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Introduction

EMILIOS AVGOULEAS AND DAVID C. DONALD

1. The Case for "Political Economic" Analysis

Financial crises spawn regulatory reform.[1] Before a crisis, "the fickle nature of confidence"[2] enables markets and regulators to ignore the vulnerabilities caused by false policy assumptions, changes in the economic and technological environment and inadequate regulation. Part of the problem lies in the invisible competition between interest groups, where the industry normally holds the upper hand and the constraints of "bounded rationality" restrict the actions of regulatory decision-makers.[3] These subjective constraints on regulators often go unnoticed when the scope and powers of a financial regulator are reviewed from a legal or economic point of view. In fact, the "invisible hand" of industry lobbying may be an even more significant barrier to reform than is bounded rationality.[4] Certain arrangements can help industry money to flow easily in ways some politicians find attractive, and "the power of a political coalition is precisely the power to get a public official to go along with something that he knows is not in the long-run public interest because it

[1] "The pattern is that each crisis leads to a new set of regulations." R. Z. Aliber and C. P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*, 7th edn (Basingstoke: Palgrave Macmillan, 2015), 239. Also see S. Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690–1860* (Cambridge: Cambridge University Press, 1998).

[2] C. M. Reinhart and K. S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton NJ: Princeton University Press, 2009), Kindle Locations 594–595.

[3] H. Simon, "A Behavioral Model of Rational Choice," *The Quarterly Journal of Economics*, 69 (1955), 99. Bounded rationality means here: "limited access to information . . . and [incomplete] computational capacities." On how bounded rationality played a key role in the decisions/inertia of financial regulators in the period up to October 2008, see E. Avgouleas, *The Governance of Global Financial Markets – The Law, the Economics, the Politics* (Cambridge: Cambridge University Press, 2012), chap. 2.

[4] See, e.g., S. Johnson and J. Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Vintage Books, 2010), 92–104.

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is in his own short-term interest."[5] As Sinclair once observed, "it is difficult to get a man to understand something, when his salary depends on his not understanding it."[6] Even when problems are recognized and regulators have the will to take action, limitations "hardwired" into the financial system by the conceptual framework of law and the social position of market participants can block improvement.[7] Thus desirable and achievable reform can as a result be neglected, whether from overconfidence, bounded rationality, self-serving neglect of duty or the limitations of the very tools through which reform must act.

With its interdisciplinary and systematic perspective, political economic analysis can uncover such hidden causes within the organization (rules and structures) of financial regulation impeding the success of its expressed goals. Unger defines political theory as "the study of how men organize their societies and how society should be organized."[8] On such organization, Bentham, in his *Manual of Political Economy*, observes that a "desirable effect" cannot be achieved in government without the combination of "power, knowledge or intelligence, and inclination."[9] This is the nexus where modern political economy scholars focus their efforts. Such works investigate the epistemological and environmental limitations facing regulators, the way power is structured and competences are allocated within a regulatory framework, and the forces influencing regulatory action or inertia. These factors are systematically interdependent, so that when an actor lacks any one of them – such as when a knowledgeable and powerful actor is paid to turn away from the public good – this will prevent desired action. Studying these aspects of the modern regulatory framework and activity is of critical importance not

[5] See e.g., C. W. Calomiris and S. H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton NJ: Princeton University Press, 2014) 212 ("There were public officials – congressmen, senators, bank supervisors, and regulators – who understood the game but who had good reason not to try to interrupt play or change the rules . . . the power of a political coalition is precisely the power to get a public official to go along with something that he knows is not in the long-run public interest because it is in his own short-term interest.").

[6] U. Sinclair, *I, Candidate for Governor: And How I Got Licked* (Los Angeles CA: University of California Press, 1935), 109. This is cited in A. Lo, *Adaptive Markets: Financial Evolution at the Speed of Thought* (Princeton NJ: Princeton University Press, 2017), Kindle Locations 6377–6395, with reference to Citibank CEO Charles Prince's famous need in 2007 to "dance" as long as the "music played."

[7] K. Pistor, "A Legal Theory of Finance," *Journal of Comparative Economics*, 41 (2013), 315–330, 338.

[8] Roberto M. Unger, *Knowledge and Politics* (New York: The Free Press, 1975), 3–4.

[9] Jeremy Bentham, *A Manual of Political Economy* (1843), 34.

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only in order to construct an accurate narrative about a past crisis, but also in order to formulate well-informed and balanced normative propositions.

For Polanyi, the political economic project begins with realizing the significance of something the knowledge of which exercises moral suasion over behavior. He writes that, "[w]hen the significance of poverty was realized, the stage was set for the nineteenth century . . . [and] poor relief . . . never ceased to occupy men's minds for another century and a half."[10] This closely parallels the definition of "political economy" offered by the *Encyclopaedia Britannica*, which observes that the early political economists "took a secular approach, refusing to explain the distribution of wealth and power in terms of God's will and instead appealing to political, economic, technological, natural, and social factors and the complex interactions between them."[11]

When Bentham observes that a working balance of power, knowledge, and inclination allow desirable government action, he is also suggesting that a failure to act could be the result of a hidden deficit in one or the other of these elements. Such failure could arise from "political, economic, technological, natural, and social factors and the complex interactions between them." The details of such "complex interactions" may be ignored, as they were in the 1990s and early 2000s, when market forces were viewed in awe as essentially "God's will" elevating the "invisible hand" of market forces to an automatically and self-adjusting competitive equilibrium.[12] Where that is the case, a political economic analysis would appear to be distrustful or even resentful of the natural order. Yet, an analysis that uncovers what was previously hidden opens the future to new possibilities. With regard to trust, whether that is trusting regulators, the wisdom of "market forces," or some other phenomenon, Luhmann observes that "the problem of trust is that the future contains many more possibilities than can be actualized in the present and transferred to the past."[13] Unless the present and past are viewed with a certain amount of *dis*trust, those hidden possibilities cannot be freed for actualization.

[10] Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston MA: Beacon Press, 2001), 116.
[11] *Encyclopedia Britannica*, entry for "Political Economy" (2017).
[12] S. Deakin, "The Evolution of Theory and Method in Law and Finance," in N. Maloney et al. (eds.), *The Oxford Handbook of Financial Regulation* (Oxford: Oxford University Press, 2015), 14–15.
[13] N. Luhmann, *Vertrauen: Ein Mechanismus der Reduktion sozialer Komplexität*, 5th edn. (Stuttgart: UTB, 2014), 14; translation from the German. D. Donald.

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2. Political Economy of Financial Regulation

As regulatory change often follows financial crises, it is not surprising that the 2008 global financial crisis and the eurozone debt and banking crisis provoked intense study of financial regulation.[14] The configuration of knowledge, power, and inclination in the 2000s was particularly problematic, both leaving gaps that were unforeseen or unnecessary and creating concentrations of wealth and power at record-setting levels. The systemic collapse in credit that gradually arose in 2007 and burst in late 2008 had been understood by most to be extremely unlikely, given the quality of the regulators and the regulatory framework, the abundance of academic literature and the enormous amount of data available daily from the highly transparent financial markets. Exactly because of this highly sophisticated ecosystem of monitoring and control, governments had permitted risk to be created and embraced in unprecedented quantities and allowed regulatory deficits to arise at every level, from the shape of law to the daily operation of regulatory authorities. A global failure of the size that occurred indicates problems going far beyond poorly calibrated risk management or insufficient monitoring. The epistemic grid for markets and risk, the incentive system within government regulation and their regulators, as well as the way knowledge, power and inclination interacted in the face of innovation, invited fundamental reassessment.

The multifaceted nature of political economic analysis, particularly its focus on systemic problems within the relationships between information, understanding and power – the will to use it, and the reasons for using it – can uncover flaws that are otherwise overlooked. This volume contains nine chapters from law and finance experts, and six from economists and political scientists, giving flesh and meaning to the term political economic analysis. They examine from a political economy perspective six national and supranational regulatory systems, as well as the conceptual and epistemological frameworks underlying market structure and regulation. The analyses are empirical in the tradition of social science methodology as well as doctrinal in the tradition of law. They include institutional comparisons among national regulatory systems and between national and international frameworks, as well as epistemological and conceptual

[14] Aliber provides a rundown of the most notable thirty books written about the global financial crisis between 2008 and 2015. Aliber and Kindleberger, *Manias and Panics*, 16–18.

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analyses of the underpinnings of the financial system and its causal relationship to law on the one hand and the economy on the other.

The combined result disperses the constituent elements of financial regulation within a prism of perspectives, allowing the study of its epistemological, conceptual and policy bases and structural designs both with regard to economic function and constitution/allocation of national and international regulatory power. Requisite analysis even extends to offer explanations of how the human agents charged with the implantation, operation and application of financial regulation have dealt with their power vis-à-vis rich and influential constituencies, including financiers, other industry actors, and consumers.

3. Environmental Determinants and Impact of Financial Regulation

The financial system should fund and facilitate the real economy, smooth out liquidity shortages and facilitate monitoring of agents for the long-term benefit of society. To understand whether a disruption of the balance of power, knowledge or incentive has been overlooked, it is necessary not only to evaluate the financial system for effectiveness, fairness and efficiency within existing mechanisms, but also to explore the sources and conduits of power and knowledge. This exploration includes law in every form, the infrastructure enabling transactions, the way regulation affects differently situated parties, the impact of finance on the real economy and the even-handedness of regulatory personnel. These points of entry allow the play of power in financial regulation to be charted for improvement.

Pistor, whose chapter begins this collection, sees the shape and content of law itself as the constitutive element of finance, and in the chapter published here adds that "we need to understand both public and private law" in order to grasp how law affects finance and how regulation can be improved. The Legal Theory of Finance (LTF), which Pistor has developed over the last decade, exposes the shape of publicly enforceable private law as a source of power determining the shape and operation of finance: "many choices are made in a highly decentralized fashion that are difficult to track; and most are made outside the public eye, with their effects remaining hidden for years, typically coming into the open view only in a crisis, when it is too late."

A conceptual infrastructure previously understood as neutral and natural contains, as anyone who has drafted a contract knows, built-in choices allocating advantages and detriment. She concludes that because

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the financial system is "the product of many small decisions taken over years and decades by private actors, courts, regulators and legislatures," "small but persistent moves that roll back legal privileges and reassert sovereign rights could go a long way in rebalancing the playing field."

Donald also examines the environment of financial transactions and regulations, arguing that the stance of regulation should fundamentally change as the twin beliefs underpinning the efficient capital markets hypothesis – instant impounding of information into prices and perfect rationality of decisions – no longer present tenable assumptions. He explains how from different starting points, market microstructure studies and both behavioral psychology and neuroscience have shown that neither seamless pricing nor full and neutral judgment exist.

Donald then argues that when pricing is no longer assumed to "just somehow happen," regulators should pay close attention to the infrastructure arrangements of financial markets in which prices are created. Traditionally, the financial industry and their contractors hold all designs and operational details regarding these systems, despite the fact that any arrangement chosen will necessarily create advantages for some and disadvantages for other. Donald also argues that something of a Reformation is necessary regarding public belief in markets, and that this should be done by shifting daily disclosure away from "which stock won today" toward how the market affects economic growth, pension values, jobs, income, and employment conditions.

Chen, on the other hand, focuses on the contrast between the environment in practice and regulatory assumptions, exposing a fundamental problem in the primary market disclosure framework that has been seen but not perceived for decades. Institutional investors receive significantly more and better information in connection with an initial public offering (IPO) than do retail investors. The law she examines is that of Hong Kong, which has an unusually active base of retail investors and perhaps above-average treatment of the same. Nevertheless, by working through the means of disclosure offered institutional investors and retail investors from the moment the underwriter begins informally to test the market, through the roadshows, to the publication of the securities prospectus, she finds that retail investors receive considerably less information and receive it later than do institutional investors.

Selective disclosure is unacceptable pursuant to the best practices of securities regulation, yet rules ensuring fair disclosure do not take into

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account the specific instances in the actual IPO-building environment. In light of the gap that Chen identifies, she advises adjusting the disclosure ecosystem by introducing "deal-specific resources" for retail investors to access information in ways similar to institutional access and "general education" to "enhance the overall knowledge and skills of the investing public."

Pagano addresses the opposite side of the primary market environment by highlighting a deep legal-economic nexus that has previously gone unexplored: the relationship between the "privatization" of knowledge through expanding intellectual property rights (IPRs) and the growth of equity financing. He argues that "financialization of the economy and privatization of intangibles have reinforced each other." This is the case, as Pagano explains, because IPRs "are highly specific and often even unique assets, which cannot have thick markets like buildings and machines. For this reason they cannot be a good source of collateral for traditional types of banking," such as collateralized lending. As such, the growth in an economy based on IPRs has "been an important cause of a shift towards other forms of finance," primarily equity.

Pagano shows how this trend has tended to choke off innovation through IPR monopoly and squeeze future effective returns. He argues that to overcome the economic distortions created by the monopolization of knowledge through IPRs, financial regulation will not be sufficient. Instead, regulation could "change the nature of the assets held" through an arrangement of "IPRs buy outs" undertaken by public authorities, together with a set of international rules designed to prevent free-riding on technology developed in and bought out by other countries.

4. Political Economy Analysis of Regulatory Choices

Just beyond law lie the regulatory frameworks. The most intractable political economic problem of regulation is influence over the shape and application of regulatory measures. As Stigler observed in his 1971 paper that did much to establish the study of "regulatory capture":

> The . . . machinery and power of the state . . . is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries . . . . The central tasks of the theory of economic regulation are to explain who will receive the benefits or

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> burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources . . . . as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.[15]

Three chapters in this volume advance the literature on the important problem of channeling the "machinery and power of the state" through financial regulatory authorities for the general good or otherwise. Lambert and Igan bring together a number of points of evidence to analyze the presence and power of lobbying against banking regulators in the years preceding the global financial crisis. They examine average money spent by type of institution and regulatory changes to establish a robust ratio of lobbying to regulatory impact. Castellano and Helleringer move beyond tangible influence to examine the important and less visible aspects of capture through the sociological and psychological perspectives of financial regulators. They use EU regulators in which members have different national backgrounds connected to differing interests and agendas to explore their theory. Plato-Shinar focuses on one case study, recounting the interaction and inaction of banking regulators, the national legislature, and ad-hoc action committees established by the latter in connection with reforming banking fees in Israel.

Lambert and **Igan** acknowledge that lobbyists are an integral part of the regulatory ecosystem, driving rulemaking forward "by providing policy research, sponsoring think tanks, mobilizing grassroots constituencies, building and maintaining relationships with key decision-makers and influencers, drafting and amending bills, and assisting agencies in writing complex rules." They examine various sticks in this bundle of lobbying activity in connection with banking regulators during the decade preceding the global financial crisis. Their analysis finds "clear bank-level evidence suggesting that regulatory capture lessens the support for tighter rules and enforcement," leading to undesirable "economic outcomes."

Castellano and **Helleringer** begin the project of offering a deeper analysis of regulator motivation than either the "public choice" notion that regulators automatically seek to expand administrative power or the classical explanation that they are a simple "emanation of the structure of rules that regulates markets." Their investigation would open analysis to seek bias that arises even without the kind of economic or informational

[15] George J. Stigler, "The Theory of Economic Regulation," *The Bell Journal of Economics and Management Science*, 2(1) (1971), 3.

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pressure used in traditional lobbying. Leveraging newer work in social and behavioral psychology, they test for the presence of heuristics or forms of sociality in the thinking of regulators staffing regulatory bodies within the European Union and charged with formulating policy on banking regulation.

Examining intra-regulatory action among EU bodies, they map out the "multi-level architectural framework for financial regulation and supervision, offering a typology of EU financial regulators," and "isolate the dominant relational models for selected institutions that, within the EU legal order, are engaged in regulating and supervising financial markets," using the decision of the UK to leave the EU (Brexit) to expose "fault lines that become especially powerful following that decision."

Plato-Shinar provides an interesting case study that also captures the full environment populated by various institutions with distinct characteristics. This includes law-makers, regulators and specially constituted ad hoc committees in a long effort to address problematic banking fees in Israel. Against the background of theories predicting administrative behavior and regulatory capture, Plato-Shinar presents the historical sequence of events and measures, counter-measures and reversals taken and made by various groups. This analysis presents good evidence of how the entire ecosystem, including the press, reacts to opposing stimulus from industry and the public in order to achieve reform.

Sinha deals with the virtually intractable problem of microfinance regulation in India. After scoring some tremendous growth (above 170 percent) in the 2007–2010 period, the microfinance industry was brought to a stuttering halt after the microfinance crisis in Andhra Pradesh in 2010, and the private microfinance sector has yet to recover. Sinha offers a number of explanations for causes of the crisis that are well grounded in political economic theory. He identifies as principal culprit the fact that while microfinance is essentially an innovative financial product, it was instead treated as a device for social and economic development. He thus dismisses the dominant hypothesis of a "mission drift" or the shifting of focus from social inclusion toward profit. The chapter draws on Pistor's Legal Theory of Finance and the regulation of financial markets to analyze the characteristics of the Indian microfinance ecosystem that led to the crisis.

Tsai also applies Pistor's Legal Theory of Finance to a specific case study, which offers excellent comparison to the Israeli problem examined by Plato-Shinar. Tsai explains how the peculiar political balance of constituencies in Taiwan led its government to bail out investors – rather

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than the institutions that sold them risky instruments – during the global financial crisis.

Tsai examines the interplay of institutional actors in the legal and regulatory frameworks, showing how a legal remedy to provide relief in "changed circumstances" existed in the Taiwanese Civil Code, yet was not applied by courts due to existing judicial precedent. Then a spontaneously organized victims group spurred the Financial Supervisory Commission into action by creating an atmosphere of emergency recognized by the public and the government. That Commission then created a "makeshift Alternative Dispute Resolution system," which itself applied the "changed circumstances" relief denied by the courts. Tsai maps the web of motivations, influences and adjustments of law that led the Taiwanese legal system to provide a kind of relief that appeared on its face contrary to law.

5. The Political Economy of Global Financial Regulation – Discord, Conflict, and Cooperation

Political complexity reaches its highest level when sovereign states enter into bi- or multilateral collaboration without external enforcement by a fully binding, overarching institution. While the frameworks that have been adopted to address individual questions, such as to prevent war (United Nations), manage trade disputes (World Trade Organization) or stabilize international finance (International Monetary Fund) are based on formal treaties under international law, the bodies that govern international finance are largely voluntary. Each of these frameworks maneuvers carefully around the sovereignty of its participants, and are thus left at a workable minimum.

Avgouleas discusses the impact of instability in foreign exchange markets, and currency dumping/manipulation which as he explains can be a cause of systemic risk. For example, foreign currency exposure was a key vulnerability behind the series of emerging market crises in 1997–1998.[16] The Global Financial Crisis also showed that currency mismatches are not just a concern for emerging markets. Greater foreign currency exposure increases country vulnerability to sudden stops and currency depreciations, limiting the ability of the exchange rate to act as a shock absorber as well as

[16] See for an overview R. Buckley, E. Avgouleas, D. Arner, "Twenty Years of International Financial Crises: What Have We Learnt and What Still Needs to Be Done?" ADB Background paper, September 2017.

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