

ROUTLEDGE RESEARCH IN FINANCE AND BANKING LAW

# Redefining the Market—State Relationship

Responses to the financial crisis and the future of regulation



Ioannis Glinavos

ROUTLEDGE



# Redefining the Market–State Relationship

Responses to the financial crisis  
and the future of regulation

Ioannis Glinavos

First published 2014

by Routledge

2 Park Square, Milton Park, Abingdon, Oxon, OX14 4RN

Simultaneously published in the USA and Canada

by Routledge

711 Third Avenue, New York, NY 10017

*Routledge is an imprint of the Taylor & Francis Group, an informa business*

© 2014 Ioannis Glinavos

The right of Ioannis Glinavos to be identified as author of this work has been asserted by him in accordance with sections 77 and 78 of the Copyright, Designs and Patents Act 1988.

All rights reserved. No part of this book may be reprinted or reproduced or utilised in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

*Trademark notice:* Product or corporate names may be trademarks or registered trademarks, and are used only for identification and explanation without intent to infringe.

*British Library Cataloguing in Publication Data*

A catalogue record for this book is available from the British Library

*Library of Congress Cataloging-in-Publication Data*

A catalog record has been requested for this book

ISBN: 978-0-415-69128-4 (hbk)

ISBN: 978-0-203-71879-7 (ebk)

Typeset in Garamond

by Cenveo Publisher Services



Printed and bound by CPI Group (UK) Ltd, Croydon, CR0 4YY

# Redefining the Market–State Relationship

This book offers an interdisciplinary overview of the role of law in modern capitalism in the context of financial crisis. In this work, the reader will find a discussion of key issues relevant to the crisis that have occupied the pages of the financial press since 2007, including an assessment of the meltdown of the sub-prime mortgage market, the credit crunch, the European debt crisis and the turmoil in Greece, plus a series of theoretical contributions that are aimed at challenging perceptions of the market–state relationship and the place of law within it.

The book includes a methodological defence of the state–market dichotomy, a critique of the tenets of neoclassical economics and an evaluation of what the financial crisis heralds for the future of the political economy of western democracies. Ioannis Glinavos argues that it is a mistake to associate markets with freedom and states with oppression, and suggests that more choice for consumers can – and does – mean less choice for citizens. The book suggests that a new social contract is needed to ensure the survival of both capitalism and democracy.

In contributing a unique, legal perspective to the underlying dynamics of the financial crisis, this book will be valuable to scholars and students of regulation, financial markets and economic development.

**Ioannis Glinavos** is Lecturer in Law at the University of Reading, UK.

## **Routledge Research in Finance and Banking Law**

Available:

### **European Prudential Banking Regulation and Supervision**

The Legal Dimension

*Larisa Dragomir*

### **International Secured Transactions Law**

Facilitation of Credit and International Conventions and Instruments

*Orkun Akseli*

### **The Legal and Regulatory Aspects of Islamic Banking**

A Comparative Look at the United Kingdom and Malaysia

*Abdul Karim Aldobni*

### **Banking Secrecy and Offshore Financial Centres**

Money Laundering and Offshore Banking

*Mary Alice Young*

### **Fiduciary Law and Responsible Investing**

In Nature's Trust

*Benjamin J. Richardson*

Forthcoming:

### **Competition Law and Financial Services**

*David Harrison*

### **Redefining the Market-State Relationship**

Responses to the Financial Crisis and the Future of Regulation

*Ioannis Glinavos*

For Sophie

## Preface

This book offers an overview of the role of law in modern capitalism in the context of financial crisis. In these pages, the reader will find a methodological defence of the state–market dichotomy, a critique of the sacred tenets of neoclassical economics and an evaluation of what the financial crisis (and responses to it) herald for the future of the political economy of western democracies. This work, in summary, combines a presentation of the economic calamities that the world has suffered since 2007 with a reflection on the role of law and delivers a powerful political message. This message is that democracy is suffering under financialised capitalism and that a new social contract is needed to ensure the survival of both capitalism and democracy. In this work, the reader will find a discussion of most of the key issues relevant to the crisis that have occupied the pages of the financial press since 2007, plus a series of theoretical contributions that are aimed to challenge the way we view the market–state relationship and the place of law within it. The book will argue that we are mistaken in associating markets with freedom and states with oppression, and suggests that more choice for consumers can – and does – mean less choice for citizens.

Since my first book *Neoliberalism and the Law* was published in 2010, the world has become a very different, and not necessarily better, place. Concerns about the purposes of law reform, the role of law in modern capitalism and the links between justice, equality and security that were common in discourses about countries emerging from communism have now become prevalent discussions in western democracies. What has intervened, of course, between the time of the research that produced my first work and this book is the financial crisis in its many forms, ranging from the sub-prime mortgage collapse in the USA to the credit crunch and the European sovereign debt crisis. This book argues that there is a continuum between works on the role of law in post-communist transition and examinations of the effects of the financial crisis. The link is provided by the stranglehold economic orthodoxy has over our understanding of the balance between markets and states and the scope for policy discretion over economic decision-making allowed by neoclassical assumptions. This book, as a result, offers an indictment of the de-politicisation of economic decision-making that is so central to economic

orthodoxy, arguing that the distancing of democratic politics from norm creation in regulatory fields leads to the dissolution of liberal democracy.

Why should the reader choose this work over many others about aspects of the financial crisis that have since 2010 littered the shelves of bookshops? This work is novel because it discusses the background to the financial crisis by focusing on the role of law. Current literature on the crisis focuses on economics or politics but little on law. Key to understanding the nature of contemporary capitalism and in proposing reform, however, is a re-evaluation of the function and purposes of law. The book adopts an interdisciplinary approach to the issues under consideration, bringing together economic theory and political reflection within a normative legal framework. The book does not seek to offer yet another review of the crisis, but an explanation of underlying dynamics. The book concludes by proposing a mechanism for achieving a new organisation of the market–state relationship based on reinvigorating democracy in western societies and offers an avenue towards the creation of a new social contract wherein markets serve as a mechanism for the attainment of social goals chosen via the democratic process. In short, the book centres on the role of law in interpreting current regulatory phenomena and recommends a vision for the future.

The central underlying theme of the book is that legal changes implementing reforms with a pro-market direction reduce policy options and as such dilute the public's ability to influence economic decision-making. Law therefore becomes an instrument of de-democratisation – resulting in extremis in a dictatorship of finance. This book is at the same time a call to arms, carrying a significant political message and a contribution to academic knowledge about the nature of law and the lessons of the financial crisis. The political message is that if we wish democracy to survive, we need to have a discussion about the nature and purpose of law in modern capitalism. We need to engage in a debate that will end in a new social contract whereby a commitment to liberal democracy is reaffirmed. This debate will only be one of substance if different balance points in the market–state relationship are envisaged. We need to break out of the confines of neoclassical thinking, dispel the myths of a *homo economicus* and regain control over our fates as citizens in a democratic polity. The book also explains why the slide to 'technocracy' carries the danger of a tumble towards fascism or anarchy. The crisis, in summary, is a game changer that we can either use to reaffirm our commitment to a future of shared prosperity, or we can squander it, with unpredictable consequences.

The contribution to knowledge from an academic point of view comes from the dissection of the role of law in capitalism and from unpacking the various notions that comprise the constitutive myths of financialised capitalism. The book challenges fundamental notions about the nature of markets, the role of law and the place of democracy that have been dominant for so long we have forgotten how they came into existence. The book also offers a novel exploration of the ideology behind policy formation pre- and post crisis.



While it is beyond the aims of the book to offer an exhaustive list of policy responses to the crisis in a multi-jurisdictional environment, this work presents some illustrative examples of reform, exploring the reasons behind policy changes, and enquires into the origin (and likely destination) of current shifts in our perception of the role of law and the place of the state in regulatory frameworks.

The book has been written in what is hoped to be accessible language that will appeal to both an audience well versed in the relevant literature and to the interested lay person. There is no benefit to be gained from overtly technical language if the result is that it does not communicate its meaning effectively. Every effort has been made therefore to explain technical concepts when they are used, and this applies both to legal and economic/financial terms. The consequence of this method of writing is that the style of the book may appear simple to scholars, but it is not simplistic. Also, the book aims to use contemporary sources, while making a theoretical contribution that will outlast the newsworthiness of the content used. The purpose is not just to inform about what we have experienced from 2007 to 2013, but to put current developments in a wider context, to draw messages about the nature of law and regulation that will be relevant long after this crisis is (hopefully) past. The sources for this work are a combination of published literature, current affairs commentary and personal reflection and experience. I owe the greatest gratitude to the authors of my sources, even to those I disagree with, and I assume responsibility for any mistakes and misunderstandings. As with every cross-disciplinary work, especially one that straddles law, economics and politics like this one, readers well versed in only one of the fields involved may find the analysis occasionally lacking, superficial or partial. The aim of the book is not to offer a comprehensive examination of the literature on regulation in each field, but to combine knowledge in order to suggest something novel. To find truth we need to break through disciplinary barriers, despite the dangers of oversimplification that may lurk.

The realisation offered in this work that market-friendly reforms can have corrosive unintended consequences on the health of our democracy, even in core capitalist states, links together the many examples and themes of the book that are explored in three main parts. Part 1 introduces the main concepts that the book deals with and defines its main objective, which is to locate what the role of law should be in western capitalist democracies and to enquire into appropriate balance points between market freedoms and state policy discretion. Chapter 1 contains the main methodological defence for the book and explains why, despite the intermingling of states and markets since the 1980s, the distinction between state and market is still a methodologically sound one. The chapter delves into the theory on market intervention and then offers a reflection based on ethics. Taking one of the key illustrations used in the book, the concept of executive remuneration, Chapter 1 explores the legal, economic and ethical justifications behind inequalities in modern capitalism. The chapter concludes by a reflection on the relationship between

law and justice in financialised capitalism. Chapter 2 goes to the core of the discussion linking law with economic governance, challenging neoclassical assumptions as to the nature and purpose of finance, money, credit. This reflection then allows the chapter to proceed to an investigation of ideas and their role in policy-making, unmasking the central role ideas and ideology have in issues that are presented by the current orthodoxy as a result of apolitical, scientific enquiry.

Building on the theoretical bases set thus far, Part 2 of the book reaches into the core of the motivation behind this work, an investigation of the financial crisis and what it means for law in western political economy. Chapter 3 continues the work of unpacking neoclassical assumptions by offering a history of the state–market relationship, doubting the received wisdom that regulation is a modern concept that descended upon previously free markets after the shock of the Great Depression. Viewing history through a critical lens, the chapter argues that what we think we know about the role of law in economic management and the historical origins of *laissez-faire* needs to be taken with much caution. This re-examination of the historical record leads then to a presentation of the financial crisis in Chapter 4. Chapter 4 presents the main features of what we call the Great Recession and is split into two main sections. The first section presents the financial part of the crisis, from the sub-prime mortgage market collapse in the USA to the credit crunch. The second section is less historical and more contemporary as it addresses the European sovereign debt crisis. Chapter 4 explains in some detail events surrounding the Greek problem, which is taken as the focal point of the sovereign debt crisis, and uses Greece as an illustration of the dangers of legislating free market policies, especially when the law is used to distance market-friendly frameworks from the reach of normal legislative and political processes. The chapter concludes with a reflection on a very controversial issue, the ability of member states of the Eurozone to leave the monetary union, either voluntarily or involuntarily.

The presentation of the two facets of the crisis, the financial and the sovereign debt problems, is followed in Part 3 by an investigation of the meaning of policy responses to the crisis in the USA and Europe, a reflection on how the political economy of capitalist states may change as a result of the shock delivered by the crisis and a discussion on emerging trends in policy responses. Chapter 5 presents regulatory reform initiatives first in Europe and then in the USA, taking special note of responses to the perceived problem of excessive remuneration for top executives, especially in the financial sector. The message taken from measures so far in response to the crisis, the chapter argues, does not suggest a change in the philosophy that motivates reform. It seems that, to date, we cannot discern a challenge to an ideological background to economic governance that sees market mechanisms as the default basis for organising our economic lives. Chapter 6 uses this realisation to test how dispute resolution processes affect the evolution of norms and the respective space left to states to regulate market activities. The chapter also asks

whether the focus on law, that this book has, is in fact unnecessary and whether self-regulation and voluntarism present a lasting alternative to state regulation of market activity. The chapter suggests that unless we re-empower democratic institutions to define the nature of the market–state balance, unless we reach a new social contract to support capitalism in the future, we risk the dissolution of liberal democracy. The book concludes by challenging the current turn towards ‘technocracy’ by calling on citizens to embrace the opportunities presented by our great crisis in order to reclaim policy space, to demand that choices are opened to us as citizens rather than just as consumers in a market.

## Acknowledgments

The author would like to thank the journal *European Business Law Review* published by Kluwer and the *European Journal of Law Reform* published by Eleven, as well as Routledge for allowing the reproduction of the author's material previously published with them.

# List of abbreviations

ABS	asset-backed security
APR	annual percentage rate
BBA	British Bankers Association
BIT	bilateral investment treaty
CAC	collective action clause
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CDO	collateralised debt obligation
CDS	credit default swap
CEO	chief executive officer
CRD	Capital Requirements Directive
CSR	corporate social responsibility
EBA	European Banking Authority
ECB	European Central Bank
ECJ	European Court of Justice
EFAMA	European Fund and Asset Management Association
EFSF	European Finance Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
ESA	European Supervisory Authorities
ESMA	European Securities and Markets Authority
EVCA	European Private Equity and Venture Capital Association
FDIC	Federal Deposit Insurance Corporation
FSA	Financial Services Authority
FSB	Financial Stability Board (formerly FSF)
FSF	Financial Stability Forum
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
ICSID	International Center for the Settlement of Investment Disputes
IEA	Institute of Economic Affairs

IMF	International Monetary Fund
ISDA	International Swaps and Derivatives Association
MFN	Most Favoured Nation
MP	Member of Parliament
NAFTA	North American Free Trade Agreement
NEET	Not in Employment, Education or Training
NGO	non-governmental organisation
NRSROs	Nationally Recognized Statistical Rating Organizations
OECD	Organisation for Economic Cooperation and Development
OFT	Office of Fair Trading
OTC	over-the-counter
PSI	Private Sector Involvement
SEC	Securities and Exchange Commission
TARP	Troubled Asset Relief Program

# Contents

<i>Preface</i>	ix
<i>Acknowledgments</i>	xiv
<i>List of abbreviations</i>	xv

## PART 1

Theory	1
--------	---

1 Methodological framing	5
--------------------------	---

- 1.1 *Introduction* 5
- 1.2 *The state–market relationship* 5
- 1.3 *Ethics of regulation* 18
- 1.4 *Conclusion* 33

2 The role of law in markets	35
------------------------------	----

- 2.1 *Introduction* 35
- 2.2 *A story about sardines* 36
- 2.3 *What are money, credit, finance?* 38
- 2.4 *Ideas in economic governance* 44
- 2.5 *Conclusion* 54

## PART 2

Crises	59
--------	----

3 History and deregulation	61
----------------------------	----

- 3.1 *Introduction* 61
- 3.2 *The nineteenth century* 64
- 3.3 *Early twentieth century* 69
- 3.4 *Reacting to the Great Depression* 72

3.5	<i>The neoliberal era</i>	80
3.6	<i>Conclusion</i>	83
4	<b>The crisis of 2008</b>	85
4.1	<i>Introduction</i>	85
4.2	<i>The credit shortage</i>	86
4.3	<i>The sovereign debt crisis</i>	95
4.4	<i>Conclusion</i>	112
<b>PART 3</b>		
	<b>Futures</b>	115
5	<b>Responses to the credit crunch</b>	117
5.1	<i>Introduction</i>	117
5.2	<i>Regulatory wish-list</i>	117
5.3	<i>Regulatory reform initiatives in Europe</i>	120
5.4	<i>The issue of compensation</i>	123
5.5	<i>Regulatory reform in the USA</i>	128
5.6	<i>Control of compensation in the USA</i>	134
5.7	<i>Conclusion</i>	136
6	<b>The market–state balance revisited</b>	139
6.1	<i>Introduction</i>	139
6.2	<i>The market–state balance in courts and tribunals</i>	141
6.3	<i>Leaving the law behind: voluntarism</i>	151
6.4	<i>The future: politics and extremes</i>	154
6.5	<i>An alternate future: law as peacemaker</i>	157
6.6	<i>Conclusion</i>	159
	<i>Epilogue</i>	162
	<i>Bibliography</i>	164
	<i>Index</i>	176



## Part I

# Theory

Contrary to much popular perception, scepticism about the place of markets in society is not the exclusive domain of anti-globalisation, anti-capitalist agitators. This book is premised upon the central idea that in order to ensure the survival of capitalism and the perseverance of free markets, we need to reconsider the balance between the state and the market. This is not a call for revolution or a suggestion that non-capitalist ideas are necessarily viable. It is rather a pragmatic observation that a progressively less democratic capitalism is unsustainable. The suggestion that de-politicised economic decision-making does not ensure long-term stability is critically reinforced by the financial crisis. Market advocates, even more than market sceptics, therefore, stand to gain from the realisation that a growing disconnect between public support and free markets, embedded in legal structures, does more to undermine markets than state sponsored attempts at re-regulation. The nexus of this discussion is the role of politics (via law) in economic governance. The reason why the debate about better economic management and more legitimate economic decision-making is essentially a political question is because, as this book claims, it is only political processes that can determine the overall aims of policy with a degree of legitimacy and permanence that ensures the long-term survival of the capitalist project. Economic policy design currently, however, is largely being considered as an issue of technical competence, a scientific endeavour. The market (allegedly) has rules that are akin to scientific rules. These rules demand certain things of the state-market relationship and set frameworks that mandate what is beneficial and what is damaging to the market and, by extension, to the society as a whole. This perception, however, equates market needs with social needs. When social needs diverge from what is best for the market, the currently dominant analytical framework described above requires that social requirements take a back seat to the needs of the market. Determining a hierarchy of needs and goals for government policy, however, cannot be made the prerogative of so-called scientific economic analyses. The explanation for this is that lacking legitimacy and public support, any system of government is unstable and potentially incapable of keeping the peace. It is politics, which this book regards as representative democratic politics, which should determine the