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Problematique

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RETHINKING FINANCIAL MARKETS

A conference from the WEA

1st November to 31st December, 2012

Problematique

Introduction

It is not wrong to believe that recent financial crises and general discontent with the economy demand not just regulatory reform, but more fundamental reconsideration of the purposes, contexts, and methods of financial regulation. As contemporary policy discourse conclusively demonstrates, however, the emergence of fresh thinking tends to be hampered by more or less subtle anachronisms, patterns of thought that hardly describe the world and so obstruct the achievement of collective intentions. If we were to redescribe the world, however, we could reconsider the politics of finance writ large.

This conference of the World Economics Association aims to foster just such collective reconsideration of the social role of finance, and consequently, the regulation of financial markets. A key difficulty, for any collective consideration of such a vast topic, is coherence. How to make something cogent out of a call to rethink financial markets, which raises myriad concrete and specific issues?

In an effort to provide some shared reference points for discussion, a hub for many spokes, this problematique sets forth three general and contestable suppositions for contemporary thought about the sensible construction of financial markets going forward. This problematique then asks more specific questions in a number of contexts, which numerous talented scholars have been invited to address. Of course, the participants may expand upon or take issue with the general suppositions, too. And all of the proceedings will be available for public comment – the hope is that the set of contributions will coalesce into a broad yet trenchant consideration of the issues raised by contemporary financial markets, and by extension, political economy writ large.

The first supposition on which this conference proceeds, discussed in more detail below, is the idea that a great deal of social life has been capitalized, so that individuals and institutions in all reaches of society are directly dependent on the functioning of capital markets. Consequently, much politics (including legal regulation and humane sentiment) should be understood to operate through financial markets, as opposed to in opposition to markets – hence "social capitalism." As a corollary, financial market regulation should be understood as constitutive of core social processes, rather than the correction of the "failure" of some natural market. Markets are a form of politics, and should be evaluated accordingly.

Second, the traditional imagination of finance, founded on conceptions like the scarcity of capital and intermediation, and legitimated by promises of innovation and growth, has become outdated, due to this same capitalization of social life, that is, by the success of finance itself. Wall Street has colonized Main Street: financial markets, often even banked assets, are larger than the "real" economies they were meant to serve. The discipline of finance should be reinvented to account for the mercurial sea of liquidity that characterizes "economies of money."

Third, and in consequence of the first two suppositions, the practice of financial regulation should shift focus, from fostering the formation and allocation of capital, to maintaining the stability of the institutions, now all perforce monetary institutions, on which contemporary social life depends, hence "custodial regulation."

As noted, these suppositions are all contestable. As a matter of intellectual history, few ideas are logically necessary. It is quite possible that financial markets shall not be reconsidered along the lines suggested here. Were the suppositions mentioned above and clarified below to be taken seriously, however, the practice of financial regulation would change in concrete ways. Our institutions, and hence economy, would evolve differently.

After discussion of these general suppositions in more detail below, this problematique will list a series of propositions, designed to stimulate and focus discussion, to explore possible directions and concrete proposals, for matters ranging from sovereign debt to exchange regulation to labor markets.

General Suppositions

1. Social capitalism. Much of a contemporary society's work depends on capital markets. Nowhere is this more obvious than in the United States, where endowed institutions are widely used to provide for health care, education, artistic and spiritual life, and retirement. Even in societies in which the state takes more direct responsibility for social needs, access to credit markets remains critical, as painfully illustrated by the sovereign debt aspects of the crisis in Europe.

Moreover, ordinary economic operations – at the individual, business, and governmental levels – rely on well-functioning credit markets. The so-called real economy runs more on credit than on cash. Consider, in this regard, household credit cards, commercial paper markets, and credit facilities offered by banks to firms. Indeed even cash, the payment system and ultimately, the institution of money itself require the health of leveraged financial institutions, as again illustrated by the European crisis. Once the functioning of the "ordinary" economy is understood to require smoothly operating capital markets, then the venerable tendency to understand finance as extraordinary (used to achieve something that the borrower cannot or will not pay for out of retained earnings, at least not immediately, such as the purchase of a house or a company) becomes less significant. Simply put, daily business in the real economy requires the financial economy to be functioning reasonably well.

Understanding the extent to which capital suffuses contemporary societies has profound consequences for political economy. The traditional distinction between Main Street and Wall Street and the related distinction between labor and capital lose much of their normative force. Those who work and those who own are both dependent on capital markets. By extension, "the social," once thought to be workers and their dependents, cannot be understood in simple opposition to capital, despite drastic increases in inequality, notably in the United States. Most obviously, workers are dependent on capital markets to secure their retirements. But more deeply, many people (nearly fifty percent of the US population) do not hold jobs. Consider the old, children, students young and not so young, the sick, caregivers of various sorts, and so forth – all of whom are directly dependent on capital markets, or dependent on institutions that are directly dependent on such markets. Political economy must see to these people, too.

This capitalization of social life should mark a fundamental shift in social policy, even for those who think of themselves as progressive or on the left: in the present context, the task is not to oppose capital in the name of labor, conflated with humane sentiment. The task is to construct capital markets, indeed markets more generally, that serve people – hence "social capitalism." The object of regulation is not to correct for the "failure" of some market, but to design contexts in which relatively autonomous actors competitively and cooperatively pursue social goods.

2. Economies of Money. The capitalization of social life has monetized contemporary economies. In recent decades, many markets in specific assets and obligations, ranging from houses to much compensation to pensions, have been replaced by markets in more liquid legal instruments. Such instruments tend to be abstractions from, and more or less faithful representations of, the economic relations in question. For examples, traditionally closely held entities, notably investment banks, have been converted into corporations and their equity traded. The assets and liabilities of firms are managed through the free creation of legal entities, with consequences for both accounting and capital formation, and for the network of indebtedness, exposure, and systemic risk, as illustrated by the constellation of structured finance, credit default swaps, and banks in 2008-2009. More generally, long and short term debt markets abound, and are used by public and private institutions as well as households. The resulting debt streams, ranging from commercial rents to auto payments to home loans, are securitized as a matter of course.

To put matters more generally, recall Marx's observation that as a society becomes more commercial, social relations are replaced by perhaps more productive, but less personal, economic relations – "all that is solid melts into air." In recent years, we have witnessed a second wave of abstraction, as specific economic relations have been replaced by more formal and ephemeral claims, which are also more liquid. Insofar as contracts have been replaced by securities, i.e., as (real) marketplace relations have been replaced by (financial) market relations, then political economy should be thought in terms of finance, which is hardly the same as thinking in terms of tangible goods and services – hence "economies of money."

The monetization or liquification of what is still often called the real economy has created a sea of liquidity; this liquidity needs to be managed; the financial industry has grown apace. One may of course view causation, and even blame, the other way 'round: the financial industry had incentives to create and sell services and products that ultimately resulted in capitalizing a great deal of economic life. At any rate, the monetization of the real economy has required a lot of work. The discipline of finance colonized management, providing conceptual tools for understanding business as if it were investment. Finance made the assumption of risk, especially the extension of credit, seem more manageable, and credit arrangements have proliferated. And, as already suggested, an essential objective of financial engineering has been to make illiquid forms of property more liquid, and thus more easily managed, making it easier to reinvest assets in pursuit of higher returns, to smooth cash flows, and perhaps most importantly, to diversify the risk commonly associated with large illiquid assets.

But financial engineering need not confine itself to property, things in the world, however ephemeral. In many countries, the banking sector, which now seek operating capital through commercial paper markets, or latterly, central banks (depositors, equity and earnings being hardly

sufficient) has assets in excess of national GDP. The development of derivative markets has meant that risks, always also understood to be opportunities, could be priced directly, without the need to own anything. Freed from the shackles of the material world, the supply of derivatives is limited only by the willingness of counterparties. Derivative markets are many times larger than the total value of the assets they were once thought to insure. To generalize, since the supply of bets and promises (legally binding instruments) is limited only by hope, financial markets – the sum of monetary promises – have become much larger than the "real" economies of goods and services they supposedly finance. Thus, whether we begin with the abstraction of assets and obligations, or with the proliferation of finance, we find ourselves speaking of a global economy of money.

While the development of fundamentally more liquid economies and perhaps even an economy of money appear to be historical changes of the longue durée, it should be noted that much contemporary liquidity stems directly from politics in the ordinary sense. That is, although the development of an economy of money may be structural – characteristic of global society, founded on incessant representation, electronically mediated – much contemporary liquidity is occasional. The United States has cut taxes and therefore borrowed money while fighting wars and funding rising entitlement, especially health care, costs. Unwise choices were made. In Europe, nations provided their people with ever more commodious European standards, equalized trade imbalances, and enjoyed more than a few bubbles, often despite lackluster growth and discouraging demographics, through massive private and public borrowing, and conversely, imprudent investing. The ability to repay, and hence the credit-worthiness of borrowers and the soundness of lenders, are now in question. Surely more prudent policies were imaginable. The Chinese have pursued Ordnung and global market share through currency management, effectively subsidizing the cost of capital worldwide, albeit at both systemic risk and substantial domestic human cost.

Finance, in a fully monetized economy, to say nothing of an economy of money, cannot be understood in the traditional fashion. Traditionally, finance understands itself in terms of the allocation of scarce capital. The idea is that financial markets intermediate between savers, those with surplus social capital, and entrepreneurs who have good ideas, but who cannot realize such ideas with their own assets. If capital markets are functioning well, good ideas will be realized, i.e., there will be innovation, and hence growth. We may call this the Silicon Valley story.

In a monetized economy, however, capital is in principle abundant, not scarce. Due to the relative scarcity of investment opportunities (and conversely, the surplus of available liquidity), lenders are impelled to use enormous amounts of leverage in an effort to profit from narrow spreads, thereby increasing systemic risk. To quip, in contemporary financial markets, during ordinary times, drowning appears to be a greater danger than dehydration. In times of crisis, however, confidence, and hence liquidity, can evaporate, or at least flow away from specific contexts. Consider, in this regard, the market for auction rate securities, or interbank loans, or even the sovereign debt of some advanced countries: in each of these markets in recent years, liquidity was plentiful and cheap, until suddenly, it was expensive or even unavailable. Water is difficult to manage.

The problem of growth is even more difficult for contemporary political economy than the challenges of rethinking finance in terms of the abundance rather than the scarcity of liquidity. Innovation, growth, and by extension job creation appear to be ephemeral, unpredictable. While ideas may require capital for their realization (the Silicon Valley story is not impossible, just very unlikely), the provision of capital is hardly tantamount to innovation. History gives us no reason to believe that everyplace will become a center of innovation. Most of the countries now at risk in Europe were not growing prior to the present crisis; economic growth in the United States has been regionally concentrated even during boom times. In short, it cannot be assumed that the structural reforms being undertaken worldwide, however sensible, will lead to innovation, much less substantial growth, much less employment, in any direct or automatic fashion.

Even good economic news may not be particularly good social news. Banks may raise (or be given) capital without extending credit. Companies may improve their balance sheets, their production processes, and even grow, without hiring more people. A fundamental difficulty for political economy is that the polity and the economy need not have the same demographic scope. The economy is likely to need less than all the people. People who cannot be expected to contribute to growth (the old, the sick, and most of the poor), and people who simply will not contribute much to growth (most workers, most of the time), as well as most institutions and countries, are nonetheless proper subjects of political economy, and for that matter, deeply invested in financial markets. In short, financial policy that depends for political justification on the uncertain hope of localized innovation and growth is hardly adequate for a social understanding of capitalism.

3. Custodial regulation. In a global society in which social commitments have been capitalized and are held on a portfolio basis by highly leveraged and interdependent institutions, the traditional imagination of finance – how to intermediate scarce capital between savers and worthy entrepreneurs, while preventing fraud – should lose its dominance, to be replaced by a more custodial understanding of the vitality of stable capital to social order and humane understandings of institutions. The managers of a pension fund, a university endowment, or even a bank's sovereign debt portfolio, rather than the venture capitalist and the entrepreneur, should become the paradigmatic figures for contemporary thinking about capitalism and its regulation. For such managers, the issue is fulfillment of fiduciary obligation, which requires the ability to deliver what and when promised. The paradigmatic fiduciary, the trustee, is the custodian of the beneficiary's interests, and from a custodial perspective, finance is the mediation of existing social obligations among parties and across time. Growth is desired but hardly essential: the fiduciary obligation exists nonetheless.

The custodial perspective is thus quite different from the perspective traditionally taken by finance, and epitomized by the rationally self-interested venture capitalist who seeks innovation and is willing to tolerate a substantial number of failures. Should the relevant elites take this conceptual turn to social capitalism operating on an economy of money, the aesthetics and so practices of financial market regulation will be far different from those that have characterized the last several decades. Rather than an emphasis on risk taking in the hope for creative destruction that, on balance, may be said to serve society's best interests, financial regulation could become more explicitly concerned with the reliable flow of social capital.

Policy Contexts

What would financial policy and regulation look like, if financial regulation were understood to be the construction of markets on which society could rely?

1. Recent history and the art of the possible. The financial crises from 2008 to the present have made apparent structural deficiencies in our financial markets, and have impelled reform efforts. Although this entire problematique might be understood to ask "what have we learned and what may be done," the following general questions may be fruitful, especially in considering the more specific questions that follow.

First, although the recent crises exhibited great greed and substantial fraud, such human failings are by no means new. Moreover, in the right measure things like self-interest, optimism, and trust are virtues, even if their exaggeration can lead to disaster. On the basis of recent experience, what might be said about the relations between human frailty and institutional structure that might guide the design of regulatory regimes, the provision of incentives, and the establishment of sanctions?

Second, crises often provide an opportunity for reform. At the same time, the regulated actors often have interests opposed to reform, and are politically powerful in their own right. As one considers ideas for better financial markets, the question of political possibility looms large: can we get there from here? For example, it might be argued that too many banks in European countries are overexposed to the sovereign debt of their own governments, meaning that fiscal crises can trigger financial crises and, in turn, further worsen conditions in the real economy. Better integration of European banking, i.e., weakening the links among a country's government, banks, and local economy, might serve to ameliorate the effects of fiscal crisis on local financial institutions, businesses and households, and hence people. But is such denationalization and inevitably consolidation of European banking politically imaginable?

Third, consider the interaction of short term and long term measures. Oftentimes, a crisis requires immediate action in order to avert disaster. The intervention may nonetheless have long term consequences. For example, in 2008 and into 2009, the United States financed the "private" acquisition of several institutions deemed too big to fail, resulting in the creation of even larger, and presumably systemically more important, institutions. Similar, the ECB's injection of liquidity into financial institutions in late 2010 may have been necessary, but its medium term effects are being questioned.

Fourth, interactions among institutions (markets, flows) of international and national scope may be difficult to sort out precisely because of incongruities of scale, differences between what is "national" and what is "international" or even "global." The obvious example is the now famous observation that financial institutions live and work internationally, but die nationally. In response, it is not too difficult to call for an international bankruptcy code, or in a similar vein, international accounting standards, or even cross-border banking resolution. But how are such things to be achieved? To make matters more difficult, it is not clear when the international is superior to the national. Some things – and perhaps the establishment of a fiat currency is one of them – seem to function better if backed by a truly sovereign authority. (For an American, it is not entirely clear when the federal is superior to the state.) Thus, to generalize, in thinking about financial regulation – and hence, constructing markets – one must consider the political context in which such regulation takes place.

2. Fiscal and monetary policy. The governments of many advanced economies are in periods of substantial retrenchment, or at the very least are arguing that such retrenchment is necessary in order to gain competitiveness and economic health generally. A few nations – China and Germany spring to mind – are running substantial surpluses (implying deficits elsewhere). Finally, in cases of highly indebted governments and recessionary economies, it has become commonplace to note that austerity measures may be pro-cyclical. In all of these situations, it is argued that that "pro-growth" policies are necessary, in order to work down current debts, and for long-term welfare.

From the perspective sketched above, at least three related problems suggest themselves. First, growth may not eventuate, despite the establishment of virtuous policies. Second, and related: surpluses imply deficits. If the issue is global, or even European, economic peace, then the answer mathematically cannot be universal trade surpluses, and practically speaking, will not be competitive equilibrium at some sort of median welfare. Finally, even if it occurs, growth may do little to address the social problems for which government is responsible, including, not incidentally, environmental concerns. But if "growth" is no North Star, then what guides fiscal and monetary policy?

3. Tax, capital formation, and inequality. Tax policy discourse, particularly in the US, is characterized by several often conflicting values. First, it is argued that taxes on individuals and firms should be low, so that capital may be concentrated and invested, leading to economic growth, employment, and ultimately, higher tax revenues. Second, there is considerable anxiety that tax

burdens are falling unfairly on the broad middle class, who are also understood to be the "backbone" of the nation. Inequality and therefore populism are rising. Populism is often understood to exert inflationary pressure on policy making, and otherwise to conflict with long term interests of the polity – unless such arguments are merely camouflage for creditors. Third, there is some sentiment to use tax as an incentive for good behavior, e.g., saving for retirement, and a disincentive for less desirable but often necessary behavior, e.g., driving a car or perhaps (in Europe) securities trading. Fourth, taxes themselves may come at great political cost. Unwillingness to impose taxes, or inability to collect taxes, may have encouraged governments to issue too much debt. How would adopting a self-consciously custodial capitalism affect the priorities of tax policy?

4. Financial instruments. In response to the substantial human and institutional costs of recent economic crises, and the anemic economies established in their wake, might we see a shift from an emphasis on disclosure-based regulation of financial markets to a greater emphasis on substantive approaches to regulation? Recall that financial regulation, especially of securities markets but also of other markets, has been based on mandatory disclosure, and more generally, the management of information. Since the 1930s, across a range of markets, the law has tended to regulate information about risk, rather than risk itself. Parties that are presumed to have both incentives and capacity to assess risk, e.g. private equity investors, or hedge fund managers, have been allowed to operate with minimal regulation. To lesser extent, other markets of significance to consumers, e.g., real estate and health insurance, have also been regulated through the mandated provision of information designed to facilitate sound investment choices.

At least three interrelated developments have put this approach to regulation under considerable strain: the degree of capitalization of socially important institutions and even households; the degree of leverage and interconnection found among institutions and households; and the prevalence of volatility and systemic risk. If financial regulation is understood in custodial – as opposed to entrepreneurial – terms, then it may not be prudent to rely on the provision of sound information to guide consumer choices in relatively rational markets.

A number of specific questions spring to mind. Is more substantive regulation of finance required? If so, in light of the difficulties inherent in risk assessment, perhaps most conspicuously demonstrated by rating agencies, how should such substantive regulation be designed? Should certain instruments, such as over the counter derivatives, be banned outright? Or do efforts to move OTC trading onto exchanges suffice?

5. Financial markets (exchanges). If the purpose of financial regulation is to ensure institutional ability to deliver social capital, then volatility is a real problem, for the simple reason that human needs may occur during downturns. For concrete example, in light of recent losses in equity markets and perhaps interrupted employment, many people on defined contribution plans may have to postpone retirement indefinitely. The problem that volatility poses for social capitalism is exacerbated by the prevalence of systemic risk (by definition, risks that cannot be diversified away, because asset prices move in the same direction).

The desire to suppress unreasonable volatility, i.e., the desire for relatively stable markets, may be seen to be in tension with widely held belief that the quantity of trading is positively correlated with informational efficiency. Trading practices, notably including short selling, high frequency trading, and even certain forms of insider trading, invariably have been justified in the name of price discovery. Presumably a shift toward more custodial notions of financial regulation would also shift the balance toward efforts at dampening volatility, at the expense of at least some practices legitimated in terms of price discovery. Is this conflict between stability and information real? If so, is it avoidable? If it is not avoidable, how might one think about striking a balance?

6. Financial institutions. Since at least early 2008, it has become clear that large, or merely highly connected, financial institutions may serve as vectors for systemic risk. It has also become clear that numerous financial institutions, while not legally defined as banks, exhibit the structural weaknesses of banks: the mismatch between the terms of assets and liabilities make such institutions vulnerable to "runs" and sudden collapse, with potentially calamitous ramifications. Thus the classic rationales for emergency intervention into banks, and by extension, bank regulation, apply to numerous institutions. Finally, events of recent years have demonstrated that many such institutions were, and in many cases still may be too leveraged and too integrated to be operated safely.

In response, it broadly has been suggested (i) that such institutions should operate with more capital and less leverage, and (ii) that financial institutions be disaggregated. At the same time, actual developments, notably consolidation in the banking industry in the United States and the liquidity policies of the European Central Bank, have tended to tighten, rather than loosen, the integration of the financial system. Moreover, the suggested reforms tend to lower the profit margin on permissible trades (because less leverage is used), and to prohibit presumptively profitable trades.

Understandably, such reforms have been resisted by financial industry participants (the Volcker Rule is a pale shadow of Glass-Steagall). But while these new approaches to regulation are unlikely to be politically palatable or practically easy, reforms nonetheless may be advisable. Thus the question of how systemic risk within financial institutions may be reduced is conjoined with a narrow political question, viz., the extent to which a custodial understanding of financial regulation can overcome the class interests of financial industry insiders.

7. Custodial relations. Entailed in the idea of social capitalism is the idea that financial institutions

and markets are not merely means to ends, but fairly directly serve human and institutional needs. The purpose of a mutual fund used for retirement purposes, or a line of credit, is to provide money when and where it is needed. Liquidity is just as necessary for modern life as access to electricity or communication networks. The market's institutions, in this view, are much like utilities, expected to run smoothly and consistently, to be reliable, even boring. Profit margins ought to be concomitantly low, at least in contrast to expectations among contemporary market participants.

Also entailed in the idea of social capitalism is that much capitalism takes place in and among not-for-profit institutions, including governments. That is, the distinction between public and private is far less clear in this context than it was once believed to be; what has become clear is that various institutions serve various missions that benefit different sets of people in different ways. By extension, we should expect to see far more articulated ideas of fiduciary relations, that is, the obligations owed by those in power over socially significant institutions, including for-profit corporations.

This understanding of the centrality of custodial relations to social capitalism is in tension with traditional conceptions of finance, in which violent market interactions, the often destructive clash of the rational self-interests of market actors, were celebrated because such conflicts supported growth, innovation, and hence new jobs. It has been said that financial volatility, creative destruction, and so forth are the hallmarks of a dynamic, creative capitalism – a capitalism that is highly localized at the best of times. So the question arises: will broader needs for a more stable, boring capitalism bring about Schumpeter's prophecy of the bureaucratic end of entrepreneurial capitalism?

8. Labor markets and social capitalism. As suggested above, a great deal of political economy rests upon the belief that capital formation leads to growth, and that growth will require labor, leading to high rates of employment, and hence human well-being. As also suggested, however, capital may not lead to growth, and even if it occurs, growth may employ relatively few people. To which it is often said that what is therefore necessary is (still more) education. It is not at all clear that technological markets tend to employ many (code is infinitely replicable), and, as noted, surpluses imply deficits. Even if all workers could somehow be made competitive in technological economies, however, the fact remains that a humane political economy must account for many people who are not economically productive. In short, social capitalism appears not only to have transformed the opposition between labor and capital that was long an article of faith on the left, it has almost severed the relationship between labor and capital that has long served, for those on the right, as justification for capital's antics and inequality generally. What does this state of affairs mean for labor policy? What are the consequences for education policy?

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There is much more to say, but the foregoing ought to provide this conference with a few points of reference if not a tight focus, and at any rate, ought to be enough provocation for a problematique. I trust that conference participants will not feel overly constrained by my effort to articulate these problems, and will say what they wish.

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