

**Conference on**  
**“Reforming the Financial System: Proposals, Constraints and New Directions”**  
**January 25-27, 2010, Muttukadu, Chennai, India**

**Finance and the real economy –1**

**The Unraveling of Financialization: A Macroeconomic Perspective**

**Saúl N. Keifman<sup>1</sup>**  
**Universidad de Buenos Aires**  
Draft for comments

“If not now, when?”  
Hillel<sup>2</sup>

**Introduction**

The current crisis offers an opportunity to redefine the relations between the real economy and finance, for the first time, perhaps, in three decades. I would like to place the discussion about macro-prudential regulation in a broader perspective. The financial crisis which caused this big recession is symptomatic of much deeper problems that go well beyond the failure of inadequate (or missing) financial regulations (Commission of Experts, 2009, Stiglitz, 2009). No doubt, the ongoing discussion on reforming micro and macro-prudential financial regulation is a very important and welcome development. The new emerging consensus on the serious macroeconomic destabilizing nature of the self-regulation paradigm which prevailed in global finance before the crisis and the need to overhaul it, is a sea change. However, the task of stabilizing financial markets, let alone the overall economy, will necessary take much more than new financial regulations.

**Macro-prudential regulation and excessive credit supply**

UK’s Financial Services Authority (FSA) released The Turner Review (2009a) (and also the related Discussion Paper No. 2/09, 2009b), a remarkable document which provides a critical (and, I guess, self-critical) insider’s view of what went wrong with global finance. The analysis is very comprehensive. The array of views examined is quite broad: Keynes, Minsky, Kindleberger, Shiller (among other heretics) are quoted. Market failures and irrational behavior contribute to explain financial market bubbles. The report even nails the IMF by quoting its eulogy of securitization:

The IMF’s *Global Financial Stability Report* of April, 2006 stated that ‘the dispersion of credit risk by banks to a broader and more diverse set of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient’. It noted that this dispersion would help to ‘mitigate and absorb shocks to the financial system’ with the result that ‘improved resilience may be seen in fewer bank failures and more consistent credit provision’<sup>3</sup>

---

<sup>1</sup> I thank Fernando Couto for many valuable suggestions and comments.

<sup>2</sup> Pirkey Avot, 1:14.

<sup>3</sup> Financial Services Authority, 2009a, p. 42.

Financial liberalization is pointed out as one of the causes of higher macro instability, as warned by the BIS:

'Financial liberalisation may have made it more likely that financial factors in general, and upswings and downturns in credit and asset prices in particular, act as drivers of economic fluctuations.'<sup>4</sup>

Basel II micro-prudential regulations are also found to be pro-cyclical. For instance, mark-to-market valuation of assets combined with fixed capital adequacy requirements, exacerbated the pro-cyclicality of credit supply. The report includes several proposals to revert or mitigate this problem. At the micro-prudential level, it is suggested that *asset-based leverage ratio*, a leverage based regulatory capital floor can address some of the shortcomings of a risk-based solvency regime. But special emphasis is placed on the need to take into account systemic risk and introduce counter-cyclical or macro-prudential regulations. *Counter-cyclical capital reserves/buffers* is one of the ideas advanced in this regard. Banks should be required by an automatic formula to build up buffers of capital resources when the economy is growing strongly and profits are high. The virtue of automatic stabilizers is resurrected; we will return to this later on. Still, the FSA underlies the need of discretionary macro-prudential policy and recommends the adoption of a *core funding ratio* to help ensure that banks asset growth is supported by stable funding sources, such as retail deposits and long-term borrowing.

The so-called 'dynamic provisioning' introduced by the Banco de España in June 2000 is offered as an example of counter-cyclical capital reserves/buffers. The fact that this regulation did not prevent Spain from having one of the worst real estate bubbles in Europe, is not discussed at all.<sup>5</sup> However, as pointed out by Blanchard the "challenge is clearly in the details of the design, the choice of an index, the degree of pro-cyclicality."<sup>6</sup> Besides, any automatic formula-based provisioning is necessarily backward looking, therefore biased and subject to the same critique the report makes of VaR.

But whether the emphasis of macro-prudential regulation is placed on automatic or discretionary measures, its paramount goal is to inhibit "*excessive credit supply*"<sup>7</sup>. This is rather curious. After recognizing the importance of market failures, irrational behavior, financial liberalization and securitization in determining asset price bubbles, (almost) all the action comes down to finding ways to preventing or mitigating excessive credit supply. It is, perhaps, understandable that the focus of financial sector

---

<sup>4</sup> Monetary and prudential policies at a crossroads? New challenges in the new Century, BIS Working Papers No 216, September 2006 [www.bis.org/publ/work216.pdf](http://www.bis.org/publ/work216.pdf).

<sup>5</sup> According to Francisco Pérez (2009), from Universidad de Valencia, the rate of growth of total factor productivity was negative in Spain during 1997-2007. He concludes that the misallocation of capital due to the real estate bubble was one of the main causes as the user cost of capital was negative because of the huge capital gains associated with land capital.

<sup>6</sup> Quoted by Philippon (2009).

<sup>7</sup> "The adoption of a core funding ratio to help ensure that banks' asset growth is supported by stable funding sources, such as retail deposits and long-term borrowing. The potential macro-prudential benefits would include more stable and sustainable funding of banks' asset growth and a brake on excessive credit supply.", p. 9. "In an environment of robust real economic growth and credit demand a core funding ratio would act as a powerful inhibitor of excessive credit supply", p. 114. (FSA, 2009b).

authorities be on financial regulation. However, such a diagnosis would suggest a move towards more structural regulation instead.

The goal of curbing excessive credit supply seems more consistent with a different diagnosis. The Turner Report criticized the view which prevailed among monetary and financial authorities before the crisis, according to which price stability, understood as low goods inflation, was a necessary and sufficient condition for macroeconomic stability and sustained growth. Something was missing: low goods inflation need not ensure financial stability. This seemed to be a departure from economic orthodoxy, particularly, from the efficient market hypothesis. However, the emphasis on avoiding excessive credit supply might reveal a diagnosis which interprets bubbles as asset price inflation. Therefore, the key to macroeconomic stability would lie on fighting not only goods inflation but also asset price inflation. This is clearly stated on the report:

“Characteristics of the new global financial system, combining with macroeconomic imbalances, helped create an unsustainable credit boom and asset price inflation.”<sup>8</sup>

It doesn't seem such a radical departure from conventional wisdom. After all, were the references to Keynes, Minsky, Kindleberger and Shiller, mere lip service?

Of course excessive credit might fuel or exacerbate bubbles, but it won't create them. Inflation is defined as a rise in the general level of prices. Asset price inflation means, then, a general rise in the price of assets. However, if you review Kindleberger's *Manias, Panics and Crashes*, you'll see that under manias (his term for bubbles) speculation is concentrated on some specific objects. In fact, the last mania was the real estate bubble. A monetary or credit theory of bubbles must assume (like the monetary theory of inflation) that money/credit is exogenous or somehow under the control of authorities. This is arguable. The hypothesis of endogenous money/credit has a respectable pedigree in the history of economic thought, especially, in the Keynesian and Post-Keynesian tradition.

Shiller (2008) discusses the roots of the last housing bubble and dismisses loose monetary policy as an *exogenous* cause of the bubble:

“For the monetary policy—both that of the Fed and that of other central banks around the world—was driven by economic conditions that were created by the bursting of the stock market bubble of the 1990s, and the real estate boom was itself in some ways a repercussion of that same stock market bubble.”

...

“The interest rate cuts cannot explain the general nine-year upward trend that we have seen in the housing market. The housing boom period was three times as long as the period of low interest rates, and the housing boom was accelerating when the Fed was increasing interest rates in 1999. Moreover, long-term interest rates, which determine the rates for fixed-rate conventional mortgages, did not respond in any meaningful way to these rate cuts until 2001–03.”<sup>9</sup>

Stiglitz (2003) discusses the monetary hypothesis of the stock market bubble driven by telecoms and dot-coms in the late nineties and discards it since interest rates were not

---

<sup>8</sup> FSA (2009a, p.28).

<sup>9</sup> pp. 40-41.

low in that period. However, he criticized Greenspan for not taking some *specific* discretionary macro-prudential action, namely, an increase in margin deposits.<sup>10</sup>

Since the FSA view associates the trade cycle with bubbles, the credit theory of bubbles is indeed a credit theory of the trade cycle. This is more enlightened than Chicago's monetarism but still remains in the quantity theory tradition.<sup>11</sup> I believe that Keynes rebutted this view in chapter 22 of the *General Theory*, "Notes on the Trade Cycle". He discusses :

"... the view of those who hold that over-investment is the characteristic of the boom, that the avoidance of this over-investment is the only possible remedy for the ensuing slump, and that, ..., the boom can be avoided by a high rate of interest."<sup>12</sup>

Keynes underscores the ambiguity of the term over-investment which it may refer:

"... to investments which are destined to disappoint the expectations which prompted them or for which there is no use in conditions of severe unemployment, or it may indicate ... a state of affairs where every kind of capital-goods is so abundant that there is no new investment which is expected, even in conditions of full employment, to earn in the course of its life more than its replacement cost."<sup>13</sup>

According to Keynes, it is only in the second sense that a boom can be said to be characterized by over-investment, but this situation is not typical. Instead, it is likely that the:

"... illusions of the boom cause particular types of capital-assets to be produced in such excessive abundance that some part of the output, is ..., a waste or resources; ... It leads, ..., to *misdirected* investment."<sup>14</sup>

But this is exactly a bubble. Keynes questions the empirical relevance of over-investment proper, given the lack of evidence of labor shortages (p. 322). Then, Keynes rejects the use of high interest rates to avoid improper over-investment, namely, bubbles, to mitigate the trade cycle:

"It may appear extraordinary that a school of thought should exist which finds the solution for the trade cycle in checking the boom in its early stages by a higher rate of interest. The only line of argument, along which any justification for this policy can be discovered, is that put forward by Mr. D. H. Robertson, who assumes, in effect, that full employment is an impracticable ideal and that the best that we can hope for is a level of employment much more stable than at present and averaging, perhaps, a little higher."

...

"... such an outlook seems to be dangerously and unnecessarily defeatist. It recommends, or at least assumes, for permanent acceptance too much that is defective in our existing economic scheme."<sup>15</sup>

---

<sup>10</sup> Margin deposits regulate the amount of stock investors can buy with borrowed money. Investors could borrow up to 50% of the stock they intended to buy.

<sup>11</sup> Recalling that Wickseil, Fisher, Keynes (before the *General Theory*) and Patinkin, to name a few, wrote in the quantity theory tradition, it is clear that Chicago's monetarism represented an impoverished and simplistic version of the former.

<sup>12</sup> Keynes (1936), p. 320.

<sup>13</sup> Keynes (1936) pp. 320-321.

<sup>14</sup> Keynes (1936) pp. 321, italics in the original.

<sup>15</sup> Keynes (1936), pp. 326-327.

I believe that the credit theory of bubbles is a sophisticated restatement of Robertson's views of the trade cycle and counter-cyclical policy, which instead of (or besides) recommending the use of the interest rate as the main policy tool, introduces different financial ratios to curb credit supply (a paradoxical recognition of its endogenous nature).

### **Towards a broader perspective of bubbles, cycles and policies**

In contrast, the Stiglitz Commission Report (Commission of Experts, 2009) takes a broader view. It is, of course, essential to revert the pro-cyclicality embedded in the Basel agreements regulations. However, limiting crisis prevention to new financial regulations is a dangerous and self-defeating illusion.

To continue the discussion about bubbles determinants it is paramount to point out the key role played by deregulation not only in the financial sector but in the overall economy. Stiglitz' *The Roaring Nineties* does a superb job in explaining how *deregulation of telecoms and electricity* interacted with financial deregulation, lax accounting standards and corporate governance problems, to inflate the late nineties stock bubbles that led to the Enron and Worldcom scandals (to name the two most notorious). A narrow focus on finance would miss much of what happened (Stiglitz, 2003, chapter 4).

Fiscal policy also fueled the bubbles in the last decade and a half via the Clinton and W. Bush Administrations temporary reductions of the capital gains tax rates (Stiglitz, 2003, chapter 7). If we take a historical perspective on fiscal policies, we will see that the trouble is much older and larger, as pointed out by the Stiglitz Commission. In the Golden Age of Fordism, high levels of government expenditures, progressive taxation and social protection schemes acted as powerful automatic stabilizers. The general trends of fiscal policies in the last three decades weakened or removed these three fiscal pillars of macroeconomic stability and a fairer distribution of income. Given the recent rediscovery of the importance of counter-cyclical policies, in general, and of the virtues of automatic stabilizers, in particular, it would be wrong to focus just on financial tools to pursue the complex task of macroeconomic stability.

In other words, the increased frequency of financial crises and macro instability (and the higher inequality) that we have suffered in the last three decades is the necessary consequence of the triumph and implementation of the neo-liberal program which resulted in the currently hegemonic variety of capitalism known as finance-led capitalism or *financialization*. Epstein defined financialization as "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operations of the domestic and international economies." (quoted by Guttman, 2008).

Financialization has been patiently and gradually constructed from the political arena. It took decades and many political struggles to dismantle the broad array of institutions characteristic of what John Ruggie called "embedded liberalism" and replace it with a new institutional architecture which included the inception of WTO, perhaps, its most emblematic organization. Of course, powerful actors pushed consistently to build the

neo-liberal economic order but they became more powerful in time with the extension of market liberalization and globalization. They seized upon the political opportunities created first by the crisis of the Bretton Woods regime, and then by each of the crises caused by the implementation of the neo-liberal program by pushing harder for a new round of reforms allegedly needed to achieve full success.

When taking stock of financialization, it is important to make a clear distinction between discourse and reality. The achievement of one of its proclaimed tenets, the maximization of shareholder value (Guttman, 2008) would be in doubt given the bubble roller-coasters that prevailed. However, after reading, for instance, insider accounts and critiques such as the Turner Review or *The Roaring Nineties*, it is obvious that the goal was not seriously pursued by the main actors in the drama: CEOs, accounting firms, global banks, etc. Instead, pervasive conflicts of interest, informational imperfections and asymmetries, “creative” accounting and executive compensation, might have led to exploitation of shareholders (besides workers) if not outright theft (Akerlof and Shiller, 2009, Stiglitz, 2003).

The new plutocrats who run the game inevitably reminds you of the XIX century American Robber Barons. Which brings us to the *political economy* issue of the need to seize the moment to pursue serious reform and foster the unraveling of financialization. Buitter (2009) asserts that:

“Financial regulation is a now-or-never proposition as the sector’s lobbying power is greatly diminished” and favors “robust regulation, risking over-regulation.”

Philippon (2009) in turn, highlights the power dimension of effective financial regulation:

“The critical issue in my view does not lay in the construction of an appropriate cyclical index, but rather in making sure the regulator is powerful enough to enforce tighter prudential regulations based in part in subjective and debatable interpretations of economic data. The financial industry will not like it, and it has a strong track record of capturing regulators, so this will not be easy.”

### **A developing country view**

The financial crises bore by developing countries in the last decades were forerunners, *mutatis mutandi*, of the current global one, but of course, the implicit warnings about the dangers of financial globalization were ignored and instead the victims were blamed (Keifman, 2009). However, from a developing country perspective the priorities in regard with a revamping of financial regulations are quite different from the ones highlighted in the North. Financial deepening and sophistication is much less important in our countries, which probably acted as a buffer of contagion. The issues of portfolio diversification gains (which proved to be illusory or second order in the First World) were never very important. The main challenge is how to design financial and non financial institutions and regulations which prevent capital flight, reduce drastically capital flows volatility (a main source of macro instability), and mobilize and allocate domestic savings to productive investment.

We have given up long ago the illusion of tapping substantive financial flows in international markets to finance development. We cannot count much on the underfunded international multilateral banks. We insured ourselves against “sudden stops” accumulating huge international reserves in order to smooth the cycle and avoid the torture of IMF conditionality. But this has a sizable welfare cost and collectively imposes a global deflationary pressure. Capital controls could help to reduce the amount of international reserves needed for self-insurance, and will also allow more policy space to pursue monetary and exchange rate policies more conducive to developmental goals, moving away from the corners of Mundell’s triangle.

However, WTO commitments and bilateral preferential trade agreements clauses on financial services, and bilateral investment guarantees might be a serious obstacle in this regard. It is perhaps high time we reviewed the sensibility of these and other commitments (such as intellectual property rights) signed during the pinnacle of neoliberalism.

So we live in a world of “inverted aid” in which the poor lend money to the rich. This is a terrible anomaly which requires a profound reform of the international monetary and financial system. American or European governments won’t give away their international seigniorage powers. They won’t commit substantial resources to multilateral banks either given the fiscal overhang of the financial crisis. In the meantime, South-South monetary clearing arrangements to reduce the level of international reserves, and truly regional banks and/or monetary funds to help out during country-specific crises, have better chances to do the job. It is true that risks in developing countries are correlated but given the international synchronization of the cycle, even developed and developing countries risks are closely correlated. To the extent that partner countries economic structures are not identical, risks won’t be perfectly correlated and it will pay to build regional or South-South banks/funds.

To prevent capital flight, the closing down of tax and regulatory havens, the ending of bank secrecy and the implementation of global taxation are of paramount importance for developing countries. It is hard to overestimate the importance of these measures. The gains from preventing capital flight are orders of magnitude larger than any likely increase in foreign funding coming from a recapitalization of multilateral banks for most developing countries.

It is remarkable that the crisis have prompted several analysts to reconsider the nature of banking and the positive and important contributions that state-owned banks can make. For instance, state-owned development banks have played an important role across the world with the main exception of the UK and US (although there are several programs of government-guaranteed lending).<sup>16</sup> Privatization or downsizing of these institutions have been the dominant mantra in the last two decades. To have state-owned banks was viewed as a sign of financial backwardness. Now we have a growing recognition not only of the *public utility* nature of banking but of the advantages of departing from the private corporate model of banking. For instance, Buiters (2009) concludes that:

“Given the failure of the efficient market hypothesis, it is not at all obvious that systematically important financial institutions should be allowed to be listed companies. ... Partnerships,

---

<sup>16</sup> Commission of Experts (2009).

mutual ownership, cooperative ownership, and various of public and mixed public-private ownership may be more appropriate for financial institutions.”

## Conclusion

Financialization is in deep trouble. Crises are opportunities for radical change. The unraveling of the current regime demands much more than well-meaning but limited financial sector reform. In particular, we need to overhaul many of our institutions, not only the financial ones, in order to reestablish the balance between the market and the state, and to turn finance into the servant of the real economy. We need to employ more active fiscal, monetary, and exchange rate policies and strengthen social protection institutions. Institutions conducive to social justice not only serve well this goal but are also a means to achieve macroeconomic stability and sustained growth (Commission of Experts, 2009). If not now, when?

## Bibliography

- Akerlof, George and Robert Shiller (2009) *Animal Spirits*, Princeton University Press.
- Buiter, Willem (2009) “Regulating the new financial sector”, VoxEu, 9 March.
- Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System (2009) *Final Report*, September 21.
- FSA (2009a) “The Turner Review. A regulatory response to the global banking crisis”, March.
- FSA (2009b) “A regulatory response to the global banking crisis”, Discussion Paper 09/2, March.
- Grossman, Sanford and Joseph Stiglitz (1980) “On the impossibility of informationally efficient markets”, *American Economic Review*, vol. 73, No. 3, June, pp. 393-408.
- Guttman, Robert (2008) “A Primer on Finance-Led Capitalism and Its Crisis”, *Revue de la régulation*, n°3/4, Varia, 15 November.  
<http://regulation.revues.org/document5843.html>
- Keifman, Saúl N. (2009) “Hello Global Financial Crash, Good Bye Financial Globalization?”, International Conference on ‘Re-regulating global finance in light of the global crisis’, Tsinghua University-IDEAs, 9-12 April Beijing.
- Keynes, John Maynard (1936) *The General Theory of Employment, Money, and Interest*, McMillan.
- Pérez, Francisco (2009) “España: patrón de crecimiento reciente y características de la crisis actual”,  
[http://www.aep.org.ar/anales/download/2009/perez\\_mesa\\_crecimiento.pdf](http://www.aep.org.ar/anales/download/2009/perez_mesa_crecimiento.pdf)
- Philippon, Thomas (2009) “An overview of the proposals to fix the financial system”, VoxEu, 15 February.
- Shiller, Robert (2008) *The Subprime Solution. How Today’s Global Financial Crisis Happened, and What to Do about It*, Princeton University Press.
- Stiglitz, Joseph (2009) “Explaining the Financial Crisis and What it Means for the Future of Global Development”, Emerging Thinking on Global Issues Lecture Series, 24 February, UNU/ONY. <http://www.ony.unu.edu/events-forums/new/ET/2009/emerging-thinking-series-expla.php>

\_\_\_\_\_ (2003) *The Roaring Nineties. A New History of the World's Most Prosperous Decade*, Norton, 2003.