Crisis without a Legacy: Reflections on Institutional and Regulatory Reform

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Historical comparisons always furnish a way for human memory to be jogged and for coming up with reasonable yardsticks. The Western world is going through an unprecedented crisis that has many facets: financial crash and credit crunch, recession, unemployment, excessive indebtedness, and extensive business failures. The legacy of a crisis is always multifaceted. Collective memory, new habits, and changes in ideology form what I could call the "softer" part of a legacy. It is probably too early to start assessing this softer part, although some features are already emerging.

The "harder" part, which can be assessed on a more measurable level, is institutional change and regulatory reform. This is the aspect of the legacy to which policy interventions are directed and on which I would like to focus. This is also the part of the legacy that will determine the environment in which business firms, investments, and development initiatives will work in the future.

In terms of the scale and threat to normal functioning of the capitalist system, the crisis of 2008 can be compared only to the crisis of the 1930s. A financial crash ushered in a generalized failure of credit, and this in turn produced a disarticulation of commerce, a wave of bankruptcies, a decline in production and employment. But the comparison to the Great Depression

This essay was adapted from a speech given at the Fifteenth Annual Conference of the European Business History Association on 16 August 2011. An earlier version was presented at a forum held by the Institute of Chartered Accountants of England and Wales, Brussels, 28 June 2011.

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Mediterranean Quarterly 23:1 DOI 10.1215/10474552-1540684

also reveals that the aftermath of each crisis has been very different: On one hand, strong policy responses were implemented in 2008–2009 in the area of macroeconomic interventions that sought to stabilize economies. These were quite extraordinary as compared to the hands-off policies President Herbert Hoover chose to follow when the depression started in the United States in 1930.

On the other hand, following the crisis of the 1930s and its recognition as a market failure, there was a large movement away from the dominance of markets toward a regulated economy. This was represented by President Franklin D. Roosevelt's New Deal. A whole web of institutions, rules, and limitations on financial market functions was established. The United States was a leader in regulating its financial system, and many countries emulated its example. The regulatory system of the 1930s survived for fifty years. After World War II, it was transposed into the Bretton Woods system, which enabled a spectacular phase of growth in incomes and economic welfare.

Do we see a comparable response in the present era? Will the financial system, which is the epicenter of the outbreak of the crisis, be placed under strict regulation? Regulatory reform was being discussed with great fervor at the start of this crisis but has been practically limited to specific areas and appears now to be losing steam. If one casually examines the trajectory of G-20 declarations, for example, the loss of momentum is very visible.

In part, the lack of decisive institutional change may have a theoretical origin. There are competing theories not so much on the contours of the crisis but about basic causes. Macroeconomic imbalances, bad monetary policy, lack of regulatory enforcement, misdirected incentives, perverse behaviors, greed, and panic figure prominently in public and scholarly discussion on the crisis. The seeming multiplicity of theories about the fundamentals of the crisis makes consensus on institutional remedies hard to imagine and to design. The world economy functioned for the better part of the past thirty years with the dominant idea that markets and self-regulation could produce both welfare and stability. Now the multiplicity of competing theories is rushing to fill a gap of many years of theoretical oblivion about the need to regulate markets for overall stability.

In the 1930s there was a retreat to a regulatory state. This was of course coincident with a more general reassertion of the power of nation-states and the rise of protectionism. Some argue that there are clear signs in that direction today also, but this is ambiguous. Some opt for a nationalist narrative of the current state of affairs by pointing out that powers such as Germany and China—the states with large surplus economies—made choices that effectively relaunched the banners of economic nationalism. Yet nobody denies the deep interlinkages of even the strongest national economies with the global economy. The power of surplus economies is after all based on exports and world markets. Nobody denies that economic interdependence runs deep in the functioning of capitalism. And the rhetoric emanating from high level policy statements insists, as a result, that economic openness, integration, and global markets must be preserved.

Are we then faced with a crisis that will leave no institutional legacy, beyond the collective memory of protracted economic distress? Are we witnessing an ultimate reassertion of nationalist politics as happened in the 1930s in Europe, within which we must seek a differentiated mapping of institutional change? Or do we see, on the contrary, a reassertion of the power of global financial markets over policies and public sovereignties postcrisis?

History and memory play a role. The difference between the 1930s and now in terms of short-term stimulus policies is very pronounced and not accidental. What has happened in the current crisis has been no less than a result of collective memory. The short-term policy response of 2008–2009—large fiscal stimulus and monetary easing for ample provision of liquidity to faltering financial markets—has been in large measure politically legitimized by a fear that the Great Depression of the 1930s was about to repeat itself. In order to prevent a repetition, expansionary and liquidity measures were undertaken in the United States, China, and elsewhere. In Europe it has been mostly liquidity provision. The memory of the 1930s became in this respect an important influence upon political response.

Historical memory did not energize a drive to regulatory reform in analogous fashion, however. There are both historical and current political reasons for that.

Intersystem Competition

In the 1930s institutional change was powered by competition between systems: failing Western capitalism was pitted against thriving Soviet socialism. In our day the global challenges are very different: there is no rivalry between systems but rather between versions of capitalism: Anglo-Saxon, German, Chinese, Brazilian, Indian, and Japanese. It is not intersystem but intrasystem rivalry. An alternative to capitalism is not threatened as such. It is varieties of capitalism that antagonize each other. What is threatened is a reallocation of economic power and growth across the globe. This is, of course, no small challenge. A reallocation of power and growth may yet present us with large and uncontrollable conflict. That is why the threatened reversion to nationalism must be averted.

Nevertheless, there are large differences in the ways that the substance of the threat is and was translated into a difference in incentives for change. In the 1930s there was a visible transfer of power to the regulatory state in the capitalist world. Now it seems the world is in a state of ambivalence. There has been ample recognition in many forums (G20, European Union, Financial Stability Board, and so forth) that regulation must be reformed and reinforced. But the drive for comprehensive reform is weak and mediocre. The emergence of the G-20 is itself an expression of the effort to arrive at coordinated solutions in a context of intrasystem rivalry, with the major versions of capitalism represented in the process.

Financial Globalization

The most pronounced difference of the present context from that of the 1930s, underpinning the present ambivalence on regulatory reform, is the scope and depth of financial globalization. The shift to flexible exchange rates and the complete deregulation of financial flows, instruments, and markets since the 1980s have created a world where financial risks became enormous and complex compared to anything that existed in the 1920s. In very simple terms, the world system has been redesigned since the 1980s on the principle of unfettered capital movement. We know that capital mobility poses a great limitation on national policies. Monetary policy is constrained by free foreign exchange flows. Financial regulators everywhere have to work under the compulsion of a threat of either capital flight or cascading capital influx that can change financial prices very quickly. Capital mobility across sectors, nations, financial centers, or regions more often than not creates positive and negative bubbles in financial markets and leads to the emergence of new forms of financial risks, including the very parameters of what we have now finally been forced to recognize as "systemic risk."

The deeper impact of deregulation and of free capital movement has been the privatization of the business of managing risks. Under either the gold standard of the 1920s or the Bretton Woods system of the early postwar period, governments and central banks shouldered most of the burden of keeping financial risks at bay and stabilizing markets. This meant that there was explicit recognition of the systemic nature of financial stability and of the need to create a predictable environment in which entrepreneurial and individual decisions could be taken and tested.

In an era of deregulation and free capital movement, however, there was no way for governments and central banks to retain that role. Huge new markets developed for the private undertaking and management of financial risk. Stock exchanges, derivative markets, informal over-the-counter markets, and insurance markets grew and diversified to fill the gap left by government withdrawal. These markets together constituted a huge growth in the private financial sector, a growth that surpassed by far the growth of real production and income. Just before the crisis erupted in 2007, the financial sector's assets were conservatively estimated to exceed forty times world gross domestic product. In the United States, 30 percent of all profits took the form of financial returns. The industrial multinational corporation was eclipsed by global financial firms, banks, hedge funds, insurance companies, and mutual funds. Furthermore, the rise of a "shadow financial sector" at the very heart of world capitalism played an enormous role in the erosion of traditional ethical standards in favor of the pursuit of short-term superprofits.

Privatization of risks and risk management and the growth of the financial sector have had a huge impact on everyday business life. Financial growth has led to a veritable revolution in business models. Nonfinancial firms, large and small, have had to acquire finance departments and cede to them major responsibility within corporate governance. Financial firms, especially banks, also underwent a veritable revolution, moving away from traditional deposit-based funding to market-based liquidity. Financial economics and financial history overtook in importance many competing subspecialties within the disciplines of economics, economic history, and management. All in all, the world of finance became prevalent in public and policy discourse. And all the instruments and new markets that were invented to manage risk opened up avenues of speculative activity that did not exist before. The seeds of financial instability were to be found therein.

If financial globalization is to be maintained, new market regulation must develop under that premise. As a consequence, institutional arrangements cannot be national. Regulation and coordination should be global. This is the issue of "global economic governance," and I certainly subscribe to that aspiration. But how feasible is this in a politically fragmented world?

The difficulties of coordination multiply as the circumstances across the globe vary, and they vary all the more because of the crisis and because of the fear of contagion. Take the example of the eurozone crisis. In the early stages of the problem of Greece, it was pretty evident that other countries in the European south would also face similar pressure. Instead of coordinating with Greece, however, they each chose to distance themselves, to picture themselves as different, for fear of contagion. This contributed to the slow, ambivalent, and delayed European reaction to the crisis, which proved very harmful and dangerous for both the European south and north.

International coordination has at least three levels. One is *commonality in objectives*. The second is *commonality of standards of behavior*. The third is *consistency of actual policies*. Coordination presupposes convergence at all levels, but it can be hampered by local and regional politics.

A famous exercise of world coordination has been for several years the goal of a unified framework for accounting standards. Convergence in accounting standards, a process that affects market infrastructure, was following a fast track precrisis, but has become very convoluted since the crisis. This is mainly the outcome of what I would call "balance sheet wars." Banks and insurance companies may stand or fall depending on how their balance sheets portray their cumulative losses.

The Indebtedness of States: A Dangerous Legacy

The major difference one sees between the 1930s and the present crisis is the size and the scope of public response that sought to avoid a repetition of the Great Depression. This response was successful in averting an immediate fall off a cliff and therefore blunted the sting of a true emergency from political discourse for a while. There was, however, another much stronger factor that weighed in on institutional change: the emergence of seriously indebted states.

A new arena has now been created in which the legacy of this crisis may unfold. The large response in terms of fiscal and monetary stimulus has meant that the state and its monetary mechanisms (central banks) undertook to exercise their roles as spenders of last resort, lenders of last resort, and insurers of last resort. This is the normal role states have traditionally played, until the dissolution of the Breton Woods arrangements. Now, after deregulation, the exercise of these roles became extraordinary actions, as many of them had been banished from the institutional design and the toolkit of public activities.

In exercising its role as agency of last resort, the state—and I mean by this the entire nexus of public actors, including central banks—found itself overspending, overpurchasing "toxic assets," and overborrowing. The inevitable outcome has been a huge growth in public liabilities. In short, this has spearheaded the emergence of the indebted state. This is a radical transformation of the crisis, a transformation whose scale and scope was not to be seen in the 1930s.

From private financial matters, the crisis has migrated into the arena of public finance. This represents a U-turn of historic proportions. The state intervened to save private agents in order to safeguard the financial system. Once salvaged, private agents found themselves in the position of creditor to indebted states, and are pushing indebted states to abide by market discipline. Once losses were socialized, states have assumed liabilities that clearly require a long-term plan for working them down. But they have now become trapped in a global market discipline that works with short-term horizons and with fluctuating investor moods.

The U-turn in the standing of sovereign states occurred at great speed. At the peak of the crisis, unprecedented public interventions appeared to imply a new era in which hands-off policies would give way to public activism. Only a few months ago the commentators were remarking on the return of the Leviathan state. However, the emerging reality is in the opposite direction. Indebted states become weak actors, who have to engage in heavy fiscal restraint in order to pass tests of market discipline in the credit markets. But market discipline is especially harsh when capital is mobile in a crisis. The moderation of mobility would naturally increase the policy space and the time horizon for government actions. This is the policy option that prevailed in early postwar Europe and laid the foundation for economic miracles on the continent. In the present instance, however, no thoughts of that kind are entertained. Capital mobility is not questioned. Thus, the emergence of an interventionist state has been only a temporary turn. The focus of activism and discipline has returned back to the markets. The indebted state, subject as it is to short-term market discipline, has a very different agenda of interventions than those that we historically associate with the "regulatory state."

As regulatory discipline on financial actors gives way to market discipline for states, this implies that private sector instruments for discipline will enjoy an enlarged role, and that conversely state regulation will see a diminished role. The most emblematic indicator of this U-turn is the shift in the fortunes of the credit rating agencies (CRAs). Their precrisis failings have been castigated by many and led to an agenda of serious regulation. The sovereign debt crisis has, however, signaled a great redemption, a turnaround in their fortunes, as they now are the authoritative arbiters of the credit standing of various governments. There has been for at least two years an agenda for the regulation of CRAs in Europe. I am not at all optimistic about the future of this project. The balance of power has shifted again in favor of market discipline. Exercises of regulatory discipline will take a back seat.

Disabilities of the Indebted State

The indebted state in a global financial environment cannot undertake to regulate, that is, to place limitations on the profit opportunities of the market agents on which it depends for its liquidity needs. It cannot mete out discipline to market agents, as it is subject to the discipline that they mete out for market access, funding, and liquidity arrangements. If anything, the interventions and reforms of the indebted state can only go in the direction of deregulation—opening up more space for market action—rather than regulation.

The example of Greece is perhaps the most illustrative because it is extreme. My experience as a financial regulator helps me to appreciate the rivalry of regulatory versus market discipline.

In a crisis, financial markets always become dysfunctional, investors are prone to panic and herd behavior if they are "competitive," and to manipulation, information exploitation, and market corners if they are "powerful." One would think that this would be the moment when regulators should be more vigilant and more daring in limiting market excesses. I believe that there are many abusive practices right now in sovereign bond markets, nurtured by "sentiment," fear, greed, or market power. But do you expect that a Greek regulator could act now? Not in the least. Constrained by a fear of interfering with the country's access to liquidity, the financial regulator is in fact neutralized and far more likely to wait on the sidelines than to intervene. Whether this is conscious policy or simple omission does not matter. What is certain is that a weak state either cannot or will not regulate the financial market. An inactive regulator is equivalent to the reign of de facto deregulation.

This lack of capacity to regulate is supplemented by other disabilities that plague indebted states. The most obvious is the lack of resources for public growth initiatives. If you believe that provision of infrastructure and other public goods by the state is a vital precondition for growth, this disability is one that curtails the future and constrains growth. In the long term this even hurts the prospects of creditors, since it weighs down the indebted economy toward public default. That is why the great wisdom of the Marshall Plan needs to be reinvented in the present day in Europe and elsewhere. This is the simple principle that combines financial assistance for debt service with outright grants for investment and growth. But the debilitation of the growth potential, although frequently quoted by many commentators, is by no means the only flaw of the indebted state. There is another equally fundamental one.

Institutions are a human device that reduce uncertainty by organizing economic reality. This is also a fundamental role of the state as an institution: it controls uncertainty in many ways, especially when it acts as an insurer of last resort. Societies and economies are always faced with disasters and crises of external or internal origin. The state is the primary agent that can mobilize social resources in order to prevent ex ante, or mollify and correct ex post, the negative consequences of such disasters. This is a role, triggered by a negative circumstance, that provides a deep sense of assurance and offers the prospect of safety. It is like a silent infrastructure. I am very much reminded of words reputedly spoken by Nikolai Berdyaev, that government exists not to turn life on earth into paradise but to prevent it from becoming a complete hell.[1]

The indebted state is robbed of its role as agent of last resort. It cannot act as social insurer, as crisis mitigator, as lender of last resort, or as protector of those stricken by the crisis. The crisis we are going through has brought forcefully to the forefront this role of the state, which at times of economic euphoria is completely ignored. The crisis has produced states that have used up their borrowing capacities and stand debilitated for further public action. This is the deeper meaning of the downgrades that rating agencies have been meting out recently, not only to peripheral European economies, but also to the transatlantic superpower, the United States.

Private agents of capital, workers, citizens, savers, the disenfranchised—all are now becoming deeply aware of this disability in a world where perception of life risks has skyrocketed. Many of the protests sweeping through Greece and other countries have at their root this awareness that the state is withdrawing from its role as insurer and as protector. They want this role reestablished. They see creditors and their demands as the prime reason why this is not to be. Many who are economically active will therefore seek to migrate toward states that can offer the surety of last resort, at first pass. At second pass they will seek collective arrangements for systemic insurance outside the classic arena of the state, as we know it. This is something for all of us to ponder.

1. Berdyaev is quoted without citation in Vito Tanzi, *Government versus Markets: The Changing Economic Role of the State* (Cambridge: Cambridge University Press, 2011), with the relevant section available at assets.cambridge.org/97811070/96530/excerpt/9781107096530_excerpt.pdf. More about Berdyaev can be found at www.berdyaev.com/.

Whence Regulatory Reform?

Regulation of financial markets would be superfluous if all assets were riskless and all agents were honest. Neither applies in the real world, particularly in the postcrisis era. What has arisen from this crisis—the indebted state—has meant the emergence of government obligations that are risky assets. But if risks migrate, as they do, to the assets supplied by the public sector, it follows that the agents of regulation must somehow be themselves placed at arm's length from the indebted state, all the while remaining agents of the public interest. Supranational entities are one possible solution. Independently appointed regulators who are not financed by the state budget but through direct levies on market agents are a distinct possibility. Essentially this means that the pursuit of public interest through regulation should be divorced from the operating exigencies of public sectors, which are market participants themselves. The major issue in this conception is, of course, how to secure political legitimacy and credibility for such agents.

The international bond markets where sovereign debt is issued and traded are the most unregulated markets in the world. Their regulation should be very high on the agenda and should be thought of in ways similar to the contours of the regulation of other markets. Issuer transparency, prohibition of abusive practices, safety of transactions and settlements, and supervision of derivatives are obvious points in this agenda. But this does not appear to be forthcoming.

What appears to emerge instead is a coalition of markets and surplus states whose joint focus is the regulation not of markets but of the policies—that is, budgets and debts—of the indebted states. This is promising to become an apotheosis of market discipline. The aspiration for global regulation of financial markets can be energized now on the basis of only two premises.

The first is the creation of supranational rules and capacities for moderating capital movement and for limiting the profitability of speculative finance. This could involve coordinated taxes, credit ceilings, and transparency requirements for markets. Only in this way will it be possible to achieve two concurrent goals: financial stability and the freeing up of productive capital from the crowding out effects of disproportional financial activities driven by the prospect of unlimited returns. Only in this way will finance regain its original function, which is to facilitate private and public real investment. And only in this way will new space and new resources be created for governments and states to pursue long-term policies that will enable a permanent exit from this crisis.

The second premise relates to the fight against the negative externalities of financial innovations. It is in response to this need that many jurisdictions, notably the United States and the European Union, have taken institutional initiatives for control of systemic risks posed by the risk taking of financial agents. This initiative is indeed a valuable institutional reform but is mostly focused on large banks, whereas externalities and risks to the system may arise from many other subsectors of the financial universe.

However, a more fundamental, deeper step is needed that will be proportional to the disasters that this crisis has piled on humanity. Societies have from time immemorial developed deep-seated defenses against negative externalities, and these were articulated long ago in the writings of Aristotle and are very well known: ethical codes and value systems that restrain dangerous and destructive behaviors. There is an urgent need to revive the discussion and to elevate the priority given to ethics throughout the entire web of professional activities that make up the operation of markets, firms, and governments. I remember a generation of businessmen and bankers who would simply not engage in some activities that would bring in profits at the expense of overall stability. This class of agents, and the underlying ethical code, all but disappeared in the past few decades from the habits and behaviors of individuals who act in financial markets, especially the so-called shadow financial sector. Easy money and quick superprofits wiped away internal restraint.

There are many economists who ascribe the causes of the financial crisis to "misdirected incentives." This undoubtedly has some basis, but there is a deeper issue as well: incentives always embody an intertwining of material motives and ethical standards. Their effectiveness is always calibrated against a background of ethical principles and personal values. We have many examples where individuals make choices not to maximize wealth but to uphold their self-respect, their reputation, and "what is right." This must be revived, as it is the only and truest source of self-regulation. Each professional group, including economists, every firm, and every regulatory authority must develop and uphold explicit ethical codes.

There are numerous examples of codes of conduct and standards of behavior that are used in financial business. If one examines them carefully, it is easy to discover that they all focus on the honest treatment of clients and the avoidance of conflicts of interest. These are important building blocks but are not at all sufficient in the present juncture. What is needed is a code of ethics that will go beyond fair treatment of clients and conflicts of interest and uphold fundamental principles of the public interest. This may range from the integrity of markets to the avoidance of conferring upon others unperceived and unpriced social costs.

There are many who say correctly that trust has been shattered by this crisis. Trust always mirrors the ethical grounding and the perception that others will adhere to commonly accepted ethical codes. For the permanent reestablishment of trust it is not enough to make financial agents more resilient and more transparent, as is sought, for example, by current revisions of banking regulations in Basel III. It is also necessary to elevate ethics to center stage and to give them a new strength against simple material motives. This must hold for the functioning of markets as well as public agencies. Otherwise, the fragilities and the failures that are correctly ascribed to the dissolution of trust are bound to remain and be repeated, and any mending of shattered trust will prove only transitory.