An alternative to financial regulation: Financial stability as a public good

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I. The theoretical & methodological reference: An Institutionalist approach

"The thesis of this article is that significant (problem-solving) economic theory must include the Institutional Principle of the Principles of Economics" (Dudley Dillard, 1986: 361).

The IPPE: the necessary reference to the institutional and historical context in order to develop a relevant economic analysis.

The purpose of this article is to develop this theoretical stance with regard to the characteristics of a (monetary) capitalist economy in order to deal with the problem of financial instability.

II. The state of the economists' world

Dudley Dillard (1986: 357):

"… the founding of the American Economic Association (AEA) in 1885 sprang from opposition to classical economics and its policy counterpart, laissez-faire economic doctrine".

The state is therefore seen as an agency which should provide society with assistance to enhance conditions of human progress.

To date, the economics are in a similar position: in a ***need to move from market efficiency hypothesis to the study of institutions of capitalism as a monetary and uncertain economy***.

Indeed in the wake of the catastrophic consequences of the 2007-2008 crisis, the economics profession should renew its basic lessons about the nature and the working of market-related (and the like) economies.

This requires some reflections on financial structures and the related regulatory rules and supervision processes.

III. Basic issues and statements: a collective action problem

This article draws upon the Institutionalist tradition that regards capitalism as a “Money Economy” which rests on a historically specified set of social institutions, structured by and structuring social interaction.

The starting statement is that capitalist evolution could be traced to the characteristics of money (cf. Commons, Schumpeter, Veblen, …).

Those characteristics make that financial operations play the role of an economic reactor determining whether decentralised actors’ expectations-based productive activities can become effective through a stable financing and repayment process (debt-money approach).

A specific "collective action problem" comes into the picture as a relevant way of developing a monetary institutionalist approach to capitalism that could lead to **reframe finance according to the needs of socially sustainable activities** in order to ensure their viable and durable funding and to prevent systemic instabilities that too often disrupt economic and human development.

(Remark: This analysis is developed for a capitalist economy and no as an alternative society project)

- Economic relations rest on the feasibility of continuous payment and settlement relations that rely on some specific rules.
- This requires financial stability that nobody could individually and partially ensure because of the related costs but also because of the impossibility to realise such a system wide control and checking process at an individual level.
- ***⇒ Financial stability appears to be a public good that every member of society needs, but no one can provide at individual level.***

- As capitalism develops through more financialised forms, new institutions and working rules (in the sense of John Commons) (should/must) emerge to govern economic and social relations among public and private actors.

- Continuity (Viability) of society relies on the (relevance of the) institutional transformation process seeking to provide economies with relevant public supervision/regulation that could shape financial markets' strategies so as to ensure macro-stability.

IV. Capitalism as a monetary economy: basic characteristics

- Monetary and financial relations are at the core of market-based capitalist economies since every economic transaction involves the use of money and occasions various financial operations.
- The very specific feature a monetary economy lies in the financing process of decentralised private economic decisions that rests on debt-creation-circulation-repayment cycle.
- In this “endogenous money” environment (Keynes, Kaldor, Moore, Wray, etc.), two major (monetary/financial) constraints frame economic activities: financing constraint and repayment constraint.

Those constraints are society-wide and are mainly organized through profit-seeking markets.

The creation of money through debt-related financing process and the use of financial products/processes in markets make actors (especially the enterprises) able to undertake activities in a continuous way through the future positions notwithstanding their current asset/liability position.

In this picture, money is the name of the payment system which is a set of rules and mechanisms that govern the creation, circulation and repayment conditions of private debts mainly generated through the financing of entrepreneurial *expectations.*

Those debts flow through the entire economy and are used as money.

Money has some specific characteristics.

First, it is ambivalent: private & public

→ it is a private decisions-related, individual and decentralised action system.

→ It stands as a public system of account, payment and repayment and then rests on no-market reference (public-common rules) to keep its economy-wide validity (though created in a private way).

It is accepted and used as the general means of payment and ***settlement*** within entire society.

Second, money is transversal:

Monetary & financial relations concern the whole society and its viability conditions.

Everything and everyone are everywhere directly/indirectly involved in monetary (debt) relations without necessarily taking directly part in the monetary and financial operations through which the economy does usually evolve.

Directly/indirectly everyone uses money and contributes to financial operations and is under the burden of the systemic consequences of market operations (and the related policy decisions) even though she/he is not plainly involved in related economic relations.

Although related to private decisions and interests, money and subsequent financial relations have societal consequences.

From this perspective, money and finance may be seen as public utilities the provision of which often requires specific policies and intervention of the public power that must play the role of referee and **stand outside of the private and decentralised market relations** in order to organise, supervise and regulate the production, the use and the evolution of the monetary/financial system.

The stability of monetary and financial operations is then a first order issue to be dealt with at society level.

V. Financial stability: a public good

Musgrave (1959: 44): a public good is a good the *inherent quality of which requires public production*.

Public goods are conceived as crucial to the community but for the most part they cannot be adequately addressed by separate private individuals' optimisation plans.

The inherent quality (or features) of financial stability rests on its macro/systemic nature which cannot be only provided by micro safety mechanisms.

First, the information and the perspective required for thinking of macro-stability are not available at individual's level.

Second, individuals cannot undertake decentralised and partial micro operations to make stability sure at a systemic level.

Financial instability must be handled at a systemic level as a public good.

In an interdependent world: “Many critical issues facing humanity today - global warming and ozone depletion, banking crises (…) are ones whose effects are global and resist the control of both markets and national governments. (…) Global public goods differ from other economic issues because there is no workable mechanism for resolving these issues efficiently and effectively. (…) if problems arise for global public goods, such as global warming or nuclear proliferation, there is no market or government mechanism that contains both political means and appropriate incentives to implement an efficient outcome. Markets can work wonders, but they routinely fail to solve the problems caused by global public goods.” (Nordhaus, 2010: 1)

Shirakawa (2012) defines public goods as “the goods markets depend on and which are not provided spontaneously by markets and global public goods as those needed for the global economy to function properly.”

The global public good in this case would be the avoidance of financial crisis, as it has significant non-excludability and non-rivalrous characteristics and considerable crossborder spill-overs (Sagasti and Bezanson, 2001).

- Drawing upon Olson's (1965) analysis of the problems of provision of public goods, Ostrom (1990, 2003) argues that **the debate on the public-private distinction of goods is ultimately related to "collective action problems**" such that whereas individuals would all benefit from the provision of a good or an activity, they cannot realise it alone at their individual level given the costs associated to such a good or action.
- **The solution relies then on the possibility of collective provision-collective action of the good/activity but raises the question of how to do it in a relevant manner to give the expected results.**

VI. Financial stability/Public good regulation

Macro (systemic) financial stability (super-individual environment) is a prerequisite for a stable and durable micro-efficient market behaviour.

One could assert in a Minskyian way, that financial system's stability relies on a consistent financial regulation ***which is not only private-incentives producing regulation*** but must also be a ***macro-consistency-seeking framework*** because if there is no macro-stability, there cannot be micro-initiatives able to push economies toward a growth path.

The problem: how to organise a relevant regulatory framework to make the provision of a crucial public good (financial stability) possible and consistent with the characteristics of monetary market-based economies.

In the production of money (*an ambivalent and transversal societal constant*), a peculiar public service, the regulation-supervision of financial markets - that must take the form of collective action irrespective of the private actors’ interests - is required.

Macro-prudential regulation-based principles must be substituted for micro-regulation schemas at a global level aiming at preventing short-sighted speculative activities.

Micro-regulatory frameworks cannot address the systemic instability issues and take into account counter-cyclical and systemic needs to stabilise the whole economy.

But the design, establishment and implementation of non-market-dependent, tight and regular public regulation / supervision requires a stronger coordination/cooperation agency which must aim at strengthening the conditions of provisioning of a peculiar global public good (financial stability) essential for economic and social sustainability in capitalist societies.

Epstein et al. (2009: 144) maintain that:

“Thus it will be crucial to develop *social governance structures* to prevent "finance without financiers" from becoming "finance FOR financiers".

These social governance structures will need to have several components, including democratic governance by those affected by the financial institutions' actions, strong financial regulation over-all to prevent massive gaps in practices between publicly oriented financial firms and the market, and compensation and/or tax schemes which reduce the benefits in the system for destructive financial practices.”