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**American Finance and American Democracy:
Towards an institutionalist “law and economics”**

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**American Finance and American Democracy:
Towards an institutionalist “law and economics”**

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ABSTRACT

This article reconsiders the financial and economic crisis of 2007-2009 and the present debate about the regulation of finance in the light of a vision of how finance can better serve the American economy and American democracy. The central claim is that regulation as conventionally understood cannot adequately redress the problems, and seize the opportunities, revealed by the crisis. We should approach financial regulation as the first step in a series of institutional innovations designed to put finance more effectively at the service of the real economy (financial deepening) while broadening economic opportunity in the country (financial democratization). I develop and defend this thesis by arguing for four subsidiary claims.

A first subsidiary claim is that a major part of the causal background to the crisis was an inconclusive hollowing out of the New Deal regime for the governance of finance. That regime failed to be replaced by an alternative coherent scheme. Instead, it gave way to a ramshackle compromise -- powerful, opaque, recalcitrant, and damaging. Such a situation -- I argue -- represents the rule rather than the exception in the history of law and institutions. The outcome of the hollowing out in the United States was a weakening of the links of finance to the real economy, paradoxically accompanied by the hypertrophy of the financial sector.

A second subsidiary claim is that the New Deal critics and reformers of finance, such as Louis Brandeis and William Douglas, were right in their intuition that a strong link exists between the legal and institutional requirements of financial deepening and of financial democratization.

A third subsidiary claim is that to make good on this intuition in today's circumstances we need a new agenda of reform with an explicit and ambitious institutional content. Such an agenda includes the transfer of sophisticated financial capabilities to the country's remarkable network of local banks as well as a vast expansion and popularization of financial services, channeling long-term saving into long-term productive investment.

A fourth subsidiary claim is that law and legal thought provide the chief storehouse of the ideas and methods needed to conceive and to implement such innovations. Prevailing styles of economic theory, including those underlying the dominant practice of "law and economics," remain largely bereft of institutional imagination. This article illustrates how a revised practice of legal and institutional analysis can help fill this lacuna. In so doing, this piece takes "law and economics" in another direction.

Keywords: Finance, Democracy, Financial Regulation, Legal Reform, Dodd-Frank Act, Shadow Banking, Law and Economics, Institutions, Institutional Reform

JEL Classification: G01, G28, G30, K20, K22, K23

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Introduction: Theme of the article

This article addresses the present American debate about the regulation of finance as an opportunity to rethink the role of finance in our democracy and in our economy from the vantage point of lawyers' ideas and lawyers' skills. My central idea is that the regulation of finance is best understood and practiced as an initial step toward the reorganization of the institutional arrangements, defined in law, that govern the relation of finance to the real economy. The reorganization should – and can – be motivated by two overriding goals: tightening the link of finance to the productive agenda of society and broadening access not just to credit but to economic opportunity more generally. Although much of what I have to say presupposes or implies a series of theoretical claims, my argument is largely inspired by engagement with the detailed materials of law and the distinctive methods of legal analysis.

My argument advances in three simple steps:

1. A conception of the larger intellectual and practical issues at stake;
2. An analysis of the present debate about financial regulation as well as of the resulting legal enactments from the highly selective – but I hope revealing – 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.¹

Under present arrangements, this task is carried out very 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

¹ This claim is universally accepted. In theory, the idea that finance – or savings – is important to the production of wealth has been a mainstay of economic theory since classical political economy (whether in the formulation of Adam Smith or Marx). The idea is equally present in modern growth theory, even though the precise nature of the causal nexus remains controversial. Recent empirical studies and policy discussions take the premise as given. See, for example, FSA (2009), *The Turner Review*. A third source is provided by recent studies of financial liberalization, especially in developing countries and global markets.

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.

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.

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.

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.² 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.

This piece takes a different view. I advance two ideas:

- a. The first idea is that the relation of finance to the real economy can and should be reshaped.

² In the US setting, these ideas have been most clearly and forcefully articulated by Lawrence Summers and Timothy Geithner.

- b. 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 ³

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.

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.

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 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.

³ Under established economic and political arrangements, there has always been a tension between finance and the real economy, given both the structure of financial markets and the organization of production. Yet this tension has deepened in recent years, in response to many different factors. The following section identifies a series of policies, ideas and arrangements that may have contributed to this situation.

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.⁴

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 equilibria; 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.

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 equilibria. As a result, mainstream thinking today would have little to say about the distinctive character of the US arrangements, or

⁴ 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). See also the recent writings and speeches of Turner, Haldane and D'Arista.

the contribution of these arrangements to the boom-bust cycle of debt-fueled asset speculation and collapse that would characterize the financial crisis of 2007-2009.⁵

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.

I develop the argument at two levels. At one level – national and historical – I present 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 mid 20th century nor a coherent alternative to it. It was a hodgepodge created by a circumstantial evisceration of the New Deal regime.

At a second level – analytic and programmatic – I use the national and historical discussion as a point of departure for the outline of a more general way of thinking about the role of law and legal thought in generating or suppressing institutional alternatives, not just in finance but for economic and social organization more generally. A key idea in this part of the essay is that the variations and contradictions of established arrangements supply practical and conceptual materials for the construction of institutional alternatives. To seize this constructive potential is the most important vocation of legal analysis and comparative law today. I develop this argument in part III of this essay.

Two preliminary issues need to be addressed before embarking on this analysis. A threshold issue involves overcoming the problem of regulatory dualism. For purposes of this essay, regulatory dualism may be defined as the coexistence of a highly regulated financial sector, and a lightly regulated financial sector. The distinction exists today in all leading economies of the world. Yet both the practice and theory of lightly regulated finance – typified by the now infamous “shadow banking system” – would achieve its greatest expression in the US and global markets in the years leading up to the financial crisis.

⁵ 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 a 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.

The traditional justification for regulatory dualism was the belief that neither high net worth individuals nor sophisticated financial institutions needed the protection of a paternalistic state. But as the crisis would reveal, this traditional defense against heightened scrutiny failed to take into account a far greater danger: namely that the lack of transparency and regulation available at the margins of the regulated banking system created the opportunity and incentive for a vast array of regulatory arbitrage and circumvention. The combination of easy money, global liquidity, and a tolerance for vast current account deficits would add fuel to the fire, by broadening the market and shrouding the nature and identify of its key participants.

A second issue concerns the relation between finance and its institutional setting, and the particular characteristics of the institutional setting that exists today. Finance operates in a setting beyond its own control and even beyond its own level of vision. It is susceptible to major instability arising from this setting.

To form an initial impression, consider the following list of institutional factors that would play a decisive role both in the build-up of systemic risk and in the relative weakness of the government's policy response to the financial crisis:

1. The transformation of the laws and institutions of finance in the US and other countries. The present framework is a hodgepodge rather than system, resulting from the hollowing out of the New Deal financial reforms, especially in the areas of banking and the mortgage market.
2. Attempts to use popularization of credit as a functional surrogate for redistribution of wealth and income
3. Anarchy in international monetary arrangements after the collapse of Bretton Woods in August 1971
4. Fads and fashions in the policies of Central Banks, etc.⁶

The idea that these policies and arrangements might themselves have become major sources of instability is, by now, uncontroversial. After all, these items form the stock and trade of conventional narratives of the financial crisis. But in the view informing most mainstream economic and policy analysis, these features are trivialized and reduced to failures of regulatory vigilance, when in fact no amount of regulatory vigilance would ever suffice to deal with these vast sources of instability. What can alter the situation over time is a change in the balance between

⁶ This point has been most eloquently and insistently emphasized by Turner (in his many jeremiads against the reliance of policymakers and regulators on prevailing economic orthodoxy of the time). See also, Krugman (echoing Keynes), Perry Mehrling, *The New Lombard Street*, and Ross Levine, "An Autopsy of the US financial system".

hypertrophy and deepening. Financial deepening tends to limit financial instability. Financial hypertrophy tends to aggravate it.

The point can be generalized. Three different sets of institutional arrangements bear on finance: (a) the arrangements governing the actual organization of the financial system; (b) the arrangements governing the relation between finance and the real economy; and (c) the broader institutional setting of the market economy within which financial markets operate.

Consider the following example: suppose an economy depends for aggregate demand on a market for mass consumption. Suppose, further, that established institutional arrangements fail to insure broad access to economic and educational opportunity while at the same time favoring a regressive redistribution of income, wealth and advantage (as has, in fact, occurred). In these conditions, it is likely that there will be an attempt to use the expansion of credit to support the market in mass consumption, in the absence of a progressive redistribution of wealth and income.

The most effective redistribution would not be compensatory redistribution by tax and transfer; it would be a redistribution of primary (before tax) income and wealth, achieved through an organized broadening of educational and economic opportunity.

The expansion of credit may be made through a policy of monetary ease in the domestic economy; or through dependence on foreign capital; or through an over-valuation of the housing stock, which can then serve as collateral for credit expansion.

At some point, the combination of these methods will generate a crisis that affects finance.

It would be wrong to interpret this sequence of events as simply the result of the failure to regulate finance. It arises from the broader institutional structure of the predominant political economy. Institutions matter at each of these three levels.⁷

Three main implications flow from this preliminary discussion. The first implication is that it is necessary to address both issues – both the problem of regulatory dualism and the problem of the complex and changing character of the relation of finance to its institutional setting - if we are to make any head way in addressing the present crisis and the conditions required to reduce the risk of further crisis.

The second programmatic implication is that the need to counteract, manage and avert instability creates a permanent opportunity to turn regulation into

⁷ The main focus of my argument is on the second level – i.e. the arrangements linking finance to the real economy. But I remark in passing on each of the other levels as well.

reorganization: The reorganization of finance and of its relation to the real economy in the service of financial deepening. This opportunity is always present. But under conditions of crisis, this opportunity for transformation becomes even greater, in the realm of politics as well as finance (because of the loosening in the hold of financial interests, as well as the direct participation of the state in bailing out and support the banks and financial system).

The third implication has to do with the role of law and legal analysis, and in particular, the project of comparative law. Alternative sets of institutional arrangements, in finance as in any other aspect of the market economy, exist only as law: law not simply as rules, but as the detailed dialectic between arrangements and the conceptions informing them. From this idea there results a view of the task of legal analysis and of the role of comparative-legal study, which I here seek to illustrate. On the view defended here, a major task of legal analysis is to reveal the range of hidden institutional variation that already exists, delineated in the detailed institutional arrangements defined as law, way beneath abstractions like the idea of a regulated market economy, and to suggest how this existing variation can provide material and inspiration for the project of institutional reconstruction.

Thus, I turn in the next two sections to a detailed analysis and criticism of contemporary arrangements and debates. For it is here that we can find the materials of critique and reconstruction: in the realm of historically specific legal and institutional detail, where diversity is disclosed and constructed, for good or for ill.

Part 2: The Historical Context of our Present Predicament: An Elementary Institutional Genealogy

Aim and scope of this institutional genealogy

In this -- the second of the three parts of the present piece -- I look back to salient features of the history from which the present debate over financial regulatory reform has emerged. My purpose is not to provide a historical narrative, however schematic. It is to select from the historical background to our present predicament a number of aspects that are directly pertinent to the analytic and programmatic claims standing at the center of my argument. I preface this exercise with a summary statement of what I see as the chief lessons of this historical experience for insight and reform today.

When the financial crisis broke 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'etat.

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 in 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 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.

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, 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.

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.

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.

The combination of a commitment to economic security with a commitment to the popularization of consumption opportunities prompted the 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. The brief programmatic argument in the third part of this piece proposes, in the light of this experience, a path beyond what the New Deal accomplished in finance, not back to what it achieved, and argues that having taken a step back we can and should now take two steps forward.

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

How we got here: A schematic institutional genealogy

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.

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

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.⁸

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.)⁹

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.

Hollowing out of the New Deal reforms and 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:

⁸ See Bernanke (), and Dodd ().

⁹ See Dodd, *supra*, D’Arista, *supra* note (), and Edward M. Gramlich, *Subprime Mortgages: America’s Latest Boom and Bust* (2007).

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 (“nbfis”), 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.¹⁰

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

¹⁰ See Charles W. Calomiris, “The Regulatory Record of the Greenspan Fed”, paper prepared for 2006 American Economic Association, Daniel K. Tarullo, “Financial Regulation in the Wake of the Crisis”, speech at the Peterson Institute for International Economics, Washington, D.C. (June 8, 2009) [hereinafter Tarullo, Financial Crisis], and Ben S. Bernanke, “Housing, Housing Finance and Monetary Policy”, speech at the Federal Reserve Bank of Kansas City’s Economic Symposium, Jackson Hole, Wyoming (August 31, 2007) [hereinafter Bernanke, Housing Finance].

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.

We can understand this part of the historical trajectory as the combination of three simple steps.

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.

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.¹¹

Increasing reliance on foreign portfolio capital to finance trade deficits and to fuel credit-driven, household consumption¹²

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.

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).

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

¹¹ For a similar point, developed in a different setting, see Michael Pettis, *Emerging Markets and the Threat of Financial Collapse*. Both the argument of this essay and the Pettis work illustrate the contribution of direct experience of financial markets to the theoretical exploration of the content, character and consequences of historically specific financial policies and arrangements.

¹² The first three institutional tendencies have, as their main theme, the emergence and expansion of increasing financial hypertrophy in the US and global economy

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 failures 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 structure and limits of the present debate

The inconclusive hollowing out of the New Deal regime helps account for the shape and limits of the contemporary debate about the reform of financial regulation. The most striking feature of this debate is its emptiness of structural imagination: the lack of understanding of the institutional genealogy of the present ramshackle set of arrangements is wedded to a lack of insight into institutional alternatives. Fragmentary reforms proposed in the course of this debate can nevertheless serve as material for the development of alternatives, if only we could understand both the actual and the possible under the lens of a view more penetrating than the one offered by ruling ideas.

The four main reform agendas

Both in the United States and elsewhere, the debate about financial regulatory reform has been dominated by four agendas. Neither separately nor together do they amount to an alternative capable of addressing the problems discussed in this article.¹³

The New Deal agenda

The first agenda is the New Deal agenda. Its characteristic concern is to insulate the core banking and payments system from the excesses of speculative finance. To this end, it advocates structural and institutional precautions, such as the division between insured deposit taking and proprietary trading, tools prominent in the American and European response to the Depression of the 1930s.

The New Technocratic agenda

The second agenda is a New Technocratic agenda. Sponsored by the high governmental officials in the Finance and Treasury ministries, its guiding concerns are the strengthening of supervisory and resolution authority – meaning, authority to take over, close down or turn around failing financial institutions, especially when their instability threatens the stability of the financial system as a whole. The perspective is very clear. It views the crisis as a threat, rather than a harbinger of things to come. Once the threat is contained, everything else can presumably go back to the good old days, presumably before the conflagration.

The Basel agenda

The third agenda can be called the Basel agenda. Its source is the intellectual and bureaucratic elite of international high finance, as represented in the Bank for International Settlements in Basel. The chief concern of this third agenda is to

¹³ Much of this material is drawn from accompanying work. See, for example []

contain the risks of financial instability, through capital adequacy and other requirements designed to limit risk-taking in individual banks and in the financial sector as a whole.

The Consumer Protection agenda

The fourth agenda, and the only one with overtly popular concerns, is a Consumer Protection agenda. It seeks better to protect the public against the abuses of the finance industry, through a combination of paternalism and mandated transparency. In the US, the favored instrument would become the Consumer Protection Agency, one of the hallmarks of the Dodd-Frank reforms.

Together, these four initiatives represent a variety of concerns and perspectives. Yet from the standpoint of this piece, the most important point to note is that they converge on a single point: namely, the lack of a structural agenda. None of the different agendas succeeds in addressing -- much less solving -- the twin structural problems that are central to the genealogy of the financial crisis.

Little, if any, effort would be made to tighten the links between finance and the real economy in general, or in the area of production and innovation, in particular. Nor would there be any effort to connect the debate about financial regulation to the debate about the policies and arrangements required to support a broadening of economic and educational opportunity.

It may well be said -- for the architects of reform -- that it was never their purpose to pursue these themes. Their, intent, so the argument goes, was to discipline finance and to prevent it from continuing to do or from doing once again, the harm that it has just done to the livelihood and welfare of millions of people. But, as I have argued in the earlier section, neither of these tasks can be separated from the effort to deal with the larger structural concerns.

Two objections are commonly raised in response to the argument on behalf of structural reform. The first objection is that the government simply has no room for maneuver: the effects of the crisis and the bankers' lobby limit the possibility of any more basic reform agenda.

But it would be wrong to assert that the government acted with no discretion. In fact, the government was the author of a series of bold and unprecedented actions, both in the period immediately following the crisis and in the period leading up to the DF reforms. Indeed, as many have pointed out, the crisis created an opportunity for the government to act in ways unthinkable before the crisis.

The second and deeper argument is that there really is no alternative. Even if the government had an open hand, there was simply nothing more to be done. No alternative strategy of development or project of reform could or would improve on

the basic framework of the market economy and financial system as developed in the US and other north Atlantic countries at the close of the twentieth century.¹⁴

The appeal of this position is obvious. Our lack of faith in institutional alternatives seems to be confirmed by both contemporary and historical experience.

But the view is inadequate, nonetheless. To see this we need only return to the discussion above of the available reform agendas. Three points stand out: all have to do with the underutilization of the margin of maneuver that exists, despite the array of interests aligned against reform.

This margin of maneuver has three components:

- a. The disharmonies evident in the four reform agendas described above; the plurality of reform agendas, and the many different formulations made possible by the four agendas.
- b. The ramshackle character of the present institutional arrangements. The hollowing out of the New Deal reforms was incomplete. Nor did it create an alternative to the New Deal settlement. As a result, the reforms and re-regulations could take many turns, even apart from any broader ideological or political agenda.
- c. The – as yet voiceless – opposing interests and aspirations, reflected throughout the debate about reform, as well as the crisis and response itself.

The net result from all these factors is an opportunity that still exists, even as the crisis itself recedes. The plurality of interests, aspirations and views, together with the lack of any settled interpretation or approach creates an opening for new ideas as well as arrangements. New ideas and approaches, once accepted, could have a large effect, informing a cumulative trajectory of legal and institutional reform capable of making good on this underutilized room for maneuver.

The Dodd Frank reform bill of 2010 as an illustration of the nature and limitations of the contemporary debate and of the squandering of transformative potential

The Dodd Frank reforms provide a perfect illustration both of the nature and limitations of the contemporary debate, and of the possibility of using practical reforms, inspired by inadequate ideas, for another, better purpose. The central

¹⁴ For a recent expression of this view, see Kenneth Rogoff, “Is Modern Capitalism Sustainable?” at www.project-syndicate.org. The view continues to be the prevailing view, even though the metaphors change from time to time. “Throwing the baby out with the bathwater” used to be standard expression used to describe the (assumed) narrowness of realistic alternatives. Recently, a new moniker has emerged, with the expression, “a plan beats no plan”.

theme of the new legislation would be that the arrangements are essentially sound. But the very act of legislation would belie this idea and provide an opening for transformation.¹⁵

The basic structure and orientation of the Dodd-Frank program of financial regulatory reform

Consider first the basic structure of the DF reforms. The main focus is on too-big-to-fail institutions: an idea of risk that is not based on the idea of alternative institutions, but focused instead on the idea that some organizations have been allowed to become so large that they can take the government hostage. It's not just that some institutions have a very large amount of capital, but that they occupy a strategic place in the financial system as a whole. There is a density of interconnections. It is as if there were large stars with an intensified gravitational field. Thus there is a hunt for culprits. To the suspect classes of financial transactions is now added a suspect class of financial organization requiring a heightened level of scrutiny.

Four different sets of institutional arrangements lie at the heart of the new reforms:

1 Suspect classification of financial organization

The Act identifies and draws a ring around systemically important financial institutions – the largest and most “interconnected” financial intermediaries. These banks are singled out for heightened scrutiny and supervision. Increased capital and liquidity requirements are thought to provide the main instruments for heightened regulatory vigilance and control.

2 New apparatus of supervision and resolution, especially in relation to the risks assumed by these organizations

The Act creates a new apparatus for supervision and monitoring of systemically important financial institutions (“SIFIs”). Two new institutional vehicles anchor the new regime. The first is the Financial Stability Oversight Council (“FSOC”), an assembly of regulators charged with three main tasks: monitoring and identifying systemically important financial institutions; insuring the development of

¹⁵ Note the distinguishing character of the approach taken here. A common form of criticism begins by accepting a given set of widely shared understandings and then attacking the reforms enacted as imperfect realizations of these understandings. My argument is different. My point is to understand and evaluate the new Dodd Frank reforms from the standpoint of a different conception. From this perspective, the problem isn't the fragmentary character of the financial reforms – reforms will always be fragmentary - but the inadequacy of the ideas and idea world informing the reforms. For a summary of the ideas informing my approach, see Lothian, Tamara, Rethinking Finance through Law: A Theoretical Perspective (November 21, 2011), Columbia Law and Economics Working Paper No. 412. Available at SSRN: <http://ssrn.com/abstract=1962843>.

appropriate micro- and macro-prudential policies and arrangements; and deciding, in the last instance, whether to subject a SIFI to the new Orderly Liquidation Authority (“OLA”). The OLA is the second main institutional innovation established by the Dodd-Frank reforms. Although scholars disagree on both the merits and the feasibility of the new special resolution regime, the OLA has been designed as an alternative to the perceived inadequacies of the traditional tools of bankruptcy and bailout, especially as practiced in recent years.

3 Prohibition of certain kinds of trading in the spirit of the New Deal agenda

The third pillar of the new regime is the reinstatement of a series of restrictions on proprietary trading and position taking by commercial banks and bank holding companies. Commercial banks – and bank holding companies – are subject to a number of new restrictions on proprietary trading, position-making, and other forms of heightened risk taking. Speculative investments in hedge funds and equity funds are to be limited and placed outside the regulatory perimeter. These prohibitions express the view that “socially-useful” banking should return to an earlier paradigm, in which banking was first and foremost an instrument for the extension of consumer and commercial credit, rather than an agent of high stakes gambling or the placing of bets in financial markets.

4 Demand for heightened transparency and scrutiny, mainly achieved through an exchange for derivatives, under government supervision

The fourth main pillar of the Dodd-Frank regime involves the regulation of derivatives trading. Intended as a belated defense to the run-away market in over-the-counter derivative transactions, the new rules require that the vast majority of derivatives be listed and cleared on a public exchange. The idea itself is not new. After all, the Commodities Exchange Act [1936] had established a similar principle at the time of the New Deal reforms. But in the context of recent practice, the decision represents a striking change in direction.

Consequences of the Dodd-Frank reforms in the terms set out in this essay

At their best, these reforms may be seen as a strike against what I have earlier called the hypertrophy of finance.

But they do not, by virtue of this function alone, represent a strike in favor of financial deepening. Little or nothing has been done to tighten the link between savings and productive investment, or finance and the real economy. Little or nothing has been done to promote an expansion of credit to productive sectors; little or nothing has been done to limit the size or scale of risk-taking in areas beyond the commercial banks.

And little or nothing has been done to promote a new national, productive agenda – i.e. the broadening of economic and educational opportunity through a new program of socially inclusive growth, with finance at the very center. Let me take each point in turn.

For the government, of course, it was easy to dismiss each of these two objections. In each case, the reason would be the same: it was not the government's place to tell the market what to do; "we don't do planning," in the words of a former Treasury Secretary and leading economic advisor of the present Administration.

The problem, of course, with this discourse is that it fails to recognize that the government commits itself to the preservation or revision of institutional arrangements under the guise of regulatory policy. Institutional choices are intrinsic to a regulatory framework. It may readily happen that a regulatory initiative intended to preserve a set of established institutional arrangements becomes a possible first step in the revision of those arrangements. Thus, the DF regulatory reforms, chiefly conceived as an attempt to preserve rather than revise the existing institutional organization of the financial system and its relation to the real economy, could be enlisted in the service of a program of more consequential change, as I next argue.

Consider, for example, the separation of proprietary trading from government-insured depository institutions. Both the Volcker Rule and the Lincoln Amendment impose restrictions on finance, but do nothing to increase financial deepening. But if these measures were accompanied by institutions designed to channel to local banks the whole apparatus of modern, financial engineering, then this purely negative restriction would have turned out to be an element in a broader project of reconstruction, to the end of financial deepening.

The same principle applies to the two main institutional innovations of the Dodd-Frank regime: the new Financial Stability Oversight Committee, and the new Orderly Liquidation Authority. The narrow mandate to mitigate the risk of collapse of a large and highly connected financial institution could in the course of time be broadened into the more transformative mandate of discouraging financial activities of little use to the growth of output and the enhancement of productivity, and encouraging the financial activities that are useful to this endeavor.

Consider, finally, the new special resolution regime, placed at the center of the campaign to prevent any particular financial organization from threatening the stability of the economy and financial system. This lesser mandate can gradually be expanded into a broader task. What is now conceived as simply a device for the orderly liquidation of a failing institution, or even for the socialization by government of private losses, can over time become an instrument for reshaping these organizations and redirecting them to the work of inventing new forms of finance and financial organization useful to practical enterprise.

The basic point is clear. Each different feature of the DF reform, although conceived as part of an attempt to restore the existing system, can be re-interpreted and redirected as part of an effort to reshape the existing system.

Indeed, the point may be generalized. At every stage along the way, at least two alternative approaches are available: acting within the existing framework and acting upon the framework. The response embodied in the new Dodd Frank regime – whether directly or by delegation to the regulatory agencies involved in the task of rulemaking and application – represented only one among many alternative solutions. Whether the approach pursued would achieve, in fact, the goals of financial reform could not itself be inferred from the fact that the laws emerged from the legislative process, or inhered in the more general commitment to a market-oriented financial system

There is no single, uncontroversial form of a market economy; that every effort to respond to a perceived localized market failure reveals the falsity of the original belief: i.e., that the market or market-oriented financial system, as understood and organized at the time represents the built-in legal and institutional logic of a market-oriented financial system; that these markets and these arrangements could be counted on “axiomatically” to promote efficiency in allocation and stability in global markets; or even more, could be counted upon to correct itself in the face of the greatest disturbance in nearly a century. Indeed, in the context of crisis, it was far easier to believe that the very opposite might be true.

Indeed, by its very nature, a program of legislative reform would reveal what in normal times remains obscure: namely, that regulation always has institutional consequences and intentions, either reaffirming or revising established institutional arrangements. The Dodd-Frank reforms seem to be a reaffirmation disguised as a reform. The point is not radicalism versus moderation; it is the presence or absence of structural vision.

Concluding comments and observations to this part of the discussion

Three main implications flow from this discussion. The first and most important point to note is the transformative opportunity provided by the global crisis, but largely squandered, at least to this point. The second and related point is the need to reorient the debate about financial reform, for the sake of the progressive agenda – an agenda broadly shared and espoused, but until now largely unrealized. The third point is that the key to both one and two lies in the law.

In the following section I propose a series of institutional reforms designed to address these key issues.

Before embarking upon this task, it may be useful to consider the standard objection against any proposal involving a more ambitious set of legal and institutional reforms.

It has become commonplace to assert that what I have referred to as the third alternative simply does not exist. It does not exist as a viable alternative for two reasons. The first reason is that any reform proposal that departs too much from existing practices and arrangements is un-testable; and, second, because such a proposal would inevitably arouse fierce opposition from the “financial sector,” especially that part of the financial sector most heavily involved in the kinds of financial activity at the heart of the global crisis.

There are two responses to this point. First, it is no more, and probably less objectionable to existing financial markets (or to the financial sector conceived as a social group) than the second alternative. For this approach does not involve an effort to attack or cut down to size existing markets and arrangements; but instead, to reorganize existing arrangements, for the sake of values and objectives universally shared.

The second response is that it is a mistake to assume that the third position requires or implies wholesale substitution of one “fully-worked out” system for another. The issue is not “pressing the market” but reshaping the market; and this can be done, piece-by-piece.

Consider, finally, one further aspect of the discussion. Little has been said so far of the criteria and merits of this broader conception, especially in comparison with the perspective of conventional policy and economic analysis. But as I argue in the following section, a proposal of the kind outlined here is better in two different senses. It is better (a) from the standpoint of explaining what has happened; and (b) from the standpoint of proposing what can and should happen – i.e. proposals for reform.

Part 3: Another Direction for American Finance ¹⁶

This part develops the implications of the conception and analysis of financial regulatory reform advanced in the earlier section.

Two main principles guide the approach. The first is the belief that the process of financial regulatory reform can and should serve as the frontline in the effort to

¹⁶ This part proposes an alternative approach to the interpretation and development of the Dodd-Frank reforms. The enactment of Dodd-Frank in July, 2010 did not end the debate over the meaning and development of many of its most controversial provisions. As many have noted, the passage of the legislation simply made more urgent the task of agreeing upon and developing the detailed rules and regulations to be used in implementing the reform agenda. In each major area of legislation, legal and institutional understanding and imagination would be crucial.

reshape the institutional organization of the financial system in the service of the democratic reorganization of finance. The second is the belief that the recently enacted DF reforms both require and invite a series of cumulative legal and institutional transformations that can help advance the agenda described and defended in the earlier pages (i.e. the agenda of democratizing financial reform).

I organize this part of the discussion around six complementary themes:

1. Repudiation of regulatory dualism
2. Restricting financial activities unrelated to the expansion of output or the enhancement of productivity
3. Transforming local banks and financial institutions
4. Reinventing and multiplying the GSEs
5. Popularization and democratization of financial services
6. Reinventing and popularizing venture capital

Each of these legal-institutional innovations is designed to respond to the problems presented by the recent crisis and to do so in ways that contribute to the advancement of the two overriding goals with which the whole of my argument has been concerned. The first goal is more effectively to place finance at the service of the real economy while diminishing the likelihood of major financial instability damaging to the level of real economic activity. The second is to mobilize finance in the service of the most widely professed social and economic goal in the world today: the promotion of socially inclusive economic growth.

The setting of the argument is the contemporary United States. But given the chain of analogies binding contemporary economies together, despite their diversity of circumstance, these proposals may apply, with modest adjustments, across a broad range of economies.

The six sets of proposals I sketch in the following pages fall into the three pairs.

The first pair of legal and institutional proposals addresses the enabling conditions of the direction I defend. The second pair regards the legal and institutional vehicles or agents of the change. The third pair responds to the concern with access and inclusion: who benefits.

1. The repudiation of regulatory dualism

The dominant strategy for the regulation of finance over the last half century has been regulatory dualism. Although formulated most clearly and forcefully in the United States, it has achieved a leading role throughout the world.

Regulatory dualism distinguishes a thickly and a thinly regulated sector of finance. The standard justification of the distinction is that the thinly regulated sector is inhabited by high-net worth individuals and financial professionals who do not require the same level of monitoring as is called for by the thickly regulated sector, which renders services to the general public. The most celebrated example of financial organization in the thinly regulated sector is the hedge fund. The sector also contains all the forms of shadow banking.

To impose on all financial activity the same regulatory standard would, according to this view, be to compromise both allocational and dynamic efficiency in a context in which flexibility, and the financial innovations it makes possible, count for much and the risks of financial speculation are borne by those who are best able to understand and to bear them. Moreover, in the thinly regulated sector, public resources are not committed, as they are in the situation of governmentally insured deposits in deposit-taking financial institutions.

The basic objection to regulatory dualism is that it represents a standing invitation to circumvention. The transactions prohibited in the thinly regulated sector can be repackaged, and offered under different labels, in the thickly regulated sector. That is not a hypothetical danger; it forms a significant element in the run-up to the recent crisis.

There is an additional objection, briefly invoked in an earlier passage of this text. Finance operates in broader institutional setting from which destabilizing forces of great power may arise at any moment. These forces cannot be controlled by finance, and to some extent may not even be visible or intelligible to financiers. Instability is not simply endogenous to finance; it is also exogenous to it.

The repudiation of regulatory dualism would be followed by the imposition of a single, uniform level of regulatory severity throughout the whole range of financial activities and organizations. The imposition of regulatory uniformity is not, all itself, a solution to any problem, other than the specific problem of massive circumvention created by regulatory dualism. It is a necessary but not sufficient condition of an alternative faithful to the interests and ideals that I take here as paramount.

2. The discouragement or prohibition of transactions that make no significant contribution to the real economy

A major premise of my argument has been that the institutional arrangements governing the relation of finance to the real economy can either tighten or loosen the link between the former and the latter. Neoclassical economics supposes that insofar as there are no market failures capital will be allocated by a market to its

most efficient uses. The fundamental institutional and legal content of a market economy is, according to that point of view, not in doubt. To the extent that there are market failures, they are to be redressed by similarly targeted exercises of regulatory vigilance.

A simple and incontestable observation already begins to create trouble for this view. The whole panoply of organizations that channel long-term saving into long-term productive investment -- the different kinds of banks, capital markets, stock markets, and, more generally, of financial and non-financial firms that exist in contemporary economies -- are inventions, developed in politics and thought and confirmed by the law. An institutional invention such as the remarkable network of local banks that the United States developed in the nineteenth century may make finance more useful to the productive agenda of society. Contrary to many of the dominant ideas, the link between finance and production is far from been an analytical tautology; it is, to a large extent, a function of the institutions that organize finance and that shape its placement in the economy as a whole.

A corollary of the arguments concerning this theme is that we should and can distinguish between desirable and undesirable forms of financial speculation. What makes finance speculative is the he making of judgments or bets on an uncertain future: particularly on the unquantifiable uncertainties that we cannot hope to reduce to quantifiable probabilities. Speculative finance performs a valuable role in generating information and in organizing the allocation of risk.

It is not financial speculation of itself that represents a danger to be averted; it is the disassociation of speculation from any significant service to the real economy. The evil to be avoided arises when the transactions of the real economy become mere pretexts for the self-referential activities of finance itself. If such a diversion or perversion is repeated on a large scale and in many different theaters of economic activity, the result will be to create a situation in which finance, relatively indifferent in good times to the real economy, becomes a threat to the maintenance of the level of real economic activity once major financial instability breaks out.

The practical significance of this problem is not limited to the effects of financial instability on the real economy. Its broader dimension is the squandering, under present arrangements, of the productive potential of saving. Under those arrangements production is largely self-financed on the basis of retained and reinvested earnings of private firms. The vast amount of capital held in the banks and invested in the stock markets has an episodic or oblique relation to the funding of production.

To make finance more useful -- and less dangerous -- to the production system requires a series of institutional innovations. Some of them I consider in the

subsequent items of this program. They should and can be complemented by initiatives designed to discourage and, in some instances, to prohibit financial activity yielding no significant and demonstrable benefit to the real economy. There should be a presumption against sets of financial activities that make no plausible contribution to either the expansion of output or the enhancement of productivity.

An economist inattentive to the systemic consequences of present institutions may respond that, absent specific market failures, or failures in the regulatory response to them, a financial activity that makes no such contribution cannot be sustained over time. Unhappily, however, it can, given the enormous potential under established arrangements for finance to descend into a parasitic relation to the real economy and the consequent divergence, in the area of finance, between private and social returns.

Consider the homely but characteristic example of futures contracts. They were pioneered in commodities markets, in which they make an indisputable contribution to liquidity. Many keen observers have remarked, however, that their extension to securities markets is devoid of any such justification. In futures markets, according to these students of the capital markets, futures contracts amount to gambles that do nothing to enhance liquidity.

The analysis of reasons to bring particular families of financial transactions under the aegis of this negative presumption lies beyond the scope of the present programmatic argument. Such a presumption depends on far-reaching empirical study, which should be one of the responsibilities of research organizations assisting the Executive and Legislative branches of government.

To the extent, however, that we conclude that a particular set of transactions, such as future contracts outside the setting of commodities markets, make no colorable contribution to the expansion of GDP or to the increase of productive we should either discourage them (by tax and regulatory means) or, in the most egregious and dangerous instances, forbid them outright.

3. The enhancement of the capabilities of local banks

I now pass from the preliminaries or conditions to the agents or vehicles of an alternative direction.

A major resource of American democracy is its unrivaled network of local banks. The struggle over national banks in early American history culminated in the disbanding of the national banks during the Presidency of Andrew Jackson. The outcome was the most decentralized system of finance, at the service of the local

producer and consumer, that had ever existed in the history of the world up to that time. This broad-based network of local banks represents an immense latent tool that can be mobilized in the service of an effort to ensure that financial deepening triumphs over financial hypertrophy. These banks typically The most important area for this enhancement is not credit for consumption (including housing), with regard to which the local financial institutions have always been prominent agents.

There has long been a striking disparity between the sophistication and diversity of the capabilities deployed by the major national banks in the design of their services and the relative primitiveness of the skills, products, and services offered by the local banks. These capabilities would need to be dramatically enhanced. As examples further ahead in this programmatic argument will suggest (e.g., the later argument about the democratization of options and hedges for agriculture), it is not enough mechanically to transpose the transactions designed for large, multinational enterprises to the environment of a local economy and of small and medium-sized businesses. It is necessary to reinvent those transactions, and to make the skills that they require yet stronger and more adaptable.

The most important area for such an enhancement is not in credit for consumption (including housing), with regard to which the local financial organizations have always been important protagonists. It is in the strengthening of their role with respect to credit for production.

4. The establishment of new GSEs: new agents for a new style of industrial policy

Such a transfer of skills from the commanding heights of national and international finance to local financial organizations will not take place spontaneously. It requires initiatives and agents.

This task represents one spur among many to the creation of new GSEs, giving that New Deal invention a broader remit, well outside the narrow albeit important area of the mortgage market. Such para-state organizations might be designed to count with the presence of representatives of private industry, especially small business, as well as of the federal, state, and local governments.

One of its responsibilities would be to organize the enhancement of the capabilities of local banks to which I have just referred. This work should best be seen as simply a fragment of a novel conception of industrial policy. I use the industrial policy as a term of art, describing collaboration between governments and firms in all sectors of the economy, including financial services, not just industry.

Understood in this way, industrial policy would have as its main addressees small and medium-sized firms, which, in the United States as in every economy in the world, generate the major part of output and support the vast majority of jobs. In its guiding concerns, it would seek to expand access not just to credit but also to advanced practices and technologies, rather than dogmatically to advance or subsidize certain sectors ("picking winners"). What would above all distinguish it, in its subsequent and future developments, would be a horizon of institutional innovation marked by two sets of advances.

On the vertical axis, of relations between governments and firms, it would seek a form of coordination between governments and firms that is decentralized, pluralistic, participatory, and experimental. Thus, it would diverge from the northeast Asian model of unitary trade and industrial policy, imposed top-down by the bureaucratic apparatus of the state. It would also differ, however, from the traditional American model that reduces the dealings between government and business to the arm's-length regulation of the latter by the former.

On the horizontal axis, of relations among firms, it would favor the development of regimes of cooperative competition, such as have come to characterize some of the more successful sub-national economies within the European Union as well as certain high-tech economies within the United States. Groups of small and medium sized firms cooperate with one another, pooling certain financial, technological, or cognitive resources, at the same time that they compete against one another. Through cooperation, they achieve economies of scale and scope.

Finance is not simply an important requirement for the development of such an alternative form of industrial policy. The relations between finance and local economies are also a propitious terrain for the advancement of this innovation. The broader goal is to enlist finance in the effort to afford more people, access to more markets in more ways, thus democratizing the market economy rather than only regulating it.

5. The democratizing reinvention of financial products and services

I now turn to a final pair of institutional and legal innovations, intended to serve, in the realm of finance, the twin interests of making finance more useful (and less dangerous) to the real economy and of using finance to democratize rather than just to regulate the market economy.

To this end, a broad array of financial products and services would have to be reinvented. As with the enhancement of the financial capabilities of local banks, the

simple transposition of the established products and services, as well as of the skills and practices that sustain them, to a less advanced environment would not be enough. The skills and practices would need to be broadened and the products and services redesigned. Once again, a coordinated combination of governmental and private initiatives would be vital to secure this result.

Consider an agricultural example. We are accustomed to think of agriculture as an isolated exception within the economic order, requiring idiosyncratic policies.

In fact, in historical perspective, agriculture has often been a front line: a sector in which new forms of economic organization emerge before spreading to other sectors of the economy.

Family-scale agriculture, a historical strength of the United States, can be mechanized and capitalized to the point that any clear distinction between it and entrepreneurial agriculture is effaced, as it long has been in the country. Beneath the largest scale of agribusiness, agriculture always faces the combination of physical and economic risk: climate volatility and price volatility. All over the world, the traditional antidotes to these threats -- food stockpiles, price supports, and insurance (whether of crops or of income) -- are in the course of being replaced by a new financial engineering of options and hedges. These are derivative contracts, in their original and legitimate function of managing risks.

The problem is that such products and services are not normally accessible to even the entrepreneurial family farmer. They would have to be redesigned to become accessible. And, once again, given problems and costs of scale, a combination of private and governmental initiative may be needed to secure the result, as well as new institutional agents -- possibly in the form of a GSE -- as its agent.

You may well suppose that such innovation comes too late to rescue the family farmer in the United States: if he has not expanded, he has vanished. Nevertheless, take the agricultural example as a small and simple paradigm of a democratizing reinvention of financial products and services that would can and should take place over a broad range of financial activity.

6. The deepening of the venture-capital function

If there is one financial activity that most directly and fully embodies the idea of financial deepening as I have described here, it is venture capital: the mobilization of capital not only to invest in emergent enterprise but also to bring together the capital, the practices, the technologies, and the people needed to make it a success. If financial deepening had advanced more than it in fact has in contemporary market economies, venture capital would be a central concern of the capital markets. Where not present, its functions would be performed in other ways and by agents other

than self-described venture capitalists.

In fact, venture capital is minuscule, by any standard, as a proportion of financial activity, even in the United States, the country in which it is by far most established. It should become a major financial activity, exercised through a wide array of private and public agents. It can and should serve as one of the instrumentalities of the alternative style of industrial policy I previously sketched.

A task of government, in the absence of such a rapid expansion of private venture capital would be to mimic, in market form, what venture capital does. Here is an example among many of how such an initiative might be pursued.

A major part of saving in the United States, as in all the rich industrial democracies, resides in the accumulated pension moneys: not just the private pension funds to which employers and employees contribute, but also in the public, defined-benefit systems like Social Security. Without any privatization of these public pension systems, part of this vast store of capital might be placed under independent, competitive, and professional management, in diversified portfolios of venture-capital style investment. In this way, the dormant productive potential of saving could begin to better used. The results, for the pensioners as well as for the country, could then be easily compared to the results of other forms of private and public investment.

That would not be an example of the displacement of the market by government.

It would be an example, in the vital area of finance, in a country that has assigned to finance a major if not a leading role, of the use of the powers of government to democratize the market economy and to bind finance more closely to the real economy.

Conclusion

In this article, I have developed an argument about the past, present, and future of American finance, seen from the limited by revealing vantage point of the crisis of 2007-2009 and of the continuing effort to respond to its consequences. More important to this argument than the particular explanatory, critical, and programmatic ideas that I have here put forward is the way of thinking about law and finance that these ideas are intended to exemplify.

I conclude by emphasizing three aspects of this way of thinking.

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 reassuring to the crypto-systematizer.

In fact, for the most part, in contemporary societies, the institutional settlement is not a system, in any recognizable sense of the term, and it has no systemic logic. This feature is perfectly exemplified in the condition of American finance before as well as after the crisis of 2007-2009. The New Deal reformers may have come close (or at last tried to come close) to the establishment of a comprehensive institutional scheme for the organization of finance and for the governance of its relation to the real economy.

Whatever their success in that endeavor, their creation has been long but inconclusively gutted. The New Deal framework has been -- I have argued -- hollowed out, significantly but unevenly and inconclusively, to serve the interests of autonomous, hypertrophic finance as well as to suit the prejudices of the doctrines with which those interests have been allied. The hollowing out has not been succeeded by another scheme or another coherent logic. It has instead been followed by a gingerbread construction, by a series of ad hoc compromises among conflicting interests and ideas.

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.

Many of the New Dealers, Brandeis and Douglas first among them, intuitively grasped the connection between these two goals, although they lacked both the analytic apparatus and the institutional program that could do it justice. It has been my purpose to resurrect their aspiration but to establish on another basis, in a new

historical circumstance.

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 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 rediscover and reaffirm our power to transform, from the bottom up and from the inside out.

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.

Chart 1

The institutional context of finance: comparative variations and their consequences

	Internal organization of national finance	Finance and the real economy	Finance in its international setting	Consequences: Internal institutional dynamic
US today	Short-term portfolio flows intermediated through the shadow banking system	Decoupling of finance from the real economy; government intervenes to stabilize and support the existing fin system	Dependent on massive inflows of foreign portfolio capital	Credit boom – asset bubble; debt deflation on systemic basis
US in the 1930s and in the early post-war period	Ample domestic savings intermediated through regulated banks, GSES and newly created institutional investors	Household savings channeled to government and non-financial enterprises	Relatively high domestic savings, institutional impediments to speculative trading by leveraged intermediaries	Virtuous cycle of domestic savings, investment, growth; active engagement in global markets
Mexico and Argentina in the 1980s and 1990s	Foreign portfolio inflows intermediated through domestic banking system	Decoupling of finance from the real economy; increased internal and external liquidity fuels asset inflation and debt-fueled consumption	Dependent on massive inflows of foreign portfolio capital, increasingly USD-based	Credit boom – asset bubble; debt deflation on systemic basis
BRIC countries today	Foreign and domestic funding intermediated via strategically coordinated banking system; capital controls and surplus reserves	State-owned banks and development agencies channel funding to firms and sectors deemed “strategically” important	Relative autarky: high level of domestic savings fuels domestic spending and investment; capital controls limit exposure to global shocks	Virtuous cycle of domestic savings, investment and growth; active participation in global markets
A better alternative	Rejection of credit dualism; decentralization of domestic banking system to broaden access and opportunity; institutional diversification and experimentation	Use of public-private partnerships to deepen domestic markets and to accelerate innovation in the forms and uses of finance	Active participation in global markets: restrictive treatment of short-term portfolio capital; accommodating treatments of investment in production	Finance subservient to the creation of new forms of production and new forms of finance

Chart 2

Different pathways to change: alternatives in the institutional response to financial crisis and to the reshaping of finance

	Approach to the basic framework of finance	Crisis management and response	Finance in its broader setting: regulation versus reorganization
US today	Acceptance of the existing framework, supplemented by enhanced regulatory vigilance	Government intervenes to bail-out the largest banks and stabilize financial markets	Regulation as an alternative to reorganization
US in the 1930s and early post-war period	Re-organization of the basic framework, reinforced and extended through federal insurance, liquidity facilities and multiple GSEs	Government responds to the economic and financial crisis by restructuring existing markets and creating new markets	Regulation as the first step toward reorganization of finance and its relation to the real economy
Mexico and Argentina in the 1980s and 1990s	Reshaping of domestic market by foreign capital and financial intermediaries	Diminished room for maneuver in the context of free flowing capital, and increasing use of USD-denominated assets	Deregulation as an alternative to the domestic reshaping of finance
BRIC countries today	Heterodox arrangements reduce hypertrophy in a context of limited financial deepening	Government control of credit and currency markets permits stabilization and support of domestic market in the context of a global crisis	Regulation as an alternative reorganization
A better alternative	Use of heterodox arrangements to promote financial deepening and socially-inclusive growth	Crisis as an opportunity to strengthen, stabilize and deepen domestic finance	Regulation as the first step toward reorganization of finance and its relation to the real economy

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