THE THIRD MILLENNIUM CRISIS AND THE LAW

Author: Bogdan Olteanu – Candidate for a Doctor's Degree Iasi Al. I. Cuza University, Faculty of Law

Law, Crisis, Economy, Justice

The present paper has as purpose to present the role of the law in the context of the present economical crisis, the importance of regulations in order to avoid and attenuate the effects of the crisis. The paper begins with a succinct presentation of the crises which marked the last century, their classification from the generating elements point of view in order to point out the importance of the regulation for the proper functioning of the market. The paper continues with the analysis of the theories which governed the manner in which the economical and financial operations were carried out on the market and the way in which the actual crisis marks the beginning of this millennium, by emphasizing the role and importance of the law.

1. Introduction

The beginning of the third millennium is marked by a strong and profound crisis which extended its effects at world level. The analysis of those effects upon the markets in the entire world shows the fact that the implications of this crisis at economical and financial level are long term implications.

Its importance, profoundness and its spreading area lead to the idea that this crisis at the beginning of the third millennium is different from the others that marked the last century. The theories that led and imposed the action directing lines in the world economy for tens of years regarding the economical freedom, free markets, economical transparency, the Law and State role for the good work of the economy are now refuted or confirmed by the new economical realities and the role of the State and the importance of the law and of the regulation are again important subjects for debates.

Alan Greenspan, FED President between 1987 and 2006 affirms presently the fact that "the present system was based on false suppositions that the markets can independently regain their equilibrium and the systems can auto-correct." However the present shows us that "we need international regulations in order to control the international markets."

If it is true that the economical freedom and the enterprising spirit are based on the free markets would be incorrect to affirm that the free markets are synonymous with the unregulated markets, with the disappearance of the public sectors and the public policies. The economies and the modern societies need regulations and economical policies so that the economical and financial operations should carry on under the best conditions, the goods should be properly supplied and the negative aspects should be prevented and limited.

The present crisis is based on a sub-regulated financial system. What the present crisis should point out for everybody is the fact that the regulations are necessary because the market cannot regulate itself.

Although the regulation concept is defined in different ways, it is nothing but the result of the promulgation activity centred on establishing the rules, their infringement being sanctioned by the Courts of Law. Within the present context, the law as regulation factor, as well as the activity of the courts of law have a very important role in the administration manner and in removing the effects of the crisis.

2. The Lack of Regulations – an important cause of the crisis

The causes of the crises are multiple nowadays and they have made the object of many studies and classifications. The lack of the regulation is considered as one of the important elements generating the economical and financial crises. An inadequate regulation or even the lack of it can generate the instability of the prices, their exaggerated and unjustified bulge, the increase of the bank system vulnerability, real estates markets collapse.

The last century and the crises that marked it should have been taken into consideration when assessing the necessity of a regulation, the law and the role of the State and the justice in the good work of the economical and financial operations.

The USA crisis in 1907 – "*the 1907 Bankers' Panic*"- was generated by the collapse of the bank system, which on the recession background existing at the time, confronted with massive withdrawals of money, with bankruptcies and a severe decrease of the confidence in banks. At that time, there was no "official" institution which could guarantee the deposits or inject liquidities in the economy. The Dow Jones (DJIA) stock index collapsed in March, followed by another severe decrease in October, moment in which the USA Treasury together with the JP Morgan bank provided the liquidity necessary to the bank system. The confidence was restored in February 1908.

The LTCM crisis in 1998 imposed the adoption of a report by the President of the Financial Markets and the Work Groups regarding the importance of the regulations on the market discipline that should limit the excessive risks. The black Monday, October 19, 1987, is known as the day with the greatest decreases in the history. In 1986 the USA economy began to fail, however DJSI reached it maximum point in August 1987, 44% higher than at the end of 1986. At October 19, the stocks collapsed and the DJSI decreased by 22.6%; in only one day the companies lost 500 billiards USD of the capitalization. The applied anti-crisis measures were the introduction of regulations regarding the possible temporary interruption of all the commercial operations.

The Great inter-war Depression of 1929-1933 was caused by the great increase of the investors' number, the policy of the easily granted loans, the increase of the saving rate, supra-production generated by the investments and reinvestments of the companies, the lack of regulations regarding the stock activity. At that time, the legal background was an extremely permissive one and therefore, the companies increased their share capital many times, by issuing new shares which were sold to the investors. The lack of regulations regarding the restrictions and the limits of the economical and financial operations led to an explosion of the warranties prices, a bitter competition between the banks increasing their vulnerability and leading to a sudden fall of the real estate market and the personal values market.

The transactions exploded: the investors, convinced that the ascending trend will continue, were purchasing shares in margin (paying only a fraction of the value), selling them after a few months at a higher price and gaining the difference, which led to a huge pyramidal game and most of the money invested at the stock actually did not exist.

The Great Depression pointed out the role of the regulation for the good work of the markets, of the economical and financial operations.

Among the adopted measures which contributed to the attenuation and removal of the crisis effects was also a careful regulation of the financial markets by creating the Security and Exchange and Deposits Insurance Fund Commission and a separation of the bank activities regulated by the Glass Steagall Act. The elaborators of the Act were convinced that the banks had an important role in promoting unjustified increases on the real estate and financial markets. The Glass Steagall Act imposed restrictions to the bank operations regarding the acceptance of the deposits, extending their term, credits granting and bank investments.

The liberalization which later on removed the previously mentioned restrictions showed the world that the bank and financial system needs regulations in order to avoid the risks and the vulnerabilities which led to the crises of the last century and to the present world crisis. More important than adopting post crisis regulations is maintaining them in force even when the effects of the economical and financial crises disappear from the collective memory.

3. The Economical Theories and the Regulated Market

The crises of the last century, as well as the present crisis, were preceded or followed by the fall or the confirmation of the theories regarding the operation, functioning and regulation manner of the markets.

"The markets regulate themselves" theory is one of the main theories of the economy according to which the prices vary as a result of the equilibrium between demand and offer. According to this idea, a correct price is formed without an outside intervention, the markets having the capacity to auto-regulate, without the state intervention or ensuring regulations being required, the latter being even inadequate for the proper work of the economical and financial operations.

The economical crises presented above, as well as the present crisis which marks this beginning of millennium demonstrated the contrary: the State and the companies do not afford to let the economy to auto-regulate.

The *"invisible hand of the market"* theory, another important theory regarding the market operation manner, specified that the individuals, in their attempt to ensure individual welfare, contribute to the social welfare, without an outside intervention being required in this respect. Illustrated by the economist Adam Smith in the paper “Nations’ Wealth”, it is used in order to describe the natural force guiding the free capitalism on the market by means of the competition.

According to it, on a free market, by aiming their own interest, the individuals indirectly stimulate the economy. Smith finds that in case of the capitalist societies aiming one’s own interest contributes to the good of the society. He also says that the interaction of the actors on the market leads to the maximization of their welfare, because in this way each participant tries to improve oneself.

He also said that there should not be regulations on a free market in order to be able to provide beneficent mutual exchange of assets and services, if the invisible hand guides the actors on the market.

The present situation illustrated that exactly the attempt of the companies and of the other actors on the markets to obtain greater and greater benefits, the ambition and the greed prejudiced the society, now paying for their mistakes.

The “*State Interventionism”* theory, recalled by J. M. Keynes in the 30’s has as main idea the fact that the governments should use fiscal and money measures in order to temper the negative effects of the economical and financial crises.

Although not long ago there existed the belief that the State should not be involved in the functioning of the economical and financial operations, starting from the last fall, when the collapse of the Lehman Brothers bank generated a true shock on the markets, it became the most important player in the economy.

As a result of these theories, as well as of the past or present crises, there should be made a clear distinction between the free markets and the unregulated ones. This distinction does not exist for many persons; they mistake the economical liberalism with the lack of any regulations which should provide the stability and the proper functioning of the markets. The regulated markets are free markets as well, but markets where norms and rules try to promote the transparency, the fair-play, by avoiding the conflicts of interests and the abuse of the dominant position on the market. Some people argument in favour of eliminating the regulations, which can turn against the proper functioning of the markets. The USA crisis from 1907, the LTCM fall, the Great Depression, they only emphasize the importance of the law and of the regulation regarding the economical and financial operations.

When the markets are entirely free to self-regulate, to self-govern, the collateral damages can be huge and there can be generated strong relations, which could question the spirit of free market economy itself. The evolution of the modern capitalism should be done in parallel with the development of an adequate system and founded on regulations.

The regulations influence the performance from economic point of view. There can be asserted that the more regulated an economy is, the more tempted the agents in the underground economic sector are. There can be also affirmed that only by means of a structure and the best regulation level of the economy, it is possible the maximization of the welfare of the society. The supra-regulation, as well as the sub-regulation result in an inferior configuration of the economic system as far as the welfare of the society is concerned. The supra-regulation is equivalent with an expansion of the underground economy. The sub-regulated system, in exchange, can lead to an official expansion of damaging activities from social point of view.

The free markets are not unregulated markets. The inevitable consequence of the strong deficit of regulations is the poor functioning of the markets, with strong negative effects for most of the participants to the economic game.

4. Causes of the Present Crisis

The present crisis began from a measure suggested by Alan Greenspan, the former president of the Federal Reserve which involved nothing but the de-regularization of derived financial instruments. Besides this measure, he also fought vehemently against Commodity Futures Trading Commission, directed by Brooksley E. Born, when he tried to impose limitations in this respect.

In the article titled “What went wrong”, Anthony Faiola, Ellen Nakashima and Jill Drew emphasize again Greenspan’s and his libertarianism damaging influence in the beginning of the nowadays global economical crisis:

“In private meetings and public discourses, Greespan also militated for a liberalized vision of the market. The auto-regulation, he concluded, would function better than the heavy hand of the government. The investors have a natural wish to avoid self-destruction and this serves as the most logical and the best limit for the excessive risk. Besides, the derivates became a huge activity in USA and the overwhelming rules would have the opposite effect.”

Alan Greenspan himself admitted his fault, confessing to be astonished before the helplessness of the unregulated market. He stated that he was shocked by the collapse of the USA credit markets and he admitted the he was partially wrong regarding the total rejection of any regulations.

Therefore, we noticed that the global proportions economical disaster that we all experience presently is the result of the idea that the rejection of any type of regulations whatsoever cannot have negative effects, as the market is capable to regulate and govern itself.

From the ashes of the economical theories: the market auto-regulation and the invisible hand theory, taken down by the severe recession affecting the world economy, the state interventionism theory, launched after the First World War by John Maynard Keynes and put into practice during the Great Depression in the 30’s is reborn.

The causes generating the present crisis are multiple and they acted interdependently. Among the most important we can mention:

- A dramatic accentuation of the capital markets role in the financial intermediation process;
- An increase in using new financial instruments which spread new risks at world level, but which led to the reduction of the markets transparency;

- The reduction of the market transparency generated an accentuation of the risk;

- The globalization pressure and the increase of the trans-frontier operations;

- And especially, inadequate or obsolete regulations, the absence and the failure of efficient control systems;

George Soros, one of the most famous financial speculators, referring to the present world crisis said that “it does not resemble to the previous crises, but it marks the end of an era.” Not long ago the markets were capable to auto-regulate or at least the great names, such as Alan Greenspan, asserted so.

It is stated that the market possesses the capacity to auto-regulate as long as there is trust, and in the moment when it is damaged by the state interventions, the markets become hypersensitive and unstable.

Referring to the present crisis and the way in which it must be solved, Alan Greenspan confessed that “the State should intervene, should offer guaranties to the financial institutions and rise the level of the government expenses”, adding that he sustained the anti-crisis measures adopted for this purpose by the United States administration.

The State, not long ago considered as unnecessary to the economical and financial system, now returns to the forefront. Right before the debut of the crisis, the State did not enjoy too much social credit. The marginalization and blaming the state became a compulsory exercise for the economists and a subject in fashion for politicians. It was seen from the perspective of a poor relative who had to be satisfied with what was left from the business men table, also called taxes. Now he is the one saving the companies, which not long ago looked down on it, from collapse. The State has now a series of responsibilities on its shoulders, speculating its responsibility for the public good.

Joseph Stiglitz, a Nobel Prize Laureate in Economics in 2001 and a teacher of Economic Sciences at Columbia University USA summarizes the explanation in only one paragraph in his article of January 2009 symbolically titled “Capitalist Fools”.
“The truth is that most of the mistakes are finally reduced to only one: the belief that the markets auto-regulate and the role of the State should be minimum. Looking back at this belief, Alan Greenspan exclaimed – I discovered a mistake.” The Congressman, Henry Waxman provoked him by replying: “In other words, you have discovered that your vision upon the world, your ideology was not correct, did not function. “Exactly”, Greenspan replied. America and most of the world embracing this erroneous economic philosophy made inevitable the situation we are in at this moment.”

5. The Law and Justice Role during Crisis

As we pointed out in the previous sections, it is historically demonstrated that the absence of the law as regulation method in sectors such as the bank or the financial one, represent one of the main causes for the economical crises.

The present crisis which marks this beginning of millennium and which produces effects at world level has led to a strong abandon of what until present was considered to be the *bible* of the functioning method of the economical and financial markets. Just as during the Great Depression, the states began to deny the rules governing the free market even since 1980.

Presently there are suggested several strategies to act against the world crisis in order to ensure the financial stability such as: improving the transparency of the economic operations, the efficient settlement of the conflicts between participants and especially an efficient regulation of the background for carrying on the economical operations and for the financial activity supervision method.

The new regulations should provide an efficient cooperation between the bank system and the one of the capital markets, which should be considered as a whole, a careful and coordinated supervision of the bank and financial operations, a normal activity of the markets specific for the new financial instruments, bank deposits insurance, risks control procedures.

The regulation role is very important in ensuring the efficiency of any anti-crisis measure, but, as we have already affirmed, the new regulations should also survive in the context of the economical stability, when the crisis and its effects shall have disappeared from the collective conscience.

Thus, the role of the law, of the regulation should be recognized as not only for removing the effects of the economical and financial crises, but also an essential one for the economic development and evolution.

The present crisis is regarded as an opportunity for improving the regulation and the supervision method. Thus, OECD affirms that this financial crisis pointed out the necessity to strengthen the regulation of the financial and economical regulation, without falling into the temptation of establishing a conservatory system.

Besides the new regulations that should be adopted in order to provide a beneficent economic climate under optimum conditions, the role of the justice is huge in maintaining and respecting the present normative acts regarding the safety and the good work of the economical and financial relations. During crisis the intensification in the disturbances of the commercial relations, the financial problems experienced by certain participants on the market, the bankruptcy suffered by important economical agents generate chain reactions, jeopardising the development of the commerce under proper conditions. The debts become pressing, the economical infringements can increase the attempt to avoid the existing norms. In this context, the role of the justice is very important in sanctioning, preventing and removing such phenomena, which could deepen the effects of the crisis.

The role of the justice, together with the necessity of a coherent and more especially adequate regulation should be recognized within the present context, the increase of all the matters, at economical, financial, bank, salary level. That is why, the functioning of the justice should be ensured at the best level, by guarantying the impartiality, the freedom and the responsibility of the act of justice at the same time, an act of justice with an importance that should be recognized and maintained.

In the context of the present crisis that marks this beginning of millennium, the law, the regulation, and the justice have regained their important role in maintaining the world economical and financial health. This aspect is recognized by the leaders of the great powers gathered at the G20 Summit in order to adopt the necessary measures for the stabilization of the financial markets, reforming and strengthening the economical system. Thus, Gordon Brown at the end of the G20 Summit in London April 2009 pointed out the necessity to reform the international financial institutions in order to surpass the present crisis and to prevent the future ones. The conclusion of the Summit was the necessity to strengthen the regulation and the supervision, promoting the integrity and the transparency as guardians against the risk in the financial system.

The present world crisis reminded the importance of the law and of the justice in the good work of the economy, of the financial and bank operations. The time and the evolution of the markets will demonstrate if the collective memory will retain the permanent necessity of the regulations or if other future crises will bring on these aspects.

Bibliography:

1. Ioannis Glinavos- “Regulation and the Role of Law in Economic Crisis”- A paper presented at Advanced Legal Studies Institute WH Hart Workshop;
2. Daniel Daianu - „The Capitalism. Where to? The economical crisis, ideas course, institutions” – Polirom Publishing House, 2009;
3. Joseph Stiglitz –“Capitalist Fools” http://www.globalresearch.ca/index.php?context=va&aid=11356
4. G20 Summit of London of April 2009 http://www.londonsummit.gov.uk/en/summit-aims/timeline-events/summit-outcomes