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# Financial deregulation and the 2007-08 US financial crisis

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# Financial deregulation and the 2007-08 US financial crisis

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**Abstract**

Financial deregulation was a significant factor in preparing the conditions for the 2007-08 financial crisis. In the run up to the crisis, deregulation created an environment in which mortgage lending expanded and speculation in other financial markets were heightened, even though riskiness was steadily increasing. In this paper, I review the history of regulation and deregulation in the US and discuss the channels through which financial deregulation contributed to the 2007-08 crisis.

I begin with a brief overview of the history of regulation and deregulation in the US economy. Then, I discuss the channels through which financial deregulation contributed to the financial crisis. I review policy suggestions of those who see financial deregulation as the main contributor of the financial crisis and provide a critical assessment of these, while broadly situating financial deregulation within the context of the broader changes in capitalism since early 1980s.

**Key words:** financial deregulation, financial crisis, financialization, Great Recession

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## 1. Introduction

Following the Great Depression of the 1930s, A series of financial regulations were introduced in the United States. The main aims of these regulations were to ensure the stability of the financial sector and enhance its role in supporting investment and production by the nonfinancial corporate sector. In addition to these regulations, the state's involvement in active macroeconomic management increased, especially after the Second World War, and international trade and finance regulations were introduced following the Bretton Woods conference. Keynesian policies were used to generate demand and to tackle business cycles while the state carried out heavy infrastructural investment and regulated key industries. Social expenditure programs were established together with a redistributive taxation system. This configuration provided high rates of economic growth and hence the era is usually referred to as the "golden age" of capitalism. While on the labor side membership ratios in unions were increasing and real wages going up in this period, corporations were taking advantage of an environment where domestic product markets had an oligopolistic character and foreign competition was limited. However, a serious crisis emerged in the 1970s. At the international level, the fixed-exchange-rate regime of the Bretton-Woods system collapsed. The US economy entered into a period of stagnation accompanied by high rates of inflation. Profitability of the US nonfinancial corporate sector declined significantly. This decline in the rate of profit and the associated problems created the dynamics that led to the dismantling of the regulatory framework of the era. Two dynamics were central in determining the path of economic transformation in the coming decades: the corporations' search for ways to increase profitability and the rise of finance in a gradually deregulated system (Orhangazi 2011).

Financial deregulation (and the reluctance to introduce regulation on new financial products) was a significant factor in preparing the conditions for the 2007-08 financial crisis. In the run up to the crisis, deregulation created an environment in which mortgage lending expanded and speculation in other financial markets were heightened, even though

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riskiness was steadily increasing. The end result was, first, the failure of mortgage firms, banks and a major insurance company, followed by the collapse of the market for short-term loans. This initially led to a liquidity crisis and then to insolvencies and a debt deflation and the whole economy sunk into a deep recession. In this chapter, I review the history of regulation and deregulation in the US and discuss the channels through which financial deregulation contributed to the 2007-08 crisis.

It is important to underline that financial deregulation was not the only reason behind the financial crisis and the ensuing "Great Recession." In fact, As Epstein and Wolfson (2013) notes, "financial crises are not caused by finance alone and certainly have impacts that go way beyond finance" (p. 2). The financial deregulation process should be understood within the context of the broader structural changes that took place in the US economy as well as in the global economy within the last decades. Financial deregulation was not simply a change in policy preferences but an important part of a broader structural transformation. As the regulations were declared inefficient and the Keynesian regime of accumulation was dismantled, trade and finance were liberalized in a process where privatization and deregulation became the policy principles. The attempts to recover profitability included breaking up labor's power with the help of anti-labor policies and globally relocating production to lower cost sites. Labor incomes were curtailed, real wages stagnated and inequality increased to historical heights. This process was accompanied by intensified international competition among large corporations, excess capacity and increased financialization of nonfinancial corporations (Crotty 2003, Stockhammer 2004, Orhangazi 2008a, 2008b).

Keeping these in mind, I begin in the next section with a brief overview of the history of regulation and deregulation in the US economy. In the third section, I discuss the channels through which financial deregulation contributed to the financial crisis. I review policy suggestions of those who see financial deregulation as the main contributor of the financial crisis in the fourth section. In the last section, I provide a critical assessment of these, while broadly situating financial deregulation within the context of the broader changes in capitalism since early 1980s.

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## 2. Regulation and deregulation in historical perspective

US financial markets in the early 20th century were largely unregulated and high volumes of speculative activity prevailed, culminating in the stock market crash of 1929. Many banks failed and significant misconduct was revealed in the Wall Street. 1929 stock market crash and the ensuing Great Depression led to a series of regulatory acts. The main objectives of these regulations were to ensure financial stability and to support growth and capital accumulation. A stable financial sector was to provide low-cost credit to the nonfinancial corporate sector and support production and investment. Hence, a new financial structure emerged based on the following key features: First, the Federal Deposit Insurance Corporation (FDIC) was formed to provide deposit insurance and ward off bank runs. Second, 'firewalls' were created between capital markets and depository institutions in order to isolate the money markets from the riskier activities of capital markets. The intermediary function of dealing with corporate shares and bonds was reserved solely for investment banks. Deposit banks were prohibited from underwriting and placing corporate stocks and bonds and from holding speculative assets. Commercial bank loans were to meet mainly short-term financing needs, while investment banks managed long-term financing needs. Third, Regulation Q put limits on deposit interest rates to limit excessive competition among banks and to ensure low loan rates. Fourth, the FDIC and the Comptroller of the Currency were given powers to ensure the prudence of the banking sector and limit competition in and entry to the sector. Fifth, the Securities Act of 1933 regulated the securities markets and Securities and Exchange Commission (SEC) was established to regulate secondary trading. Sixth, the Commodity Exchange Act of 1936 regulated the exchanges for commodities and futures trading. Furthermore, other pieces of regulation were established for different parts of the financial system. Savings and loans associations were to be overseen by the Federal Home Loan Banks created in 1933, and credit unions by the Bureau of Federal Credit Unions. The regulation of insurance companies was left up to individual states. The international financial system was also

regulated, a fixed-exchange-rate system based on a dollar standard tied to gold and capital controls were introduced (Isenberg 2000, 2003; Sherman 2009).

This configuration, combined with a series of regulations in key sectors and an active macroeconomic management by the state, contributed to the high rates of economic growth during the "golden age" of capitalism. Nevertheless, a serious crisis emerged in the 1970s. The economy entered into a period of stagnation with an increasing rate of inflation. This coincided with the collapse of the fixed-exchange-rate regime of the Bretton Woods international financial system.

The significant decline in the profitability of the nonfinancial corporations and the associated problems created the dynamics that led to the transformation from the regulated system to neoliberalism. Two dynamics were central in this regard: the corporations' search for ways to increase profitability and the rise of finance in a gradually deregulated system (Orhangazi 2011). Keynesian macroeconomic management policies were renounced and deregulation in key industries was gradually put in motion. Starting with the Airline Deregulation Act of 1978, regulated industries were subjected to a process of deregulation and regulated monopolies such as the AT&T were going to be broken up. At the same time, cutbacks in social programs were put in motion together with tax cuts for corporations (Kotz 2013). Paul Volcker was appointed to the Federal Reserve in 1979 and he quickly increased the interest rates. The end result was a significant increase in the unemployment rate and hence undermining of the bargaining power of labor. The Reagan administration signaled that this shift in policy was permanent by introducing a direct attack on labor, beginning with the break up of air traffic controllers' strike in 1981. Regulated industries such as transportation, communications and power were deregulated. Financial sector tried to eliminate or undermine the regulations beginning immediately in the 1930s and 1940s, but it was the 1970s that were the beginning of a long process of deregulation for the sector. The 1970s witnessed a tendency towards liberalizing finance, accompanied by financial innovations aimed at circumventing financial regulations as well as responding to adverse macroeconomic conditions (Orhangazi 2008a). The end of the fixed exchange rate regime and then of capital controls led to subsequent volatility of

exchange rates, which provided a major impetus for the development of financial derivatives. The first wave of financial deregulation included the Depository Institutions Deregulation and Monetary Control Act of 1980 and Garn-St. Germain Act of 1982. Interest rate controls were abolished in 1980. The second wave began with the U.S. Financial Modernization Act of 1999 that allowed increased diversification of financial activities that can be undertaken by financial institutions. The 1933 Glass-Steagall Act imposing a separation between commercial and investment banks was repealed in 1999. The Commodity Futures Modernization Act of 2000 left credit default swaps (CDS) and equity default swaps (EDS) unregulated. The amendment to the Employee Retirement Income Security Act in 2000 permitted pensions to buy mortgage-backed securities (MBS) and asset-backed securities (ABS), which increased the demand for securitized assets. In addition to the removal of existing regulations, in this era there was reluctance on imposing tighter regulation on financial innovations. Kregel (2010) describes this reluctance as follows: "there was no lack of regulation governing the financial institutions that engaged in the buildup of financial layering and pyramiding on an ever-declining cushion of cash" (p. 12) and "many difficulties stemmed not from lack of regulation but from a failure to fully implement existing regulations. . . . all that was necessary was the appropriate application of existing regulations, and nothing more needed to be done" (p. 1).

While the crisis of 1970s and the collapse of the fixed exchange rate regime provided the general conditions for financial deregulation, a number of specific developments in the 1960s and 1970s had already paved the road to financial deregulation and liberalization (Orhangazi 2008a). To begin with, accelerating inflation in the 1970s pushed this system to its limits. The regulated financial system depended on a stable rate of inflation as banks could tolerate low interest rates and finance long-term loans with short-term deposits without a high risk of maturity mismatch as long as inflation stayed in check. Increasing inflation pushed real interest rates down, especially after 1973, and lowered the profitability of commercial banks. Around the same time, large corporate borrowers began turning towards the commercial paper market (short-term money market securities issued by private firms) exacerbating commercial banks' problems and expanding the commercial

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paper market. The decline in corporate loans in banks' portfolios was going to be a major factor in the banks' expansion into the consumer credit and mortgage markets in the following decades. Banks responded with a series of innovations that were devised to keep their market share by working around regulations. An earlier example of these innovations was the introduction of the negotiable certificate of deposit. These innovations contributed to the dismantling of the regulatory framework by making the existing regulations obsolete and at the same time contributed to the expansion of the financial sector in general. Later on, rapid progress in information and communication technologies enabled further financial innovations.

A wave of US mergers was accompanied by a move overseas of these merged corporations at the end of the 1960s. The internationalization of production created a change in the financial needs of the nonfinancial corporations by the 1970s and this has contributed to the deregulatory drive. The Glass-Steagall Act kept commercial banks away from this merger wave and they were not involved in the financing of the mergers. When the large conglomerates increasingly looked abroad in search of markets, the US commercial banks started to move out in order to meet these corporations' financial needs. However, they were constrained by the 'Interest Equalization Tax,' which was introduced in 1963 and aimed to stop the movement of US dollars abroad. This led banks to open foreign branches to meet the borrowing needs of these multinational corporations. As industrial firms reached their national limits and intensified their pursuit of opening up to cross-border operations, the predominant business and economic theories of the era began to claim that regulations and restrictions were barriers to development, employment, profitability and survival. Hence, the success of industrial and productive firms created a powerful push to get rid of the regulatory restrictions to spread to new markets, areas and lines of business. Increasing power of financial institutions over time was another significant factor in the push towards further deregulation. After the oil price hikes of the 1970s, oil producing countries recycled their vast amounts of "petrodollars" through banks in Europe and New York. Banks began searching for profitable investment opportunities after suddenly acquiring these large amounts of funds. As the rates of return in the US and in Europe were

not high in the slow growth years of the 1970s, they began pushing for an opening up of international investment opportunities. The need for international financial opening required by these banks and their increased power contributed to the pressures towards financial liberalization and deregulation. The banks acquired a significant amount of influence through the command of these large funds and began a process of "loan pushing." The key event was the Mexican default in 1982, which threatened the solvency of most New York banks. What the decade of the 1980s showed to the world after the default of Mexico was that the creditors were protected (financial power indeed won), while the 'Washington Consensus' policies - shaped in response to this crisis (or seizing this opportunity) by the IMF, World Bank and US Treasury, and surely influenced by financial lobby in Washington and elsewhere – were now the new way of thinking, doing business and governing.

Among these financial institutions, the share of institutional investors' asset holdings in total financial assets began increasing especially in the 1990s. Investment funds attracted savings that were previously held in fixed term bank deposits. The introduction of funded pension schemes created a huge rise in the flow of money into the securities market to buy corporate stocks as well as corporate and government bonds. Taxes on finance capital were also reduced, especially on the new pension and investment funds in order to create incentives for small investors' participation. While institutional investors benefitted from deregulation, technological advances enabled them to increase their size by driving their costs down.

## 3. The role of financial deregulation in the crisis

### *3.1 Theoretical background*

As these developments contributed to the impetus towards deregulation, "free market" theories in economics and finance slowly gained predominance and provided a theoretical support for the structural transformations. According to the mainstream economic and financial theory, the financial sector simply serves the needs of the economy and improves its efficiency. The standard models portray markets and economies as inherently stable

and macroeconomic models study only stable states that are affected by external shocks. Financial markets provide essential services such as providing liquidity, mobilizing and pooling savings and allocating them to investment. They gather, process and disseminate information possessed by different agents in the economy and hence provide services of screening and monitoring, risk management, diversification and hedging. According to these models, as financial markets provide these functions, the prices of financial assets are supposed to reflect the fundamental values in the real economy. Financial markets, hence, increase the allocative efficiency of the system. These models conclude that financial markets do their job best in an environment of minimum regulation. Regulation distorts the system. Investors seeking to achieve maximum return for a certain risk level will choose the optimal risk for them and in the process allocate resources to their most productive use. Left on their own without any regulation, financial market actors will behave in their own interest and this will create outcomes that are efficient (Dowd 1996). As financial economists developed these models with strong unrealistic assumptions, individuals and businesses built on these model. Crotty (2013), who provides a thorough critique of the deregulated financial system and the theories that support it, argues that the theory of "efficient financial markets" is a fairy tale based on grossly unrealistic assumptions. This theory was a significant contributor to the crisis as it helped justify the financial deregulation process. It gained predominance in economics partly because of the flawed methodological argument that the realism of the assumptions did not matter. However, this theory could not be empirically validated for a number of reasons. Crotty (2013) concludes that an analysis of the financial markets should be based on the Keynes-Minsky approach, which has affinities with the Marxian approach. These approaches see capitalist financial markets as inherently unstable. The basic dynamics of a financial crisis originate in the fundamental features of the capitalist system, while variations in each crisis appear as a result of institutional changes over time (Wolfson 2013). Keynesian and Marxian approaches attribute a dual role to finance where finance is at the same time a significant accelerator of accumulation and a major source of instability (Orhangazi 2011). Keynes had argued that investment under capitalism is fundamentally unstable and

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financial markets further contribute to this instability. Minsky (1982, 1986) developed this argument and concluded that only big government institutions can bring a certain level of stability to the fundamentally unstable capitalist economy. In the Minskian version of the argument where investment spending is seen as the main force in the economy, a financially robust environment (low levels of debt, low interest rates, and liquid conditions for businesses and households) encourages higher levels of investment spending. Increased investment generates an increase in profits and encourages even further investment and increased confidence in the economy. As confidence increases banks make more and riskier loans, leading eventually to increases in debt ratios as coverage ratios fall. This process creates financial fragility in the sense that an unexpected downturn in the economy would lead to payment difficulties for the fragile units. Furthermore, speculation in financial markets can create euphoria and an intial increase in asset prices can lead to further increases through expectations channel. As the demand for these assets and their prices increase, risks associated with these assets are underestimated and asset bubbles are formed. Such a bubble in financial markets has signficant effects on the real economy as it could lead to an increase in consumption through wealth effects or in investment expenditures. However, a reversal leads to serious problems by deflating the aggregate demand as well.

Marxian approaches, while mostly emphasizing the real sector roots of capitalist instability, also point out the potentially destablizing role of finance. Financial institutions support capital accumulation by mobilizing large amounts of money capital and allow accumulation to take place at a faster rate and a larger scale than otherwise possible. However, finance also contributes to capitalist instability, which can originate either in the financial realm or in the real sector and got exacerbated by finance. When there are favorable conditions for accumulation, investment expands rapidly leading firms use more credit. The pace and scale of expansion at this stage would depend on the amount of financial capital invested in capital accumulation. These expansions endogenously create disturbances in the financial or real side of the economy. An adverse development in the real side of the economy could be turned into a crisis and collapse if it leads to or is accompanied by troubles in the

financial markets. Likewise, a disturbance originating in the financial sector can spread to the real side of the economy by disrupting the accumulation process. An overextended and fragile system can turn what might have been a mild downturn into a financial crisis (Orhangazi 2011).

### *3.2 From deregulation to crisis: channels*

The 2007-08 financial crisis erupted at the end of a long process of financial deregulation. Securitization was widespread and the originate-and-distribute model in mortgage lending was prevalent as risks spread through the system with little accountability. When housing prices began declining and adjustable mortgage rates were raised to higher levels, a number of borrowers began defaulting on their mortgage loans. Asset-backed securities linked to the mortgage market began losing value. As the mortgage-backed securities were spread across all financial institutions, the crisis spread to other assets based on short-term debt. Repo markets, asset-backed commercial paper markets, and money market mutual funds were at the center of this crisis. Securitization loosened the link between creditors and borrowers and created the possibility for illiquidity as concerns about marketability rose.

Financial deregulation prepared the conditions for the crisis through five different but closely related channels: i. rapid expansion of financial innovations including complex financial derivatives and the accompanying excessive leverage; ii. increased securitization; iii. emergence and expansion of shadow banking with minimum regulation and a concomitant banking concentration; iv. increased risk taking by financial institutions; v. flawed decisions based on flawed financial models. Each one increased the fragility of the financial system in different ways. Let's look at them briefly.

#### Financial innovations and leverage

Financial innovations contributed to the increase in leverage by allowing financial institutions to offload risky assets and thus reduce capital requirements. Lack of regulation encouraged excessive leverage. Unregulated financial innovations contributed to risky

credit expansion and financial investments. In the housing market, the appearance of ever-increasing prices led households to borrow up to the full market value of their houses and borrow more through refinancing arrangements encouraged by banks as the market value of houses went up. In this process, little, if any at all, attention was paid to the ability of these households to service the debt.

On the other hand, a major problem with the derivatives is that even small losses on derivative holdings have the potential to destroy bank capital as they are not included in capital ratios. While derivatives could allow banks to hedge risks, they also increase risk taking activity and allowed banks to increase their leverage. After the collapse and bailout of the AIG, it was revealed that it used bailout funds to pay off bad bets made by banks on CDOs. These bets were pure gambling by banks as banks placed bets on securities they did not even hold (Nersiyan and Wray 2010: 18).

Securitization

Financial deregulation and liberalization enabled increased securitization. Securitization refers to the process where traditionally illiquid loans are packaged into different types of securities and sold in financial markets. In the process, the original lender brings together a portfolio of loans - a method known as pooling of loans - and sells it to a Special Purpose Vehicle (SPV). The SPV sells rated securities in order to finance these. At the end, securitization turns a loan that would have traditionally been held on the balance sheet of the originating bank into a marketable security and moves it off the balance sheet.

Securitization led to higher levels of risk and fragility because it encouraged the reduction of standards for procedures and inadequate evaluation of the loans since each party began relying on others for a thorough investigation of the loans. The subprime mortgage market was a case in point. While investors who bought mortgage-backed securities did not thoroughly investigate these, financial institutions failed to understand and disclose the risks and the credit-rating agencies failed in evaluating the complex securities.

Securitization also loosened the link between the creditors and borrowers and created the possibility for illiquidity as concerns about marketability rose. Furthermore, securitization

created the illusion that subprime mortgage lending became much safer and led to a rapid inflow of money into the market (Pollin 2008: 120). However, when asset prices started to decline, complex interconnections in the financial markets began working in reverse and bringing financial institutions down and uncontrolled securitization and high leverage led to spreading panic. For example, credit default swaps (CDS) made securitized loans appear safe. CDSs were marketed as a tool to hedge against risks and it was argued that they helped distribute risks to those who were most willing and able to bear them. Banks used them to hide risks on their balance sheets. While they were engaged in risky activities, they bought CDSs to "hedge" and managed to maintain a risk free appearance (Nersiyan and Wray 2010: 15). For example, a bank could hold risky financial assets and then buy "insurance" from AIG on these securities. On top of this, it could make a bet that AIG would fail and not honor this insurance. All this was supposed to protect the bank from any risk. However, for these bets there was always a counterparty and this at the end brought the whole structure into a crisis (Nersiyan and Wray 2010: 15-6).
Complex techniques of pooling and trenching different types of financial instruments with different levels of risk led to the creation of more and more complex securitized pools of loans that were supposed to bring high returns with low risk. Flawed mathematical models were used for their evaluation. In the mortgage market, this meant an expansion of mortgage loans to riskier borrowers and it provided the basis for what can be called an inverted pyramid of structured products. Moreover, lack of regulation led to a decline in underwriting standards as well as consumer protection. In addition, securitization contributed to financial institutions' becoming interconnected through an intricate web of financing, investment and securitization operations which further made it increasingly more difficult to assess risk independently.

Shadow banking

Shadow banking, in its broadest definition, refers to institutions such as "investment banks, money-market mutual funds, and mortgage brokers; rather old contracts, such as sale and repurchase agreements ("repo"); and more esoteric instruments such as asset-backed

securities (ABS), collateralized-debt obligations (CDOs), and asset-backed commercial paper (ABCP)" (Gorton and Metric 2010: 1). Financial deregulation, together with financial innovations, caused an expansion of these instruments of shadow banking. Money-market mutual funds, securitization and repurchase transactions played a central role in the crisis as they are key elements of off-balance sheet activity. Financial deregulation opened up the way for banks to engage in all sorts of risky activities. These activities were mostly incompatible with traditional banking roles. In fact, "[m]any of the larger banks have changed so much that it is unclear whether they can be called banks - since they did little underwriting, and tried to shift risks off balance sheets - either by packaging and selling assets or by purchasing 'insurance' in the form of CDSs" (Nersiyan and Wray 2010: 9-10). The ABS were issued by SPVs, which were established to hold assets as well as debt obligations backed by these assets. However, these were not actual institutions but were entities created for bookkeeping purposes. Banks used these to move securitized assets off their balance sheets onto the SPVs, which then would issue bonds and commercial paper that was backed by the pooled assets. In this way, banks could avoid capital and reserve requirements and increase their leverage as well as return on equity (Nersiyan and Wray 2010: 8). Furthermore, financial deregulation has contributed to increased concentration in the banking sector through the repeal of the Glass-Steagall Act. This made the financial system more fragile as it created only a few institutions that dominated most of the sector. Deregulation also turned these giant banks into 'universal banks' that engage in all sorts of financial activities in addition to commercial banking, investment banking and insurance activities.

Risk

Financial deregulation and complicated financial innovations created incentives for the financial institutions to undertake risky investments. The high degree of competition among financial institutions created further incentives for them to take risky actions in order to protect their market share and profitability. A long period of economic expansion with low default rates contributed to these by increasing the level of confidence in the economy in

general and especially within the financial sector. On top of this, the pay structure in financial institutions favored and encouraged excessive risk taking while not paying enough attention to long-term risks. For example, in the subprime market, loan officers were earning large commissions as they brought new customers to the banks. They did not have to return these commissions later on when the loans began not performing (Pollin 2008: 120).

Flawed models, flawed decisions

Part of the rhetoric on financial deregulation included an emphasis on self-surveillance and self-policing of the financial sector. For example, assessment and regulation of sophisticated financial instruments such as derivatives, collateralized debt obligations and structured investment vehicles were mostly left to financial market institutions and they used highly sophisticated quantitative models of risk assessment for this purpose. This led to an underestimation of the real risks and created a situation where it became increasingly more difficult to distinguish poor judgment from fraudulent behavior. The belief that market mechanisms and the profit motive bring socially optimum outcomes created an environment in which both complicated financial innovations and risky decisions made by the financial institutions went unchecked. Government intervention in markets has been considered to be counter-productive and the belief that self-regulation of markets has slowly gained sufficient support since the 1980s. This belief presupposed that financial market decision makers are in a better position to understand what they are doing than government officials who have no expertise in banking and finance and since these financial market decision makers are sophisticated people they will not take actions that could undermine their own interests and create fragility. In fact, Tymoigne (2010) argued that risk management techniques encouraged unsound financial practices and high leverage while self-regulation only created dangerous and at times even fraudulent business practices. While emphasis was put on short-term profitability, lending standards were loosened in a "race to the bottom."

Greed, irrationality etc.

Those who attribute financial deregulation a central role in creating the financial crisis see other arguments putting factors such as subprime-lending, greed, speculation and so on at the center as having little explanatory power. In fact, the greedy actions of market participants are explained by the requirements of market mechanisms. While some such as Blundell-Wignall, Atkinson and Lee (2008) point out 4 regulatory changes regarding homeownership strategies, these were not causal factors but rather compounding factors. Subprime lending itself also does not explain the whole thing as it is only part of the story and even subprime lending would not be "bad" if its financial terms were carefully adapted and related to the core incomes of the borrowers enabling them to meet their payment obligations. Moreover,

... most market participants behave rationally in the sense that stiff competition and short-term incentives to reach money-return targets push them to do whatever is legally (and sometimes illegally) possible to maintain their market shares. ... this exclusive concern for individual financial accumulation pushes aside the long-term and indirect feedback effects that lead to financial fragility and increased systemic risk... Market participants have no patience for those indirect effects, even if these indirect effects make them directly worse off, because they are too complex to include in the decision-making process or because it does not look like that market participants will be affected by them. (Tymoigne 2009: 16)

International transmission

International transmission mechanisms included investments of banks outside the U.S. in assets tied to U.S. mortgage lending. The financial crisis in the US quickly turned into a global financial crisis due to the unregulated nature of international finance. Initially, increased uncertainty over the credit worthiness of counterparties both in the US and in Europe created a liquidity crisis. Banks began preferring to remain liquid and were unwilling to lend. As a result of this short-term spreads quickly rose to record levels (Kregel 2008:2-3). Deregulated and interconnected financial markets together with increased securitization and leverage spread the risk around the world. Yet, some of the

contagion of the US financial crisis was controlled by the liquidity injections of the central banks and the efforts of the G20 together with the IMF (Singh 2013).

## 4. Regulation, deregulation, re-regulation?

Given the size and significance of the financial crisis, it is not surprising that a large number of policy proposals were put forward. While after the crisis there was general agreement about the need for new regulation (for example, the Basel Committee on Bank Supervision (2010) focused on liquidity requirements, flexible capital requirements, maximum leverage ratios, etc.), there were more fundamental reform calls as well. The basic idea in these proposals is that unregulated competition and profit motive creates short-termism in the economy and results in the prioritization of individual interest over social interest. The general argument is that the stability of financial system is in the interest of society at large and should take priority over private financial interests. The suggested reforms have the general aim of detecting and preventing financial fragility and hence protecting against financial crises. A more general and fundamental policy proposal and a general idea looming behind most of the proposals above is that the financial sector has grown too big and it needs to be downsized. A number of more concrete policy proposals include the following.

A financial transactions tax has been proposed in order to raise the cost of speculative trading and hence to discourage excessive speculation in the financial markets. For example, Pollin (2008) argues that a small sales tax on all financial transactions would be a measure that would promote both financial stability and fairness. Asset-based reserve requirement is another proposal to discourage financial institutions from holding excessive amounts of risky assets and, at the same time, to provide a cushion when market downturns occur. This kind of a regulation would require financial institutions to keep a certain amount of cash in a reserve fund in proportion to the risky assets that they hold. On the other hand, excessive competition is seen as one of the reasons behind excessive risk taking. Therefore, it is proposed that a new regulation should protect banks from

competition and provide them with reliable and cheap financing source through the central bank. (Tymoigne 2010, Wray 2007).

Given the role of financial innovations in the run up to the financial crisis, it is argued that each and every financial innovation should be regulated and supervised. Tymoigne (2010) argues that a one-time regulation is not sufficient and there should be regulatory follow-ups after financial innovations are permitted to exist for a certain period of time.

Rating agencies were seen as partly responsible for the financial crisis as financial assets that received high ratings from these agencies turned out to be quite risky. It was highly improbable for rating agencies to perform large amounts of credit assessments with the required diligence and accuracy and when their ratings turned out to be inadequate they were not held accountable. A more fundamental problem was that an issuer of a structured financial product would usually shop around the rating agencies to find the one which would give a high rating with the lowest cost. Therefore, conservative risk assessments would never make it to the market and over time conservative rating agencies would also begin conforming to the others to protect their market shares. Therefore a new structure for rating agencies is proposed by some (Kregel 2008, Diomande et al. 2009).

Another regulation proposal is the introduction of different ways of evaluating creditworthiness and different measures of financial robustness. According to Tymoigne (2010) evaluating credit worthiness only by the value of the collateral asset is not sufficient. What matters is the capacity to generate incomes that are sufficient enough to cover debt commitments. Hence, for individual institutions as well as the economy, regulators should focus on these cash-flows. This is different from the probability of default, credit ratings and FICO scores as financial fragility is measured based on an analysis of not only balance sheets and cash flow but also the underlying assets. In this type of an evaluation the essential questions would include whether continuous refinancing is needed and if so whether this need is growing in relation to outstanding debt. These questions can be explored by key financial indicators such as the ratio of refinancing loans and their growth rate; the dynamics of debt and asset prices; and structure of net cash inflows vs. cash outflows.

Especially in the U.S. case, the high number of regulators with limited mandates about different segments of the financial system is seen as part of the problem by some. For example, Edgar (2009) argues that in the US a number of regulatory agencies with limited mandates to particular segments of the financial system creates both confusion and room for regulatory arbitrage. Therefore, a unified regulatory structure is envisioned in order to prevent the financial sector from engaging in regulatory arbitrage.

While this brief overview gives an idea about some of the regulatory proposal that were put forward after the financial crisis, D'Arista (2009) provides a succinct overview of financial reform proposals and Ash et al. (2009) provide a detailed program of both financial regulation and economic reform under the title of "A Progressive Program for Economic Recovery and Financial Reconstruction."

## 5. Deregulation and structural problems of the economy

Analyses that focus on financial market deregulation as one of the main causes of the crisis are based on the theoretical premise that left to their own workings financial markets are inherently unstable. We see that in the past decades financial deregulation created an environment in which financial fragility steadily increased and resulted in a deep financial crisis. However, it is important to underline that financial deregulation was not the only reason behind the financial crisis and the prolonged economic stagnation that followed it. Above, I tried to situate the financial deregulation process within the context of the broader structural changes that took place in the US economy as well as in the global economy. The growing financialization of the economy and financial deregulation was directly related to the problems in the rest of the economy. In the post-1980s era, structural problems such as slow growth of aggregate demand, cutthroat industrial competition, global restructuring of production and global imbalances accompanied the financial deregulation and liberalization trends (Crotty 2003, Orhangazi 2008a, 2008b). In fact, finance has both contributed to some of these problems, and, at the same time, provided temporary solutions to the same problems (Orhangazi 2011). For example, asset bubbles in the 1990s

and 2000s largely drove the US economy and created a strong source of demand (Baker 2013).

Still, another important issue that needs to be considered is that the discussion on financial regulation often leaves aside the issue of power. In the US, the political problem is the excessive power of the financial industry (Dymski 2010a, b). For example, a significant part of the literature on deregulation seems to ignore the power of the financial sector and its capacity to affect legislation regarding the financial sector. Much reference is made to the first wave of financial regulation in the US in the 1930s. However, this was also a period when labor was successful in organizing and increasing its power vis-à-vis capital. Wolfson (2013) notes that ". . . although the 1930s and 1940s saw a relative balance of power between labor and capital rather than the dominance of either one. Workers were able to influence government and use the power of government to promote their interests – to encourage the formation of unions, to create a social safety net, and, most relevant for our purposes here, to restrain the destructive competitive tendencies of an unrestrained market and to provide government support for depositors through deposit insurance" (p. 181). Furthermore, the issue of power needs to be considered at the global level as well.

Finally, most policy suggestions in general aim to constrain finance and sort of bring it back to its function subservient to the needs of the economy. They are built on the understanding that a more managed capitalism is required in order to sustain stability and growth. This is clearly a very radical position given the state of the economics discipline. The aftermath of the financial crisis showed that this is also a lot more radical than the politicians can accept. However, both the Keynes-Minsky tradition and the Marxian tradition remind us that even stability under capitalism is destabilizing and in the absence of a change in the main economic structures, relations and incentives, fixing the system will prepare the ground for future crises (Seda and Orhangazi 2010). Furthermore, the global financial and economic crisis is only one among many crises, including the crises related to the environment, energy and food. Yet, the 2007-08 financial crisis and the ensuing economic stagnation, increased unemployment and poverty and the general deterioration in living

standards reminds us that we need to be looking for radical alternatives in organizing the economy.

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## THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

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