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Less Government is Good Government? Deregulation as an Undermining Principle of Financial Markets[1]

Since liberalization became the dominant global narrative the stock response to market shortcomings has been to "slim down" the state and deregulate. In most countries the slogan of "less government is good government" has become a constitutive feature of economic policy since the 1980s. Markets lie at the heart of every successful economy, and despite not necessarily working well on their own, the economic policy of deregulation has been one of the most persistent currents in the global economy. Based as it is on classical liberalism and – at least in its origins and leanings – neoclassical theory, deregulation aims to minimize the influence of the state. But in the context of the current financial and economic meltdown – the worst economic dislocation since the Great Crash of 1929-32 – "downsizing" the state causes growing turmoil. Global networking has made financial markets much more volatile and therefore much more susceptible to crisis.

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Keywords:
deregulation, financial market, Hayek, interventions, liberalism, market constitution, neoclassicism

When on Sunday the fifteenth of September 2008 the American economy stood on the brink of its most severe economic crisis since 1929, an eye-witness commented on the fall of Lehman Brothers in colourful language: "Pier 6, beside the East River. The 'Masters of the Universe' – as Tom Wolfe described the Wall Street elite in *The Bonfire of the Vanities* – arrive in quick succession at the Downtown Manhattan Heliport. It takes them five minutes by limousine to a fine address with Carrara marble floors and Swiss pear-wood panelling: 745 Seventh Avenue, round the corner from Wall Street. The CEOs of America's biggest banks are gathering this evening at the scene. If they fail to act tonight all hell will be let loose when the Asian markets open. New Yorkers are used to seeing their great offices towers lit up through the night, but the atmosphere this Sunday is different. Fear is palpable. Fear of a collapse on Wall Street, fear of a collapse on the international financial markets. Cameras and TV crews crowd the sidewalk in front of Lehman Brothers' headquarters as black limousines deliver bankers and politicians. The only question that matters this evening: is Lehman Brothers too big to fail? Will the bank – turnover sixty billion dollars – have to be saved? US Treasury Secretary Henry Paulson is in charge of this piece of open-heart surgery on the American economy. He was also once CEO of Lehmann rival Goldman Sachs. His answer is "no". Rescue refused. Lehmann Brothers, venerable investment bank and for 150 years one of the standard-bearers of international finance, is bankrupt. In the days that follow, thousands of bankers and analysts leave the building for the last time carrying cardboard boxes containing their personal effects. Only a week ago among country's top earners, they are haggard from sleepless nights and shocked by the mercilessness of contemporary capitalism."

Regardless of how we evaluate this personal insight into a situation that with hindsight we might one day name historical, the crisis – commonly considered as the worst downturn since the Great Depression 75 years earlier – has shattered the faith in unfettered and deregulated markets that correct their mistakes quickly (Reinhart, Rogoff 2009). Since the commercialization of the grain trade in late-nineteenth-century Chicago it has been common knowledge that the impact of market forces is nowhere more effective, and sometimes fateful, than on the floors of the exchanges. But – as governments all over the world implement packages costing billions to save distressed companies, reassure anxious citizens and prevent their economies from sliding into the worst calamity since the Great Depression of 1929-32 – it still raises questions of how the market as a 'spontaneous order' could lose its fundament and demanded a strong state to take matters in hand. Governments of all colours have acquired stakes in the former giants of the financial world: Goldman Sachs and JP Morgan in New York, RBS and Lloyds/HBOS in London, Dexia and Fortis in Brussels.

Assuming that markets lie at the heart of every successful economy, but do not work well on their own under any circumstances, this paper tries to track one of the most persistent currents in global economy: deregulation. It tries to clarify the design and impact of deregulation concepts which – according to my thesis – triggered the 2008/09 financial crisis. Nevertheless,

1 The author would like to thank both reviewers for very constructive and detailed comments.

the following arguments are not based on the current crisis, but rather cast light on the intellectual foundation of deregulation as a highly influential economic current. Necessarily, the paper focuses on concepts and consequences of deregulation on a very general scale. The universalization of market concepts (chapter 2), i.e. the tendency to disparage differences between different types of markets such as the goods market, the labour market, the traffic market and the financial market, is connected to neoclassic equilibrium theory (chapter 3) as well as to fundamental parameters that gave rise to market liberalization (chapter 4). The arguments presented in this paper cannot be drawn on solely to explain the financial meltdown, but must be amended by further explanations. There are various other causes for the financial turmoil that finally affected the real economy, amongst them such as asset-liability mismatches, information uncertainties and herd behaviour. Notwithstanding deregulation politics can be qualified as a determinant 'underlying carpet'.

1. Introduction

For more than a quarter century the 'deregulation doctrine' prevailed and in line with the view that regulation impedes innovation, inefficiencies of regulatory frameworks have been outlined – and partly overdrawn (Stiglitz 2010, xi). Against this background the Managing Director of the International Monetary Fund (IMF), Dominique Strauss-Kahn, explained the financial crisis by addressing the "regulatory failure to guard against excessive risk-taking in the financial system, especially in the US" (2008). However, to some extent regulation is counterproductive and amplifies market dysfunctions. Notably, the Basel II Accord has come under scrutiny for forcing banks to increase their capital when risks rise, which causes them to decrease lending exactly when capital is scarce, contingently aggravating financial crises.

State interventions as we saw them in response to the recent collapse of the financial markets represent quite a U-turn, given that for more than a quarter century the "control deficits *of* the state and *within* the state" have been stressed and the benefits of the "lean state" held high (Jänicke 1993, 65). Under that logic state interventions to correct market outcomes or overall economic planning to pursue society-wide or social policy aims were a long time considered as alien interference. For many economists such interventions represent a "usurpation of knowledge" that ultimately ends in totalitarianism (Hayek 1975). But although the current tempest in the international capital markets now causes numerous economists to cease their public demands for "humility before the market's unpredictability" (Hayek 2001, 47), liberalization politics must still be regarded as an immensely influential intellectual current whose principles and tenets define the international frame of reference for social and economic policy. Thus, the transformation of the Keynesian welfare state into a "Schumpeterian workfare state" (Jessop 1993) in pursuit of the need to secure international competitiveness continues unabated in most developed industrial states.

2. Universalization of Market Concepts

Based as it is on classical liberalism and – at least in its origins and leanings – neoclassical theory, the economic policy of deregulation (and privatization) aims to minimize the influence of the state. Whereas 'liberalization' is commonly defined as the opening of closed markets, a stronger accentuation of market forces and a selective task sharing between market and public sector, the term 'deregulation' – having its roots in the US-American debate about basic elements of a political order – primarily focuses on waiving market barriers, price controls, terms and conditions as well as laws that legitimate governance control. The deregulation discourse cherry-picks fundamental ideas from the classical liberalism of Adam Smith, Jeremy Bentham and John Stuart Mill, regurgitating them to fit the changed circumstances of the political economy. Unlike the "old" laissez-faire liberalism that emerged in opposition to protectionist mercantilism, neoliberalism regards economic interventions as necessary to ensure functioning markets, true to the spirit of "liberal interventionism" (Rüstow 1963, 253).

With the goal of the broadest possible realization of the ideal of total competition intervention in the economy was now to be "in exactly the opposite direction, namely concurrent with the laws of the market rather than against them" (Rüstow 1963, 252-253). Rüstow, who taught at Istanbul University as a German exile from 1933 to 1949, is much more explicit in the immediately preceding passage: "The much-maligned Manchester capitalism has at least revealed a much more manly and courageous attitude than those whiners who immediately get the public authorities to stick the biggest possible plaster on the slightest scratch" (1932, 251). The above quote shows that as a system of ideas this new liberalism was about more than a resurrection of traditional liberalism: namely, a fundamental realignment of social and economic policy. On the basis of the neoclassical equilibrium theory – developed in the last third of the nineteenth century out of classical economics – according to which the market possesses efficient incentive, control and penalty mechanisms, the supporters of this liberal turn argued for the primacy of the economy, for an economic policy of antistatism (Moore 1983, 93).

Assuming perfect capital markets, the neoclassical perspective holds the "money view", according to which consumption and investment are affected by interest rates regardless of potential institutional intervention. Consistent with neoclassical theory, mo-

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netary policy-makers have certain objectives, such as moderate long-term interest rates, stable prices, and the promotion of sustainable economic growth in order to provide sound macroeconomic conditions for a thriving economy. In neoclassical theory, the allocation of resources and equilibrium prices, fundamental in a market based financial system, remains unaffected by institutional structures. But the recent past illustrates how market friction provides reliable insights into the inherent dynamics of the institutional structure of the financial system.

The traditional concept of financial intermediation, namely to accomplish a welfare-improving safeguard against fluctuations in financial market returns, was to a significant degree abandoned when market participants were no longer protected against competition. As the optimal structure of risk-bearing is a key function of a financial system, a drawback of market-based systems is that investors are exposed to substantial market risk, when they rely on market information that trigger changes in asset prices. This reliance requires financial institutions and publicly traded corporations to disclose more information than privately held companies in bank-based systems (cf. Geithner 2009).

The "dethroning" of politics entails a wide range of measure: implementing competition through comprehensive deregulation of the economic and social order, liberalization and privatization of public services and publicly owned businesses, tax cuts in tandem with cutting state spending, and restrictive monetary policy (Bellamy 1994). But how can the universality of the free-market principle be justified, the broad-brush fixation on the market as the central instance of coordination? Gary S. Becker, who won the 1992 Swedish Riksbank Prize in Economic Sciences (often referred to as a "Nobel prize" although it is awarded in memory of Alfred Nobel rather than by his foundation) formulated the benefits of the free-market principle in terms of its universal validity: "Indeed, I have come to the position that the economic approach is a comprehensive one that is applicable to all human behavior, be it behavior involving money prices or imputed shadow prices, repeated or infrequent decisions, emotional or mechanical ends, rich or poor persons, men or women, adults or children, brilliant or stupid persons, patients or therapists, businessmen or politicians, teachers or students" (1978, 8). The originators themselves described the universalization of the free market, expressed in the desire to apply cost/benefit considerations to all spheres of society, as "economic imperialism" (Boulding 1973, 118; Schlösser 2001, 4), strikingly highlighting the messianic dimension of this redefined liberalism.

Charles E. Lindblom sees the superiority of the market over a system of central coordination grounded in the former's evolutionary potential: "Market systems encourage thousands and millions of initiatives. They are turbulent, open-ended systems that can change or grow at any of innumerable points. They allow great room for invention and improvisation, individual and local resourcefulness, a multitude of challenges and potential responses ..." (1980, 77). Market economies are claimed to be extraordinarily adaptable evolutionary systems driven by competition as the central coordinating mechanism (Weizsäcker 2000, 2-3; Knieps 2000, 7-22; Donges 2002, 7-11).

The supporters of intense competition at all levels from individual to international claim that it solves the innovation problem by functioning as "abstract knowledge management"; businesses competing with one another in pursuit of profit (which represents the result of a competitive advantage) drives technical progress, inducing growth, innovation and growing market share. Competitive structures are also regarded as significant in resolving motivation problems through the mechanism whereby performing adequately in the market earns companies profits whereas inefficiencies lead to losses and in the longer term elimination from the market.

The view that the free market filters out the best methods and behaviour, is not restricted to competition between businesses, but also encompasses competition between nation-states *(Standortwettbewerb)*. In short: competition functions as a regulatory principle acting to order and channel market forces. At the same time, competition – in the opinion of those who regard it as the only driving force of general well-being apart from self-interest – can only express its ordering powers if it is managed and institutionally secured by the state.[2] The market must not just be *permitted* but much more permanently *facilitated*. Ultimately, historical experience shows that the free play of market forces alone could not be expected to produce a market order of economic processes, but that instead the state had to guarantee the survival of competition on the field of competing interests as a "robust umpire" (Röpke 1979, 310) rather than just a "night-watchman" (Lassalle 1919, 195).

3. Weighty Borrowings from Neoclassicism

One central pillar of neoclassical economics – on which numerous deregulation arguments are at least implicitly based – is the theory of equilibrium, according to which the market is automatically self-optimizing (i.e. its allocation function always tends towards equilibrium). Many representatives of the economic fraternity regard Adam Smith's oft-quoted quasi-religious metaphor of the "invisible hand" as "perhaps the major intellectual discovery in the whole

2 Leonhard Miksch described the free-market economy as a *"Veranstaltung",* because the state appeared as an ordering instance to guarantee the functioning of competition (1937, 5 and 9).

history of economics" (Buchanan 1986, 17). Here the metaphoric expression stands for the condition that is generally understood as the spontaneously price-controlled order of market events.

Hayek's implicit equilibrium of a market order that forms spontaneously of itself describes a market emerging as the coordinating instance by securing interaction of the economic subjects, regardless whether this is the labour, commodity or capital market (1969). Although Adam Smith's striking image pertinently illustrates the way the coordinating effect of the market is often hidden from view, the theoretical concept of neoclassical economics has come in for criticism not only as a metaphorical exaggeration but even as a gap in economic theory tending towards economic theology.

James M. Buchanan and Gordon Tullock responded to this criticism with an economics orientated on the "world as it is" rather than the "world as it should be". Their public choice theory, which must be regarded as further evidence of the immense breadth of variation and versatility of deregulation theory, became one of the most influential economic theories of the past century. The constitutive feature of the theory, also known as "new political economy", is the application of the rational choice approach of neoclassical economics (which holds that the goal of maximizing utility determines individual decision-making calculations) to phenomena in the political sphere.

Buchanan's academic reputation is grounded in his contribution to a free-market reconception of the state, in the sense of a critique of the (welfare) state couched in terms of political economy; unlike many contemporary protagonists of a deregulation turn, the thrust of his argument is not to attack nation-state socialism, but instead to make what liberal economists felt was the "mushrooming" welfare state the starting point of his critique, "Socialism Is Dead But Leviathan Lives On" (Buchanan, 1990). The award-winning economist declared the absence of free-market principles and the utility maximization of politicians to be the causes of state bureaucracy. Thus, Ralf Dahrendorf's call to banish "the talk of a good society" from the vocabulary of the social sciences because openness and liberty in a society were "absolutely adequate goals" (2000: 15) finds a broad echo among economists, historians and political scientists. By contrast they regard any orientation on the common good as "preceptorially imposed virtuousness" (Willke 2003, 68).

According to deregulation politics the market represents a system of rules that excludes the application of categories such as justice and social acceptability (cf. Etzioni 1988). In fact the costs of social inclusion are simply never set in relation to the costs that ensue – in the form of criminality, ghettoization, squalor, drug addiction, etc. – as a consequence of social turmoil and disparities. The historical roots of this short-sighted perspective are found in Hayek's famous statement about the Keynesian welfare state: "A social market economy is not a market economy, a social constitutional state not a constitutional state, a social conscience not a conscience, social justice not justice and, I fear, social democracy not democracy" (1979, 16).[3] Those who interpret the predicate "social" as a meaningless pleonasm or as a "weasel-word" (Hayek 1979, 16) and regard the free market as a moral concept consistently resist any subsequent correction of the results of the market.

However, the postulate that if the free market is to rule one must adapt to and fit in with it (Eucken 1952, 371) is subject to justified objections. Moderate and radical critics of deregulation criticize both the rigorousness of the market and its anonymity. Whereas Richard Sennett, whose *The Corrosion of Character: The Personal Consequences of Work in the New Capitalism* analyses global capitalism's demands on its subjects, sees the "profit imperative" as the reason for capitalism to rid itself of all responsibility (1998), others criticize the return to Manchester capitalism as sheer "market fundamentalism" (Giddens 1990). Critics from ethical communitarian currents complain of the lack of state institutions to provide a social counterweight to the market when they see "individuals ... as quivering atoms abandoned to the chill of neoliberalism" (Reese-Schäfer 2001, 131). Harsher criticism of the reformatting of liberalism – widely lauded as *economia triumfans* – comes from those who identify destructive elements with respect to the development of society above and beyond the points of criticism already mentioned. Whether claiming that the market is under any circumstances inherently stable is the same as a quasi-religious message may be a moot point, but it serves to illustrate a persistent criticism. It is generally believed that "there is no alternative" to the course of economic renewal "that sets social romanticism to one side" (Sinn and Sinn 1993, 485). Until the current economic and financial crisis erupted even prominent sceptics eked out a marginal existence without any meaningful media resonance.

In order to understand the role of the slimmed down state it is worth taking a look back at its origins. The deregulation doctrine was able to establish itself as the predominant paradigm of political econ-

3 While many observers regard Germany's Social Market Economy as a highly ambitious and extremely successful ("economic miracle") blueprint for a coordinated economy cum welfare state, the original conception was in fact designed in opposition to Keynesian and other ideas in favor of extensive state planning for economic and social purposes. At the same time the founding fathers of the Social Market Economy critiqued classical laisser faire liberalism in order to create considerable room for maneuvers needed to cut political deals with a strong socialist and trade union opposition in post WW II Germany.

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omy. First under Margaret Thatcher in Britain and Ronald Reagan in the United States and subsequently in most of the states of continental Europe there has been a "passive revolution" (cf. Gramsci 1971, 44-120). Ideas of the welfare state, pillars of public services and historically evolved sectors of state economic activity that had once been matters of public consensus came under a barrage of criticism from all sides. At the latest by the end of the "short century" as Eric Hobsbawm named the era of "real existing socialism" from 1917 to 1989 (1995, 20), the efforts to implement market doctrine not only as the roadmap for efficient economic policy but also as the solution to social and ecological ills had been rewarded. For two decades now the very tangible and visible outcome has been a widely accepted dominance of deregulated markets.

If we search for an explanation for the victorious march of deregulation politics, deeper questions have to be answered: What were the driving forces that helped this economic policy to achieve acceptance across the obvious traditional (party) political boundaries? Were the years of reiterating the necessity to reduce state spending and business overheads all it took to clear the way for it? Why did the macroeconomic and political framework change in such a way as to foster the paradigm shift in very different nation-state economies?

4. Driving Forces: Crisis of Keynesianism, Faith in Flexibility and Credo of Modernity

One obvious explanation why liberalism was able to return with such vehemence is the oil price shock of 1973 and the ensuing recession, the worst since the Great Depression, which led to stagflation, currency turbulence, a drastic drop in consumption and investment, worsening deficits in social security systems, and finally to a huge jump in unemployment rates. Growing functional deficiencies of Western economies accompanied by a deliberate discrediting of state interventions led to a delegitimation of Keynesianism. The traditional mechanisms of state action, including demand-side management, were increasingly regarded as inadequate.

Here the "Waterloo of Keynesianism" (Willke 2003, 32) is sometimes explained in terms of the political actors finding themselves in a dilemma, at least subjectively, because of rampant stagflation: while raging inflation demanded a restrictive monetary policy on the part of the central banks, a situation of stagnating economic growth appeared to indicate state-initiated growth programmes. Under the assumption that restrictive monetary policy and expansive economic policy were mutually exclusive, the crucial political decision-makers declared that the Keynesian approach was stymied for that period – not least because the dilemma was interpreted primarily as a crisis of state control as a consequence of over-regulation.

Another reason why the idea of entirely deregulated markets was apparently able to succeed by stealth appears to lie in its adaptability and versatility: "There is nothing in the principles of liberalism to make it a stationary creed, there are no hard-and-fast rules fixed once and for all. The fundamental principle that in the ordering of our affairs we should make as much use as possible of the spontaneous forces of society, and resort as little as possible to coercion, is capable of an infinite variety of applications" (Hayek 2001, 17). This quote reveals that Hayeks positioning occurs not so much in the framework of a coherent, static body of theory, but rather latches as required into specific aspects of the life of society.

Economization concepts based on deregulation and privatization permeated the different spheres of society quietly and subtly rather than openly and brashly. Concepts gained traction through the creeping influence of think tanks on media, politics and business, given that there were "no work and no authors to deal a death-blow to the old teachings ... to replace old pillars with new" (Flassbeck 1982, 75). Both Hayek's *The Road to Serfdom* (1944) and Popper's two-volume *The Open Society and Its Enemies* published a year later (1945) had an enormous and unforeseen impact on the field of social theory, but they did not bring about a paradigm change in economic, financial and social policy.

Already at the beginning of the twentieth century Hans Honegger – addressing Max Weber's political economy – pointed out that attempts to order all aspects of society through the model of the market were misguided, even claiming that "the economy is fundamentally rooted in politics, through which it must ultimately be explained" (1925, 135). And also in the writings of the great ordoliberal Wilhelm Röpke – who called at the founding meeting of the Mont Pèlerin Society in April 1947 for an economic order of "economic humanism" – we find an early hint of the criticism associated to this day with the (sometimes overused) concept of deregulation: "We know well enough that it would be foolish to suppose competition, the free market and the interplay of supply and demand to be mechanisms from which we can expect the best in all spheres under all circumstances. This general notion – which no-one should take more to heart than the friend of the free-market economy – leads us to the specific recognition that the market ... one-sidedly favours activity that is the source of profit, while arguments against such activity are disregarded in the market even though the general interest demands they should be given the greatest weight" (1979, 200).

5. Conclusion

The worst economic dislocation since the Great Crash of 1929-32 demonstrates that global networking has made free markets much more volatile and therefore much more susceptible to crises. First and foremost, the great shake-out in the global financial casino is a time to rethink the relationship between the state and the 'financial economy' – and here or there readjust – after first setting aside the philosophy of destratification. The battle-cry since the end of the Bretton Woods system in 1973, that the state must withdraw from the commanding heights of the financial markets, is weakened. Instead governments across the globe agree that the financial markets have to undergo significant change – entailing a reduced exposure to counterparty risk, to mitigated funding mismatches, and to investors that bet on their 'investments' by leverage in trading. Time will show whether deregulation proposals will be checked more thoroughly before implementation in the future. Currently, decisive regulatory frameworks, which are backed by the vast majority of economists, are discussed across the globe in order to safeguard the global economy.

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