A STUDY ON FINANCIAL DEREGULATION AND SUSTAINABLE ECONOMY: HOW THE HAND SHOULD REMAIN VISIBLE[*]

Aditya Rakhman[**]

Abstract

This article focuses on the trend of States that are shifting their national economic ideologies from the traditional protectionism to the latest concept of economic liberalism. The inherited ideals of protectionism is to have governments intervene in economic activity. The surge of protectionism came in the late 19th and early 20th century where States felt the need to regulate especially to restrict and protect initial investments made by private companies in sectors that play a huge role in public services, such as communications, electricity, transportation, banking, etc. This article aims to explore and

Abstrak

Artikel ini berfokus pada tren negara – negara yang perlahan mengubah ideologi ekonomi nasional mereka dari proteksionisme tradisional ke konsep terbaru ekonomi liberalisme. Warisan ide proteksionisme adalah untuk memastikan negara – negara dalam ikut campur kegiatan ekonomi di negara mereka. Semangat proteksionisme datang di akhir abad ke-19 dan awal abad ke-20 dimana negara-negara berpendapat bahwa penjagaan ketat dan perlindungan awal terhadap penanaman modal di dalam perusahaan privat terutama di bidang yang memiliki peran penting kepada pelayanan publik,

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[*] Preferred Citation Format: Rakhman, A. (2012). A Study on Financial Deregulation and Sustainable Economy: How the Hand Should Remain Visible. J.G.L.R., 1(1), 84-95.

[**] 2005; Business Law; Faculty of Law, Universitas Islam Indonesia; Yogyakarta, Indonesia.

analyze the virtues of the current trend, because deregulations do not always come from pure initiatives of a State, so imposed deregulation may exist, and the goal of this article is to test the liberal market system, so the approach used is a cost-benefit analysis. Global economic crises that happen in the current time might be a product of a ripple effect that might have been caused years far before the crisis, and this article seeks to find how regulatory existence in a State economy can prevent, or in contrary propagate an economic meltdown.

seperti pengelolaan komunikasi, pengelolaan energy listrik, pengelolaan bank, dll. Artikel ini bertujuan untuk mendalam dan menganalisis kebaikan dari tren masa kini, karena deregulasi tidak selalu datang dari inisiatif sebuah negara sendiri, sehingga deregulasi mungkin ada, dan tujuan artikel ini adalah untuk menguji sistem market liberal, sehingga pendekatan yang digunakan adalah analisis manfaat biaya. Krisis ekonomi global yang terjadi di masa ini mungkin merupakan produk dan efek turunan yang muncul bahkan bertahun-tahun sebelum krisis terjadi, dan artikel ini mencoba untuk menemukan eksistensi fungsi pengelolaan di dalam sebuah ekonomi negara yang dapat dicegah, atau sebaliknya menyebabkan adanya krisis ekonomi.

***Keywords**: international economy, financial deregulation, protectionism.*

A. Introduction

Nowadays, the world of international business and trade is as globalized as ever. The rise of international economic organizations like the WTO (World Trade Organization), IMF (International Monetary Organization), and the World Bank is a true testament that the development of international economy has shifted states from being the only solitary unit of international subject, into sharing presence with international (economic) organizations.

Pressure to open up a state's economy and liberalize its markets may come both from inside

and outside. Some states liberalize their markets due to pressure and needs of their domestic economy. The United States, Australia, and New Zealand, for example, are all members of the OECD (Organization for Economic Co-operation and Development). Originally formed as the OEEC (Organization for European Economic Co-operation) in 1948, it attempted to implement the Marshall Plan for the reconstruction of Europe post-World War II. Part of the existence of the Marshall Plan was, as stated by Alexander DeConde et al; "Most importantly, these efforts were designed to prevent the spread of international communism" (Encyclopedia of American Foreign Policy Volume 2, p.95; 2002). In the 1960s, the OEEC faced reforms to expand its membership beyond Europe, so the OECD was established. However, it still operates under the spirit of the OEEC, i.e. to promote democracy and market economy.

Mid 1997 was the deadline set by the WTO to finalize OECD members' negotiations on commitments to liberalize financial services. At the time, the highest pressures were towards South Korea and Mexico, two states in transition between developing to developed status. As members of the OECD, they assumed developed country status so they had to adhere to the liberalization.

The case for transition countries in OECD is that while the OECD obliges them to liberalize (Liberalization of Financial Services, Stephen Woolcock; 1997), sometimes their financial services markets are still underdeveloped. Consequently, domestic financial services may not be able to compete with incoming foreign financial services.

Many developing countries now arguably have no other choice but to liberalize to remain competitive in attracting and retaining both their domestic and foreign investments. In the Philippines for example, the contentious proposals for Carter Change (Constitutional reform plan in the Philippines) include amending the economically restrictive provisions of their 1987 constitution.

Some other States liberalized their markets because it is a necessary sacrifice in order to gain capital aid from outside sources. The Ghanaian Government, for ex-

ample, has agreed to undertake liberalization efforts under the SAP (Structural Adjustment Program) framework in exchange for monetary aid. Such liberalization often comes under scrutiny as although it improves the overall allocative efficiency in the services provided on the financial and foreign exchange markets, the macro benefits seem to still remain minimal. This is because most states in the category have yet to open up their markets voluntarily due to (1) differences in economic ideology, (2) the condition of their domestic economy that is deemed unprepared for liberalization, and thus regulations withstand to preserve market resilience.

Depending on the design and purpose of the organization, some organizations do pose certain power and influence on states. WTO's Dispute Settlement Body (DSB), for example, is a highly-regarded institution where the states bind themselves to its rulings and convictions. The IMF since the 1950s has also applied a prerequisite on their loans, obliging states in need of loans to reform their national economy so that it satisfies the IMF standards (Jensen, 2004). Failure to abide to the requisite may result in the termination of the loans by the IMF.

If Martin Basiang defines law as "*the body of rules or principles, prescribed by authority or established by custom which a State, community or society or the like recognizes as binding on its members*" (Contemporary Law Dictionary, 2009: 264), then it is appropriate to establish that the influences of international economic organizations like the WTO and IMF have reached a level of a key subject to international law and its developments.

Following US President Bill Clinton's administration's aggressive financial deregulation campaign in the 1990s, most globalization leaders (States voluntarily, and international economic organizations; among them IMF) started to overturn long-standing restrictions by governments that limited foreign ownership of their banks, deregulated currency exchange, and eliminated restrictions on how quickly money could be withdrawn by a foreign investor (Derber, 2002).

That shows how globalization and its products (deregulation, market liberalization, etc) is a surg-

ing trend among States, either those willingly deregulates and liberates their markets based on their own deliberation, or those that simply abide international regulations influenced by Western economic ideologies (free market).

The remainder structure of this article shall focus on financial deregulations and its merits and risks as a product of globalization, and not on the need for IMF reform on the conditionality policy.

B. Contextualizing Financial Deregulation

In a simple explanation, financial deregulation is when a government reduces its role and allows the industry greater freedom in how it operates (Soifer, 2001).

To contextualize why States currently opens up their markets, one needs to understand why markets are closed, before they were opened. The preceding part of this article has provided subtle introduction on why States before the current trend decided to regulate their economy.

Governments are given mandate by its people based on a social contract. The government is sovereign power with the ability to produce regulation in which people must abide for the general good. The government's job is to ensure that its people are well taken care of. To ensure it, the government's major role among others is to regulate the economy. It must ensure that the economy can create well distributed welfare among the people. Many states, including Indonesia (through Art. 33 of the 1945 Constitution) regulates that major economical sectors that play a major role in providing welfare to the people shall be controlled (regulated) by the State. This covers from communications, natural resource extractions, banking systems, transportation, to electricity. This is to ensure that the orientation on the provision on such services is not purely profiteering (to ensure fair distribution on all societal classes). Even state subsidy is common to ensure that vital services are affordable to all: Indonesian government subsidizes electricity, water, transportation, and oil-gas; In the US, agricultural farming is subsidized.

Regulation also restricts and limits in sectors that are vulnerable, e.g. banking industry. Before

the Great Depression, the United States hardly put any regulation on banking activities. But after the economical recession, the government started to heavily regulate the area. One of them is by The Glass-Steagall act, promoting the creation of the Federal Deposit Insurance Corporation (FDIC). It guaranteed consumer deposits up to a certain level, in case of widespread bank failures. It also prohibited banks to engage in non-banking activities, such as the securities and insurance business. Consequently, firms had to decide whether they wanted to be a savings bank, or an investment bank. The Securities Act of 1933 (popular name: Regulation Q) even obliged full disclosure on their sales of shares, increasing transparency in the primary securities market. The Banking act of 1933 capped savings account interests at 5.25%, and timed deposits at 5.75-7.75%. This was intended to limit rate wars at sky-high levels. (Sherman, 2009).

In the 1970s United States, inflation cased market interest rates to raise above the allowed limits by Regulation Q (which remained relevant when inflation was 3-4%), but interest rates raised to 10-11% (Beebe, 1988). This drove investors to seek alternatives beyond the traditional deposits. Broker and other financial institutions (investment banks included) started making market mutual funds, in which they pooled investors and provided available commercial paper as investments (commercial paper can be; shares, securities, bonds, etc). This then drove the US government to slowly take the interest rate ceiling off, a phase planned to happen in six years (Gilbert, 1986). The events after the deregulation saw the US deposits market offering packages in exuberant yield rates (rate wars). This marks the beginning of a spiral. The US then applied a policy reform that deregulated its market.

Because of its status as a superpower and its similar models of socio-political conditions, other Western countries started mirroring the US, slowly deregulating their economies to allow more investments in.

The rationale of financial deregulation is that fewer and simpler regulations will lead to raised level of market competition, therefore

increasing productivity, and providing competitive pricing overall to society.

The pattern of deregulation usually starts in the liberalization of natural resource extraction, then to privatization of essential public services (transport, communications, etc), then to liberalization of major key economic infrastructures (bank privatization, etc). Elimination to trade barriers promoted by the WTO is also a form of financial deregulation, which makes some States under the pressure of both IMF's conditionality loans, and WTO's agenda to create a free international market economy via the Doha rounds.

C. Literature Review

As stated before, financial deregulation gained momentum (especially in the United States) in the 1970s. Besides the development of trends in various economical activities, the momentum was also propagated by the immense amount of academic support. Most academic publications on economy around the 1970s underlined the need for states to liberate their economy for prosperity.

Theorists believe that history has shown that "where banking was left most free to develop in response to the demand for its services, it produced the best results" (Cameron, 1972). Another opinion added "the best the State can do with respect to money is to provide a framework of legal rules within which the people can develop the monetary institutions that suit them best" (Hayek, 1976).

Most scholars at that time believed that the government intervention halted economical growth. It was apparent in that era that economic scholars were able to convince the State that with more freedom comes faster growth, and that it within the best interest of the society as a whole. Even 20 years after the momentum of deregulation, scholars was still emphasizing that "the proper role of the government policy should be to make markets as resilient and efficient as possible. Government policy makers should get rid of the traditional bottlenecks of overregulation, over taxation, and overprotection" (Lindsay, 1993).

The movement on deregulation was partly caused by the fact

that the emerging trends of investment games have not been tested in freer economic conditions. "Under government patronage the monetary system has grown to great complexity, but so little private experimentation and selection among alternative means has ever been permitted that we still do not quite know what good money would be –or how good it could be" (Hayek, 1989).

The proponents of a globalized market may say that a more open market is better, because it creates an economic system that is more accessible, allows healthier competition, hinders monopoly by the state, and offers competitive valuation for consumers.

But to completely eliminate a system might not be the answer. As an analogy: it is common where law, and the power holding the law, is misused, but in no way that is a reason to eliminate the existence of legal system altogether—because the state still need the law to uphold. Offering reform might work, instead of deregulation altogether. If freedom of economy is something the scholars see virtuous, they might need to take consideration that giving the ability for the market to determine their own limits, their own restrictions, might not be fair to the general public. For those who actually are enjoying freer economy with the ability of taking more risk that usually allowed by governments, may probably have calculated the possible risks if a transaction go bust. But a larger part of society is part of the game without them knowing it at all.

The subprime crisis in the US in 2008 was a testament. Because of deregulations and minimum government involvement in the commercial paper trade and the mutual funds market, banks carrying the debts of millions of debtors combined all their debts, to be sold as commercial paper in the capital market. These are subprime debts—the debtors were people who in their credit rating actually were classified as risky, but because they combined other debts, the collective investment was offered to investors in the money market as AAA-rated investments, a product that is as secure as government bonds (who obviously have larger collateral). These credit packages (derivatives) were then traded in the capital market,

a trade that had the valuation of billions. The derivatives were also insured, so that people could pay insurance companies to insure that their investment is secure from any losses, such is called Credit Default Swaps (CDS). The imminent danger of such trade is that they were collective debts from debtors that do not have a good credit rating track record. The moment credits stall, the securities become worthless, and therefore toxic.

This could happen because of the absence of the ceiling investment regulation. The government did not prohibit securities and their insurance scheme. It did not regulate or supervise the credit rating agencies responsible to publish the fake credit valuations. When the system got out of control, the liquidity of the government was sacrificed to save the economy. That liquidity mostly belonged to taxpayers, who mostly did not or profited from such trade.

President Barack Obama introduced a series of regulatory proposals in June 2009. The proposals cover consumer protection, regulation on banking and derivatives system, and enhanced authority for the Federal Reserve (among others) (Treasury Department Report, 2009). Francis Fukuyama argued that this marked the downfall of Reagan economy.

Iceland before the 2000s was an ideal sort of state. They had clean energy, fisheries that were harvested with a quota system, low unemployment, low government debt, and low crime levels. Things started to change when the Icelandic government decided to allow private extractive companies to extract their natural resources. Not only did this triggered negative environmental effect due to excessive extraction, this also led the government to privatize three of Iceland's biggest banks (Mason, 2008). Because the three biggest banks are now private, they are not bound to the monetary regulations that the government impose to protect the economy. They directly took huge loans from foreign institution, creating a new wave of wealthy businessmen who continuously took loans from the banks to invest abroad, outside of Iceland. In the absence of government regulation, they were able to continuously expand their business by using lent money.

The banking system also set up a mutual money market, in which they attracted individual investors to invest in commercial paper. This meant that the banks and borrowers sold a promissory note simply to repay the note they sold previously. Such scheme is fake investment operation that pays returns to its previous investors from money paid by current investors, rather than from the profit earned by running the allegedly running operations. This scheme is famously know since the 1920s as the Ponzi scheme (Sarah, 2010). The scheme ran so well in Iceland (dubbed emerging economy) that at the start of the crisis, households took on a large among of the debt, equivalent to more than 213% of disposable income (average total personal income minus taxes), which led to inflation (The Economist, 2008) [1].

The Icelandic crisis began to unfold as the banks were unable to refinance their debts. It was estimated that the three major banks were holding foreign debt in excess of 50 billion euro (Central Bank of Iceland, 2008), while Iceland's Gross Domestic Product (GDP) of only 8.5 million euro (Statistics Iceland, 2008).

Such economic catastrophe, as mirrored similarly with the US Subprime crisis, has brought sever economic downfall for both countries. In October 2008, the Icelandic parliament passed an emergency legislation to minimize the impact of the financial crisis. The Financial Supervisory Authority of Iceland used permission granted by the emergency legislation to take over domestic operations of those banks (E24, 2008)[2].

D. Investigating Patterns of Toxic Economy Caused by Deregulation

There is a reason why laws exist. They function to put order in society. They are in the forms of limitations, and they are restrictive in nature. But that's how legal systems are supposed to be.

The laws regulating economical activity should not be any different. Legal systems always thrive to make sure that any economical activity is done in a manner in

[1] The Economist, 9 October 2008.

[2] Gud velsigne Island! (Finankrisen, Makro og politikk, Utenriks)". E24, no. 6 October 2008.

which it does not possess latent potential for economical catastrophe. The government's interest in regulating the economy is as much as it is about growth, as it is about making sure the economic system is not about to fall.

Scholars in the 1970s might have been exuberantly supportive of deregulation, but it seemed to only orientate in the velocity of economic growth. And recent cases of US Subprime loans and Iceland's massive deregulation shows that there might be more to economy than just growing: it's also about being able to keep standing at all in the first place.

E. Conclusion

In comparison to popular theorists and their opinions in the 1970s, it was obvious that deregulations pose huge risks for state economies. It's undeniable that in an emerging economy, to free up and open markets would bring significant rapid growth for the economy.

But now, as history shows, that such rapidity may cause economies to overheat and eventually melt. Economic growth must always be supported by proportional infrastructure and distribution, and one of the ways that a State can ensure that their economy is growing at a proper speed is by regulating.

Imposing ceilings for bank interests and regulating the volume of transactions in the securities market is a necessary and urgent reform. Most governments do not regulate the volume of trade in their capital markets.

Vital economic structures must always be in the hands of the government, or at least the government still maintains key role in regulating. The banking system is a vulnerable system that may overheat due to fear, paranoia and speculations, therefore governments should keep a close eye on the banking system.

In conclusion, there is a need to emphasize that deregulation and market liberalization do pose imminent threat, if done in quick succession under a short amount of time. Free economies do not mean that the hands of the government should be invisible at all, because how an economy develops determines how sustainable it is in the long run.

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