Journal of Economic Issues ›

Volume 50, 2016 - Issue 2

Articles

Financial Liberalization as a Process of Flawed Institutional Change

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Pages 485-493 | Published online: 12 May 2016

Cite this article https://doi.org/10.1080/00213624.2016.1179055 Check for updates

Abstract:

I argue that the financial liberalization of the last decades, which resulted in a worldwide crisis, relied on an institutional change that ill-shaped actors' behavior so as to let them enter into unsustainable speculative activities at the expense of macro-stability. To support such an assertion, I draw upon a specific Veblen-Minsky approach to a credit-money economy and its endogenous fragilities. I also maintain that, when financial markets are liberalized and private-interestsrelated self-regulation replaces public macro-prudential supervision, the financial system undergoes institutional deadlock and the ensuing confusion is transformed into a market gridlock. Markets then become unable to recover without public rescue operations of banks. The subsequent negative economic and social consequences are beyond the limits of any acceptable liberal ideology and scientific understanding. Therefore, systemic stability calls for a

tighter macro-regulatory framework to remove the domination of speculative finance over economic decisions and activities.

Keywords:

cognitive dissonance financial crisis financial liberalization institutional change institutional deadlock regulation

JEL Classification Codes:

B52 G01 P11

Notes

[1] I.e., total reliance on decentralized free markets in the organization of economic operations.

[2] Chapter VI of The Theory of Business Enterprise provides an account of the major arguments developed by Veblen in opposition to the classical economists' vision of the economy. This opposition takes the form of confrontation between Minsky's approach and the neoclassical real (non-monetary) equilibrium vision of the world (Minsky 1982, 1986).

[3] Veblen (1904, 152-153) notes the discrepancy between the meaning of capital as a real-physical means of production and its modern sense in capitalist economy: "[T]he value of capital is a function of its earning-capacity, not its prime cost or of its mechanical efficiency."

[4] Minsky (1986, 195) develops a two-price analysis to point to the discrepancy between economic and financial magnitudes: "A basic characteristic of a capitalist economy, then, is the existence of two sets of prices: one set for current output, the other set for capital assets variables and are determined in different markets. The prices, however, are linked, for investment output is part of current output. Even though the technical characteristics of capital assets are the cause of basic money-now-for-money-later relationships in our economy, the existence of a complex financial system magnifies the number and the extent of money-now-money-later relations."

[5] Minsky (1986, 199) also argues that, "in a capitalist economy that is hospitable to financial innovations, full employment with stable prices cannot be sustained, for within any full-employment situation there are endogenous disequilibrating forces at work that assure the disruption of tranquility."

[6] Criticizing the neoclassical synthesis, Minsky (1986, 113) maintains that "[b]oth monetarists and Keynesians are conservative in that they accept the validity and viability of capitalism. Neither are troubled by the possibility that there are serious flaws in a market economy that has private property and sophisticated financial usages. The view that the dynamics of capitalism lead to business cycles that may be thoroughly destructive is foreign to their economic theory."

[7] It is argued that further regulatory constraints imposed by authorities in financial markets would provoke bypass strategies as banks would avoid the profit-reducing consequences of such restrictions through innovations. This would imply new regulatory reforms to "catch up" with the regulation-preventing effects of financial innovations.

[8] Usually related to the length (high number of transactions, agents, and products in markets), depth (a variety of products in markets), and liquidity (the ability of markets to make large transactions possible without any payment limits) of financial markets.

[9] Just a few months before officially announcing the subprime crisis onset in the US, the Fed Governor Ben Bernanke (2007) reiterated his belief in the market's self-adjusting capacity: "As I noted, markets are adjusting to the problems in the subprime market, but the regulatory agencies must consider what additional steps might be needed. … Markets can overshoot, but, ultimately, market forces also work to rein in excesses. For some, the self-correcting pullback may seem too late and too severe. But I believe that, in the long run, markets are better than regulators at allocating credit."

[10] Kern (2012, 8) argues, for instance, that in the case of Northern Rock, the bank run was not a cause of the failure of this institution, but a result of the funding crisis in the monetary market, related to the negative response of the Bank of England to the refinancing need of the bank.

[11] A gridlock, comparable to a traffic jam in a major metropolis, is a general paralysis of all intersections that prevents actors from either moving forward or backward to exit the congestion (see, for instance, Llewellyn 1999).

[12] See, for instance, Minsky (1982, xxi; 1986, 324 and 326).

Additional information

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