to regulatory policy in general and regulation of finance in particular, the aim of regulation is simply to redress the effects of localized market imperfections, the better to make private returns converge to social returns to economic activity.¹²

According to the second, Keynes-Minsky view, the problem is less one of localized market imperfections and constraints, and instead, a problem of the inherent tendency of the money economy to amplify cycles of despondency and euphoria. On this view, the role of the state is to build buffers and safeguards against the inherent instability of modern, market-oriented financial systems and the economies they are meant to serve.¹³

Excluded from these ways of thinking about finance and its regulation is the idea that there can be alternative ways of organizing the relation between finance and the real economy, as an initial step toward reorganizing the market economy as a whole.

By contrast, the view defended here begins and ends with a very different understanding of the central problem of finance. According to the alternative view, a financial crisis can never be fully explained in terms made popular by modern finance: i.e. as the result of a localized market imperfection or a localized failure in the regulatory response to a localized market failure. These are the terms provided by modern economics and finance theory. They are omnipresent and still in charge. Yet they are incapable of explaining the central facts of financial crises in the modern era.

The severity and course of financial crises are always shaped by their institutional settings. We should not think of this setting as “given” or fully determined by an abstract “institutional conception,” for example, the regulated

¹¹ Classic treatments may be found in Minsky (1986) and in Kindleberger and Aliber (2005).

¹² See Stigler (1971).

¹³ See Papadimitriou, D.B. and Wray, L.R. (eds.) (2010).

market economy or financial system. The arrangements governing the relation between finance and the real economy can take radically different directions. In some of these directions, the arrangements loosen the link between finance and the real economy. In other directions, the arrangements tighten this relation.¹⁴

The present arrangements governing the relation of finance and the real economy produce a result that is only apparently paradoxical. Finance remains relatively indifferent to the real economy in good times: the vast amount of capital assembled in all the capital markets in all the major economies of the world bears an oblique relation to the financing of productive activity. Yet major disturbances do arise within finance. They arise all the more readily because the ties of finance to the real economy remain so loose, not just because of the swings of euphoria and despondency; nor just because of the localized market and regulatory failures that have attracted so much attention. When they do arise, they can wreak havoc, as we have recently seen.

A key distinction presupposed by these claims is the contrast between financial hypertrophy and financial deepening. By financial deepening, I mean the increase of the service that finance renders to the expansion of productive output and the enhancement of productivity. By financial hypertrophy, I mean the expansion of the size of the financial industry, as a proportion of national income or profits as well as a magnet for talent, without a corresponding reinforcement of support for the expansion of output and the enhancement of productivity. The concept of financial hypertrophy, as I propose to use it, is therefore parasitic on the concept of financial deepening. Financial hypertrophy is the expansion of finance without financial deepening.¹⁵

This distinction would have limited significance if it merely described a psychological condition. But it is not a psychological condition. Whether and to what extent any given financial regime contributes to financial deepening or financial hypertrophy depends on the institutional setting. It is the setting that determines the balance between financial hypertrophy and financial deepening.

The point may be generalized. Keynes helped develop the idea that there are multiple, market-based equilibriums; some of them compatible with massive unemployment of resources (especially labor or employment). He also had an interest in the content and effect of institutional arrangements in particular areas of the market economy, including the stock market.¹⁶ Remarkably, however, neither he nor his successors connected the two themes. His interest in institutions and institutional alternatives was not generalized as a basis for thinking about the multiple equilibriums. As a result, mainstream thinking today would have little to say about the distinctive character of the US arrangements, or the contribution of these arrangements to the boom-bust cycle of debt-fueled asset speculation and

¹⁴ See Lothian (2012) (a) and (c).

¹⁵ The concept of financial hypertrophy is closely related to the idea of financialization, as developed, for example, in the work of post-Keynesians such as Epstein (2005) and Krippner (2011).

¹⁶ See Keynes (1936).

collapse that would characterize both the sub-prime crisis in the US (2007–2009) and the sovereign debt and banking crisis in Europe.¹⁷

This is the distinctive contribution I hope to make here. I do not reject the conventional understanding of the causal background to the crisis or the kinds of policies and arrangements that would be most useful in addressing the defects of the present order. I argue, however, that these arguments and ideas provide an inadequate basis on which to understand the content and course of the crisis and the contribution of historically specific policies and arrangements to the crisis.

Part 2

Theme and variation: A schematic comparative-historical contextualization of the theoretical argument

The best way both to develop and to support the way of thinking outlined in the first part of this essay is to suggest how it can inform a comparative-historical understanding of the transformation of finance in a number of contexts since the great world economic crisis of the 1930s.

I develop my argument through a comparison of two different sets of experiences of financial crisis, regulation and reform. I begin by presenting a schematic view of the genealogy of the crisis in the American setting. A central idea in my account is that the hollowing out of the New Deal arrangements in the closing decades of the 20th century, to the benefit of speculative finance and of the interests associated with it, produced a regime that was neither the social-democratic framework of the 20th century nor a coherent alternative to it. It was a hodgepodge created by a circumstantial evisceration of the New Deal regime.¹⁸

I then compare the American experience with a very different institutional approach to the organization of finance and financial regulation. I consider the situation of Brazil and the BRICs today under the aegis of a contemporary model of state capitalism. The relative success of the BRIC economies in weathering the global crisis of the past few years has sometimes been used to suggest that we do not need to look for an alternative approach to the management of finance and to its relation to the real economy. I argue here that the experience of the BRIC economies, although it provides lessons of great value, supplies no such alternative worthy of imitation.

¹⁷ The financialization of the American economy in the late 20th century permitted a progressive decoupling of finance from the productive agenda of society. This decoupling was powerfully assisted by two forces. One force was the preference for regulatory dualism, which allowed the emergence of the shadow banking system. The other force was the encouragement to expansion in household and corporate indebtedness as a surrogate for the redistribution of wealth and income in the maintenance of a high level of economic activity and a market in mass-consumption goods. Easy money policy and a tolerance for vast current account deficits operated as enabling conditions of these developments.

¹⁸ See Lothian (2012) (a) and (b).

Genealogy of the crisis in the American setting: Hollowing out of the New Deal Financial reforms to the benefit of speculative finance

When the financial crisis broke out in America in 2007, the institutional setting in which finance operated had degenerated into a ramshackle construction. (A similar evolution or involution took place in many of the other rich industrial democracies.) The New Deal arrangements for the governance of finance had been partly but not completely bent and gutted. They had been hollowed out, unevenly and discontinuously, in response to an alliance of powerful interests and ideas.

The interests were chiefly those of high finance. The more high finance succeeded in getting its way, the larger it grew and the weaker its links to the system of production became. It gained a degree of influence over government that led one mainstream economist to describe this influence as a *coup d'état*.¹⁹

The interests of high finance could not have made so powerful a dent on the New Deal regime for the governance of finance had they not been able to count on the support of prestigious economic ideas. Rational expectations doctrine, the efficient market hypothesis, and real business cycle theory represented extreme, but influential, examples of an approach to theory and policy that derided the efficacy of many forms of financial regulation, including the forms to which the New Deal had given prominence, and that attacked the case for the para-statal entities—the GSE's—that the New Deal had crafted.

We cannot understand the influence exercised by these putatively "free-market" ideas unless we appreciate what they shared in common with the two major theoretical traditions in modern economics: the neoclassical and the Keynesian. What they shared with them was the conviction that problems arise from localized market failures and from localized failures in the regulatory response to such localized market failures. There are no systemic alternatives: that is, no alternative sets of institutional arrangements, detailed in law, for shaping the service that finance can render to production and, more generally, no alternative ways of organizing, in institutional detail, a market economy. I develop my argument in this piece from a perspective contradicting this key and almost universally shared assumption, although I contradict it here in a way that remains fragmentary and half-explicit and goes only so far as my thesis and topic require.

The outcome of this loose but powerful alliance between financial interests and economic ideas was not, however, the total overthrow of the New Deal system in finance. It was its partial evisceration and its juxtaposition with policies, practices, and institutions that ran in a direction opposite to the goals of the New Dealers. What resulted was not the replacement of one system by another; it was a gingerbread construction, a crazy quilt of compromise and concession.

There was nevertheless a method to this madness. The doctrinal and institutional disharmonies that ensued from this "bricolage" enabled finance to grow in a fashion that weakened its links to production and to the productive agenda of society rather than strengthening them. In the analytic categories central to this piece, financial hypertrophy came to prevail over financial deepening. Each of

¹⁹ Johnson, (2009).

the points I single out for attention in the next few pages represents a part of the road to the triumph of the former over the latter.²⁰

If the foreground theme of this institutional genealogy is the partial hollowing out of the New Deal framework, as a major source of our present predicament, the background theme is the interpretation of the goals and nature of that framework. It is a concern of more than antiquarian interest. We cannot and should not seek simply to repeat or to reinstate the work of the Rooseveltian reformers (or of their European counterparts). We must nevertheless learn from what they achieved as well as from they failed to accomplish.

The New Deal approach and its consequences

The New Deal, it has often been remarked, went through an evolution: it began as one project, or array of projects, and ended as another. We must understand this shift in order to appreciate its financial reforms. The early New Deal was characterized by bold albeit often half-baked institutional experiments in the reshaping of the market economy. Some of these experiments looked in the direction of corporatism, or of managed competition, pinning their hopes on new forms of coordination between governments and firms. Others used public works -- like the Hoover dam under the authority of the TVA -- to find new ways to broaden economic opportunity. They amounted to projects of social, not just physical, engineering.²¹

Almost all these experiments were struck down, politically or constitutionally, before they had a chance to either succeed or fail on their own merits. After their repudiation, the New Deal came to settle on a narrower focus of economic security and mass consumption. That was the orientation that became "normalized" after the Second World War.

The transformation of the New Deal agenda was not completed, however, before the astonishing and misunderstood interlude of the war economy. Under the provocation of a life-and-death threat to the country, the forced, large-scale mobilization of resources was combined with institutional experiments, even bolder and certainly more sustained, than those that had been tried out, half-heartedly in the early New Deal. However, the resulting innovations remained quarantined, as if pertinent only to the special circumstances of a nation at war.

Two features of this evolution deserve emphasis if we are correctly to understand both the nature and the limits of what the New Deal achieved in the domain of the governance of finance. First, the concern with economic insecurity resulted in the new system of federal deposit insurance and in the crystalline distinction (later to be attacked by the hollowers out) between governmentally insured deposit taking and proprietary trading in the finance industry. The savings of the individual were not to be placed at risk—at least not at uninsured risk—by bankers' bets. Second, the combination of a commitment to economic security with a commitment to the popularization of consumption opportunities prompted the

²⁰ See Lothian (2012) (a). See also Wilmarth (2002).

²¹ See Kennedy (1999), Russell (2008) and Rauchway (2008).

New Dealers to go further in the reorganization of the housing market than in their reform of any other aspect of the American economy. Finance was mobilized in the service of a chance for the working family to own a family home. One of the few institutional innovations of the New Deal to survive—the public-private GSEs (Fannie Mae first among them)—survived as instruments of this policy, until much later diverted to the service of speculative finance.

Two limitations of this achievement immediately stand out. The first limitation is that at no point did the New Deal advance toward institutional innovations designed to make finance more serviceable to production and to ensure the ascendancy of financial deepening over financial hypertrophy. The second limitation is that where the New Deal reforms went deepest—in the housing market and in the redesign of its legal-institutional framework—they went deep narrowly. The sector-specific character of the legal and institutional arrangements made them appear to be, and to be in fact, exceptions rather than instances of a broader institutional logic, depriving them of practical and doctrinal supports, and rendering them susceptible to reversal or perversion.

The purpose of this commentary on the background theme of the nature and limits of the New Deal program in finance is to state at the outset that this institutional genealogy should not be read as a lament over a lost paradise. The New Deal framework fails to provide a model for today. It was not good enough then, and it is certainly not good enough now. However, we cannot grasp our opportunities, of insight and of reform, without understanding both its accomplishments and its failures.

With these observations in mind, I now turn to my highly selective institutional genealogy: the analysis of certain changes that weakened the New Deal framework the better to sacrifice financial deepening to financial hypertrophy

Hollowing out of the New Deal reforms

Beginning in the decade of the 1970s, the legal framework for the regulation of finance was progressively eviscerated. At the same time, increasing inequality in income and wealth would lead policy-makers to rely on monetary ease and credit expansion as a surrogate for a strategy of socially inclusive growth and redistribution.²² Neither of these tendencies was insuperable. They formed no part of a systemic assault—or systemic alternative—to the social democratic settlement of the post-war era. The effect was substantial nonetheless. Financial deepening had in effect been sacrificed to financial hypertrophy.

Four key developments would contribute to this result:

Privatization of the GSEs and of the secondary mortgage market

²² This section draws heavily on Lothian (2012) (a). See also Kripper (2011), Picketty and Saez (2003), Rajan (2010), Tarullo (2009) and Turner (2014).

A first development was the hi-jacking of the mortgage market and its New Deal institutions and arrangements by speculative, private finance. This development took place in two steps. The first step consisted in the restructuring of the federally sponsored mortgage agencies and the introduction of securitization for GSE-sponsored mortgage pools.

The second step involved the development of “private-label securitization,” i.e., a parallel system for the origination, pooling and securitization of residential mortgages that failed to meet the standards established in the GSE segment of the market (thus, the name, “subprime” mortgage market.)

It is commonplace today to treat the outcome of this process as the natural and necessary counterpart to increasing complexity and sophistication. But this interpretation is clearly wrong. Even the slightest scratching of the historical record is enough to suggest the complex and contradictory process involved in the move from state-sponsored securitization to the highly speculative and, at times, even fraudulent process of private label securitization—which would be applied to great effect in the development of the subprime mortgage market.

The movement to privatize securitization fatally weakened the New Deal regime in the very sector—the housing market—in which it had advanced furthest in the attempt to combine its devotion to economic security for the individual with its interest in the expansion of his opportunities to consume. The GSEs were eventually transformed into instruments of speculative finance, as the secondary, asset-based mortgage market turned into the largest free-floating pool of resources on which the bankers could draw to keep doubling their bets and expanding the market for profitable (and unprofitable) trading opportunities.

The rise of shadow banking

A corollary to the privatization of securitization was the rise of shadow banking. This point is often overlooked. But it is of the utmost importance. In the US setting, the hollowing out of the New Deal arrangements in the area of mortgage finance would provide the context and occasion for the vast expansion of shadow banking. Shadow banking would, in turn, provide a stimulus for the hypertrophy of finance in the area of housing and mortgage finance.

Two major developments stand out: The first development was the emergence of new money and funding markets beyond the traditional banking system. Examples include: money market mutual funds; tri-party repo; and asset-backed commercial paper. The second development was the proliferation of non-bank financial intermediaries (“nbfi”), free from the New Deal regulatory restrictions, but nonetheless supported in many ways by monetary and regulatory authorities. In the US setting, finance companies, conduits and special purpose vehicles would come to define the new “shadow banking” system. But they were not alone. Together with leading broker/dealers and investment banks, the new intermediaries in the shadow banking system would come to dominate US credit markets.

The assumption of many traditional banking functions by the shadow banks illustrates two connected themes. The first, relatively more superficial theme is the damage done by the main strategy for the regulation of finance in the second half of the twentieth century: regulatory dualism, with its contrast between, a thickly and a thinly regulated sector of finance. Regulatory dualism was advanced on the ground that the high net worth individuals and financial professionals who populated what was to be the thinly regulated sector did not require a heavy-handed paternalism. However, the practical result was to make it possible to repackage—and to implement under different form—in the thinly regulated sector, everything prohibited in the thickly regulated sector. The shadow banking system served this purpose.

The second theme was the sacrifice of financial deepening to financial hypertrophy: size without productive function. The central point of shadow banking was always to expand the opportunity to profit from financial trades. It was never to enhance the funding of productive activity.

Imagine a legal test—simple in conception, although difficult in application—that would forbid or burden (with regulatory restraints and tax burdens) all financial transactions not plausibly useful to the expansion of GDP or to the enhancement of productivity in the economy. Under such a test, the vast majority of the transactions in which the shadow banking system has specialized would be outlawed or discouraged.

Creation of institutional links connecting shadow banking to the traditional banking system

Neither the hollowing out of the New Deal framework, nor the rise of shadow banking, would have, without more, created the conditions for the crisis of 2008. The amplification of the crisis, from a breakdown in the tiny sub-prime mortgage market to the breakdown in global markets was made possible by the rationalization and extension of a generalized system of regulatory dualism from the 1970s on.²³

We can understand this part of the historical trajectory as the combination of three simple steps.²⁴ (1) Elimination of regulatory restrictions on bank activities and affiliations; (2) Creation of new legal and institutional vehicles designed to facilitate the extension of credit from the traditional to the shadow banking sector; (3) Rationalization and integration of the new shadow-banking sector into a generalized system of regulatory dualism.

Nothing is more revealing of the dependence of finance on its institutional setting than this last, extraordinary development. It is commonplace to consider the rise and fall of the New Deal reforms as a natural and necessary process, responding to changing circumstance and the imperatives of objective, economic constraint.

²³ The concept of regulatory dualism is developed in Lothian (2012) (a) and (b).

²⁴ See Lothian (2012) (a).

But nothing could be further from the truth. The liberalization of the rules governing bank activities and affiliations, together with the creation of a new legal vehicle—the complex, multipurpose bank holding company—to rationalize and integrate commercial banking into the new system of market-oriented financial activity—would create the conditions for a shift in the balance between financial deepening and financial hypertrophy without rival in the world.

It would be wrong to treat these developments as the natural unfolding of a higher logic or rationality. At each step along the way, both in the design and in the defense of the emerging pattern of finance, government took the lead.

As the functional separation broke down, monetary and regulatory authorities crafted new forms of monetary and fiscal policy—to strengthen and support the financial sector, which would increasingly be seen as an entity in itself, rather than the servant of society or the public interest. The process culminated in the repeal of GS and the enactment of GBL in 1999, sanctioning the connection and providing through the device of the new bank holding company charter, a formal way to integrate and cross-subsidize all financial activities.

The point is simple and telling. The extraordinary scope and scale of the worldwide financial crisis was not—as so many have argued—the natural result of globalization or financial innovation in the banking sector. Nor are we able to understand the content and course of the crisis merely by reference to the inherent tendencies of modern financial markets. In the closing decades of the 20th century, the US government undertook a series of bold initiatives to construct the emerging order, in local and global markets.

It is difficult to underestimate the contribution of this set of policies and arrangements to both the phenomenon of leverage, instability and speculative risk-taking within the US banking system. Just as the crisis of 2007-2009 was primarily a first world banking crisis, so the standardization and integration of the shadow and formal banking systems would create a series of amplification or transmission devices—for speculative risks-taking and leverage in the US and global banking system.

Monetary ease and credit expansion as a surrogate for a strategy for socially inclusive growth

To understand the developments enumerated in the previous three elements of this schematic genealogy, it is necessary to place them in a broader context. The most important aspects of this context: the US failed to establish a viable strategy of broad-based, socially inclusive economic growth. It stopped producing enough of the goods and services that the rest of the world wanted.²⁵

Rather than confronting this problem, however, it tried to make up the shortfall through a debt-driven expansion of consumption, made possible by foreign money (the foreign capital inflows as the inverse to the ballooning trade deficit) and accommodating monetary policy (including the creation of paper money).

²⁵ See Duncan (2009).

It was like throwing kerosene on the flame. The hypertrophic financial system, already increasingly decoupled from the real economy by the hollowing out of the New Deal arrangements, now found almost unlimited opportunities in a circumstance of massive consumption-oriented liquidity and diminished regulatory vigilance.

The diminished regulatory vigilance helps explain the immediate triggers of the crisis. However, it is a mistake to suppose that the triggers had a causal efficacy independent of these deeper background factors.

In particular, many have argued that the crisis had localized and shallow causes: e.g. failures of judgment and regulation in the repo markets for certain classes of asset-backed securities. The fact that the sudden and massive expansion of trading in such securities was almost exactly paralleled by a similar expansion in the oldest and most conventional forms of finance (such as commercial paper) shows that these explanations are false.

The key to an understanding of the crisis lies in the interaction between the attempt to make up, through debt-sustained consumption, paper money expansion, and global structural imbalances, for the absence of a feasible strategy of economic growth on one side, and the institutional changes, listed under the previous three headings of the genealogy that took the country toward financial hypertrophy, rather than financial deepening.

The interpretation of the genealogy of the crisis that I have just stated contrasts with many familiar and influential understandings of its causes in several ways. The conventional view has resulted in a conception of the genealogy of the crisis that combines two elements: (a) a very general element, such as the view that financial crises are simply part of the natural scheme of things, or a permanent and recurring feature of a modern, market-oriented economy; and second, (b) a very concrete element, i.e. in each crisis, there is a set of relatively accidental and narrowly focused triggers of the crisis. For example, an analyst might emphasize the sudden shift in perceptions of risk spurred by the decline in the housing market in 2007, or the failure of Lehman Brothers of September, 2008, or any other market or regulatory failure revealed, in hindsight, by the collapse of financial markets in the US and around the world.

By contrast, on the account sketched here, the key factors leading up to the crisis are neither just accidental triggers, nor elements in a recurrent pattern of financial crisis and reform. Instead, the center of gravity is at an intermediate level, emphasizing the decisive influence of institutional arrangements that may either tighten or loosen the link between savings and productive investment. And it is at this intermediate level that law is decisive, because the arrangements are products of law.

The argument may be formulated in different terms. On the view presented here, the nature and significance of the crisis cannot be understood merely by appealing to the supposed regularities inherent in an abstract conception of the market economy or financial system. Instead, policies and arrangements of the kind summarized in the brief list above become pivotal at each stage in the analysis: both in the diagnosis of the structural and institutional factors leading up to the financial crisis and in the design and development of an appropriate project of reform.

This schematic genealogy directs our attention to the interplay between a momentous legal-institutional transformation and a doomed effort to use debt-driven consumption and easy money as a substitute for a productivist strategy: a trajectory of broad based economic growth. I speak to the content of this missing strategy in Part 3 of this article.

The BRIC alternative: An effective but costly shortcut to national power and prosperity without a deepening of democracy or the development of inclusive growth

Consider next a contrasting example of institutional experimentation and reform. I refer here to the BRIC alternative, as it has developed in recent years.

The following discussion of the BRICs, with special focus on Brazil, has a simple point. The BRIC countries were relatively successful in using state capitalism and export-led growth to mitigate the effects of the worldwide financial and economic crisis of recent years. China and Brazil, in particular, used governmentally controlled banks to maintain credit flows and to keep production on a forced march. Brazil exported natural resources and commodities, increasingly to China as well as other markets. And China transformed such resources and commodities into manufactured goods exported to the rest of the world.²⁶

The combination of state capitalism and export-led growth failed, however, to result in a model worthy of imitation in the rest of the world. It averted economic ruin without achieving necessary economic transformation. It failed to deepen the internal market and to democratize access to productive resources and opportunities. It amounted to a short cut, or even to an evasion, rather than to a solution. State finance was used to benefit governmental controlled enterprises in China and a handful of big private businesses in Brazil.

Democratization of the market economy, capable of giving practical content to the ideal of socially inclusive growth, would have required much more by way of reshaping the relation of finance to the real economy as well as the relation of governments to the mass of small and medium-size business that remained the most important—and the most neglected—part of these economies.

The false alternative of the Brazilian and BRIC experience of state capitalism and export-led growth

To understand the true significance of the BRIC experience, we must examine in greater detail two sets of arrangements at the heart of their relative success. For this purpose, I take Brazil as the chief focus: free of some of the complications that attend the experience of its much larger BRIC equivalents, its experience enables us directly to grasp something unexpected.²⁷

²⁶ See Lothian (2012)(c) and Lothian and Unger (2011)

²⁷ See Banerjee, R. and P. Vashisht (2010) and World Economic Outlook (2013).

A first major factor explaining the relative success of these economies is the use of governmentally controlled banks to ensure the continuation of credit flows. It is a great advantage to count such banks among the instruments of public policy. However, it is not as great an advance as genuine financial deepening would be: a tightening of the link between credit for producers, by enterprises in all sectors and of every scale. Better to decentralize and democratize the whole of finance than to use banks controlled by the state to make up for the deficiencies of an unreconstructed banking system.

A second factor is relative autarky. Despite the vast changes of recent decades that have brought the large emerging economies into the global economy, they remain relatively autarchic. It is obviously true of Brazil; foreign trade is still less than 15% of GP. However, it is more surprisingly true even of China today; its exports are still under 30% of GDP, by comparison to roughly 50% for Germany.

A paced and limited integration into the world economy, subordinated to the requirements of a national development strategy, is better than an unconditional integration. By an unconditional integration I mean one that accepts the present allocation of comparative advantage among national economies as the basis for place in the world economy, and then goes on to subordinate national strategy to the constraints imposed by this global niche.

However, the best is a movement that enhances integration but seeks to shape it in the serve of a project designed to create new comparative advantages. The most effective way to create them is not dogmatically to choose sectors that are supposedly bearers of the future. It is to empower experimentalism: by establishing arrangements that broaden economic and educational opportunity, by giving small and medium-size business access to forms of credit, technology, marketing, and knowledge normally reserved to big businesses, by creating the means and the conditions for pluralism and experimentation in the institutional forms of the market economy.

In no area is the contrast between the lesser evil and the greater good been more striking than with regard to finance itself. A simple reason why many of the large emerging economies did relatively better in the crisis than the advanced economies is that they had refused fully to open their capital accounts. In this way, they limited their vulnerability to the national effects of international financial turmoil.

Consider, again, the case of Brazil. Brazil had generally followed the major Latin American economies in accepting what was in effect a functional equivalent to the gold standard. In the closing decades of the twentieth century, most of the Latin American republics accepted a constellation of policies and ideas yielding a similar effect: acquiescence in a low level of domestic savings, consequent dependence on foreign capital, including greater freedom for capital to enter and leave. The practical result was to make the national government relatively more dependent on international financial confidence.

There was, however, an exception to this surrender to the functional equivalent of the gold standard, in the form of continuing limits to the openness of the capital account. These limits proved important in explaining the relative success of these emerging economies in resisting the effects of the crisis of the early

twentieth century.

Nevertheless, in accord with the spirit of my argument, closure to world finance is not as desirable as openness on the basis of financial deepening, a mobilization of national resources, and an institutional broadening of economic and educational opportunity. Such a basis provides elements of a strong national project.

The dangers of financial openness do not grow simply, as the conventional discourse assumes, in proportion to the avoidance of conditions that bring the national economy to its knees by making it dependent on foreign finance and financial confidence.

We cannot find in the recent and relative success of the large emerging economies the lineaments of a program of recovery and reconstruction of enduring and general interest. What we can find is a record of fragmentary insight and luck in the avoidance of disaster: a series of distant second bests rather than the demarcation of a reliable path.

Part 3

A new direction for the regulation of finance

This schematic comparative-historical discussion supports a number of propositions that develop and refine the theoretical view outlined at the beginning of the piece.

First, the worldwide experience of the last eighty years discredits the view that there is a narrowing funnel of workable institutional arrangements for the organization of finance and of its relation to the real economy. The twin imperatives of protecting national development from cycles of liquidity in the world economy and of using national finance to help spur the creation of new comparative advantage has fueled successive waves of innovations in the institutional setting and set-up of finance. The modesty of many of these innovations is counterbalanced by their number: as limited as many of the may seem to be, they represent potential points of departure for more far-reaching innovations.²⁸

Second, many of the most successful innovations have had the twofold effect of making national governments and economies less dependent on the interests and whims of international finance, and thus enhanced national economic sovereignty, and of tightening linkages between finance and the real economy (financial deepening rather than financial hypertrophy).²⁹

Third, in the production of this double effect a particular set of institutional devices has played a central but ambiguous role: the creation of public financial entities, such as the American GSEs or the Brazilian and Chinese development banks. On the one hand, they have represented a way to work against the current of national or global cycles and crises. On the other hand, they have sometimes seemed to exempt national governments and politics from the harder work of deepening

²⁸ Examples are provided in Rodrik (2003), Rodrik (2014), Streek (2009) and Streek and Thelen (2005).

²⁹ This argument is developed in Lothian (2012) (c) and in Lothian (2011).

finance by democratizing it to a greater extent. Small business—the source of most of the product and of the vast majority of the jobs—has been shortchanged in relation to big business. The important programmatic and theoretical implication is that the reversal of this bias requires more than a reallocation of governmental resources or a reorientation of legal incentives and burdens: it requires bolder experimentation in the institutional forms of finance and more generally, of the market economy than has yet taken place.³⁰

Fourth, in each case, the failure to carry forward the project of democratic experimentalism would exact a terrible price: limiting the stock of available ideas and arrangements for deepening democracy and development everywhere else.

Conclusion

In this article, I have developed an argument about democracy, law and global finance from the limited but revealing standpoint of the financial crisis of 2007-2009 and the continuing effort to respond to its consequences. More important to this argument than the particular ideas that I advance is the way of thinking about democracy, law and global finance that these ideas are intended to exemplify.

One aspect of this way of thinking is an approach to the legal and institutional setting of public policy as well as finance. It is common today to insist that we no longer believe in the existence of “systems”. Yet we remain inclined to imagine that the established institutional settlement IS a system, with a logic all its own. According to our ideological and theoretical orientations, we may call this system capitalism or the regulated market economy or any other number of labels. In fact, for the most part in contemporary societies, the institutional settlement is not a system, in any recognizable sense of the term, and has no systemic logic.³¹

Such a circumstance is not, with respect to finance or to any other area of social and economic life, exceptional. On the contrary, it is the normal situation. The approach to a rational scheme is the exceptional limiting case. In this piece, I have tried to explore some of the implications of this circumstance for the practice of explanation, criticism and proposal.

A second aspect of the way of thinking exemplified in this article is that it takes there to be an intimate relation between two goals that we often value but only rarely connect. The first goal is the one that I have called financial deepening: the organization of finance so that it in fact does, or does better what it is supposed to do:—support the expansion of output and the enhancement of productivity in the real economy. The second goal is to organize the market economy so that it affords more people more access to more markets in more ways, and turns the broadening of opportunity and of inclusion into a driving force of economic growth.

A third aspect of the way of thinking that this essay embodies is to identify in law and in legal thought an extraordinary storehouse of materials for the

³⁰ On the role of state-owned enterprises in the BRIC economies, and on public-private partnerships in the liberal market economies see Amsden (2001), Wade (1990) and Rodrik (2007).

³¹ See Lothian (2012) (c).

institutional imagination. By understanding the genealogy of our present institutional settlement, by recognizing the hidden variations and contradictions that this non-system contains, and by enlisting some of them as material for the development of institutional alternatives, we discover and reaffirm our power to transform, from the bottom up and from the inside out.³²

Economics may take a long time to become, once again, what it once was: a discipline of the institutional imagination. Legal thought can become such a discipline right now. As an object of this work of insight and reform, finance, so widely feared for its manifest harms and so little understood for its potential benefits, is a good place to begin.

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³² See sources cited in note 8 above.

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