GLOBAL FINANCIAL CRISIS AND GOVERNMENT INTERVENTION: A CASE FOR EFFECTIVE REGULATORY GOVERNANCE

Stephen K. Aikins

ABSTRACT

The recent financial and economic crisis in the United States and the rest of the world, as well as the interventionist efforts of respective governments to stabilize their economies, have generated a lot of controversy about the virtues of the free-market system and the wisdom of state intervention. The objective of this article is to put the debate on the relative efficiency of the free-market and government intervention in a larger theoretical perspective and make the case for the importance of efficient regulatory governance of financial institutions in ensuring economic stability. Drawing on the theories of laissez faire and market failure, the Keynesian and Marxian theories and the theory of regulation, I argue that mutual co-existence of the market and the government is beneficial to society, and that periodic global financial crisis occur because of the failure to learn from history and ineffective regulatory governance. Governments need to put in place proactive regulatory framework to guard against regulatory capture, arbitrage and forbearance in order to control financial market excesses.

INTRODUCTION

The recent financial and economic crisis in the United States and the rest of the world, as well as the interventionist efforts of respective governments to stabilize their economies have generated a lot of intellectual debate and controversy about the virtues of the free market system, and the role of government in an economy. Fearful of the escalation of the financial crisis in September 2008, leaders of the western industrialized nations took drastic measures to rescue troubled financial institutions in their respective countries. The United States led the way by embarking on the most sweeping government economic intervention since the great depression through series of financial sector rescue packages, followed by Great Britain, and other European countries with comparable rescue packages for their financial institutions. A study conducted by Anderson, Cavanagh and Redman (2008) for the Institute for Policy Studies (IPS) reveals that as of November 13, 2008, the key components of the U.S. financial sector bailout amounted to $1.3 trillion, while the European financial sector bailouts amounted to $2.8 trillion. Together, the bailouts by the western nations amounted to $4.1 trillion in commitments. Tables 1 and 2 show the details of the United States and Western European countries commitment to the financial sector bailouts as of November 13, 2008.

In the United States alone, as illustrated in Table 1, $700 billion was approved for the troubled asset relief program and another $243 billion for commercial paper funding facility, $200 billion in cash injections to keep Fannie Mae and Freddie Mac afloat, $112.5 billion to rescue AIG, $29 billion to guarantee Bear Stearns’ losses on investment portfolio, and $13.2 billion for FDIC takeovers (Anderson, Cavanagh &
Redman, 2008). On top of all this, the United States Congress in February 2009 approved 787 billion dollars to stimulate the economy and additional packages have been announced to address the depressing housing market. Table 2 also reveals that the United Kingdom committed $734 billion for interbank lending and short term loans, Germany $637 billion to guarantee medium term lending and recapitalization, and France $483 billion to guarantee bank debt and recapitalization. As laudable as these rescue packages may be, many worry that such efforts do not only subsidize financial sector inefficiencies and unscrupulous behavior of free-market actors, but also divert much needed resources from other social problems that need to be addressed.

Table 1: US Commitment to Financial Sector Bailout as of November 13, 2008 ($ Billions Unless Otherwise Stated)

<table>
<thead>
<tr>
<th>Program</th>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Troubled Asset Relief Program (TARP)</td>
<td>700.0</td>
<td>Original plan was to use the funds primarily to purchase troubled mortgage-related assets. The Treasury Secretary has since decided to use the funds for cash injections for banks.</td>
</tr>
<tr>
<td>Commercial Paper Funding Facility</td>
<td>243.00</td>
<td>Through this facility, the Fed buys commercial paper (short-term debts) from banks to help finance day-to-day business operations.</td>
</tr>
<tr>
<td>Fannie Mae/Freddie Mac</td>
<td>200.00</td>
<td>Federal officials assumed control of the mortgage firms and are providing cash injections to keep them afloat.</td>
</tr>
<tr>
<td>AIG</td>
<td>112.5</td>
<td>Does not include $40 billion drawn from the $700 billion bailout fund. After an initial bailout in October, AIG negotiated a larger rescue package with easier terms. Special lending facility to guarantee losses on the investment bank’s portfolio; facilitated buyout by JPMorgan.</td>
</tr>
<tr>
<td>Bear Stearns</td>
<td>29.0</td>
<td>The Federal Deposit Insurance Corporation has put up to cover deposits on failed banks.</td>
</tr>
<tr>
<td>FDIC Bank Takeovers</td>
<td>13.2</td>
<td></td>
</tr>
<tr>
<td><strong>Total U.S.</strong></td>
<td><strong>$1.3 trillion</strong></td>
<td></td>
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</table>

Source: Anderson, Cavanagh and Redman (Instituted for Policy Studies, November 2008)

The neo-classical school of economics is divided over the relative merits of the market and the state in achieving the objectives of efficient allocation of resources to strengthen the financial sector, to reverse the downturn of the economy and to ensure high aggregate demand, low unemployment, low inflation and high economic growth. Proponents of the free-market system argue that without government intervention, the dynamics of demand and supply will help the economy adjust to recession and automa-
Table 2: Western European Commitment to Financial Sector Bailout as of November 13, 2008) ($ Billions Unless Otherwise Stated)

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>United Kingdom</td>
<td>743.0</td>
<td>The UK bailout was the first announced and largely served as the model for other European rescues. Half of the package is for guaranteeing inter-bank lending, 40% for short-term loans and 10% for recapitalization.</td>
</tr>
<tr>
<td>Germany</td>
<td>636.5</td>
<td>The bulk is to guarantee medium-term bank lending, with 20% for recapitalization.</td>
</tr>
<tr>
<td>France</td>
<td>458.3</td>
<td>The bulk is to guarantee bank debt, with about $50 billion for recapitalization.</td>
</tr>
<tr>
<td>Netherlands</td>
<td>346.0</td>
<td>To guarantee inter-bank loans.</td>
</tr>
<tr>
<td>· Sweden</td>
<td>200.0</td>
<td>For credit guarantees.</td>
</tr>
<tr>
<td>· Austria</td>
<td>127.3</td>
<td>For bank buyouts, interbank lending, and bank bond issuance guarantees</td>
</tr>
<tr>
<td>Spain</td>
<td>127.3</td>
<td>For bank buyouts, interbank lending, and bank bond issuance guarantees.</td>
</tr>
<tr>
<td>Italy</td>
<td>51.0</td>
<td>To purchase bank debts.</td>
</tr>
<tr>
<td>· Other European Countries</td>
<td>110.6</td>
<td></td>
</tr>
<tr>
<td><strong>Total European</strong></td>
<td><strong>$2.8 trillion</strong></td>
<td></td>
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Source: Anderson, Cavanagh and Redman (Instituted for Policy Studies, November 2008)

Note: European currency conversions to US Dollars based on exchange rates as of 11/14/08.

In spite of the ongoing debate, few studies are yet to focus on the importance of mutual co-existence of both market and government and the significance of effective intervention to correct its imbalances, by purging inefficiencies within the system, and then move toward equilibrium and the strengthening of the overall economy. Advocates of intervention argue that the current recession and financial crisis constitute a manifestation of market failure and that the role of the government is to mitigate the undesirable consequences of market activity through regulation and appropriate fiscal policy instruments without losing the benefits of competitive economy.
regulatory governance to the health of a nation’s financial sector and the overall economy. The objective of this article is to put the debate on the relative efficiency of the free-market and government intervention in a larger theoretical and regulatory perspective and make the case for the importance of efficient regulatory governance of financial institutions in ensuring economic stability. Drawing on the theories of laissez faire and market failure, the Keynesian and Marxian theories and the theory of regulation, I argue that mutual co-existence of the market and the government is beneficial to society, and that periodic global financial crisis occur because of failure to learn from history and ineffective regulatory governance. Governments and their regulatory authorities need to put in place proactive regulatory framework and institutional safeguards to guard against regulatory capture arbitrage and forbearance in order to control financial market excesses.

REGULATORY POLICY AND ECONOMIC STABILITY

Regulation is a mechanism to insist that public purposes be respected by businesses and other nongovernmental institutions in their operations (Lehne, 2006). Our understanding of the role of regulation in the relationship between government and private institutions is dominated by two basic theories – the public interest theory and the private interest theory (Mitnick, 1980). According to the public interest theory, regulation is instituted for the protection and benefit of the public at large or some large subclass of the public. Most analysis based on this view present regulation as a response to market failure (Bernstein, 1955) by, for example, seeking to achieve the benefits of market place competition for consumers and society in situations in which competition does not occur.

The theory of market failure is concerned with establishing the conditions under which competitive market allocations will be inefficient. The theory suggests that under certain conditions, the production and distribution of a good or service through a competitive market in which all the relevant agents are pursuing their own self-interest will result in an allocation of that good or service that is socially inefficient. This implies in the situation where companies have power to fix prices or limit competition, consumers lack the information needed to make the best product choices, market exchanges affect people who are not party to the transaction, the structure of an industry creates barriers to entry (Lehne, 2006), or market allocations result in inequities in the distribution of income and wealth, a market failure has occurred and government can put in place appropriate institutional and regulatory framework to correct it.

The private interest perspective of regulation views it as a means to pursue private interest, and nothing more than an effort to use government authority to redistribute income from one group to another. For example, a company with less than optimal profit can invest in lobbying effort to secure beneficial regulatory action (Owen & Braeutigam, 1978), and members of Congress can benefit by transforming regulation into pork barrel politics (Posner, 1969). The need for good regulatory governance as part of a broader effort to prevent or better manage financial crisis and ensure economic stability stems from the fact that a financial system is only as strong as its governing practices, the financial soundness of its institutions, and the efficiency of its market infrastructure. Just as market participants in the financial system should establish good governance practices to gain the confidence of their customers and to help ensure a stable economy, regulators have fiduciary responsibility to follow sound governance.
practices in their operations to maintain credibility and moral authority in their oversight responsibilities. This requires the establishment of appropriate economic and regulatory policies to prevent political and institutional interference in the regulatory supervision of financial institutions, as well as to prevent regulatory forbearance, regulatory arbitrage and regulatory capture. Unfortunately, undue interference and ineffectiveness of oversight have contributed to the depth and magnitude of nearly all financial crisis in recent years (Udaibir, Quintyn & Taylor, 2002).

FINANCIAL SERVICES AND INEFFICIENT REGULATORY GOVERNANCE

Stigler (1971) suggests that regulators are commonly subject to intense and effective pressure from regulated firms to modify regulations and their implementation to suit the interests of the latter. Regulated firms may exercise pressure at the political level, for example, by supplying politicians with one-sided evidence supporting their positions and attempting to gain their allegiance through campaign contributions. Additionally, they may exercise pressure and influence at the regulatory agency level by implicitly offering agency staff lucrative employment opportunities in exchange for being cooperative, and generally inducing the regulators to identify with the regulated industry (Hardy, 2006). As emphasized by Laffont and Tirole (1991) and Laffont (1999), regulatory capture is likely to be more effective when one interest group is highly concentrated and organized and has much at stake, and when the regulations are technically complex and asymmetric information is pervasive, so that outside verification is difficult.

Some empirical evidence indicates capture affects regulation in the banking (Kane, 1990), non-bank (Woodward, 1998) financial sectors and related areas of activities such as accounting (Godfrey & Langfield-Smith, 2004). In his analysis of how U.S. savings and loan institutions successfully influenced the regulations applied to them, Kane (1990) argues both the regulatory agency and the U.S. Congress were not only subject to influence but also had conflicting incentives. In his subsequent study, Kane (2001) also found while capture was not complete, managerial and bureaucratic interest, as well as budget constraints and shifting objectives contributed to what became a debacle. Rosenbluth and Schap (2003) present evidence to support their hypothesis that different electoral rules will affect the extent to which bank regulations favor producers over consumers of financial services. From the standpoint of regulatory capture, such a situation could be a reflection of a certain commonality of outlook and interests of the financial institution and the regulators. For example, Hardy (2006) suggests the bank of England used to view the promotion of the City of London as one of its prime mandates, and much of the debate on harmonized regulations in the run up to the European Monetary Union consisted of defense of national financial industries by the respective central banks.

Historical and empirical evidence show that regulatory arbitrage is a significant contributing factor behind the failure of financial institutions. In Japan, credit cooperatives were subject to looser supervision and regulation than those applied to banks, a fact which allowed them to engage in more risky banking activities than in the banks. These relaxed restrictions on their lending to non-members enabled them to engage in unhealthy competition in the credit market, which indirectly contributed to the weakening of all financial institutions (Kanaya & Woo, 2000). In the United States, research by Minton, Sanders and Strahan (2004) show that unregulated finance
companies and investment banks are much more apt to securitize assets than banks, and that risky and high levered financial institution are more likely to engage in securitization than safer ones.

Regulatory forbearance has also been a significant problem regarding the monitoring of financial soundness and undue risk taking by financial institutions in western advance countries. Following the savings and loans debacle in the 1980s, the United States Congress imposed on federal regulators an obligation to take proactive steps to control taxpayer exposure to loss from bank risk-taking. The goal was to monitor and to discipline the extent to which a bank’s capital position can comfortably absorb the risk exposures that the bank pursues. As Mathews (1998) argued, despite this pattern of monitoring and control, the nation’s 100 largest banks lost almost one-fourth of their market capitalization in the third quarter of 1998. The root cause of the problem, as explained by Kane (2000), is that regulators seemed disinclined to constrain circumvention opportunities by enforcing market-based standards and definitions for measuring bank risk and bank capital instead of accounting-based ratios and definitions. As discussed in subsequent sections of this article, the continual existence of such a problem and failure to learn from history such as the Japanese financial crisis contributed toward the 2008 global financial crisis.

During the Japanese financial crisis in the 1990s, the lack of independence of the financial supervision function within the ministry of finance and the inability of the regulators to take steps quickly to address and forestall problems in the financial system is widely believed to have contributed toward the financial sector weakness. Typical of most banking crisis, the underlying causes of the Japanese banking crisis were excessive asset expansion in periods of economic boom, liberalization without an appropriate adjustment of the regulatory environment, weak corporate governance and regulatory forbearance when the system is under stress (Kanaya & Woo, 2000). As noted by Hoshi & Kashyap (1999), this situation had profound consequences for the banks and other depository institutions. The keen price competition placed downward pressure on banks’ risk-adjusted interest rate margins, and led them to expand the riskier segments of their loan portfolios by sharply increasing lending to the real estate industry, consumers and small and medium sized enterprises (Hoshi & Kashyap, 1999).

Expert accounts of the Japanese financial crisis show persistent focus on market share and the basing of lending decisions primarily on collateral rather than cash flow analysis caused the Japanese banks to loosen credit standard as real estate prices climbed (Kanaya & Woo 2000). Despite these lack of controls, and evidence of worsening conditions in the banking system, the authorities did little between 1990 and 1995, to address the problem. After 1995, it had become evident that systematic public intervention was inevitable, but the regulators hesitated to take strong action because of fear of triggering public panic, especially in the absence of an adequate deposit insurance scheme and a legal framework for bank restructuring to deal with a full blown banking crisis. Therefore, until 1997, the regulators were thought to have exercised forbearance (Kanaya & Woo, 2000). Although the Japanese banking crisis served as a warning that such a crisis can befall a seemingly robust and relatively sophisticated financial system, the western nations and their regulators apparently ignored such warning signs and repeated the same mistakes of the past.

The problems of regulatory governance have profound implications for economic growth and the welfare of nations. For example, beyond spending 12% of the
nation’s GDP in restructuring the banks, the crisis was probably responsible to a great extent for the stagnation of the Japanese economy in the 1990s (Brunner & Kamin, 1995; Bayoumi, 1998; Motonishi & Yoshikawa, 1998). Without appropriate economic policy and regulatory framework, a nation’s financial system becomes vulnerable to crisis and thus jeopardizes the stability of the entire economy. As argued by Hardy (2006), the system of regulatory controls strongly influences financial institutions’ behavior and performance, and therefore the supply of financing to the economy and the incentive to save. Therefore, it is extremely important that appropriate regulatory supervision be developed and directed to promote the creation of a financial system that is sound, efficient, and conducive to overall economic growth.

Despite the merits of appropriate economic and regulatory policies to spur economic growth and financial stability, government intervention in the financial market is plagued with controversies. Advocates of intervention argue that the current recession and financial crisis constitute a manifestation of market failure and that the role of the government is to mitigate the undesirable consequences of market activity through regulation and appropriate fiscal policy instruments without losing the benefits of competitive economy. Proponents of the laissez-faire free-market system argue that without government intervention, the dynamics of demand and supply will help the economy adjust to recession and automatically correct its imbalances, by purging inefficiencies within the system, and then move toward equilibrium and the strengthening of the overall economy. The question that comes to mind therefore is that from historical perspective, what does the evidence tell us?

**MARKET SOCIETY AND LAISSEZ-FAIRE ECONOMICS**

The theory of laissez-faire economics is predicated on the idealized competitive model where the production of goods and services is governed by the rational actions of individuals in their capacity as consumers and producers. In an idealized competitive economy, market exchange is based on the fundamental principles of exclusion and revealed preferences (Allan 1971), free flow of information and self-regulating mechanisms. The assumption of the primacy of an individual’s interpretation of his or her own welfare, and of the revelation of his or her preferences by the choices made, constitute the basis of consumer sovereignty. Exchange between consumers and producers can occur only when there is exclusive title to the property to be exchanged and property rights can exist only if it is possible to exclude an individual from the consumption of a good or service for which he does not pay. The possibility of exclusion implies consumers have no choice but to bid for various goods and services, thereby revealing their preferences to producers. Consequently, utility maximizing consumers and profit maximizing producers interacting through the price mechanism achieve an efficient allocation of resources for a given distribution of income. An allocation is defined as efficient or Pareto-optimal when no re-allocation can improve the welfare of any individual without adversely affecting the welfare of any other (Davis & Kamien, 1977).

The nineteenth century was characterized by the ‘market society’ that resulted from the liberal self-regulating state (Polanyi, 1957: 250). The liberal state represented decision makers who supported market oriented institutions and were driven by principles of economic liberalism. This view of economic liberalism was rooted in the classical and neoclassical vision of economics which believed that some level of
competition provided adequate basis for the market to provide sufficient wealth without systematic state intervention (Galbraith, 1970:50). The underlying faith of such a vision was the ability of markets to restore to equilibrium based on the forces of demand and supply working through a healthy price mechanism. In a nutshell, the nineteenth century liberal state was marked by a disjuncture between politics and economics and an underdeveloped political market for prosperity due to the lack of incentive to relieve the macroeconomy from the burdens of recession and poverty (Galarotti, 2000). Consequently prices, employment and growth were merely residual properties of a system over which there was no political control. Thus the policy makers of the nineteenth century state were not held accountable for recession, unemployment and poverty, and therefore did not have the incentive to manage the macroeconomy.

The end of World War I saw the end of the market society and classical liberalism gave way to embedded liberalism – a liberal philosophy embedded in a socialist welfare concerns for growth, employment and redistribution (Ruggie, 1983; Polanyi, 1957). The war and economic turbulence in the 1920s served to consolidate an interventionist policy orientation that was germinating in the Progressive period before the war. This forced many western nations to step forward as economic champions to maintain income and employment, and to put in place institutional infrastructure that laid the groundwork for the Keynesian policy responses to the Great Depression in the 1930s. The adversity of the market at the time synthesized the rise of both the welfare state which provided safety net for society, and the interventionist state which incorporated functions and institutions aimed at macroeconomic stabilization for the purpose of maintaining income and employment (Gallarotti, 2000).

The Great Depression of the 1930s strongly reinforced the macroeconomic interventionist posture of the state in capitalist nations through both its length and severity, and the motivation to guard income and employment was heightened by the possibility of deep-secular stagnation in the economy (Gallarotti, 2000). As alluded to by Lehne (2006), the laissez-faire economists, who belong to the Classical tradition guided by economic liberalism and self-regulation, believed that in recessionary times when demand for goods and services was low, prices would fall, the revenues of inefficient producers would dwindle, workers would be laid off, poorly managed factories would shut down, and the well managed surviving firms would supply society’s goods more efficiently to strengthen the overall economy. Demand would increase, resulting in strained productive capacity which would prompt producers to raise prices, and the economic cycle will begin again. Laissez faire economists therefore regarded layoffs, bankruptcies, and economic downturns as inherent elements of a natural process that would eventually improve the economy. Additionally, they believed government actions were more likely to disrupt the natural recuperative powers of the market system, rather than alleviating suffering and resuscitating economic activity (Lehne, 2006). The Great Depression however resulted in low aggregate spending and extremely high unemployment without creating the equilibrium the laissez-faire economists had anticipated.

The consequence of the Great Depression was the realization that even the most advanced capitalist economies are not capable of achieving self-regulating growth. The laissez-faire neoclassical economic policies had resulted in a market failure characterized by an unprecedented social and economic crisis in terms of mass unemployment, fall in production and social and political unrest threatening the very survival of the capitalist world order. Between 1929 and 1933, the United States Gross
National Product (GNP) fell by 46%, unemployment rose from less than 4% of the labor force to over 25% by 1933, and the impact of the economic decline was felt by virtually every sector of the economy (Menza, 2000). This, indeed, brought into reality and ‘empiricized,’ some of the theoretical and normative arguments of Marxism. According to Marxists, the primary objective of state in a capitalist society is the suppression of contradictions inherent in capitalism through, for example, the separation of the means of production from the producers of surplus value and the confining of the state’s economic role mainly to the protection of private property relations (Gamble & Walton, 1976). Writing in the mid nineteenth century, Karl Marx saw capitalism as an evolutionary phase in economic development that would self-destruct to be succeeded by a world without private property. Marx believed all production belongs to labor because workers produce all value within society, while the market system allows capitalists, the owners of machinery and factories, to exploit workers by denying them a fair share of what they produce. Therefore, Marx predicted that capitalism would produce a growing misery for workers as competition for profit led capitalists to adopt labor-saving machinery, thereby creating a “reserve army of the unemployed” who would eventually rise up and seize the means of production (Itoh, 1988).

In order to protect the capitalist state from self-destruction as predicted by Marx, many capitalist nations did not have a choice but to pursue policies of the social service state which rejects the apportionment of income and wealth produced by market activity and uses government authority to enhance societal equity. It was obvious that the liberal self-regulating state lacked the institutional capacity and control mechanisms to ensure the effectiveness of the free-market system. Additionally, both policy makers and market agents did not understand the conditions under which the production and distribution of a good or service through a competitive market in which all the relevant agents are pursuing their own self-interest will result in an allocation of that good or service that is socially inefficient. The capitalist crisis that resulted from self-regulation had intensified the working class struggle that began in the 1920s, spawned several social movements, including those among the unemployed workers, old age movements, and the industrial labor movements (Menza, 2000), and the bourgeoisie initiated welfare measures to protect their self-interest (Ginsburg, 1979). Indeed, it is open secret that today, socialists, social democrats, social reformers, and conservatives all attach some importance to distributional issues, although their notions of equity range from egalitarian to merit-based (Lehne, 2006). It is therefore not surprising that the United States and other major industrial nations now devote about half of their outlays to social service purposes, such as healthcare, retirement costs, and assistance to low income groups. Unfortunately, this state of affairs has also resulted in rising national debts because the influence of politics on economic decision-making has often led to the social costs of implemented policies and programs exceeding social benefits.

**KEYNESIAN MODEL OF MACROECONOMICS AND THE NEW DEAL**

The interventionist policy orientation that began after World War I was given theoretical identity and intellectual legitimacy by the Keynesian revolution that took hold toward the end of the great depression. During the inter-war period, the state in the capitalist societies had learnt that the crisis in the capitalist economies could be averted by undertaking large-scale public expenditure, and John Maynard Keynes later made a theoretical summary of what the capitalist state had learned from its practical experience
Robinson, 1973). Reacting to the severity of the worldwide depression, Keynes in 1936 broke from the Classical tradition with the publication of *The General Theory of Employment, Interest and Money*. Like many standard economists, Keynes believed that a given aggregate level of demand in an economy would produce a commensurate amount of employment. However, he also believed that falling prices and wages, by depressing people’s incomes, would prevent a revival of the spending. He argued low employment during the Great Depression resulted from inadequate demand, and government intervention was necessary to increase aggregate demand. Keynes’ arguments proved the modern rationale for the use of government spending and taxing to stabilize the economy. He showed that in a market economy, there is an inbuilt trend toward stagnation, implying that effective demand tends to be less than what is required for full utilization of productive capacity, thereby resulting in the dry up of capital accumulation.

Keynes believed the objective of state intervention was to complement the market forces in achieving a high level of economic activity and full employment making the liberal market societies more productive, harmonious and suitable (Kethineni, 1991). To counteract the falling demand, Keynes also advocated large-scale government expenditure on public works, especially roads, power projects, schools, hospitals, etc. (Brown, 1984). Western economies adopting Keynesian policy prescriptions sought to perfect the self-regulating capitalist system through series of interventionist measures to achieve both the objectives of social justice and freedom (Mishra, 1984). In the United States, the crisis of the Great Depression catapulted the Democratic Party to power in the 1932 elections, and ushered in the New Deal of the Roosevelt Administration with a number of legislative initiatives, political reforms and policy innovations. To help combat the recession, a series of emergency relief and work programs were adopted, including the Works Progress Administration, as well as the National Housing Act of 1934 (providing low interest loans) and the reform of the nation’s banking system. During the Great Depression, one out of three commercial banks in the United States closed between 1930 and 1933, bank loans fell by 44 percent and bank deposits had declined by 30 percent within the same period (Hawke, 1999). Congress enacted the Glass-Steagall Banking Act of 1933, and among others, restricted affiliation between banks and security firms, and subsequent legislation also barred banks from owning insurance companies in order to safeguard customer deposits and restore confidence in the financial system. The Glass-Steagall Act also created the Federal Deposit Insurance Corporation (FDIC) to help boost customer confidence regarding the safety of their deposits.

In order to safeguard citizens’ investments and enforce the restrictions of affiliation between banks and security firms, the Roosevelt Administration sought to regulate the activities of investment companies through the passage of the Security Exchange Act of 1934 and the creation of the Security and Exchange Commission. In spite of these interventionist efforts, recovery was slow and in the summer of 1935, a second set of reform legislations were passed. These include the Banking Act which centralized the Federal Reserve, and the Social Security Act which established unemployment insurance, old age insurance, old age assistance, and Aid to Dependent Children. The final major reform of the New Deal era was the adoption of the Fair Labor Standards Act of 1938 (Menza, 2000). The interventionist and regulatory measures of the new deal helped to stabilize the nation’s financial system and grow the economy. However, critics argue that the depression era rules have had unintended
consequences and that public agency self-interest was present in granting privileges and regulating.

Bornemann (1976), for example, argues the depression era regulatory agency pursuing the generally perceived welfare of the particular constituency industry was, if anything, the captive of its own special interest rather than of outside special interests, even though the requirements it imposed coincided with the interpretations of interest group. Thus, when its own interest demanded protection and change, the agency undertook the necessary steps. Bidhe’ (2009) argues while the creation of the FDIC both ensured the safety of deposits and also freed bankers from the challenge of earning the confidence of depositors, banks used their regulatory canopy to undertake more complex and dangerous innovations. In the 1970s for instance, banks started using futures to hedge the risks of making long-term loans with short-term deposits. Without deposit insurance, and the reassurance of state supervision, most depositors, even the sophisticated ones, would shun banks that traded futures (Bidhe’ 2009).

A central argument in the Keynesian theory of macroeconomics is that the government could counter a recession through fiscal policy by either reducing taxes to spur consumer or investment spending, or directly increasing its own spending, even if this could result in deficit spending. This implies in a period of deep recession, the government can, for example, engage in deficit spending by providing funds to financial institutions if it is deemed that such action could spur lending, increase private spending and investment and thus increase aggregate demand in the economy. The downside of government intervention through injection of funds into the financial system is that not only does it compromise the independence of the financial institutions but also could result in politically motivated forbearance, thereby posing challenges to effective regulatory governance. For example, in the United States, government injection of capital to rescue financial institutions has led to government ownership of substantial shares of many of these institutions at least in the short run. As stated earlier, the lack of independence of the Japanese financial supervision function within the ministry of finance is widely believed to have contributed to financial sector weaknesses. Although there was probably little direct pressure on the ministry of finance to exercise forbearance, the system lacked transparency and was known for widespread implicit government guarantees of banking sector liability (Udaibir, Quintyn & Taylor, 2002). The argument here is that while effective intervention is necessary for the proper functioning of the free market system, such policies should be implemented with caution as ill thought out intervention could be ineffective, and result in higher than socially efficient cost of such intervention.

In the process of using state intervention to complement market forces in achieving high economic activity, many western countries engaged in massive deficit financing, with potential adverse impact on the economy. Large fiscal deficits result in higher real rates of interest or larger stocks of international debts, with consequent negative effects on investment expenditures, capital stocks, and future per capita national income levels. Larger fiscal deficits also tend to lead, frequently, to higher rates of inflation in the long run and undermine the stability of a nation’s economic system if the deficit is financed by selling bonds to the central bank, i.e., by printing money (Mishra, 2001). This could, in turn, lead to massive decreases in government revenues and mounting budget deficits, and force western governments to reduce public expenditure on social programs and regulatory monitoring.
Historical evidence suggests that mounting deficits and the arrival of stagflation all over the western capitalist world in the 1970s threw the Keynesian economics into disarray and the welfare state lost its ideological as well as material basis (Kethineni, 1991). The stagflation in the 1970s was overcome at very high cost. While the world economy expanded at about 5.1% during the period 1960-1973, it grew at much slower 3.2% during the period 1973-1989, due mainly to worldwide squeeze on profits and restrain on investments, jobs and growth caused by tight energy supplies (Sachs, 2008). With the discredit of Keynesianism, laissez-faire economics gained a new impetus and re-metamorphosed into neo-classical monetarism with the call for cut in government spending on social services, privatization, new public management, liberalized financial markets, tax concession to the rich, decreasing the role of the state and public expenditure, and the free play of the market forces in the economy (Brown, 1984).

FINANCIAL SECTOR LIBERALIZATION AND THE 2008 GLOBAL FINANCIAL CRISIS

The emergence of neo-classical monetarism, new public management and economic globalization did play integral role in the financial sector liberalization that ultimately led to the current global financial and economic crisis. The sea change of public sector reform in the 1980s and 1990s resulted in privatization, outsourcing and load shedding of public responsibilities, with the United States and the United Kingdom leading the way. During the same time, discourse about the proper size, role and functions of government underwent sharper transformation (Lee & Strang, 2006). While the neo liberals argued for the importation of market mechanisms into the public arena, their New Public Management allies argued lean public agencies will be responsive to citizen customers (Osborne & Gaebler, 1992). Some empirical evidence (Lee & Strang, 2006) reveal that downsizing has international contagious effect, and that change in the size of the public sector is linked not only to domestic economic and political conditions but also international policy diffusion. Neoclassical liberalism and the call for New Public Management led to market-based regulation of certain public entities, including financial institutions in the western world, and ushered in periods of not only economic growth but also unrestrained capital markets. Indeed, since the beginning of the 1990s, the world had seen a shift from a largely legally based regulatory approach toward a greater use of voluntary, collaborative or market-based regulatory instruments (Busch, Jorgens & Tews, 2005). In fact, existing governmental regulatory institutions were paralyzed by the problem of regulatory capture, regulatory forbearance and regulatory arbitrage. Consequently, little or no institutional safeguards and control mechanisms were put in place to guard against the excesses of the free market self-regulatory system.

The liberalization of the financial markets coupled with self-regulation resulted in the proliferation of financial products that substantially increased the risks of financial institutions with little or no oversight by financial regulators. Money markets and mutual funds eroded traditional lending franchises, and banks securitized all kinds of loans, mortgages, credit card and auto loans, traditionally referred to as asset-backed securities (ABS), by packaging them as bundles and selling off shares to investors. Securitization involves packaging financial promises and transforming their cash flows into a form whereby they can be freely traded among investors. Minton, Sanders & Strahan (2004) suggest that from 1995 through 2001, the market for ABS increased...
from $316 billion outstanding to $1.69 trillion. As argued by Bhide’ (2009),
securitization meant banks had to warehouse their loans for short periods, and this
encouraged them to not only lower credit standards but also to extend mortgages to sub-
prime borrowers who could not pay. New securities also created opportunities for
reckless speculative trading, while banks extended credits to the trading operations of
investment banks, hedge funds and warehouses of dodgy sub-prime loans awaiting
securitization.

While the excesses of the liberalized financial market activities went on,
regulators exercised forbearance and succumbed to the idea, peddled by financiers and
modern financial theorists, that if a little financial innovation was good, a lot must be
great (Bhide’, 2009). As argued by Kanaya & Woo (2000) if there is a lesson that the
global financial system learnt from the Japanese financial crisis of the 1990s, it is that
liberalization without proper regulations and undue regulatory forbearance have the
potential disastrous consequences for a nation’s financial system and the entire
economy. In the case of the 2008 global financial crisis, regulators tried to adapt instead
of discharging their oversight responsibilities by taking appropriate measures to curb the
so called financial innovations that were far outside their capacity to monitor. The
regulators should have understood that merely requiring banks to hold more capital for
riskier assets, to disclose what proportion of their trading positions could not be marked
to market, and pressing dealers to improve the processing of trades in over-the-counter
derivatives, in the face of mounting complex and high risk transactions, would prove
ineffective. It is therefore not surprising that given the asymmetry of resources and
incentives, the measures proved inadequate and the regulators could not keep up
(Bhide’ 2009). Unfortunately, the policy makers and the regulators they oversee once
again failed to learn from history by ignoring the lessons of the past and by not adopting
what worked in the past.

Regulatory capture was a prime factor in the liberalization of the banking
industry in the late 1990s. As indicated earlier, the Glass-Steagall Banking Act of 1933
restricted affiliation between banks and security firms, and subsequent legislation also
barred banks from owning insurance companies in order to safeguard customer deposits
and restore confidence in the financial system. In 1999, Congress passed, and President
Clinton signed into law, the Financial Services Modernization Act, which repealed parts
of the Glass-Steagall Banking Act of 1933 and allowed banks to become affiliated with
security firms and insurance companies (Lehne, 2006) without putting in place
appropriate safeguards to address the fallouts from deregulation and inefficiencies in the
free-market system. This was in spite of the fact that a similar deregulation in 1982
which expanded the range of permissible investments in the savings and loans
institutions resulted in the collapse of those institutions, costing the tax payers several
billions of dollars. Faced with several criticisms that the financial services industry had
put profit above safety and soundness by pushing for the legislation, supporters of the
Financial Services Modernization Act insisted it will spur competition in the industry,
reduce prices, enhance the stability of the nation’s financial services system, equip
financial services firms to compete more effectively in global financial markets, and
improve responsiveness to consumers (Weissman, 1999). The evidence now shows that
while the Act spurred competition, it did not stabilize but rather, contributed toward the
crippling of the nation’s financial services industry, and responsiveness to consumers
was at best minimal.
The neoliberal policies in the financial sector, coupled with the information and capital flow across continents stemming from technological advancement and globalization did facilitate what some scholars term as global diffusion of regulatory capitalism. Diffusion in this instance refers to an international spread of policy innovation driven by information flows rather than hierarchical or collective decision making within international institutions (Busch, Jorgens & Tews, 2005). At the micro level, it is triggered by processes of social learning, copying or mimetic emulation (Lazer, 2005; Dolowitz & Marsh, 2000). The essential feature of policy diffusion is that it occurs in the absence of formal or contractual obligation, and is basically a horizontal process whereby individually adopted regulatory approaches add up to a decentralized regulatory structure (Levi-Faur, 2005). Unlike the case of multilateral legal treaties which are negotiated centrally between states and subsequently implemented top-down, diffusion decision-making procedures are decentralized and remain at the national level. Thus, other western nations experienced liberalization of their financial systems and thereby imported any potential economic and financial malaise, through the diffusion of regulatory capitalism, into their economies without any meaningful analysis as to the historical significance of such diffusion.

Regarding developing nations, the liberal economic policies packaged under the Washington consensus which aimed at opening up national economies of those countries, and reducing the role of the state, with privatization, deregulation and support for property rights (Williamson, 1990) is widely believed among scholars and practitioners to have generated policy learning among nations. This implies what happens in the United States and other major western countries have repercussions for the rest of the world as evidenced by the 2008 global financial and economic crisis. However, as demonstrated by Weyland (2004), bounded learning overrides rational learning in the sense that while politicians do actively seek solutions to their problems by purposive search, their search is biased by the use of particular cognitive shortcuts. Basically, governments look at what is close, favor initial successes and tend to limit the number of changes in the implementation of foreign policy models. Consequently, many of these governments almost copy blindly, and in the process end up deteriorating their economies and worsening the plight of many of their citizens.

Given the enormity of the global financial crisis, most reasonable minds agree that government intervention is necessary to turn the global economy around. However, the history of public economic management suggests that mutual coexistence of the market and government serves the best interest of society. Self-regulation during the pre depression era proved catastrophic, and excesses of Keynesianism in the post-war era proved costly. Additionally, ineffective regulatory governance in the mist of intense market competition is problematic. Considering the history and consequences of government response to financial and economic crisis, the questions that beg answering are: What analysis has been performed to get to the root cause of the problem? What institutional safeguards are being put in place to avoid excesses and inefficiencies of intervention? What measures of accountability are being implemented to ensure judicious use of tax payers’ money? What performance measures are being formulated and implemented to ensure the intended goals are achieved? What regulatory framework is being put in place to modernize financial oversight and ensure effective regulatory governance? Finally, how do western governments ensure that the interventionist policies being pursued do not end up further wrecking the global economy and usher in another round of calls for unfettered free-market system?
ADMINISTRATIVE AND POLICY IMPLICATIONS

The global financial and economic crisis has profound policy and administrative implications when placed in historical context regarding prudent regulatory governance and healthy financial and economic system. Each nation seeks governing arrangements that help it to achieve material well-being and to secure its political and social goals. As argued by Lehne (2006), a society establishes a set of political institutions, which in turn construct the legal framework in which the country’s economy operates and its markets function. This framework reflects the nation’s political judgment, and since the nation’s political values permeate economic institutions, markets can never be completely divorced from politics and public policy. Therefore, despite the different governing arrangement of each nation, the basic truth is that although politics and markets are frequently viewed as alternative mechanisms guiding societies, they are indeed, intertwined (Zysman, 1983; Dobbin 1994). This implies the nature of a nation’s public policy and hence regulatory framework impacts the functioning of its financial and economic system.

Although there is widespread speculation about the future of the free-market system as a result of the current financial and economic crisis, the fact is that in the capitalist societies, the market and government do and can complement each other given appropriate administrative and institutional capacities, as well as enforceable regulations. Indeed, the principal task of government under the market capitalist model is to guarantee that the markets function properly. For example, free markets with self-interested agents tend to under provide activities with positive external benefits and over provide activities with negative external costs because the agents do not consider these costs and benefits in their decision making. The financial institutions operating in the unregulated sub-prime mortgage sector over produced such mortgages based on profit motivations without considering the external costs to society because they were not obligated to do so. The regulatory arbitrage that characterized the sub-prime market encouraged corporate greed and adjustable rate mortgage loans were granted to many consumers who clearly were incapable of repaying these loans. The United States government had obligation to intervene through tailored regulatory mechanisms to protect not only society but also the financial institutions from unreasonable risks. In this regard, government intervention would have been a necessary ingredient for the stability and survival of the financial institutions, and for the safeguard of governmental resources that otherwise could have been used to provide various social services. Unfortunately, the government failed in its oversight responsibility, thereby costing society hundreds of billions of dollars.

The legislature establishes public policy by passing laws and playing administrative role through the monitoring of budgets and overseeing government administrative operations such as regulatory activities. However, the effectiveness of discharging its administrative responsibilities is usually hampered by self-interest, campaign contributions and rent seeking from special interest and certain business groups. This results in inefficient government intervention, as concentrated benefits and diffused costs from rent seeking usually divert societal resources to certain privileged groups at the expense of broader social interests. Financial institutions, like any other industry group, will want to influence the regulator to favor their interests, and they typically have the means to engage in rent seeking in this regard. Rent seeking leads to regulatory capture, and a captured regulator acts primarily in the interest of the regulated institutions, rather than in accordance with their putative mandate to promote the common good.
Considering the fact that banking is characterized by asymmetric information between banks and their clients and that risk is an inherent feature of the banking industry, the need for independent regulation of the industry is paramount.

The independence of the legislature and regulators from undue special influence is crucial in formulating and implementing policies for which the marginal social costs do not exceed the marginal social benefits. Problems such as bureaucratic bottlenecks and weaker incentives for innovation reduce the ability of administrative agencies to use appropriate regulatory tools to efficiently intervene in the market system. Therefore, there is the need for the legislature and the administrative agency heads to work jointly to modernize and streamline existing procedures and technology, and put in place appropriate measures of performance and accountability in order to bring monitoring and enforcement tools to the twenty first century, and to facilitate legislative oversight activities. Considering the destructive and ripple down effects of the financial crisis and the diversion of public resources to rescue financial institutions, there is the need to rethink the way the financial services sector is regulated. The focus should not only be on compliance but also on efficiency, risk management and global coordination through appropriate use of technology and innovative processes to minimize the chances of failure.

Policy makers need to recognize that liberalization without appropriate controls within the regulatory environment, as well as ill-thought out and uncoordinated regulation can destabilize a country’s financial and economic system with far reaching global implications. For example, regulatory arbitrage resulting from unequal regulatory and supervision of different financial institutions engaging in similar securitization activities can result in unhealthy competition and concentration of risks. Additionally, although regulation and bank supervision are viewed in many circles as the last line of defense, there is the need for regulatory authorities to take proactive attitude toward supervision. As argued by Kanaya and Woo (2000), regulatory forbearance can postpone a crisis, but at the cost of raising the fiscal cost of the final resolution. By giving rise to moral hazard problems, regulatory forbearance and “too big to fail” doctrines can lead to “gamble for resurrection” which often weakens financial institutions further. Therefore, Prompt Corrective Action framework is often necessary to save financial institutions and the economy from deterioration (Kanaya & Woo, 2000).

In the formulation of interventionist policies, western governments need to recognize that with the private sector being the largest employer in capitalist societies such as the United States, the economic power of the market and its corporate agents can not be ignored. The decisions private firms such financial institutions make about production, investment and employment do affect both citizens’ living standards and public revenues. This implies the need for appropriate legal, regulatory and business environment to enhance economic growth and employment while controlling inflation. Government policies that unduly threaten the banking and financial environment could stifle innovation and reduce business and economic activity. When that happens, business investment, production and employment could decline, resulting in decreased standard of living, economic deprivation, lower government revenues, astronomical budget deficits and potential social unrest. Creating the right banking and financial environment, however, does not mean lapses in regulatory enforcement as we have seen in the financial services sector in recent years. What it does mean is both the government and the agents of the free market system working and complementing each
other to ensure economic growth and social diversity without dominance by any particular institution as long as societal norms, rules and regulations are enforced.

While interventionist policies to correct market failure is unavoidable in many situations, government and its regulatory agencies should be cognizant of the fact that under certain conditions, deregulation can be helpful and lead to economic expansion if planned carefully and implemented skillfully. A typical example is the deregulation that broke up the AT&T monopoly in the United States and facilitated the telecommunication revolution. Times do change and so do socio-economic and technological factors which result in structural changes in the economy, requiring modernization of existing regulatory framework for continual economic growth and higher employment. What is inexcusable is the failure, in the deregulation process, to learn from the past and to put in place institutional safeguards and risk control mechanisms to address potential problems. Unfortunately, the policy makers failed to learn from history by doing away with the post-Great Depression safety and soundness in the financial system and by not implementing comparable safeguards and, as a result, the United States and the rest of the world is now paying for such mistakes with billions of taxpayer’s money.

CONCLUSIONS

The banking and financial crisis that began in 2008 is rooted in liberalization without appropriate adjustment of the regulatory environment, ineffective regulatory governance and failure to learn from history. Without appropriate economic policy and regulatory framework, a nation’s financial system becomes vulnerable to crisis and jeopardizes the stability of the entire economy. The system of regulatory controls strongly influences financial institutions’ behavior and performance, and therefore the supply of financing to the economy, the incentive to save and aggregate demand. Excessive asset expansion during economic boom and market liberalization requires the establishment of appropriate economic and regulatory policies to guard against market failure, to prevent political and institutional interference in the regulatory supervision of financial institutions, and to prevent regulatory forbearance, regulatory arbitrage and regulatory capture.

Historical accounts and evidence show that dominations of either the free-market system or government intervention in an economy have had disastrous consequences mainly due to the failure to avoid past mistakes, to build on past successes, and to put in place institutional safeguards and control mechanisms to minimize potential inefficiencies. Governments in capitalist societies depend on business for investment, production, employment, higher standard of living and government revenues. This calls for regulatory and business environment that encourages higher aggregate demand and high economic growth, as well as increased revenues to fund government budgetary priorities. The market and its self-interest agents, on the other hand, depend on government for competitive operating environment to ensure level playing field and profitability. This implies both government and the market need to co-exist in a manner that respects the contribution of each other toward sustainable and vibrant economy in a democratic society. Such coexistence will be beneficial with a regulatory framework that emphasizes compliance, efficiency, risk management and global coordination through appropriate use of technology and innovative processes to minimize the chances of failure.
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