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Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model

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Against the background of a close presidential election campaign, the U.S. government responded to the great financial crisis of 2008 with a great financial bailout, a massive federal effort to prop up financial institutions and the economy itself. The crisis in credit and financial markets was the most serious since the collapse of the nation's banking system in March 1933. A seismic generational shift in values has led to our present crisis. The generation that came of age during the Great Depression and World War II, the so-called Greatest Generation, achieved its most important public policy objectives—converting the economy first to enormous wartime production and then to peacetime rebuilding—in large part because of a financial regulatory regime that kept competition within prescribed limits while allocating credit and capital away from private, speculative activity and into longer-term public investment in physical and social infrastructure.[1]

The microeconomic fixations of today's law and economics school have replaced this comprehensive Keynesian model of financial regulation. The economic model underlying today's failing regulatory regime is a neoclassical equilibrium model that is highly abstract and mathematical, often based on unrealistic assumptions and ignorant of historical contexts and the many complex dynamics and interdependencies of human behavior and market psychology.[2] Largely uncontrolled and uncoordinated, the current regulatory approach does not serve the interests of the public, but rather the far

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[1] Adam Smith, the grandfather of neoclassical economics, believed that the state should invest in public works. DOUGLAS F. DOWD, THE TWISTED DREAM: CAPITALIST DEVELOPMENT IN THE UNITED STATES SINCE 1776 8 (1974); *cf.* Press Release, American Society of Civil Engineers, America's Crumbling Infrastructure Eroding Quality of Life (Mar. 9, 2005), http://www.asce.org/reportcard/2005/page.cfm?id=108 (reporting that the United States must spend $1.6 trillion by 2010 to prevent deterioration of public infrastructure).

[2] *See* David Colander, *IS/LM Model and Diagram*, *in* AN ENCYCLOPEDIA OF KEYNESIAN ECONOMICS 259, 260–61 (Thomas Cate ed., 1997) (noting criticisms of this widely employed economic model as simplistic and based on unrealistic assumptions).

narrower interests of the regulated institutions that have captured the agencies of government and the policy-making process.

This Essay seeks to analyze the most important institutional and regulatory factors that have contributed to the ongoing financial market failure and offers a framework for designing a new approach to financial regulation that would meet the demands of the present. Part I, "The Logic of the Keynesian Regulatory Regime," describes the adoption in the United States of a "command-and-control" financial regulatory regime, beginning in the 1930s and 1940s. This regime was part of a larger model, which I refer to as an institutional law and Keynesian economics model, that focused on macroeconomic policy objectives and was designed to achieve full employment, more equitable distributions of wealth and income, and greater transparency and accountability in the regulatory process.[3]

Part II, "The Demise of the Economics of Control," describes the shift away from Keynesian economics and command-and-control regulation toward privatization and deregulation, a dangerous devolution that picked up tremendous momentum beginning in the 1970s. During this period, concern for Keynesian objectives fell by the wayside. Part III, "The Introduction of Risk-Based Capital Standards," focuses on one component of this trend: the movement toward industry self-regulation. This Part argues that the dangers of the deregulatory trend became more apparent as industry self-regulation undermined the transparency of financial institutions and markets while encouraging the development of an unsustainable, bubble economy.

Part IV, "Agency Capture and Revolving Doors," argues that the replacement of an effective system of command-and-control regulation by industry self-regulation was a function of larger institutional flaws. This Part analyzes the failures of regulation in an institutional landscape marked by agency capture and privatized authority—failures that set the stage for the current financial crisis.

Part V, "The Bastard Keynesianism of the Bailout," critiques the economic rationale of the current bailout in the context of continuing market failure due to past deregulatory reforms. The financial crisis of 2008 did not put an end to the flawed institutional super-structure that had been taking root over the preceding thirty years. Part V describes a profound failure in the rule of law and argues that the privatized Federal Reserve System represents the primary institutional roadblock preventing effective financial regulation, a proper balance of constitutional authority on monetary and fiscal policy, and needed reforms in public finance.

In conclusion, Part VI, "A New Economics of Control," presents recommendations for reviving the model of institutional law and Keynesian economics as the best alternative to prevent future financial crises. This Part builds on the original Keynesian model, suggesting a more complete and integrated economic approach to counter the flawed policies that set the

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[3] John Maynard Keynes, The General Theory of Employment, Interest, and Money (1936).

stage for our current financial crisis. But this approach can be developed and implemented only if mechanisms for regulation are well-coordinated and safeguarded from a meddling and self-serving financial industry.

I. The Logic of the Keynesian Regulatory Regime

Laissez-faire capitalism was the prevailing orthodoxy in both law and economics from the time of the 1929 stock market crash until the banking crisis of 1933. Financial markets were largely unregulated and unsupervised, and it was not seen as the responsibility of government to stimulate economic activity, even in a recession. British economist John Maynard Keynes turned this orthodoxy on its head in his 1936 book, *The General Theory of Employment, Interest, and Money*.[4] This Section is primarily concerned with Keynes's proposals for financial regulation, but in order to fully appreciate these proposals, it is important to understand the broader economic and policy context in which they were crafted. Accommodation to its broader context sets Keynes's approach apart from the narrowly conceived financial regulations of the last thirty years.

Keynes's proposals rested on a recognition that the economy could become stuck in a liquidity trap in which expectations of falling prices and falling profits, or what he referred to as a "declining marginal efficiency of capital," would choke off new investments no matter how low interest rates fell. According to Keynesian theory, there were complex economic and psychological factors that could lead to such a liquidity trap. A top-heavy distribution of income could drain purchasing power from those segments of the population most likely to spend and maintain demand for goods and services—in economic terms, those with a high marginal propensity to consume. Economic growth would thereby become dangerously dependent on the luxury spending of the wealthy few and on unsustainably high levels of private investment. A reduction in aggregate demand resulting from a steep and sudden fall in prices and wages would bring the economy to a new, lower equilibrium. Monetary policy would be unable to pull the economy out of the trap.[5]

To Keynes, the implications of his theory for macroeconomic policy were clear: if private investment and consumption stalled, the only realistic engine of economic growth would be government spending. In turn, a hyperactive fiscal policy would require a central bank willing to maintain low interest rates for government borrowing and spending programs.[6] Such a policy mix would also require a regulatory system of centralized credit controls to keep credit from flowing back into speculative bubbles and to bring

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[4] *Id.*

[5] *Id.* at 207–08.

[6] *Id.* at 202–06 (arguing that the central bank should maintain low long-term interest rates to facilitate an expansive government fiscal policy).

about adjustments in the propensities to consume and invest.[7] Keynes recognized that such central controls would "involve a large extension of the traditional functions of government."[8] Although he never spelled out the details of those controls in *The General Theory*, an earlier essay on the banking crisis of 1931 gives us a hint of the controls Keynes had in mind.[9]

When addressing the banking crisis of 1931, Keynes observed that much of the speculative rise in stock prices that led to the 1929 market crash was fueled by an enormous increase in loans for stock purchases without any minimum down payments. Existing stock served as collateral to borrow money for further stock purchases. There was no federal authority at the time to set margin requirements, leaving the Federal Reserve, the nation's central bank, with only two choices: moral suasion to encourage the voluntary tempering of these lending practices, or general credit restrictions. The Fed chose the latter, thereby raising interest rates and making the downturn and crash inevitable.[10] Keynes recognized that subsequent financial events were consequences of this failure in regulation and monetary policy: a worldwide collapse in the price of real assets and a wave of foreclosures and business failures that left banks with enormous portfolios of bad loans, all of which led to a liquidity crisis, freezing up the credit system and preventing banks from financing new projects and engaging in new lending.[11]

Consequently, Keynes pointed out the need for strict minimum down payment requirements for loans for housing, consumer, and corporate securities purchases:

> Experience has led to the fixing of conventional percentages for the 'margin' as being reasonably safe in all ordinary circumstances. The amount will, of course, vary in different cases within wide limits. But for marketable assets a 'margin' of 20 per cent to 30 per cent is conventionally considered as adequate, and a 'margin' of as much as 50 percent as highly conservative.[12]

Keynes viewed such margin requirements as important means to limit systematic risk and protect financial institutions from any downward change in the money value of assets by limiting the amount of credit allocated to marginal borrowers.

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[7] *Id.* at 379.

[8] *Id.*

[9] John Maynard Keynes, *The Consequences to the Banks of the Collapse of Money Values* (1931), *in* Essays in Persuasion 168, 170–71 (1963).

[10] For more on this theory of the crash, see Allan H. Meltzer, A History of the Federal Reserve: 1913–1951, at 248–49 (2003); Frederick Lewis Allen, Only Yesterday 306 (1931). Milton Friedman and Anna Jacobson Schwartz concluded that the Fed "followed a policy which was too easy to break the speculative boom, yet too tight to promote healthy economic growth" in the year leading up to the 1929 crash. Milton Friedman & Anna Jacobson Schwartz, A Monetary History of the United States, 1867–1960, at 291 (1963).

[11] Keynes, *supra* note 9, at 171–73.

[12] Keynes, *supra* note 9.

In 1944, in *The Economics of Control: Principles of Welfare Economics*, Abba Lerner, one of the leading Keynesian economists in the United States, sought to provide a more detailed theoretical framework for market regulation and public finance in accordance with Keynes's observations. According to Lerner, within a system of private enterprise and private ownership, the government should achieve regulatory coordination by taking on responsibility for controlling the allocation of resources among consumption, investment, foreign trade, and government spending.[13] Lerner understood that government at all levels imposed all kinds of regulations on a wide range of industries, institutions, and private transactions. "Yet," he wrote, "we may refer to the actual economy as 'uncontrolled' because all these activities are partial and haphazard and are not organized as they would be if it were a recognized responsibility of the government to control the resources of society to see that they are utilized in the best possible manner."[14]

Lerner likened the uncontrolled economy "to an automobile without a driver but in which many passengers keep reaching over to the steering wheel to give it a twist while complicated regulations prescribe the order and degree to which they may turn the wheel so as to prevent them from fighting each other about it."[15] He contrasted this with a controlled economy, with one driver and a clear purpose, which would be simpler and have many fewer regulations than an uncontrolled economy.

Likewise, in the field of finance much regulation can be quite complex and yet ineffective in managing risk for lenders and protecting borrowers. In contrast, margin requirements are far simpler yet also more successful at limiting systematic risk. With high margin requirements there is less need to rely on complex capital adequacy and truth-in-lending regulations to protect borrowers and ensure the safety and soundness of the banking system.

In addition to promoting a controlled, coordinated financial system, Lerner argued that government regulation should be aimed at achieving at least three primary policy objectives: maintaining full employment, diminishing the tremendous inequality of income and wealth, and putting an end to the monopoly structures that contribute to exploitation and economic waste.[16] These objectives of control are designed to reduce the factors that

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[13] *See* ABBA LERNER, THE ECONOMICS OF CONTROL: PRINCIPLES OF WELFARE ECONOMICS 3 (1947).

[14] *Id.* at 3. Government regulation, when uncoordinated and without control, can lead to market failure. For instance, Bert Ely identified several regulatory causes of the savings and loan crisis—the problem may be the wrong regulatory mix. *See* Bert Ely, *Savings and Loan Crisis*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS (2d ed. 2007), *available at* http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html.

[15] LERNER, *supra* note 13, at 4 (citing A.P. Lerner, *The Economic Steering Wheel*, 7 THE UNIV. REVIEW 257 (1941)).

[16] LERNER, *supra* note 13, at 3. Lerner also emphasized that these objectives would prove elusive if the regulated industries themselves were able to capture the regulatory agencies—in essence to cartelize their industries under the veil of regulation. *Id.* at 43, 46 (criticizing cartelization through the New Deal's Agricultural Adjustment Act). Lerner's concern with monopolistic exploitation can be seen as anticipating the Public Choice School concern with agency

Keynes diagnosed to be at the heart of depression and business cycles. For instance, the promotion of full employment and the reduction of income inequality would help maintain aggregate demand and thereby keep the economy from falling into recession and potential liquidity traps.[17]

In 1934, Congress began to move toward the vision of financial regulation that Keynes expressed and Lerner would later develop. In that year, Congress delegated to the Federal Reserve Board of Governors the authority to set margin requirements on security loans.[18] For the next two decades, these and other "selective credit controls" came to be seen as important policy tools to supplement general monetary measures that regulate the total supply of money and bank credit and the general level of interest rates. In contrast to these general monetary measures, selective credit controls influence the allocation of credit, "at least to the point of decreasing the volume of credit used for selected purposes without the necessity of decreasing the total supply and raising the cost of credit for all purposes."[19] During this period, the Fed was given authority to set margin requirements on consumer credit and real estate credit in the form of minimum down payments and maximum periods of repayment.[20] Consumer credit controls were instituted

capture. George J. Stigler, *The Theory of Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (describing how the political process allows relatively small groups to obtain favorable regulation); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J. LAW & ECON. 211 (1976); Thomas W. Merrill, *Capture Theory and the Courts: 1967–1983*, 72 CHI.-KENT L. REV. 1039 (1997). These ideas will be discussed more fully in Parts III through VI, where I observe that agency capture has become all too common in the U.S. political system, as special interest groups through money, lobbying, and the lure of private sector employment (the so-called "revolving door") have come to accumulate great influence over key congressional committees and regulatory agencies to avoid genuine competition. *See* THEODORE LOWI, THE END OF LIBERALISM: THE SECOND REPUBLIC OF THE UNITED STATES (2d ed. 1979); MANCUR OLSON, THE RISE AND DECLINE OF NATIONS (1982).

[17] Lerner claimed that the fundamental cause of the business cycle was the inadequacy of demand because of the very unequal distribution of income. LERNER, *supra* note 13, at 296. This was consistent with the view of other leading Keynesians. *See, e.g.*, JOHN KENNETH GALBRAITH, THE GREAT CRASH 182 (1961) (arguing that the Great Depression and 1929 stock market crash were due in part to a highly unequal distribution of income that made the economy "dependent on a high level of investment or a high level of consumer spending or both").

[18] LESTER V. CHANDLER, THE ECONOMICS OF MONEY AND BANKING 248–49 (5th ed. 1969). Hearings by the Senate Committee on Banking and Currency beginning in 1931 and spearheaded by Ferdinand Pecora, special counsel for the committee, revealed the dangers of buying stocks on margin, and led to stricter margin requirements under the Securities Exchange Act of 1934. *See generally* BROADUS MITCHELL, DEPRESSION DECADE: FROM NEW ERA THROUGH NEW DEAL 1929–1941 154–59 (1947).

[19] CHANDLER, *supra* note 18, at 247. Margin requirements were just one tool in the arsenal of selective credit controls. During the 1960s and into the 1970s, the federal government also employed selective controls including, but not limited to, differential taxes, lending quotas, and ceilings on foreign investments to restrain credit to foreign borrowers. For a description of these selective controls, see Donald R. Hodgman, *Selective Credit Controls*, 4 J. MONEY, CREDIT & BANKING 342, 342–44 (1972).

[20] For instance, demand for credit for particular purchases could be reduced by raising minimum down payment requirements, which would lower the maximum loan value, or by shortening the maximum period of repayment, which would increase monthly payments on loans. *See* CHANDLER, *supra* note 18, at 250.

in late 1941 and remained in effect almost continuously until 1952.[21] Credit controls for new residential construction were used from 1950 to 1952 as part of an anti-inflation program during the Korean War.[22] Together, these controls diverted financial resources from nonessential uses and assisted the government in meeting its wartime funding requirements by keeping interest rates low on government debt.[23]

Throughout the 1940s and 1950s, economists and policymakers saw margin requirements as an effective way to prevent bubbles in real estate and other sectors without raising interest rates for the entire economy and without raising borrowing costs for all levels of government. Ervin Miller, a University of Pennsylvania economist writing in the 1950s, argued that selective credit controls were more precise than general credit restrictions and therefore "very useful in periods of uncertainty when some areas of the economy show undue expansion" and other sectors are weak.[24] Throughout this period of time, even Fed officials who opposed the use of selective credit controls on ideological grounds wanted such policy tools at their disposal in case emergency conditions might suddenly arise.[25]

These policymakers, like Keynes and Lerner, recognized that when the central bank uses one blunt instrument—the short-term interest rate—it is abandoning the steering wheel for the stop-and-go of an accelerator. When the central bank seeks to contain speculative bubbles in stocks or housing through general monetary measures alone, the results can be destabilizing. Lowering interest rates for all may invite speculative bubbles in already heated sectors of the economy. Raising interest rates for the entire economy can collapse asset markets, increase unemployment, raise the debt burdens of private and public borrowers, redistribute income to top brackets, increase foreclosures and bankruptcies, and reinforce the monopolistic powers of big financial institutions.[26]

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[21] *Id.* at 247 (reporting brief interruptions in consumer credit control authority for some months in 1947–1948 and again in 1949–1950).

[22] *Id.*

[23] *Id.* at 250–51. *See also* Ervin Miller, *Monetary Policy in a Changing World*, 70 Q. J. Eco. 22, 34 (1956). Regulation X, which set margin requirements on real estate credit, was supported on broad social and economic grounds. Its proponents claimed that the terms imposed by Regulation X were not always stiff enough to produce their desired effect. *See* R.J. Saulnier, *An Appeal of Selective Credit Controls*, 42 AM. ECON. REV. 247, 251–52, 261–62 (1952).

[24] Miller, *supra* note 23, at 38.

[25] *See A Bill to Provide Standby Economic Controls, and a Bill to Provide Authority for Temporary Economic Controls: Hearing on S. 753 and S. 1081 Before the S. Banking and Currency Comm.*, 83d Cong. 1472–89 (1953) (statement by William McChesney Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System), *available at* http://www.docstoc.com/docs/986181/Statement-before-the-Banking-and-Currency-Committee-of-the-Senate-March-30-1953.

[26] *See* JAMES MEDOFF & ANDREW HARLESS, THE INDEBTED SOCIETY: ANATOMY OF AN ONGOING DISASTER 72–74 (1996); LEON H. KEYSERLING, MONEY, CREDIT, AND INTEREST RATES: THEIR GROSS MISMANAGEMENT BY THE FEDERAL RESERVE SYSTEM (1980) (Keyserling was the Chairman of the Council of Economic Advisers to President Harry Truman from 1949–1953).

No one could drive a car for long without the command-and-control regulations of traffic lights, speed limits, and traffic lanes. Likewise with financial markets, margin requirements serve important functions by steering credit away from speculative risk and overheated sectors of the economy without the need to resort to general monetary measures.

II. The Demise of the Economics of Control

Over the past four decades, there has been a profound political and ideological shift away from Keynesian economics and toward deregulation. The leadership in both major political parties came to see government as intrusive and incapable of achieving genuine full employment and other Keynesian policy objectives.[27] Deregulation created an ineffective patchwork of federal regulations. Meanwhile, replacing selective credit controls with general monetary measures to manipulate short-term interest rates helped to fuel unsustainable asset bubbles.

Selective credit controls were first discredited during the latter part of the Vietnam War, largely a case of guilt by association with President Nixon's inept and loophole-ridden use of price controls and a symptom of the general backlash against executive power stemming from Watergate and related scandals.[28] President Carter rejected the economics of control and soon after was left without any selective policy instruments to contain inflationary forces in commodity markets and consumer goods.[29] The Federal Reserve eventually stepped in by using general monetary policy instruments quite aggressively to restrict the money supply and push up interest rates for the entire economy. This in turn undermined the viability of other selective policy instruments, such as depository interest rate ceilings and usury ceilings on mortgage loans.[30]

Once the government lost control of the general macroeconomic environment, the political agenda shifted to formally abolishing selective credit controls and deregulating banking and finance.[31] The Depository Institutions Deregulation and Monetary Control Act of 1980 liberalized depository interest rate ceilings, preempted state usury ceilings on mortgage loans, and permitted new financial innovations to evade various other legal restrictions.[32]

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[27] Medoff & Harless, *supra* note 26, at 72–74.

[28] Neil W. Chamberlain, Donald E. Cullen & David Lewin, The Labor Sector 617–25 (3d ed. 1980) (analyzing the flaws and loopholes of Nixon's price controls).

[29] Alexander Cockburn, The Golden Age Is in Us 264 (1995) (discussing President Carter's rejection of the economics of control as a backlash after the failures of Nixon).

[30] Depository interest rate ceilings limited the payment of interest on saving deposits and prohibited the payment of interest on checking deposits; usury ceilings limit interest rates on mortgage and other loans. Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 Brook. L. Rev. 1295, 1310–11, 1315–16 (1995).

[31] *See generally id.* at 1314–26 (1995).

[32] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

Two years later, the Garn-St. Germain Depository Institutions Act[33] completed the deregulation of depository interest rates, removed regulatory firewalls between commercial banks and savings and loan associations, and removed numerous other lending restrictions on loan-to-value ratios, amortization, aggregate limits, and loan maturities, thereby setting the stage for such financial innovations as subprime and adjustable rate mortgage loans.[34]

The 1980s saw the dismantling of the intricate patchwork of selective credit controls that had served for decades to reduce systematic risk by discouraging the development of a subprime mortgage market for borrowers with bad credit. Without such controls, and with the added incentive of securitization of subprime loans, lenders started making more and more loans with no minimum down-payment requirements, and eventually without requiring documentation of income on many loans.[35] Variable-rate loans and loans of shorter maturity soon shifted the risks of rising interest rates from lenders to borrowers, just as opponents of deregulation had predicted at the time. Not surprisingly, the rate of business failure and foreclosure increased almost immediately.[36]

The deregulatory agenda was politically and ideologically sustained during the Clinton and Bush II years, fueling a bubble economy based on easy credit, high debt, low or no margin requirements, and the deterioration of lending standards. Lending standards were relaxed on Fannie Mae and Freddie Mac, government-sponsored entities (GSEs) that purchase mortgages on the secondary market to pool and sell as mortgage-backed securities.[37] Those who opposed higher margin requirements on housing loans argued that they would prevent some borrowers, particularly from poor and minority communities, from purchasing their first homes, thereby impeding

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[33] Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended at 12 U.S.C. 1823(c) (1994)).

[34] *See* Canova, *supra* note 30, at 1320, 1327.

[35] DEP'TS OF THE TREASURY AND HOUSING AND URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING 29–30 (June 20, 2000), *available at* http://www.huduser.org/publications/pdf/treasrpt.pdf.

[36] *The Depository Institutions Deregulation Act of 1979: Hearings on S. 1347 Before the Subcomm. on Financial Institutions of the S. Comm. on Banking, Housing, and Urban Affairs*, 96th Cong. 131 (1979) (statement of Henry B. Schechter, Director, AFL-CIO Dep't of Urban Affairs).

[37] Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES, Sept. 30, 1999 at C2 (discussing Fannie Mae's decision to ease lending standards in response to pressure from the Clinton administration and banks, thrift institutions, and mortgage companies); Jay Romano, *A Baedeker for First-Time Homebuyers*, N.Y. TIMES, March 14, 1999 at RE1 (reporting three percent margins on Fannie Mae approved mortgage loans). The Comptroller of the Currency defended the Community Reinvestment Act (CRA), the convenient scapegoat of Wall Street, arguing that it was not the cause of the wave of subprime lending. Press Release, Comptroller of the Currency, Comptroller Dugan Says CRA not Responsible for Subprime Lending Abuses (Nov. 19, 2008), *available at* http://www.occ.treas.gov/ftp/release/2008-136.htm. *But see* Eliot Spitzer, Op-Ed., *Predatory Lenders' Partner in Crime*, WASH. POST, Feb. 14, 2008, at A25 (criticizing the Comptroller of the Currency for preempting all state predatory lending laws in 2003).

their ability to build up equity capital.[38] While such arguments are true, other approaches might have been used to help low- and middle-income families save for future homeownership, such as a federal tax deduction for rental payments to match the current mortgage interest deduction for homeowners. Policymakers, however, ignored such alternatives, continuing instead to resist implementation of margin requirements.

Meanwhile, Federal Reserve Board Chairman Alan Greenspan's laissez-faire approach encouraged greater consolidation within the financial sector and the proliferation of complex financial instruments known as derivatives. As early as 1997, concerns were raised about the growth of collateralized debt obligations (CDOs), derivatives that pooled together millions of subprime mortgages and divided their income streams in complex ways.[39] Rather than reducing risk, the process of securitization served to increase risk throughout the financial system. CDOs and other such derivatives transformed the local risks of subprime lending into a far wider global and systematic problem. As the size of the subprime mortgage market grew, some officials became increasingly concerned. In 2000, Edward Gramlich, a Federal Reserve governor, proposed to Greenspan that the Fed use its discretionary authority to send bank examiners to the offices of such lenders. But Greenspan was opposed, and Gramlich never brought his concerns to the full Federal Reserve Board.[40]

By June 2005, *The Economist* was referring to the U.S. housing bubble as "the largest financial bubble in history."[41] The debt of American households was climbing nearly twenty percent a year, the savings rate had fallen below zero, and the cash being pulled out of homes from mortgage refinancing had reached about five percent of GDP, creating a bubble in consumer spending, imported goods, and the value of the dollar itself.[42] Fully one out of every five new mortgages in the United States was subprime. Greenspan has recently claimed that when he was informed of this alarming statistic in 2005, his original response was that he did not believe the number: "It became a huge revelation."[43]

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[38] These arguments were made by officials within both the Clinton and Bush II administrations. *See, e.g.*, David Streitfeld & Gretchen Morgenson, *Building Flawed American Dreams*, N.Y. TIMES, Oct. 19, 2008, at A1; Jo Becker, Sheryl Gay Stolberg, & Stephen Labaton, *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 21, 2008, at A1.

[39] FRANK PARTNOY, FIASCO: THE INSIDE STORY OF A WALL STREET TRADER 124–25, 172–76 (1999); *See generally* Evan M. Gilreath, *The Entrance of Banks into Subprime Lending: First Union and The Money Store*, 3 N.C. BANKING INST. 149, 152–54 (1999); Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002).

[40] Paul Krugman, *A Catastrophe Foretold*, N.Y. TIMES, Oct. 26, 2007, at A25.

[41] *In Come the Waves: The Global Housing Boom*, ECONOMIST, June 16, 2005, at 66–68.

[42] Timothy A. Canova, *Legacy of the Clinton Bubble*, DISSENT, Summer 2008, at 47.

[43] *House of Cards* (CNBC broadcast Feb. 12, 2009), *available at* http://hnn.us/roundup/comments/67377.html. In fact, Greenspan may have missed the significance of the housing bubble as late as September 2005. *See* Edmund L. Andrews, *Most Homeowners Not Overly in Debt, Fed Chief Says*, N.Y. TIMES, Sept. 27, 2005, at C1 (Greenspan stating: "The vast major-

Since the collapse of the housing bubble, there has been much criticism of the Fed's easy monetary policy and the low interest rates that had fueled the rise in housing prices throughout the past two decades.[44] There has been far less attention paid to the Fed's ideological hostility to selective credit controls, which could have prevented the growth in all of these bubbles. Although Greenspan testified to Congress in the middle of the financial panic of October 2008 that he had discovered a flaw in his model of how the world works,[45] he remains unwilling to consider the use of margin requirements as a tool to prevent housing bubbles by preventing the growth of a large subprime mortgage market.[46]

In the aftermath of the crash, there has been a lively debate between monetary economists on the question of how housing and other asset bubbles can best be avoided. One school of thought says that central banks should stop the growth of asset bubbles by raising interest rates[47]—a blunt general monetary policy instrument that inflicts damage indiscriminately through higher foreclosure and bankruptcy rates.[48] Others say that central banks should not attempt to stop asset bubbles because regulators are incapable of knowing when market prices are too high.[49] Neither school of thought appears to have seriously considered the use of selective credit controls as a way to prevent unsustainable bubbles in the first place by deterring the overleveraging of assets.[50]

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ity of homeowners have a sizable equity cushion with which to absorb a potential decline in house prices.").

[44] *See, e.g.*, John B. Taylor, Op-Ed, *How Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, at A19; Brian M. Carney, *Bernanke Is Fighting the Last War*, WALL ST. J., Oct. 18–19, 2008, at A11.

[45] Edmund L. Andrews, *Greenspan Concedes Flaws In Deregulatory Approach*, N.Y. TIMES, Oct. 24, 2008 at B1. *See also Obamanomics: Is This Real Change?*, (Real News Network internet video posted Nov.25, 2008), *available at* http://therealnews.com/t/index.php?option=com_content&task=view&id=31&Itemid=7&jumival=2852 (at 4:22 into the video).

[46] According to Greenspan, "The presumption that you could incrementally defuse a bubble was a fantasy." *House of Cards*, *supra* note 43. *See also* Alan Greenspan, Op-Ed., *The Fed is Blameless on the Property Bubble*, FIN. TIMES, Apr. 7, 2008, at 11 (claiming the Fed was powerless to "lean against the wind" or eliminate asset bubbles).

[47] *See, e.g.*, Paul De Grauwe, Op-Ed., *Central Banks Should Prick Asset Bubbles*, FIN. TIMES, Nov. 2, 2007, at 9.

[48] *See* Justin Lahart, *Fed Rethinks Stance on Popping Bubbles*, WALL ST. J., Oct. 17, 2008, at A4 (recognizing the dangers of fighting asset bubbles by raising interest rates, "a blunt instrument with economy-wide effects," and reporting Fed officials as leaning toward regulating financial firms "with more focus on how they are contributing to risk throughout the financial system").

[49] *See, e.g.*, Arthur Levitt, Op-Ed., *You Can't Control Animal Spirits*, WALL ST. J., Aug. 5, 2008, at A19; Gerald P. O'Driscoll Jr., Op-Ed., *To Prevent Bubbles, Restrain the Fed*, WALL ST. J., Nov. 17, 2008, at A19. *But cf.* Kevin J. Lansing, *Asset Price Bubbles*, FRBSF ECONOMIC LETTER, Oct. 26, 2007, at 1 (arguing for quantitative economic models to determine when asset prices have strayed above fundamentals, but silent as to policy tools to prevent rise in asset prices).

[50] *See, e.g.*, Lansing, *supra* note 49 (silence regarding policy tools to prevent rise in asset prices).

As explained above, this blind spot has its costs. For too long, policymakers have relied on one general policy instrument to solve all problems—the adjustment of short-term interest rates. This has been like driving a car with only an accelerator and a brake, lowering interest rates to spur economic growth, then raising interest rates to slow inflation, and all the while inflating asset bubbles in housing and stock prices, and then bursting those bubbles. Throughout the past two decades, this approach has undermined all three of Lerner's main policy objectives. The cycles of inflating and then deflating asset bubbles have coincided with and exacerbated the booms and busts of the business cycle, thereby contributing to persistently high levels of unemployment and underemployment[51] and the most top-heavy distribution of income since the stock market crash of 1929.[52] Meanwhile, the financial industry has become more consolidated, enabling it to capture regulatory agencies and to engage in monopolistic exploitation of consumers and homebuyers. Keynes' and Lerner's economics of control were replaced by the out-of-control economics of unsustainable debt-fueled bubbles.

All of the major players in the subprime fiasco were regulated, but according to Lerner's schematic, they were regulated in haphazard and uncoordinated ways. Lenders, brokers, appraisers, bankers, bond insurers, ratings agencies, and financial engineers of mortgage-backed securities were subject to various licensing and reporting requirements and to some degree of oversight, but often these were requirements that suited their own purposes, such as limiting competition from potential entrants into their markets. What was missing was an economics of control specifically designed to contribute to the objectives of full employment, equitable distributions of income, and the containment of systematic risk—objectives which, by the 1990s, were considered either outdated or outside the province of government planning.

III. The Introduction of Risk-Based Capital Standards

The post-war Keynesian model of financial regulation, based in large part on the use of selective credit controls, gradually gave way to deregula-

[51] Much unemployment and underemployment is hidden and no longer reported in official government statistics.*See* Joseph Rosta, *U.S. Government Data Needs a Redo*, U.S. Banker, Feb. 1, 2009, http://www.americanbanker.com/usb_article.html?id=20090126NYI3ZJ30 (quoting author that the U-7 measure of underemployment, which used to include discouraged workers and part-time workers unable to find full-time employment, was politically unpalatable and discontinued by the Bureau of Labor Statistics in January 1994).

[52] Jesse Drucker, *Richest See Income Share Rise*, Wall St. J., July 23, 2008, at A3 (richest one percent of Americans had the highest share of the nation's adjusted gross income for two decades, and "possibly the highest since 1929," according to Internal Revenue Service data); Meteor Blades, *Wall Street. Main Street. Why No Mention of Side Streets and Alleys?*, Daily Kos, Oct. 26, 2008, *available at* http://www.dailykos.com/storyonly/2008/10/26/202810/29 (discussing slide in U.S. real wages and increase in the Gini coefficient measure of income inequality in the U.S.); Anton Troianovski, *Majority of Jobless in U.S. Don't Get Benefits*, Wall St. J., July 29, 2008, at A4 (reporting that only thirty-seven percent of unemployed received benefits in 2007, down from fifty-five percent in 1958).

tion. Policymakers came to rely instead on general monetary measures as a response to the asset bubbles that formed in the wake of financial deregulation. Meanwhile, beginning in the 1990s, risk-based capital requirements largely replaced margin requirements as the primary regulatory tool for ensuring the strength of financial institutions and containing systematic risk. In other words, instead of limiting risk through margin requirements at the initial lending stage by requiring borrowers to post collateral, the new regulatory regime permitted all kinds of risky loans to be made and then sought to contain the risk by requiring banks to keep sufficient capital in reserve. Although it was not so apparent at first, this represented a transition from command-and-control margin requirements to self-regulation, as banks were able to set their own risk-based capital standards.

Capital adequacy rules were supposed to ensure that financial institutions would have sufficient invested capital on hand to absorb likely losses.[53] The capital that banks were required to keep in reserve ranged from equity issued by banks to long-term debt and other financial instruments. The amount of capital required to be held in reserve would vary depending on the nature of a particular asset, with riskier assets requiring more capital in reserve. The measurement of risk, therefore, would become crucial to determine whether a bank had sufficient capital in reserve. But regulators began to allow banks to rely on their own mathematical calculations to measure the riskiness of their assets and thus effectively to set their own capital requirements.[54] The banks' mathematical models often gave only the illusion of safety by measuring the boundaries of risk over short durations and assuming a "normal" market.[55] With regulators asleep at the wheel, the banks themselves had every incentive to under-measure the risk of their assets, and thereby keep less capital in reserve.

Economists and policymakers failed to learn from history that their risk models were unrealistic. Greenspan would later testify that he "did not forecast a significant decline [in the housing market] because we had never had a significant decline in prices."[56] He was apparently not aware of the enor-

[53] PETER MOLES & NICHOLAS TERRY, THE HANDBOOK OF INTERNATIONAL FINANCIAL TERMS (1997), at 40–41, 71 (defining "Basle [sic] Capital Convergence Accord" and "capital adequacy," respectively).

[54] This was done by the Basel Committee on Banking Supervision, the international body that governs how banks set their capital requirements through an accord known as Basel II. *See generally* Jeffery Atik, Basel II and Extreme Risk Analysis (Feb. 13, 2009) (working paper for American Society of International Law, International Economic Law Research Colloquium, UCLA School of Law), *available at* http://www.asil.org/files/atik.pdf; Joe Nocera, *Risk Management*, N.Y. TIMES, Jan. 4, 2009, § 6 (Magazine), at 24.

[55] *See* Nocera, *supra* note 54. Ida Hoos criticized the technical focus of traditional systems analysis: "A kind of quantomania prevails in the assessment of technologies. What cannot be counted simply doesn't count, and so we systematically ignore large and important areas of concern." Ida R. Hoos, *Societal Aspects of Technology Assessment*, 13 TECHNOLOGICAL FORECASTING AND SOC. CHANGE 191, 193 (1979).

[56] Tim Rutten, Op-Ed., *What the Oracle Didn't See*, L.A. TIMES, Oct. 25, 2008, at A23 (quoting Greenspan testimony to a House committee). *See also* Alan Greenspan, Op-Ed., *We Will Never Have a Perfect Model of Risk*, FIN. TIMES, March 17, 2008, at 9 (claiming risk

mous drop in housing prices between 1929 and 1931[57] and therefore did not consider the possibility of significant housing price declines in his model.

Similarly, credit rating agencies like Moody's, Standard & Poor's, and Fitch routinely gave high ratings to mortgage-backed securities[58] by estimating low delinquency rates on the underlying mortgages, basing their calculations on a relatively short view of historical performance. The ratings agencies, like the banks, determined their risk-based mathematical models by looking through a rearview mirror to determine future performance; but the rearview mirror reflected constantly rising housing prices and inflated appraisals, conditions that could not possibly last.[59]

Some banking and finance experts have proposed making bank capital requirements contra-cyclical by relating the capital adequacy requirements to the rate of change of bank lending and asset prices in relevant sectors, such as changes in mortgage lending and housing prices.[60] These experts claim that the contra-cyclical approach would build up capital reserves and restrain bank lending during asset price booms while encouraging bank lending during asset price deflations. A final benefit of this approach would be "to reduce pressure from the financial system for central banks to adjust monetary policy in the heat of the moment"[61]—or, in other words, to reduce the need for the Fed to step on either the brake or the accelerator in a crisis.

But others criticize this proposal because it could be extremely difficult to determine the proper cyclical indicator for a particular security held by a financial institution.[62] For example, if tranches of a CDO[63] included parts of mortgage loans pooled from widely varied geographic locations, some from markets where housing is booming and others where housing is relatively

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management systems can never anticipate wild swings between euphoria and fear, and therefore what's needed is market flexibility and open competition).

[57] *See.* KEYNES, *supra* note 9, at 174–75 (reporting steep declines in the U.S. in farm values, urban properties, and housing, down thirty to forty percent across the board, an immense problem because "such property is ordinarily regarded as relatively free from risk").

[58] *See generally* MOLES & TERRY, *supra* note 53, at 361 (defining mortgage-backed security as a "security issued on the basis of a share in a group (or pool) of mortgages or trust deeds").

[59] As a result of its flawed ratings, Moody's had to downgrade more than five-thousand securities in 2007 alone. *See* Mathew Padilla, *Did the Agencies Rating Mortgage Bonds Let Greed Trump Common Sense?*, ORANGE COUNTY REG. (Cal.), May 10, 2008, *available at* http://mortgage.freedomblogging.com/2008/05/10/did-the-agencies-rating-mortgage-bonds-let-greed-trump-common-sense/.

[60] *See, e.g.*, Charles Goodhart & Avinash Persaud, Op-Ed, *A Proposal for How to Avoid the Next Crash,* FIN. TIMES, Jan. 31, 2008, at 9 (discussing the Basel II capital adequacy regime).

[61] *Id.*

[62] *See* Charles Freeland, Letter to the Editor, *Basel II a Big Improvement on Outdated Model*, FIN. TIMES, Feb. 7, 2008, at 10. Freeland is a former deputy secretary general of the Basel Committee on Banking Supervision.

[63] A CDO is a type of mortgage-backed bond where ownership of the mortgages have been sold to individual investors and the repayments of principal and interest are separated into different maturity streams, known as tranches. *See* MOLES & TERRY, *supra* note 53, at 91 (defining "collateralized mortgage obligation"), 361 (defining "mortgage-backed security"), and 560 (defining "tranche").

weaker, it would be impractical to link the required capital reserve to housing prices.

Some liberal legal scholars have suggested a second alternative to the use of margin requirements for containing risk in the financial markets, namely the creation of so-called "suitability claims" against financial institutions for predatory lending in the markets for housing and consumer loans.[64] But suitability claims would be a way of shifting losses, not necessarily preventing losses. This litigation approach would also require a case-by-case determination of when a particular loan was not suitable to the needs of a particular borrower. A bright line rule would be more effective: adjustable rate mortgages with no minimum down payment requirements should be seen as inherently unsuitable for borrowers, and inherently unstable for the financial system. Like an unsafe vehicle, they should simply be prohibited from the highway of commerce.

A third alternative to margin requirements would be to require greater transparency in underlying mortgage loans and perhaps for investment banks and hedge funds involved in creating and trading mortgage-backed securities.[65] But it is unclear how disclosure would dissuade borrowers from staking bets on the movement of asset prices during the boom stages of a bubble. There was already plenty of disclosure to borrowers mandated through Truth in Lending regulations and to purchasers of securities through federal securities disclosure requirements.[66] With no minimum down payment requirements, a significant percentage of the underlying mortgage loans will always be suspect and inherently unstable.[67]

Margin requirements are the best way to remedy this situation, by ensuring that borrowers are credit-worthy, have sufficient savings, and are not over-leveraged in their borrowing. This will strike some liberal scholars as overly paternalistic, as the logic of margin requirements suggests that mortgages and loans for autos and other large consumer purchases should not be made in the first place to borrowers with limited resources. But in the end, there really is no risk-based substitute, nor litigation nor disclosure substitute, for selective credit controls—the traffic lights and speed limits and other safety standards that keep some cars off the road. Minimum down payment requirements will keep most of the riskier borrowers from taking

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[64] *See* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1317–39 (2002).

[65] *See* Richard H. Thaler & Cass R. Sunstein, Op-Ed., *Disclosure Is the Best Kind of Credit Regulation*, WALL ST. J., Aug. 13, 2008, at A17; Richard Thaler & Cass Sunstein, Op-Ed., *Human Frailty Caused This Crisis*, FIN. TIMES, Nov. 12, 2008, at 11; Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003).

[66] *See* Truth in Lending Act, 15 U.S.C. §§ 1601-1667f (2006); *see also* Engel & McCoy, supra note 64, at 1334–35 (arguing that disclosure is inadequate since it fails to mandate precise and essential information, and thereby fails to provide adequate protection to investors).

[67] *Cf.* Alan M. White, *The Case for Banning Subprime Mortgages*, U. CIN. L. REV. (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133609.

on debts that they likely cannot afford. Moreover, with selective credit controls, when bank lending and housing prices in particular regions escalate too much too quickly, bank regulators could simply clamp down by raising minimum down payment requirements and restricting the use of adjustable interest rates and balloon payments. Such regulation would mean fewer mortgage loans for marginal borrowers, but it would also reduce the systematic risks facing the financial system.

IV. Agency Capture and Revolving Doors

The failure of regulatory policy and the headlong rush into deregulation was the natural consequence of major institutional flaws. Several factors have contributed to the capture of key federal regulatory agencies by the nation's financial services industry. One of these is the so-called "revolving door," the tendency of regulatory officials to leave their government posts for lucrative positions in the private financial industry. The movement of key personnel back and forth between regulators and regulated has become incestuous. Policy naturally comes to reflect the bargain of the moment between the most powerful private interests.

For instance, in 2003 and 2004, the biggest Wall Street investment banks, led by Henry Paulson, then the head of Goldman Sachs, lobbied the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) for a number of key regulatory changes. The SEC commissioners unanimously granted the banks an exemption from the net capital rule, thereby permitting their brokerage units to transfer their reserves up to their parent companies and enabling the banks to invest more funds in mortgage-backed securities, credit derivatives, and other exotic financial instruments.[68] Meanwhile, the FASB, with SEC acquiescence, ruled that these same banks could use off-balance-sheet entities to evade capital requirements for these same asset-backed securities.[69] As a result of these two regulatory changes, the nation's largest investment banks were able to hide massive holdings of toxic assets, such as commercial and residential mort-

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[68] *See* Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. Times, Oct. 3, 2008, at A1.

[69] See *Corporate Accounting Practices: Is There a Credibility GAAP?: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Fin. Services*, 107th Cong. 152–63, 293 (2002) (testimony of Robert K. Herdman, Chief Accountant, SEC). Reagan era financial deregulation foreshadowed the hiding of worthless assets through phony accounting, the lifting of capital requirements and overleveraging of financial institutions, and the bailout of those same institutions. For instance, in 1981 the Reagan administration sat idly by as the Federal Reserve authorized U.S. financial institutions to establish International Banking Facilities as bookkeeping entities to attract offshore deposits. IBFs were exempt from various federal regulations, including reserve requirements, federal deposit insurance requirements, and interest rate ceilings. Canova, *supra* note 30, at 1308.

gage-backed securities containing subprime mortgages made without margin requirements.[70]

The role of Henry Paulson illustrates how the revolving door spins both ways. Paulson succeeded in his efforts to allow Goldman Sachs and other financial institutions to hide their toxic assets by excluding them from their balance sheets, to evade capital requirements, and to use their reserves to become over-leveraged—in effect, to perpetuate a giant fraud on investors and the public alike. He then moved on to become Treasury secretary, from which position he was able to help prop up these same investment banks, eventually through the Troubled Asset Relief Program (TARP).[71] Paulson's pattern of behavior was consistent with theories of "control fraud," which suggest that defrauders will use corporate and other entities to engage in massive frauds, and then use their control over the same corporate entities and the agencies of government to cover their tracks and hide their malfeasance.[72]

Paulson's path through the revolving door was paved by others who had jumped from top Wall Street positions into top posts in previous administrations. Robert Rubin, for example, was the head of Goldman Sachs before becoming a top White House advisor and then Treasury secretary in the Clinton administration. He then returned to the private sector, joining Citigroup's top management. While he worked in the Clinton administration, Rubin influenced policy to the benefit of the short-term interests of the financial industry and in ways that would undermine the stability of the financial system. For instance, even as Rubin was negotiating to step down from his position as Treasury secretary and become co-chair of Citigroup with a lucrative compensation package, he was taking part in the lobbying effort that culminated in the Gramm-Leach-Bliley Financial Services Modernization Act of 1999.[73] This Act swept aside significant portions of the Glass-Steagall Act,[74] an early New Deal measure that created regulatory firewalls to keep commercial banks and insurance companies out of the riskier busi-

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[70] *See* Alan Reinstein et al., *Consolidation of Variable-Interest Entities: Applying the Provisions of FIN 46(R)*, CPA J., Aug. 1, 2006, at 28; Pierre F. de Ravel d'Esclapon, FASB Interpretation No. 46, An Overview (Feb. 10, 2004); Press Release, SEC, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008), *available at* http://www.sec.gov/news/press/2008/2008-234.htm.

[71] *See* Greg Ip, *Fed Balance Sheet Worries Volcker*, WALL ST. J., May 15, 2008, at A3.

[72] *See* WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE (2005); William K. Black, *Control Fraud and Control Freaks*, *in* CONTEMPORARY ISSUES IN CRIME AND CRIMINAL JUSTICE 67–80 (Henry N. Pontell & David Shichor eds., 2000); William K. Black, *"Control Frauds" as Financial Super-Predators: How "Pathogens" Make Financial Markets Inefficient*, 34 J. OF SOCIO-ECONOMICS 734 (2005); William K. Black, *Control Fraud as an Explanation for White-Collar Crime Waves: The Case of the Savings & Loan Debacle*, 43 CRIME, L. & SOC. CHANGE 1 (2005).

[73] Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12 U.S.C.).

[74] *See* Keith Bradsher, *Rubin's Plan for Banking Spurs Fight*, N.Y. TIMES, Feb. 28, 1995, at D1 (reporting Rubin's early attempt to abolish the Glass-Steagall Act).

ness of investment banking.[75] Until these provisions of Glass-Steagall were repealed, Citigroup had faced the possibility of having to sell off its Travelers Insurance underwriting subsidiary.[76]

At the time, Rubin openly boasted of his lobbying efforts on behalf of the 1999 deregulation measures, though he later backtracked by claiming that his role was limited to urging preservation of Community Reinvestment Act (CRA) provisions in the final bill.[77] Nevertheless, the Clinton Justice Department never brought charges against Rubin for violating the Ethics in Government Act.[78] In fact, some of those who warned against gutting the Glass-Steagall Act were punished. John Moscow, the New York Federal Reserve Bank's deputy general counsel, was forced to resign after warning that the results of combining the prudential culture of commercial banking and insurance with the risk-taking culture of securities "could be catastrophic" and that there was not a regulator capable of fully monitoring the multi-state, multi-national full-service financial giants that would result from repeal of Glass-Steagall.[79]

The case of Robert Rubin may seem more egregious than most, with its revolving door from Goldman Sachs to the White House to Treasury to Citigroup, coinciding with his involvement in gutting the Glass-Steagall Act to the benefit of his future employment and a sanctimonious defense of his actions. But the dynamic at play in the cases of Paulson and Rubin has become all too routine in the world of financial regulation, and it has helped to foster a group-think mentality—an echo chamber—within the top echelons of decision-making.

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[75] *See* Joseph Kahn, *Former Treasury Secretary Joins Leadership Triangle at Citigroup*, N.Y. Times, Oct. 27, 1999, at A1.

[76] *See id.* With the demise of the Glass-Steagall firewalls, banks were free to load up on riskier investments, including CDOs and other mortgage-backed securities, through affiliated entities such as their own hedge funds and other special investment vehicles. The old Regulation W that had authorized margin requirements for consumer credit was re-written to cover the transactions between banks and their securities affiliates. The old Regulation W was directed to the safety and soundness of lending, and was prudential and preventive in nature. The new Regulation W was now directed to the opaque transactions between affiliates within financial conglomerates, and its approach was more akin to monitoring problems only after the horse has left the barn. *See* Canova, *supra* note 42, at 46.

[77] *See* Kahn, *supra* note 75, at C15.

[78] *See* Joseph Kahn, *Consumer Groups Seek Ethics Inquiry on Rubin's New Job*, N.Y. Times, Nov. 18, 1999, at C17.

[79] *See* John W. Moscow, Op-Ed, *Bigger Banks, Bigger Problems*, N.Y. Times, June 28, 1995, at A19 (warning that "what we do not have is an agency capable of overseeing the monster companies that would follow the repeal of Glass-Steagall"); Peter Truell, *New York Fed Official Resigns Over Article in The Times*, N.Y. Times, July 21, 1995, at B6. Those in favor of deregulation, such as Charles Calomiris and David Leonhardt, claim that the gutting of Glass-Steagall has allowed large financial firms to merge and come to each other's rescue, and thereby to act as stabilizers when the financial system went into crisis in 2008. Charles W. Calomiris, Op-Ed., *Most Pundits are Wrong About the Bubble*, Wall St. J., Oct. 18, 2008, at A13; David Leonhardt, *Washington's Invisible Hand*, N.Y. Times, Sept. 28, 2008, § MM (Magazine), at 32. But it was the Federal Reserve and the federal taxpayer that ultimately had to come to the rescue of even these financial behemoths.

The revolving door is now sometimes less visible than in the past, as former regulatory officials, former members of Congress, and even former presidents have begun moving seamlessly into unregistered and unregulated hedge funds, either managing such funds or simply parking their financial holdings there. For instance, when the Long-Term Capital Management (LTCM) hedge fund suddenly melted down in October 1998, it was revealed that a former vice chairman of the Federal Reserve Board was among its top partners.[80] Likewise, Larry Summers was a managing director for D.E. Shaw & Co., one of the nation's largest and most successful hedge funds, before becoming a top economic advisor to President Obama.[81] Perhaps it should not be a surprise that the Obama administration's attempt to revamp TARP has produced a murky plan to spend as much as two trillion dollars to guarantee purchases by hedge funds of unmarketable mortgage-backed assets from the nation's largest financial institutions, with the prices set by the hedge funds themselves.[82]

Rubin and other policymakers with Wall Street ties also played a significant role in the deregulation of derivatives, those complex financial instruments whose values are derived from other underlying assets or indices.[83] Throughout the 1990s, there were periodic calls for extending capital requirements to derivatives, but these attempts were stymied by Greenspan, Rubin, and Summers,[84] and in his final weeks in office, Bill Clinton signed into law the Commodity Futures Modernization Act of 2000, which shielded the market for derivatives from federal regulation. Rubin has since denied wrongdoing, claiming that he supported regulating derivatives but saw no way of doing so since all the forces in the industry were arrayed against it. But Michael Greenberger, who was a senior director at the Commodity Futures Trading Commission (CFTC) at the time, has argued that the political climate would have been different had Rubin, the Treasury secretary, called for regulation.[85]

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[80] *See* Judith H. Dobrzynski, *the Markets Are Back. But More Problems Await*, N.Y. TIMES, Oct. 14, 2001, at C1 (noting that former Fed vice chairman David W. Mullins, Jr. was among Long-Term Capital Management's partners).

[81] *See* Eamon Javers, *Summers Has Ties to Prominent Hedge Fund*, POLITICO, Nov. 28, 2008, http://www.politico.com/news/stories/1108/15995.html.

[82] *See* Krishna Guha & Alan Beattie, *$2,000bn Financial Clean-Up*, FIN. TIMES, Feb. 11, 2009, at 1 (reporting plan to create Public Private Investment Fund to buy up to $1 trillion of toxic assets "at prices established by private co-investors"); Edmund L. Andrews, Eric Dash, & Graham Bowley, *Toxic Asset Plan Foresees Big Subsidies for Investors*, N.Y. TIMES, Mar. 21, 2009, at A1.

[83] On the danger of derivatives generally, see BBC News, Buffett Warns on Investment 'Time Bomb', Mar. 4, 2003, http://news.bbc.co.uk/1/hi/business/2817995.stm (containing Warren Buffett's description of derivatives as "financial weapons of mass destruction").

[84] *See* Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A1 (reporting how Greenspan, Rubin, and Summers undermined the efforts of Brooksley Born, head of the Commodity Futures Trading Commission (CFTC), when she sounded the alarm about unregulated derivatives in 1997 and again after the meltdown of Long-Term Capital Management).

[85] *See id.*

Without margin or capital requirements on derivatives, these complex instruments have grown in size and become gigantic wagers on the credit-worthiness of major companies and the movement of interest rates, commodity prices, and currency values.[86] Today the notional amount (face value) of the credit default swap (CDS) market is roughly forty-five trillion dollars—about half the total U.S. household wealth; five times the national debt; and more than three times the U.S. gross national product, the total sum of all goods and services produced annually in the United States.[87] The notional amount of interest rate derivatives and exchange rate derivatives is even more mind-boggling, at more than $500 trillion and growing, approaching the disturbing milestone of one quadrillion dollars.[88] These speculative bets have indeed become the tail wagging the dog. As Keynes famously wrote in *The General Theory:*

> Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirl-pool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.[89]

Unfortunately, it is not possible to conclude with any certainty that "but for" any particular regulatory reform the current financial crisis could have been averted. However, it is likely that a coordinated regulatory scheme in accordance with the economics of Keynes and Lerner would have provided substantial protection to the stability of the financial system. But perhaps it should not be a surprise that, instead of an economics of control, we now have an economy out of control. The officials who have been responsible for designing our financial regulatory system are so often only a revolving door away from reaping the rewards of unregulated speculation.

V. The Bastard Keynesianism of the Bailout

The British economist Joan Robinson, who worked with Keynes, first coined the term Bastard Keynesianism to refer to a narrow interpretation of Keynes's *General Theory* that ignores the larger Keynesian regulatory framework and reduces Keynesian principles to an embrace of short-run

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[86] In the 1990s, as chair of the House Banking Committee, the late Henry B. Gonzalez had warned that the Federal Reserve was creating a giant casino economy supported by a "monstrous bubble." Canova, *supra* note 42, at 41.

[87] *See* George Soros, Op-Ed., *The False Belief at the Heart of the Financial Turmoil,* Fin. Times, Apr. 3, 2008, at 15.

[88] *See* Paul B. Farrell, *Derivatives the New 'Ticking Bomb': Buffett and Gross Warn: $516 Trillion Bubble Is a Disaster Waiting to Happen,* Market Watch, Mar. 10, 2008, *available at* http://www.marketwatch.com/story/derivatives-are-the-new-ticking-time-bomb.

[89] Keynes, *supra* note 3, at 159.

countercyclical stabilization through monetary and fiscal stimulus.[90] Lynn Turgeon later expanded on Robinson's description to classify those who would use Keynesian analysis to justify fiscal stimulus while departing from other important Keynesian policy goals.[91] For instance, Commercial Keynesians pursue fiscal stimulus as Keynes prescribed, but by favoring tax-cutting fiscal stimulus over public investment they often depart from such key Keynesian objectives as better income distributions. The current orthodoxy in Washington and on Wall Street resembles a Bastard Keynesian approach to financial regulation: it focuses on monetary and fiscal stimulus while missing the significance of other aspects of Keynesian analysis, most particularly its emphasis on an economics of control.[92] Perhaps it would be fair to label today's Bastard Keynesians "Wall Street Keynesians" because of their emphasis on policies that will help the financial elite rather than investing in jobs and income support for the largest sectors of the polity. The current economic recovery program, centered on the financial bailout described below, is a typical product of their approach.

A. A Bailout for Wall Street Before Main Street

The Troubled Assets Relief Program (TARP) is a prime illustration of the current uncoordinated approach to regulation. It is without clear objectives or sufficient transparency. From the beginning, the program has been administered by officials almost straight from Wall Street. Paulson chose Neel Kashkari, his former lieutenant at Goldman Sachs, to head the new Office of Financial Stability and administer the $700 billion program.[93] Similarly, Timothy Geithner moved directly from his position as head of the New York Federal Reserve Bank to Treasury secretary. He chose Mark Patterson, a top lobbyist at Goldman Sachs, to serve as his chief of staff, which required an immediate exemption from President Obama's new lobbying ethics rules.[94]

The ongoing operation of the revolving door in the Obama administration suggests that many of the problems discussed above will continue, in particular the tailoring and administration of financial regulatory policy to

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[90] *See generally* Amitava Krishna Dutt, *Joan Robinson*, in AN ENCYCLOPEDIA OF KEYNESIAN ECONOMICS 554, at 556 (Thomas Cate ed., 1997) (reporting Bastard Keynesianism as an interpretation of *The General Theory* as simply an "economics of disequlibrium" and a tendency of neoclassical economics to interpret equilibrium as the outcome of a process and its use of the mechanical concept of logical time).

[91] *See* LYNN TURGEON, BASTARD KEYNESIANISM: THE EVOLUTION OF ECONOMIC THINKING AND POLICYMAKING SINCE WORLD WAR II (1996). Turgeon also characterized those who seek fiscal stimulus based on defense spending and constructing prisons rather than creating a full-employment economy as military-Keynesians and penal-Keynesians, respectively.

[92] *See* Interview by Chris Wallace with Barack Obama, President of the United States, in Marion, Ind. (Fox News television broadcast Apr. 27, 2008), *available at* http://www.foxnews.com/story/0,2933,352785,00.html.

[93] David Cho, *Paulson Advisor to Oversee Rescue*, WASH. POST, Oct. 6, 2008, at A12.

[94] *See* T.W. Farnam, *Ethics Order Affects Aide to Geithner*, WALL ST. J., Jan. 28, 2009, at A4.

serve the narrow interests of Wall Street, rather than the public interests of Main Street. For example, within three months of Kashkari's appointment, the Congressional Oversight Panel headed by Harvard Law professor Elizabeth Warren released a report that TARP had overpaid at least $78 billion to Wall Street banks and financial institutions for stocks and other assets.[95] Meanwhile, the banks receiving TARP money continued paying large compensation packages to their executives and dividends to shareholders, including foreign shareholders.[96]

One stated objective of TARP is to get banks to lend to businesses and consumers again. But its approach is trickle down, injecting funds into banks while ignoring the deterioration of the real economy and the rising tide of mortgage foreclosures, bankruptcies, and defaults at the base of the credit pyramid.[97] In short, it is an approach that has ignored the fundamental Keynesian lessons that mass purchasing power must be maintained in the middle class by promoting high employment and an equitable distribution of income.

The disregard of Keynesian insights is replicated in the legal academy. For instance, Lucian Bebchuk has written about credit market failure simply as the result of banks' irrational lack of confidence in the lending of other banks.[98] Bebchuk's approach could marginalize rational concerns about the declining financial prospects of borrowers due to recessionary economic conditions. He assumes that there are "good projects" not being financed simply because of a somewhat technical "coordination failure" among fi-

[95] *See Regulator Says Bailout Fund is Misleading the Public*, N.Y. TIMES, Feb. 6, 2009, at B2.

[96] *See* Ben White, *What Red Ink? Wall Street Paid Hefty Bonuses*, N.Y. TIMES, Jan. 28, 2009, at A1 (reporting financial industry executive bonuses of $18.4 billion); Binyamin Appelbaum, *Banks to Continue Paying Dividends*, WASH. POST, Oct. 30, 2008, at A1 (reporting that U.S. banks receiving $163 billion in TARP funds were paying shareholders about $7 billion in the 4th quarter of 2008); William Patalon III *How Are Banks Spending Bailout Money? Anyone's Guess*, SEEKING ALPHA, Jan. 6, 2009, http://seekingalpha.com/article/113464-how-are-banks-spending-bailout-money-anyone-s-guess (citing Associate Press survey of twenty-one banks receiving at least one billion dollars in TARP funding, with the biggest banks refusing to disclose information on how the money was spent).

[97] *See* David Enrich et al., *Bank Lending Keeps Dropping*, WALL ST. J., APRIL 20, 2009, at A1, *available at* http://online.wsj.com/article/SB124019360346233883.html (concluding, according to analysis of Treasury Department data, that the biggest recipients of TARP aid made or refinanced twenty-three percent less in new loans in February 2009 than in October 2008); *Business Digest: Lending Declines at Bailed-Out Banks*, WASH. POST, June 16, 2009, at A14, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/06/15/AR2009061503066_2.html (reporting that the value of loans held by the 21 largest financial institutions receiving TARP support fell in April 2009 by 0.8 percent from the previous month, the fifth decline in six months, and that consumer lending fell one percent during the same period); Peter S. Goodman and Jack Healy, *Job Losses Push Safer Mortgages to Foreclosure*, N.Y. TIMES, May 25, 2009, at A1, *available at* http://www.nytimes.com/2009/05/25/business/economy/25foreclose.html.

[98] *See* Lucian A. Bebchuk, *Unfreezing Credit Markets*, (Jon M. Olin Ctr. for Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 622, 2008), *available at* http://papers.ssrn.com/abstract=1315436.

nancial institutions.[99] Although he supports government financing and loan guarantees for bank lending, Bebchuk's approach could prove ineffective precisely because it does nothing to firm up declining aggregate demand.

The financial bailout approaches of both the Bush and Obama administrations have suffered the same deficiencies. They have pumped trillions of dollars into failing banks and financial markets but without receiving adequate control over their operations. For instance, without any seats on the boards of these financial institutions, the federal government has lacked the ability to command or control any changes in management policies, including the payment of obligations to counterparties on derivative contracts, bonuses to executives, and dividends to shareholders.[100] TARP's shortcomings illustrate that the ideological resistance to an economics of control—the same market fundamentalist ideology that helped create the financial crisis—is now impeding recovery.

B. A Crisis in the Rule of Law

The institutional flaws of the present regulatory system are profound. As predicted by public choice theories, special interests—the financial institutions themselves—have largely captured the most important regulatory agencies, thereby ensuring that regulation will be uncoordinated and ineffective.[101] While TARP has received the lion's share of public scrutiny, a larger and more significant bailout has been proceeding off the Treasury's balance sheet, through the Federal Reserve System. Throughout 2008, the Fed stumbled from one subsidy to another, granting them first to its commercial banking constituency, then to investment banks that were not even members of the Federal Reserve System, and finally to the money markets themselves.[102]

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[99] *See* Lucian Bebchuk & Itay Goldstein, *Self-fulfilling Credit Market Freezes* (John M. Olin ctr. For Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 623, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1315462#.

[100] Contrast the U.S. bailout approach with Sweden's 1992 bank bailout. *See* Peter Thar Larsen & Chris Giles, *Self-assembly Solution*, FIN. TIMES, March 18, 2009, at 8 (quoting Arne Berggren, Sweden's finance ministry official responsible for its bank restructuring: "'We were a no-bullshit investor—we were very brutal.' The authorities also insisted on *control.* 'You take *command.* If you put in equity, you have to get into the management of the business, [otherwise] management is focused on saving the skins of the [remaining private] shareholders.'") (emphasis added).

[101] *See, e.g.*, Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983). Regulatory policy will tend to benefit coherent special interest groups at the expense of the general public. Jonathan A. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 230–32 (1986).

[102] In the fall of 2008, the Federal Reserve began using a new tool, paying banks interest on their reserves held by the Fed. In the first four months, from September 2008 to January 2009, the volume of bank reserves held by the Fed rose from $44 billion to $901 billion. Through this program, the Fed has been paying banks not to lend, a policy at odds with the needs of the U.S. economy and the stated objectives of Congress and the president, but apparently aligned with the interests of the Fed's banking constituency. *See* Robert D. Auerbach, *The Fed's Backroom Bailout Policy*, 12 CHAPMAN L. REV. (forthcoming 2009) (manuscript at 5, on file with the Harvard Law School Library).

In May 2008, former Federal Reserve chairman Paul Volcker, now an Obama economic advisor, worried out loud that the Fed's independence could be hurt by the wide variety of assets it had taken onto its balance sheet to help its banking constituency. His concern was that the Fed might be viewed "as the rescuer or supporter of a particular section of the market, [which] is not strictly a monetary function in the way it's been interpreted in the past."[103] By year's end, the Fed was outright purchasing commercial paper as well as toxic assets such as mortgage-backed securities. The Fed's balance sheet skyrocketed from around $850 billion in assets in late 2007 to more than $1.7 trillion in October 2008.[104] In March 2009, the Fed expanded its support to the long-term Treasury bond market and other securitized assets by announcing it would pump another $1.2 trillion into those markets.[105] As Volcker predicted, the perception of the Fed as working in the service of the financial services industry is increasingly accurate.

Lerner warned against monopoly exploitation. Perhaps the greatest of the monopolies is the one hidden in plain sight, the Federal Reserve itself.[106] Perhaps the time has come to consider significant institutional reform of the Federal Reserve. Over the years there have been numerous constitutional challenges to the Federal Reserve and its policy-making Federal Open Market Committee based on the private non-delegation doctrine as well as the Appointments Clause. The D.C. Circuit has dismissed each challenge on narrow procedural grounds, including lack of standing for private plaintiffs and the doctrine of equitable discretion for claims brought by congressional plaintiffs. The U.S. Supreme Court has rejected petitions for certiorari in each case.[107]

Meanwhile, the legal academy has been largely silent and therefore complicit in the enormous violation of the rule of law at the nation's central bank.[108] Conservative scholars rail against unconstitutional delegations but then ignore the most flagrant example of the Federal Reserve. Liberal scholars who purportedly care about a progressive social agenda defer to dogmatic law and economics assumptions about the wisdom of central bank independence. Arguments are routinely made that it is better to have unelected bureaucrats decide monetary policy than to trust elected officials.

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[103] Greg Ip, *Fed Balance Sheet Worries Volcker*, WALL ST. J., May 15, 2008, at A3.

[104] Posting of Phil Izzo to Wall St. J. Blogs, http://blogs.wsj.com/economics/2008/10/22/feds-balance-sheet-keeps-growing-and-growing/ (Oct. 22, 2008 15:52 EST).

[105] Neil Irwin, *Fed to Pump $1.2 Trillion Into Markets*, WASH. POST, Mar. 19, 2009, at A01.

[106] *See generally* Timothy A. Canova, *Closing the Border and Opening the Door: Mobility, Adjustment, and the Sequencing of Reform*, 5 GEO. J. L. & PUB. POL'Y 341, 403–09 (2007).

[107] *See id.* at 404.

[108] *See, e.g.*, CASS R. SUNSTEIN, THE SECOND BILL OF RIGHTS 54–55 (2004) (defending broad delegations of congressional authority to administrative agencies); Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 441 n.89 (1990) (characterizing the Federal Reserve Board as an independent agency not susceptible to capture, while ignoring the private industry ownership of the regional Federal Reserve Banks); Cass R. Sunstein, *Nondelegation Canons*, 67 U. CHI. L. REV. 315 (2000) (dismissing the nondelegation doctrine without reference to delegations to private groups).

The empirical evidence, it is asserted, shows that independent central banks ensure low inflation. But the autonomous Fed has presided over the greatest inflation of asset prices in human history, a bubble that has now gone bust.

VI. A New Economics of Control: Connecting Functional Regulation to Functional Finance

It is crucial that the proper balance of functional regulation be put in place now. As Keynes wrote in 1931, after the stock market collapse but when there still may have been time to correct course: "Modern capitalism is faced, in my belief, with the choice between finding some way to increase money values towards their former figure, or seeing widespread insolvencies and defaults and the collapse of a large part of the financial structure."[109] Between 1931 and 1933, the wrong course was chosen, as insufficient stimulus was directed toward raising either money values of assets or the income levels of debtors. As a result, the financial structure crumbled. Much the same is happening today as the portion of the financial rescue effort committed to large institutions continues to dwarf assistance for debtors, either in the form of mortgage loan modification programs or jobs programs. Without the proper regulatory system in place, there could be an intensification of financial crisis in any of a number of markets.

Because of the vital need for coordinated regulation, the intellectual resistance to the economics of control should be set aside. This resistance has always been muddled. It fails to recognize that command-and-control regulation is not necessarily a movement away from the price mechanism. According to Robert Skidelsky, Keynes himself rejected rationing and saw his framework as a defense of the price system and consumer choice.[110] It is important to remember that advocates of margin requirements have never sought to outlaw consumer choice but simply to constrain consumer choice at the margins. Without such discipline—without traffic lights, stop signs, and an occasional toll booth in the financial marketplace—those with privileged positions in the marketplace will follow their incentives to become overleveraged and to gamble with other people's money. They will continue to present a moral hazard to the marketplace as a result of their ability to benefit from bailouts and hidden subsidies.[111]

The regulatory devices of capital, margin, and reserve requirements are best seen as a way to ensure that incentives are properly aligned. In recent years, there has been a growing literature in the law and development field, popularized by Hernando de Soto, promoting the protection of property

[109] Keynes, *supra* note 9, at 177.

[110] Robert Skidelsky, John Maynard Keynes, Volume Three: Fighting for Freedom 1937–1946 67 (2000).

[111] *See generally* Melvin I. Urofsky, Op-Ed, *The Value of 'Other People's Money'*, N.Y. Times, Feb. 7, 2009, at A24 (recounting the history of the 1914 book by Louis Brandeis, *Other People's Money, and How the Bankers Use It*).

rights of investors.[112] What has been missing, in the United States more than in the developing world, has been an appreciation of the obligations of investors, beginning with the obligation to put some portion of their own capital at risk. If the present financial crisis is to be contained, and if modern capitalism is to be saved from its own excesses, the "capital" must be put back into capitalism, a project that will require coordinating anew the tools of capital, margin, and reserve requirements that helped to create financial stability in the decades after World War II. During World War II, the federal government spent twice as much as today, as a percentage of GDP, and the Federal Reserve kept interest rates at near zero to facilitate such public sector efforts. But such low interest rates did not spill over into speculation in asset markets such as the stock market or housing precisely because margin requirements steered credit away from those markets.

It should be noted that although margin and capital requirements could limit the growth of derivatives in the future, they would not address the overleveraging that already exists in these markets. For instance, while news of the American Insurance Group's (A.I.G.) payment of $165 million in executive bonuses received much criticism in March 2009, more troubling but less discussed were the $40 billion in taxpayer funds that A.I.G. paid out during the same period to settle its credit default swaps, mostly with large U.S. and foreign banks and unregistered hedge funds.[113] With A.I.G. still holding more than $1.6 trillion in "notional derivatives exposure," there have been estimates that taxpayers could face more than $300 billion in further losses. Some analysts have called for putting A.I.G. into Chapter 11 bankruptcy to avoid the claims of derivative counterparties, while others suggest that credit default swaps simply be declared unenforceable contracts in which counterparties lack any insurable interest in the underlying bonds.[114]

There will likely be battles in the Obama administration and Congress over issues like these. For example, those taking a more Bastard Keynesian, "regulation-light" approach seek a central clearinghouse to help settle transactions. Those who understand the necessity for an economics of control

[112] Hernando de Soto, The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else 57 (2000).

[113] *See* Mary Williams Walsh, *A.I.G. Lists Firms to Which It Paid Taxpayer Money*, N.Y. Times, March 16, 2009, at A1; Gretchen Morgenson, *Covering Foreign Institutions Further Upsets Some in U.S.*, N.Y. Times, March 18, 2009, at B1; Serena Ng, *Hedge Funds May Get AIG Cash*, Wall St. J., March 18, 2009, at A1.

[114] *See, e.g.*, Lucian Bebchuk, Op-Ed., *AIG Still Isn't Too Big to Fail*, Wall St. J., March 20, 2009, at A13 (arguing for Chapter 11 bankruptcy for AIG); Bert Ely, *Bad Rules Produce Bad Outcomes: Underlying Public Policy Causes of the U.S. Financial Crisis*, 29 Cato J., 13–14 (2009), *available at* http://www.cato.org/pubs/journal/cj29n1/cj29n1-8.pdf (arguing that credit default swaps be held unenforceable when the insured has no insurable interest in the bonds being insured).

seek a derivatives market exchange with the authority to impose capital and margin requirements on these complex financial instruments.[115]

There is some reason to believe an exchange will ultimately be adopted for credit derivatives. At first glance, this would appear to be significant because it would provide regulators with the authority to impose margin and capital requirements, thereby limiting the leverage and growth in credit default swaps. However, non-standard derivatives—the so-called exotic derivatives created by the largest financial institutions—would be exempt. As Joe Nocera points out, it was these "customized, one-of-a-kind products that generated enormous profits for institutions like A.I.G. that created them, and, in the end, generated enormous damage to the financial system."[116]

Moreover, in the economics of uncontrolled and haphazard regulation, policymakers always seem to be fighting yesterday's battles. Credit default swaps, which have been so significant in the current crisis, may be less important to future stability than other derivatives. For example, there is a danger that the nearly one trillion dollar fiscal stimulus package, along with all of the liquidity the Federal Reserve is creating and pumping into the financial system, could undermine confidence, push down the value of the dollar, and/or push up U.S. interest rates and bond yields.[117] If so, this could lead to trouble in other derivative markets, namely the markets for interest rate derivatives and exchange rate derivatives. Unfortunately, since these markets have thus far been relatively quiet compared with credit default swaps, most of the regulatory attention has focused on credit derivatives while ignoring these looming threats. This inability to anticipate and address the various threats to the stability of our financial system results from the failure to establish a coherent, coordinated approach to financial regulation.

There are other looming dangers to not returning to an economics of control. Unregulated hedge funds now exceed one trillion dollars in equity. Due to their high level of leverage, these hedge funds probably control tens of trillions of dollars of other people's money. A failure in any large hedge fund could have destabilizing ripple effects throughout the financial markets.

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[115] George Soros, billionaire hedge fund manager, has voiced fears about the unregulated market for credit default swaps. According to Soros, the prospect of cascading defaults hangs over the financial system like a sword of Damocles. He did not initially call for outlawing the market, but rather for its regulation by establishing a clearinghouse or exchange for the market, capital requirements, and strict margin requirements for all existing and future credit default swap contracts. Soros, *supra* note 87, at 15. However, more recently Soros has called for banning credit default swaps. *Soros Urges Ban on Credit default swaps*, UPI.com, June 13, 2009, http://www.upi.com/Business_News/2009/06/13/Soros-urges-ban-on-credit-default-swaps/UPI-20671244895874/ (quoting Soros as likening credit default swaps to "buying life insurance on someone else's life and owning a license to kill him").

[116] Joe Nocera, *A Financial Overhaul Plan, But Only a Hint of Roosevelt*, N.Y. TIMES, June 18, 2009, at A1, *available at* http://www.nytimes.com/2009/06/18/business/18nocera.html.

[117] For instance, when the Federal Reserve announced it would increase the size of its balance sheet by another $1.15 trillion to about $3 trillion the news triggered a plunge in bond yields and the dollar. Krishna Guha, *Fed Purchase Plan Stuns Investors*, FIN. TIMES, Mar. 19, 2009, at 1.

The need to extend margin and capital requirements to hedge funds should be apparent, but it is uncertain whether Congress and the president can muster the political will to impose regulation on such private centers of wealth, privilege, and power, which cross national borders.

The world is very different today from what it was in the 1940s. The financial marketplace is far more integrated and globalized. To protect the stability of our own financial system, we must consider multilateral ways to extend the economics of control beyond our borders, perhaps through financial transactions taxes on cross-border flows of currency and portfolio capital.[118] The task will be challenging, but in many ways it is the unfinished work of the Keynesian model and the Achilles heel of the system of global finance that Keynes helped to create just before his death.[119]

For Keynes and Lerner, central points of extending capital, margin, and reserve requirements were to tame investors' incentives to gamble while channeling credit and capital back into the public sector to be invested to meet the long-term needs of society. It was through great public sector projects that the foundations of a sustainable economy were to be achieved: full employment, more equitable distributions of wealth and income, and the maintenance of a truly free-enterprise competitive economic system.

Throughout the 1940s, when the Greatest Generation was not just winning a world war but reconstructing war-torn continents and creating an enormous middle class at home, the federal government spent and borrowed more than twice as much as it does today, as a percentage of GDP. But in the 1940s, the federal government borrowed at near-zero interest, and it borrowed mostly from domestic, rather than foreign, sources. What made this possible was a central bank that was strictly accountable to elected branches and that imposed selective credit controls to prevent inflation in asset markets and limit systematic financial risk. Today, we are in need of the same simple tools of regulation—speed bumps and traffic lights—to restore order to our markets and provide the resources needed to rebuild our economy.

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[118] *See generally* Timothy A. Canova, *Banking and Financial Reform at the Crossroads of the Neoliberal Contagion*, 14 AM. U. INT'L L. REV. 1571, 1621 (1999); Canova, *supra* note 106, at 411–12.

[119] *See* James R. Crotty, *On Keynes and Capital Flight*, 21 J. ECON. LITERATURE 59 (1983) (analyzing Keynes' proposal for an International Clearing Union and capital controls to empower nations to achieve full employment and currency stability).