Some notes on “The Evolution of Financial Regulation Before and After the Crisis”

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The paper written by Carlo Panico and his co-authors has three main theses. The first one is that the evolution of financial regulation from a discretionary approach, during the Bretton Woods era, to a rules-based approach, after 1980, had been one of the major causes of the economic slowdown and the reduction of wage share in income of advanced capitalist economies in the last 30 years. The second one is that a rules-based approach to financial regulation is incapable of preventing financial crisis, even after the advances in regulation achieved by the revision of such approach in face of 2008 world financial crisis. Last, but not least, the evolution of financial regulation was mainly directed by the lobby activities of financial sector in the political arena.

I do not agree with any of these theses. First of all, causality relation between the evolution of financial regulation and economic performance is just the opposite as the one supposed by the authors. Second, a rules based approach was not primary designed to prevent financial crisis, but to increase the elasticity of credit and boost asset prices. This kind of “regulation”, actually a deregulation of financial markets, was functional for capitalist development in the sense that it allowed a moderate increase in effective demand in a context characterized by a structural deficiency of demand. Finally, the deregulation of financial markets was fundamentally a sub-product of the hegemony of neo-liberal agenda after 1980 and also a consequence of the psychological and evolutionary mechanisms that induce proclivity in risk taking both by financial market participants and regulators.

Let us start with the causality relation between economic performance and financial regulation. According to the authors the movement from a discretionary approach to a rules-based approach in the United States and other developed economies – actually a deregulation of financial markets – caused an increase in financial profits as a ratio to GDP. As a consequence of that wages as a share of GDP had declined, imposing a reduction in the growth rate of effective demand and output. The reduction in the growth rate of output was followed by an increase in unemployment. Economic performance as a whole was reduced by the deregulation in financial markets.

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This chain of events has one major theoretical problem. In the classical-marxist (or Sraffian) framework used by the authors, financial profits (or interests) are no more than a simple deduction from total profits earned by productive capitalists. In other words, since financial activities are not productive in classical-marxist sense, its income can only be originated by the deduction from the surplus produced by "productive sectors". As a matter of fact, interest income is just the share of profits that is appropriated by financial capitalists. If that is so, an increase in financial income will result, for a given level of exploitation or, in Kaleckian terms, for a given "degree of monopoly", in a reduction in the share of profits appropriated by productive capitalists, not a reduction in wage share. This means that financial deregulation should result in intra-capitalist conflict, not a conflict between capital and labor.

For Keynesian economists, for example, Palley (2012), the causality relation between economic performance and financial deregulation was the other way around. The combination of globalization, labor market flexibility, privatization and the abandonment of full employment policies in the late 1970´s and early 1980´s due to the ideological dominance of neo-liberalism generated a structural deficiency of effective demand; i.e. a structural incapacity of the economic system in the developed countries to generate the volume of effective demand that is required for full-employment. As a result of that, unemployment rose, workers lost bargaining power and wages begin to grow below productivity, causing a reduction in wage share. This process of income concentration reinforces the tendency for stagnation of economic system, which was only avoided by the incredible increase in the level of domestic debt after 1980, which allowed a moderate increase in consumption expenditures of households. The increase in the level of domestic debt was sustainable for some time due to the increase of asset prices, mainly real estate prices, which increased the financial wealth of households.

In order to produce such increase in the level of domestic debt and asset prices it was necessary to increase the elasticity of credit supply by financial sector. This is where financial deregulation comes in. In the words of Palley:

"In sum, the combination of a constant stream of innovations and deregulation, changing psychology and belief, and changing business and regulatory culture created what seemed to be a perpetual motion financial machine. The new machine supported ever increasing asset prices and borrowing that plugged the demand short-fall created by neo-liberal model of growth and global economic engagement" (2012, p.66).

According to this line of reasoning, financial deregulation was functional to the growth model adopted by developed capitalist economies during after 1980. This allowed us to reach our second thesis: rules-based regulation was not primary designed to avoid financial crisis, but to increase the elasticity of credit and boost asset prices. Without financial deregulation, i.e. with a discretionary approach to financial

regulation, it would be impossible to increase credit creation in the rate required to induce growth in consumption expenditures in a context of stagnating labor income. The adoption of a so-called rules-based regulation was the perfect disguise for what was a simple deregulation of financial markets that aimed to allow an increase in the risk taking behavior of financial market participants and, by that, to increase the elasticity of credit supply.

The risks involved in this process of financial deregulation was systematically undervalued by economists, regulators and financial markets participants because of a "blind faith" in the market discipline as a device for avoiding financial distress. This is where neo-liberal ideology comes in. After the crisis of Keynesian Economics in the 1970´s, the dominant ideology in the western world was neo-liberalism which states that market forces – not State intervention – are capable to coordinate capitalist economies, allowing then to achieve an efficient allocation of resources. In the field of financial economics, this view was expressed by the Efficient Market Hypothesis (EMH) due to Fama (1970) which states that asset prices contain all relevant information for asset-holders. In this setting, asset price changes cannot be predicted, because asset prices behave as a random-walk. This random-walk theory of asset prices also establishes that asset price bubbles can´t exist, so there is no need to worry about then (Oreiro, 2003).

Another important element to explain the financial deregulation process that happens in advanced economies after 1980 was the positive feedback from financial deregulation, credit expansion, increase in asset prices and risk perception. The evolution of financial deregulation allowed a huge increase in the rate of credit creation which increased asset prices. The asset prices boom promote optimism and memory loss regarding past crashes (Palley, 2012, p.65), reducing the perception of risk by market participants and regulators, which produce a new wave of financial deregulation. This means, as noted by Palley, that market discipline and regulatory discipline weaken progressively.

Finally, there are also evolutionary mechanisms that induce risk taking behavior by financial market participants, contributing to reduce the market discipline imposed by rules-based regulation. In the words of Palley:

"(…) Managers and entrepreneurs who make profit come to dominate. Since risk takers tend to make more profit, cautious investment managers and entrepreneurs will tend to fall behind over time and the population of managers and entrepreneurs will be increasingly dominated by high rollers" (2012, p.65).

Up to this point, we can conclude that the evolution of financial regulation from 1980 on was required for the "normal" function of the neo-liberal growth model and was supported by the ideological dominance of Efficient Market Hypothesis and by psychological and evolutionary mechanisms that induce risk taking behavior both for

financial market participants and regulators. In this setting, lobby activities of financial sector in the political arena could have had, at best, a minor role in the evolution of financial regulation. But the major problem of lobby activities hypothesis advanced by the authors is that this hypothesis lacks more robust empirical evidence. As a matter of fact, the authors show no evidence about the relevance of this mechanism for financial deregulation in the United States or other developed countries.

Apart the critiques made here, I think that the article written by Panico and his co-authors can be a useful reference for those economists interested in understanding the evolution of financial regulation in developed countries in the last 30 years.

References

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