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IT'S NOT ABOUT REGULATION …

Jan Toporowski

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JAN TOPOROWSKI
Economics Department, the School of Oriental and African Studies, University of London, and the Research Centre for the History and Methodology of Economics, University of Amsterdam

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Danish Institute for International Studies, DIIS
Strandgade 56, DK-1401 Copenhagen, Denmark
Ph: +45 32 69 87 87
Fax: +45 32 69 87 00
E-mail: diis@diis.dk
Web: www.diis.dk

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ABSTRACT

The present discussions about the future of bank regulation, coming after a long period of bank deregulation, have a natural tendency to exaggerate the effectiveness of regulation. But those discussions are poorly rooted in the macroeconomic foundations of bank intermediation, including its function of risk-bearing. The debate on financial regulation, abstracted from actual intermediation, would be more effective as part of a more general discussion of financial reconstruction.

I. INTRODUCTION: THE LIMITS OF 'MACRO-PRUDENTIAL' REGULATION

Having devoted well over two decades to the study of credit cycles, I feel a certain unease at the widespread enthusiasm to 're-capitalise, accommodate and regulate' in response to crisis. By this response I mean recapitalising banks to prevent their insolvency (the condition in which a bank's assets do not cover its liabilities); lending banks money from the central bank to overcome their liquidity difficulties (the condition in which a bank's assets cannot easily be converted into means of payment of liabilities); and regulation to prevent such difficulties arising again. Recapitalisation and accommodation are ways of overcoming the immediate effects of the crisis. Regulation is supposed to give us efficient banking without the instability and economic disruption currently being experiences. Yet every student of credit cycles knows that the present crisis is a transition, a phase in a more general cycle. Regulation therefore has to be effective in an abstracted future. But that future is emerging out of a current crisis, the overcoming of which will structure banking and financial markets for a long time to come.

For this reason I take issue with the 'Geneva Report', and a number of other proposals, which consider the present crisis to be a 'systemic' failure of the banking system, and which therefore advocate 'macro-prudential' regulation to ensure the stability of the banking system. Such 'macro-prudential' regulation is contrasted with 'micro-prudential' regulation designed to stabilise individual banks. For example it is argued that increasing capital requirements in an asset boom and reducing them in a recession, will stabilise asset markets (Brunnermeier et al. 2009). This view has its roots in two central concepts that reflect the limited scale of central bank policy and thinking. The first is New Classical business cycle theory, according to which disturbances in general equilibrium are due to various (supply-side) 'shocks' that banking systems accommodate in the process of obtaining a new equilibrium. This is reflected in comments emerging from leading central bankers to the effect that with effective recapitalisation accommodation of banks, the crisis will last for no more than a year or two, before general equilibrium is restored.

The second central concept is the currently fashionable 'network theory' that emphasises the inter-dependence between the balance sheets of banks in systems where inter-bank lending is common. This is supposed to be the source of 'systemic' risk in banking. The narrow concern for the stability of systems of inter-borrowed reflects in large measure the myopia of central bankers who know well the banking markets in which they operate, but not the market processes outside those banking markets, so that information about the economy at large reaches central bankers as either 'news' or the conjectures provided by their economic modellers. In other words, central bankers can observe directly the banking markets in which central banks operate, but not the market interactions between banks and households and firms (Toporowski 2006). Central banks have an institutional preference for operating in stable markets because market stability enables central banks to implement monetary policy effectively: In situations of instability or in a Keynesian liquidity trap, central banks' operations have unpredictable or no results so that they appear ineffectual and incompetent.

The 'recapitalise, accommodate and regulate' strategy is therefore an understandable response to political pressure for action. But it overlooks certain fundamental questions of financial regulation. The first part of this paper looks at five of these fundamental questions. The second part of this paper puts forward five conclusions that emerge from a consideration of these fundamental questions.

II. FUNDAMENTAL ISSUES OF FINANCIAL REGULATION

II.1 The purpose of prudential regulation is to prevent financial crisis, whether in an individual bank or firm (default) or on a wider scale in the financial system or the economy as a whole, made manifest in a series of defaults. Unless such regulation is wholly ineffective, it will prevent defaults which, because they have not happened, will be unobservable. This gives rise to what can be called **'Empirical hazard'**. It is impossible to know what crises have been avoided by a given system of prudential regulation, so that the scale of any existing crisis might have been very much greater, or very much smaller without that regulation. Hence the effectiveness of any given system of regulation cannot be known. Similarly, the effectiveness of fiscal policy cannot be determined because we cannot know what might have happened otherwise. The only circumstance under empirical hazard would not arise would be if each situation were a reiteration of past situations that allows stable structural relations between variables to be determined. But each situation in which we, banks, regulators governments and households, find ourselves is in some way unique, because today we know more than we did yesterday (learning) and, more importantly in the case of financial regulation, we have a different balance sheet today to the one we had yesterday. Hence, actual defaults may be due to wrong regulation, or the right regulation not enforced hard enough.

II.2 Regulation ultimately depends on what is financial intermediation and the economic structures within which intermediation occurs. Therefore the effectiveness of constraining bankers' decisions depends on the business that they do. That business differs because the economic structure in, for example, the so-called most financially advanced economies where crisis germinated, the U.S. and the U.K., differs fundamentally from, say, the economic structure in Iceland, where banking markets have collapsed, or even more significantly continental Europe, where there has been no market collapse, but banks have felt the portfolio effects of the U.S. and U.K. crises, and the crucial export sector of the Euro-zone economy has been affected by the crisis elsewhere, and the general decline in industrial investment. In other words, financial intermediation is a market process, and endogenous flow of funds that determines balance sheets, rather than as portfolio theory would have us believe, a set of desired portfolio balances which determine flows. Regulation that imposes constraints on balance sheets may merely redirect the flow of funds.

Hence, given a certain ease with setting up companies (holding cos.) balance sheet constraints merely determine how financial intermediation organises itself. The periodic discovery of illegal banks operating in the regulated banking markets of China is a good example of this. The Geneva Report places considerable emphasis on so-called 'dynamic provisioning' (increasing capital requirement in a boom, and decreasing them in a recession) which is supposed to have allowed Spanish banks to avoid crisis even after a major real estate boom. But the effective part of Spanish bank regulations is more likely to have been their company legislation, which makes it difficult to set up subsidiaries or holding companies, a state of affairs regularly criticised by economic liberals as an unnecessary bureaucratic burden on enterprise.

II.3 The conventional wisdom today is that financial intermediation inflicts random 'shocks' on bank balance sheets, linked together as networks of banks. Financial crises may thereby be simulated, and actual balance sheets may be subjected to 'stress' tests (say a change in the exchange rate or interest rates, or a fall in asset prices). This allows analysts to study the effects of such shocks and the speed with which equilibrium is resumed. **In the real world, financial intermediation does not so much inflict shocks on banking networks existing within general systems of economic equilibrium, as accommodate long-term financial imbalances, by market processes such as the accumulation of reserves, or asset inflation** (Perelstein 2009). Crisis arises not so much because a general equilibrium has been disrupted by a sudden shock, but because financial systems can no longer accommodate those long-term imbalances, and financial crisis breaks out (Toporowski, 2000, chapter 3).

II.4 The accommodation of financial imbalances is linked to another central function of financial systems, that of bearing risks. A key reason why banking and financial institutions exist is to bear risks for households and businesses (Knight 1921, chapter VIII, Emery 1896. This view contrasts with the theory that has come to prevail since the 1950s, that the function of the financial system is not to ameliorate risk but to supply assets in accordance with the risk preferences of investors. See Chick 1992). This is done by techniques such as (bank) reserve management, asset diversification, overdraft facilities (note issuance facilities), deposit guarantees, liability management and so on. By these means banks can take upon themselves the risks to which the savings and expenditure of individual households and investors would otherwise be prone. Financial intermediation is risky because it has taken over the risks to which its customers are subject.

II.5 The risk-bearing function of financial intermediaries has important implications for regulation. It is possible to dream up schemes of prudential regulation that would eliminate risk in banking, for example Islamic banking, or the measures proposed in the Geneva Report. But this may merely give rise to **risk-avoiding intermediation by putting the risk back onto households and firms** (depositors and borrowers, in the case of Islamic banking, or through socialising risk in the case of the Geneva Report). For example, a capital market in which companies issued only bonds would be relatively more stable than a market in which companies only issued unredeemable common stocks or equity. This is because all securities in a bond market have assured repayment values. However, this market stability would be at the expense of companies which would have to maintain additional liquidity or access to lines of credit in order to assure repayment. Thus a system of bond finance reduces the market risk for financial intermediaries, arising out of the volatility of asset prices, at the cost of increased liquidity risk in companies. (See also Reati and Toporowski 2004, Toporowski 2007).

In the final analysis, as long as the economy itself is subject to instability, manifesting itself in liquidity failure in real markets (even creative destruction) commercial banking interests will always be able to argue that with just a little less regulation financial intermediation could automatically accommodate such instability so that we could have more creativity and less destruction. 'Empirical hazard' will be used to blame on regulation the residue of defaults that will always be found in a capitalist market economy. Moreover, aggrieved individuals and businesses, constrained by regulation in their ability to operate in credit markets, will always be found to second such arguments.

III. TOWARDS FINANCIAL RECONSTRUCTION

The summary given above of key issues in financial regulation, suggests the current discussion of financial regulation needs to be extended in the following ways:

III.1 Institutions, how they function together in markets, and how macroeconomic imbalances are accommodated are more important than how we regulate banking entities abstracted from their actual intermediation functions. The present crisis is not due to deregulation (which had occurred in 1980s) but precisely because commercial credit was allowed to take up the slack in the economy that arose after the dot.com bubble burst in 2000. Commercial credit was able to support consumption through housing market inflation, and corporate liquidity through capital market inflation, at the cost of rising indebtedness that emerged as excess debt when housing and financial asset prices fell (Toporowski 2009).

III.2 A second disadvantage of discussing bank regulation abstracted from actual conditions of financial intermediation is **the unreality of any discussion that starts with general principles of regulation when banking and financial markets are gripped, or at least driven, by crises in the U.S. and U.K. that are notable for their durability rather than their tractability**. The present discussion of 'optimum' regulation in a private sector banking system, hardly addresses the current prospects for banking. The current difficulties are largely regarded as policy problems, rather than regulatory ones. Especially in the most financially advanced countries, banking will be in state sector for a long time to come and will be affected for decades, if not years by measures to deal with the crisis. Discussions of bank regulation that abstract from the banking structures being currently worked upon are either frankly utopian or else implicitly nostalgic for a recent, but receding, past when macroeconomic imbalances were accommodated by asset inflation, rather than the efficiency of deregulated banking ('A haven of familiar monetary practice', Toporowski 2005).

III.3 The durability of the present crisis suggests that the discussion should be centred upon **not so much financial regulation, but financial reconstruction**. Such financial reconstruction has to take place within a broader programme of the reconstruction of our economic institutions, whose aim must be to reduce the dependence of global economic activity on financial market conjunctures. Such dependence has been embedded in the financialised economies through funded pension schemes, the use of privatisation as a source of government revenue, and the increasing use of the housing market to support household consumption, while the non-financialised economies, through their increasing export dependence on financialised economies, thereby acquired an indirect dependence on financial inflation. Economic activity must be reorganised to make the real economy more stable and financial markets more boring, so that enterprise is focussed on innovations that enhance welfare, rather than financial inflation.

III.4 The macroeconomic preconditions for financial stability must include appropriate fiscal accommodation. It is important to remember that the stability of banking and financial markets after the Second World War was not only due to regulation, but also due to the overhang of government debt largely held by banks and kept liquid by central banks (Minsky 1986, pp. 77-79). Such government debt operations must be part of any effective stabilisation of banking markets. To some extent this is already happening as government debt expands rapidly to refinance banks; stabilising banks by distributing among financial balance sheets government paper backed, in effect, by claims on banks.

An important limitation of this emergence of the government as financial intermediary to bankers is that government credit operations are being used to support credit ('finance is financing finance') rather than activity in the real economy, as happened in previous government debt expansions. There is a benefit in that it facilitates 'quantitative easing', that is the purchase from banks of government paper by central banks to provide commercial banks with additional reserves. But the benefits of quantitative easing have always been greatly exaggerated: It didn't have any significant economic effect in Japan when it was tried at the end of the 1990s, when the ratio of Japanese Government debt to Gross Domestic Product was approximately 150% (the U.S. and U.K. government debt to GDP ratios currently stand at 60% and 50% respectively).

A particular difficulty, which may have added to the fragility of banking systems in the U.S. and the U.K. and which today limits central bank operations with commercial banks, is the concentration of government paper in the reserves of central banks and long-term investment institutions (insurance companies and pension funds). The clear preference among long term investment institutions for government paper means that the return of ailing government-supported banks to the private sector will be limited by weak demand in the capital market for shares or common stocks. This means that banks are likely to stay in the public sector for a while. The discussion on bank regulation will remain utopian as long as it ignores the distinctive functions that public sector banks must perform.

III.5 On the agenda of discussions about financial reconstruction has to be elimination of so-called 'independent' central banks and regulators. One of things wrong with our institutions is the narrowing of the policy agenda to consumer price inflation and employment. This allowed regulators to tolerate financial inflation and get away with it, while delegating awkward questions of regulation to an abstracted market in which 'rational' agents prevail. The crisis has brought home to everyone what was apparent in the

1930s, namely that in a capitalist market economy in general, and in financial markets in particular, the 'rational' generation of cash flow does not result in any kind of social equilibrium or optimum (Keynes 1936, chapter 12; Kaldor 1939; Chick 1992).

More importantly, in the moment of crisis, it is most obvious that the previous cash flows generated by inflation in asset markets concealed structural imbalances in those markets. Delegating regulation to market participants, or even to those experienced in generating cash flows from asset markets, i.e., so-called 'expert practitioners' means delegating to those acting under the influence of illusions created by those cash flows. Among those illusions is the belief that the banking system's exposure to macroeconomic hazard arises merely out of inter-bank financial transactions which leave banks with sizable exposures to default by a single bank (Brunnermeier et al. 2009). Such a definition of 'macro-prudential regulation', and the concern for securing the survival of 'systemically important' financial institutions (i.e., institutions whose default would have an adverse impact on the balance sheets of a large number of banks) reflects the capture of financial regulators by the institutions which they are supposed to regulate. Financial inflation expands cross-holdings of each others assets by banks in liquid markets whose cash flow creates an illusion of successful credit operations. Independent regulators will always incline to deregulation at such times. The answer is to have publicly accountable regulators imbued with an ethos of public service capable of auditing market structures and market processes, rather than practitioners whose expertise in individual balance sheet restructuring blinds them to market structures and imbalances.

In conclusion then, the discussion of financial regulation will remain abstract and unreal until it is placed within a broader discussion of the reconstruction of financial intermediation. Banking as a profit-seeking business must be replaced by banking as an intermediation and risk-bearing service for governments, households and firms that generate the real use-values of an economy.

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