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Decommodification of financial regulation: some unpleasant lessons from the 2007 crisis

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Abstract

The Great Transformation of modern capitalism from the 1980s is the commodification of monetary/financial rules and related regulation. Assuming that free markets result in social optimum, financial liberalization has transformed public regulatory mechanisms into private self-regulation systems relying on market price-directed contractual schemas. In light of the 2007-08 crisis, this article seeks to question this blind faith in the market's self-adjustment capacity. It argues that free markets and individual rationality-based economic efficiency cannot result in social harmony. It maintains that financial stability should not be entrusted to the vicissitudes of markets. It then suggests the decommodification of financial supervision through alternative public regulation that seeks social-stability and economic viability.

Keywords: Crisis, decommodification, financial regulation, liberalism, social efficiency

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1. Introduction

Capitalist society evolves through continual cycles of commodification, exposure of human life and its dynamics to market mechanisms. The new millennium is the culminating point of this evolution since most of social rules and aims are shaped and evaluated according to decentralized free markets efficiency criteria. This is the dominance of market forces (marketization and commercial value creation process) over the whole society. In this general evolution, one specific but crucial aspect of *"great transformation"* of modern capitalism from the 1970s-1980s is the entire commodification of monetary and financial rules[2] and related regulation through the process of financial liberalization and market friendly (de)regulation. This process has transformed public institutions-led regulatory mechanisms into private self-regulation systems (internal self-assessment and external advising and rating agencies) that rely on market price-directed contractual schemas. The main argument in favor of such a structural evolution is the belief in the efficiency of free market mechanisms to make society able to reach social optimum thanks to non-coordinated individual decisions and behavior. In this line, economic efficiency is assumed to lead to social efficiency. So, in light of the 2007-08 crisis and its catastrophic consequences for society, it seems to be relevant to recall the neo-liberal blind faith in free market's self-adjustment capacity that let the core of capitalist society (money and financial markets) be commodified through the privatization of regulatory rules and commodification of supervision and intervention mechanisms. To deal with this issue, this article will liberally draw upon the seminal work of Karl Polanyi, *The Great Transformation* (1944)[3].

In this aim, the second section assesses the relevance of the major statements in favor of financial liberalization and of commodification of financial regulation in the working of a market economy. The third section shows that contrary to liberal axioms of market efficiency, there is no bridge between the so-called rational individual behavior efficiency and social efficiency. Free markets and individual rationality-based economic

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[2] Even though it belongs to the same process, the neutralization of monetary policies and central banks following the rational-expectations-based New Classical assertions of efficient and equilibrium-led markets will not be studied in this article. However, it is worth noting that Polanyi (1944: 74) remarks that "self-regulating market demands nothing less than the institutional separation of society into an economic and a political sphere. Such a dichotomy is, in effect, merely the restatement, from the point of view of society as a whole, of the existence of a self-regulating market".

[3] Kindleberger (1974: 45) notes that "Some books refuse to go away. They get shot out of the water by critics but surface again and remain afloat. The Great transformation by Karl Polanyi doesn't exactly refuse to go away, but it was slow in arriving and it has kept on coming".

efficiency cannot result in social harmony. Furthermore, it is argued that micro-relevant decisions often result in macro-catastrophic outcomes. The fourth section then advocates that in order to stabilize financial folly and put capitalist economies on a socially consistent evolution path one must stop the process of whole commodification of financial relations and then decommodify financial control and supervision mechanisms. An expected alternative direction is toward public regulatory mechanisms that could be related to collective development objectives and then seek "social-stability and economic viability" in the aim of attaining a socially satisfactory level of economic activity. The last section concludes that the lessons which could be drawn from this analysis can also hold for every area of human life, like the environment, health, education, etc. which should not be left to the vicissitudes of market-prices commodification mechanisms.

2. Commodification of financial regulation

Financial liberalization is a normal evolution of market capitalism since market economy is defined according to some rules stating that the organization and working of the economy must rest on free market mechanisms. This gives a specific society:

"Market economy implies a self-regulating system of markets; in slightly more technical terms, it is an economy directed by market prices and nothing but market prices. Such a system capable of organizing the whole of economic life without outside help or interference would certainly deserve to be called self-regulating. These rough indications should suffice to show the entirely unprecedented nature of such a venture in the history of the race" (Polanyi, 1944: 45).

The process of financial liberalization coincides well with the process of generalized commodification of human activities and relations in market economies. Most specific societal relations (health, education, solidarity, etc.) are directly (through privatization process) or indirectly (through the withdrawal of public agencies and entrusting of their activities to non-governmental but private-initiative-related entities seeking or not direct profit) are left to no-publicly/collectively organized groups or institutions. Explicitly or implicitly, this results in marketization of decisions, strategies and related activities which were not previously in the sphere of economic activities. The commodification process is at the heart of the market economy. It is through the

commodification that the market subordinates everything to its rationality and efficiency criteria and gives them the veil of independence of all moral criteria: "It is with the help of the commodity concept that the mechanism of the market is geared to the various elements of industrial life. Commodities are here empirically defined as objects produced for sale on the market; markets, again, are empirically defined as actual contacts between buyers and sellers" (Polanyi, 1944: 75).

Van der Zwan (2014) points to the exponential growth of financial markets and to the financialization of everyday life in the new accumulation regime of modern capitalism while Lohmann (2012) maintains that the evolution of market societies results in two major phenomena: - the increasing privatization and marketization of public goods and of the state and its functions; and – the increased economic and political dominance of finance since the 1970s.

Such phenomena have been already observed in the evolution of capitalism in the last centuries by Polanyi (1944: 60) who maintains:

"Ultimately, that is why the control of the economic system by the market is of overwhelming consequence to the whole organization of society: it means no less than the running of society as an adjunct to the market. Instead of economy being embedded in social relations, social relations are embedded in the economic system. The vital importance of the economic factor to the existence of society precludes any other result. For once the economic system is organized in separate institutions, based on specific motives and conferring a special status, society must be shaped in such a manner as to allow that system to function according to its own laws. This is the meaning of the familiar assertion that a market economy can function only in a market society."

Roughly speaking, the whole life becomes a large market where everything may be sold and bought among voluntary free individuals if there is a complete and perfect property right distribution allowing incentives for profit to push individuals toward egoist strategies that would result - by the magic of invisible hand (the gravitation of market prices around the equilibrium prices) – in social harmony and efficiency. Arguments in favor of such an assertion rest on the economic rationale of free market prices and on an "emotional faith in spontaneity" (Polanyi, 1944: 35). Like in the period analyzed by Polanyi, the "evangelical fervor of the liberal creed" was evolved, also in the last decades

of the 20th century, into a “veritable faith in man’s secular salvation through a self-regulating market” (Polanyi, 1944: 141). The new financial organization of capitalism was indeed encouraged by the assertion that deregulated/free financial markets could lead the economy to a general equilibrium without structural public interventions and prudential regulation.

In this generalized liberalization process all around the world, finance has shown an extraordinary “amphibious capacity” to bridge the gap between the political and the economic organization of the age, as it was the case also in the second half of the 19th century as stated by Polanyi (1944: 15). Polanyi (ibid.: 145-147) then emphasizes the central role played by public administrations in the establishment of a new economic order in the 19th century. Helleiner (1995) and Ülgen (2015a) also state that the late 20th century liberalization process has been supported by deliberate state decisions.

Indeed Greenspan (1997) argues that the relevant regulation must rest on private sector’s risk management systems through mechanisms of incentives (as accountability, compliance and disclosure of information) to let banks and financial intermediaries to foster financial innovation without suffering from restrictive prudential rules. The liberal Gramm-Leach-Bliley act of November 1999 which replaced the restrictive Glass-Steagall act of 1934 is a good illustration of this political direction. In the same vein, the Commodity Futures Modernization Act of 2000 put derivative market activities out of the regulatory interferences arguing that this would better incite market actors to diversify their engagements against risks and thus reduce the costs of access to the capital market (Quinn, 2009). It is supposed that open and liberalized markets would widen financial activities, enhance competition and then allow banks to diversify their risks. Enlarged strategies of rational agents are considered as the most effective means of allocation of resources and protection against shocks in the economy (Ülgen, 2015a). It is maintained that banking systems with more restrictions on banks' activities and barriers to entry are more likely to suffer systemic banking distress (Beck *et al.* 2006).

Such a theoretical and policy perspective is at the core of deregulatory policies which framed a new institutional regulatory environment in which financial stability is entrusted mainly to market mechanisms. Hence, micro-prudential mechanisms (which are more decentralized and private control practices) replaced macro-prudential public

regulation. Financial regulation is therefore commodified since it is left to private rating agencies and to internal self-assessment models of banks themselves to take care of systemic stability through market operations. These operations, resting on the usual process of market-pricing related production of services and information, generated oligopolistic private-regulation markets dominated by powerful rating agencies. Those agencies then set the tone in financial markets but also in the financing conditions of public debts in international markets. The need of global regulation is assumed to be satisfied by decentralized procedures of self-regulation which should be related to market incentives, supported by market-friendly institutions.

As pointed out by Ülgen (2014), the recommendations of the Basel Committee, from 1988 with Basel I's *Cooke ratio,* through 2004 Basel II's *McDonough ratio*, till today's after-2007 crisis Basel III's regulatory "reforms", encourage prudential arbitraging of financial actors and various internal rating procedures such as Internal Rating Based (IRB) and Rating Agencies' regular announcements about the soundness of banks, financial intermediaries (including rating agencies themselves!) and innovated products and processes. This institutional framework is an incentives-based regulatory structure that relies on rules of transparent management that must improve the disclosure of information about the characteristics of products and involved establishments. In search for solid reputation, banks and agencies would be incited to more responsibility and produce reliable information for investors, reducing the need for public regulation – assumed to impede markets efficiency by limiting freedom of action and imagination of private actors-, financial crises being mainly thought as some unpredictable accidents.

The theoretical foundations of this new organization rely on the well-known paradigm of complete and efficient markets according to which the problem of instability is only conceivable under the hypothesis of exogenous shocks that are treated as some minor frictions at systemic level. This hypothesis of complete markets constitutes the conceptual background of the faith in the efficiency of markets and in the relevance of liberal economic policies (Ülgen, 2015a). The question of insolvency and illiquidity are put only marginally with regard to these frictions. It is supposed that free markets and market prices contain self-regulating / self-adjustment mechanisms to produce necessary and sufficient information and direct effectively the behavior of decentralized actors towards equilibrium decisions.

So, self-regulation relies on two erroneous beliefs:

- There would be no conflict of interest between (private) *regulators* and (private) *regulees* (evaluated actors) when the assessment of the activities of the latter by the former is resting on supply-demand related (commodified) market relations;

- Private agencies' assessment at individual level would suffice to guarantee system-wide safety of market operations of separate and decentralized actors.

However, those assertions seem to be invalidated by the 2007-2008 financial crisis that involved the rating and rated agencies and banks which had been declared, just some hours before the crisis, the healthier actors of the market! Several arguments might be used to understand the weaknesses and inconsistencies of such assertions with regard to the very characteristics of capitalist economies. Generation of conflicts of interest between regulators and regulees, informational asymmetries and/or uncertainty dominating financial markets and making decentralized private decisions error-prone, market coordination failures without collective organization, fallacy of composition and absence of bridge between individually rational behavior and macro-economic stability are some of them; but only the latter will be developed in the following section.

3. No bridge between individual efficiency and social optimum

The dominant regulatory system leaves the care of correcting possible failures of market mechanisms to market mechanisms themselves! The efficiency of such a mode of regulation is extremely reduced since there is no immediate and obvious way or transition from individuals to society or from individual rationality to societal consistency. Contrary to liberal axioms of market efficiency, there is no bridge between the so-called rational individual behavior efficiency (individual maximization process) and social efficiency (social optimum). Free market mechanisms and individual rationality-based economic efficiency cannot result in social harmony and micro-relevant decisions often result in macro-catastrophic outcomes.

On the one hand, the stabilizing capacity of decentralized self-regulation models is extremely limited because they cannot have a long-term macroeconomic vision over the entire evolution (authentic uncertainty that dominates the market economies). On the other hand, they cannot consider the interconnectedness among private actors since they have no knowledge about the future and the whole world but through probability

models that include crises as exogenous white noise! The interconnectedness is a macroeconomic matter while self-regulation looks only at micro-consistency and does not include, by definition, a mechanism of systemic macro-regulation. Players have no capacity to consider their mutual interdependences in their internal evaluations because those interdependences have a macroeconomic nature while the models of individual evaluation do not include, by definition, mechanisms of systemic regulation.

The capacity of the market to assure the necessary coordination among individual decisions in case of stress is undetermined. The lack of long-term macroeconomic vision makes the mechanisms of spontaneous coordination unable to be positively reactive in case of generalized stress. When some (local or individual) disruptive events occur and then push the financial system towards a critical zone of instability such as the control of macroeconomic evolution becomes difficult and disequilibria propagate into the whole economy, the systemic risk enters the picture. Liberalized financial environment allows banks to undertake various innovations through monetary and financial networks that create strong linkages and interdependence among different actors (individuals, groups, institutions, countries). Therefore, individuals' decisions and actions (microeconomic behavior) become liable to generate multilateral and multilevel effects such as in period of uncontrollable disturbances chain reactions in numerous markets may suddenly occur independently of previous expectations of economic agents about future economic evolution.

A major concern in the working of markets is the confusion between micro-rationality and macro-consistency of economic decisions. The usual models of risk and crisis which are the formal references of the dominant regulatory schema do not take into account the linkages and interdependence among actors' decisions in markets (these decisions are assumed to follow a Gaussian normal distribution). Hence micro-prudential regulation and macro-prudential supervision are confused. The result of such a confusion is the fallacy of composition which points to the incompatibility between micro-rational individual behavior and macro-consistent working of decentralized markets[4]. Applied to financial markets, this principle means that the microeconomic-

[4] The fallacy means that the sum of rational individuals does not obviously result in a system which would be rational. In other words, the individual efficiency of micro-rational decisions and the societal efficiency of the whole economic system do not mean the same thing.

individual safety of banks and financial intermediaries does not guarantee a sound and stable financial system. Indeed, when an establishment perceives an increase of risks related to its commitments, its rational behavior would usually consist in reducing its exposure by undoing its engagements. This individual (rational) behavior, when it is widened to a large number of establishments in the market, will be transformed into a crisis of illiquidity and a possible subsequent panic will make numerous debtors and creditors insolvent; the market horizon being reduced at the present immediate moment and actors taking place on the same (short) side of the market[5]. Micro-prudential regulation deals only with the exposure of individual establishments at risks and their microeconomic capacity to face them. They do not integrate endogenous risks or do not take into account directly the effects of individual difficulties on the rest of the system. They *naturally* neglect the implications of interconnectedness between individuals and macro dynamics and the limits of individual actors' capacity to face the consequences of imbalances at macroeconomic level.

Micro-prudential regulation is about variables which concern directly individual risks of banks and other financial institutions whereas macro-prudential regulation looks at the factors which affect the stability of the financial system in the whole. A critical component of the macro-prudential regulation is to understand the mechanisms able to counterbalance the effects of the reduction in risk perception by markets in period of expansion and those of the increase of risk in period of contraction. The basis of macro-prudential regulation is that financial actors - who can follow individually careful strategies - can collectively generate systemic concerns. Systemic problems are mainly the cumulative results of individual actions that imply collective actions since individuals' capacities are limited to their own interests and micro knowledge. However the mechanisms of self-regulation oust the necessary questioning about the conditions of global viability of monetary systems. This latter relies on some macro-warning mechanisms that must be supported, supervised and implemented through macro-system-wide lenses and then collective rules. Furthermore, as systemic problems resolution generates social advantages which are superior to private advantages and as

[5] The failures of Northern Rock in England in 2007 and Bear Stearns and Lehman Brothers in the United States in 2008 are some recent cases related to this kind of systemic problem.

every private individual unit would benefit from the resolution of such problems even if she/he does not contribute to any effort by her/himself, the reduction of system-wide threats requires an enforceable system-wide regulation. Such regulation is obviously related to two principles. First, monetary/financial stability has a peculiar status as a kind of specific collective good as it concerns the whole society and its viability conditions. And second, monetary/financial stability cannot be "produced/consumed" according to decentralized and anonymous market mechanisms but calls for public intervention that must play the role of referee and stand outside of the private market relations in order to organize, supervise and regulate capitalist monetary and financial system (Ülgen, 2014).

4. From liberal folly to social consistency: decommodifying financial supervision

Even a market economy based society is framed through collectively-designed societal institutions. When the market is left to its own vicissitudes and market-framing public institutions are transmuted into passive agencies following the neoliberal doctrine, the result is often a social catastrophe. Polanyi (1944: 3) wisely notes that the philosophy of self-regulating market is a social innovation which gives rise to a specific civilization. But he argues that such an idea is nothing but a stark utopia since "Such an institution could not exist for any length of time without annihilating the human and natural substance of society (…)".

Minsky's endogenous financial instability hypothesis may offer a relevant analysis to understand the above assertion of Polanyi as it shows how a capitalist market economy operates. Minsky (1986) announces the fundamental propositions of this hypothesis through two features: capitalist market mechanisms cannot lead to a sustained, stable-price, full-employment equilibrium, and *serious business cycles are due to the financial attributes that are essential to capitalism*. Minsky (1982, p. 66) then states that capitalism is naturally unstable:

"Stable growth is inconsistent with the manner in which investment is determined in an economy in which debt-financed ownership of capital exists, and the extent to which such debt financing can be carried is market determined. It follows that the fundamental instability of a capitalist economy is upward. The tendency to

transform doing well into a speculative investment boom is the basic instability in a capitalist economy."

The neoliberal economics is barking up the wrong tree because the devil is not the public intervention in the economy but the uncertain and irresponsible operating way of unorganized/unsupervised short-termist and speculative markets. Neoliberalism "goes astray" when it religiously asserts that to prevent state from having a stranglehold on the economy one must liberalize the whole economic relations and institutional infrastructure. The *ad hoc* underlying assumption is that the main institutions that would inevitably lead the system to a state of rest characterized by social optimum/equilibrium would be the free markets. So, in a society, institutions and the regulatory system have two aims: - Providing individuals with a general frame of action in society and – Prodding individuals and markets into implementing actions which are consistent with systemic stability and societal viability. Regulation is not, at least in its prime aim in democratic societies, to lock individual initiatives and human freedom but to give them a positive and socially sustainable horizon of action.

In order to stabilize capitalist economies' financial folly and place economies on a socially-consistent evolution path one must put a halt to the process of whole commodification of financial relations and decommodify financial control and supervision mechanisms. In this regard, an alternative direction is through renewed relevant public regulation that could be related to collective development objectives and seek "social-stability and economic viability" by making finance "the servant not the master of society" (Helleiner, 1995: 151) in support of welfare creating and sustainable economic activities.

Recalling the economy-wide liberal experience in the US in the 19th century, Polanyi (1944: 210) states that "(…) a self-regulating market system implies something very different, namely, markets for the elements of production-labor, land, and money. Since the working of such markets threatens to destroy society, the self-preserving action of the community was meant to prevent their establishment or to interfere with their free functioning, once established."

The situation is today quite similar when one takes into account the preparation of the 2007-2008 crisis and the subsequent global imbalances that threat the continuity of economic relations and the world's peace as well:

"As long as the mechanism of international capital movements and short credits functioned, no disequilibrium of actual trade was too great to be overcome by methods of bookkeeping. Social dislocation was avoided with the help of credit movements; economic imbalance was righted by financial means.

In the last resort, impaired self-regulation of the market led to political intervention. When the trade cycle failed to come round and restore employment, when imports failed to produce exports, when bank reserve regulations threatened business with a panic, when foreign debtors refused to pay, governments had to respond to the strain. In an emergency the unity of society asserted itself through the medium of intervention" (Polanyi, 1944: 215-216).

From this perspective, a relevant alternative approach must put the emphasis on the malfunctioning of free/unconstrained markets. Market mechanisms reveal to be unable to allow private agents to adopt macro-consistent behavior; in a private-property based society, they only serve as a means of giving individuals more freedom space in their economic relations but they cannot organize their lives in society even in economic terms. Therefore, rightly structured and oriented public regulatory and supervision agencies become a prerequisite to directly monitor and discipline banks and financial institutions in order to improve macro stability in the economy. From this perspective, the stability of the financial system is a "public good" which must be produced and managed through macro-regulatory frameworks (Ülgen, 2015b).

In this line, it seems to be possible to point to some regulatory policy implications for systemic stability through the opposition between micro-prudential regulation and macro-prudential supervision studied above. In a micro-prudential schema market incentives fail to prevent short-sighted individual behavior which often develops macular degeneration reflecting the very limited horizon of decentralized private expectations and subsequent actions. This macular degeneration is permitted by new speculation-oriented financial products and processes that feed a new regime of (financial) accumulation based on the expected price rise of assets and transform the

financing relations into Ponzi structures à la Minsky. In face of those theoretical and political weaknesses, the alternative approach puts the emphasis on the failures of markets and neoclassical incentive mechanisms to deal with macro-stability concerns. It calls for powerful public regulatory and supervision agencies to directly monitor and discipline banks and financial institutions in order to improve macro stability and strengthen systemic viability. Minsky wisely argues that the central bank should use its monetary powers to guide the evolution of financial markets in directions that are compatible with financial stability in the longer run rather than improvise controls that put out fires but which allow the underlying market situation to remain unchanged[6]. Minsky (1982, p. 69) then states that: "in order to do better than hitherto, we have to establish and enforce a "good financial society" in which the tendency by business and bankers to engage in speculative finance is constrained". The "good financial society" requires above all the decommodification of financial regulation and a society-friendly macro-prudential supervision to distinguish between two opposed activities: finance to produce and finance to speculate.

5. Some concluding remarks

The lessons which could be drawn from this analysis can also hold for every area of human life, like the environment, health, education, etc. which should not be left to the vicissitudes of market-prices commodification mechanisms since those domains are related to some macro (societal) concerns and do not really rest on individual rationality criterion.

Asserting that market mechanisms are working well because life goes on through thick and thin is not a scientific position but an ideological belief that interprets the functioning of markets as a fast-moving coordination (Lindblom, 2001). It might be tempting to assert that market and government are complementary institutions but it would be also judicious to remark that the market is not a spontaneous "market

[6] The well-known neoclassical incentives system argues that supervision mechanisms must encourage private monitoring of banks through sound contract enforcement systems. In case of fire, central banks and governments must intervene to calm down manic behavior. However, as the diagnosis of the crisis is not robust in this kind approach that fundamentally rests on the belief of well-working of free markets, the cure is not sustainable. Several years after their interventions and amazing amounts of money placed in rescue operations, capitalist finance still remains highly fragile and crisis-prone in 2015.

outcome" but a voluntary and conscious construction, historically shaped under the auspices of progressive enlightenment philosophy of the 17th and 18th centuries, from Bacon to Voltaire, challenging the dominant institutions of that time. It is not a magic natural mechanism but a human construction and it is subject to changes and reframing according to the objectives of dominant beliefs and ideologies. As Vogel (2007) states, markets are - in every institutional framework (liberal or interventionist) – embedded in their own specific matrix of policies and the evolution of markets or the market reform process is a complex political process that involves opposed ideas and interests.

The role of economists in the late 20th century has been to make people believe that the market was an efficient technical device able to allow society to work in an optimal way without any political interference. The role of alternative economics in the early 21st century might consist in supplying a convincing analysis of the necessary decommodification of financial stability (and of some monetary and financial relations) in order to make better and sustainable the functioning of modern societies. Consequently, the stake behind the commodification / decommodification opposition seems to be very important. Bond (2006: 169) states that "If neoliberalism has burdened the earth with the monetization and commodification of everything, the future of progressive politics may well be the expansion of the philosophical strategy of decommodification".

In order to develop open societies without submitting them to the devastating consequences of recurrent monetary and financial crises which are open to large social and political turmoil, alternative economics have to make sustainable effort to untie the ideological straitjacket in which neoliberal economics and vested interests had locked modern societies and their institutional structure.

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