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*Reimagining Social Control for the 21<sup>st</sup> Century*

*“How to guide the economy towards socially desirable directions? Some institutional lessons from the 2007 financial turmoil”*

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## **Abstract**

This article maintains that capitalist market economies have a threefold composite characteristic (the central role of money and financial relations, the crucial role of institutional patterns, and the macro nature of stability and viability concerns) that makes social control a consistent way of designing an efficient macro environment. Institutional economics precisely relies on such a triptych and reveals to be an appropriate theoretical and practical reference to deal with today's major economic issues such as the 2007-08 systemic crisis. Therefore the article suggests an institutional analysis that points to the role of institutional-regulatory framework and the rationale of social control principles in the stabilization of the working of capitalist finance. It then advocates for an alternative organization of the banking and financial system in order to ensure systemic sustainability and to guide the economy towards socially efficient directions.

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## **How to guide the economy towards socially desirable directions? Some institutional lessons from the 2007 financial turmoil**

While keen debates and impassioned doctrinal oppositions are ongoing, there is no doubt that the current crisis and its domino effects have shaken the core beliefs and principles of liberal finance. It is then not surprising that numerous works bring these principles into question and search for answers to myriad concerns surrounding the ongoing turmoil.

From this perspective, this article studies three characteristics of capitalist market economies (the central role of money/finance, the crucial role of institutional patterns, and the macro nature of stability/viability concerns) that shed light on crucial links between the institutional/regulatory frame of the economy and the occurrence of crises and make social control appropriate to create an efficient environment for systemic performance. It then argues that Institutional economics is relevant to deal with today's major economic issues since it precisely relies on such an analysis. In this aim and without covering a plethora of issues the article focuses on the role of the institutional environment and the relevance of social control principles-based regulatory framework. It then advocates for institutional modifications in financial regulation and for macro-regulatory control mechanisms to reach social consistency by preventing speculative activities and directing markets towards socially efficient activities.

### ***Monetary and institutional characteristics of capitalist market economies***

A stern opposition between two conceptual directions dominates theoretical and policy researches in the domain of economic and financial (in)stability. The *individual ascendancy* approach (methodological individualism) maintains that a consistent society can be framed on selfish individual actions and then institutions must promote laissez-faire. That underlies the rise of Chicago-style decentralized regulatory mechanisms from the 1980s onwards which mark the decisive ascendancy of liberal finance over social control principles. The *social*

*ascendency-holistic* approach studies the meaning of social influence (convention, public opinion and the like, i.e. unintended informal social domination), and social control (intended social domination framing society's evolution) and refers to societal and political mechanisms that regulate actors' behavior to gain compliance with the rules of a given society. In both approaches, the issue is to state relevant principles to organize a society and improve its stability/viability conditions<sup>1</sup> in time. While such an issue -well developed in sociology and psychology- has not been studied in depth in modern economic theory, major economic problems obviously rest on the same opposition: controlled/supervised society versus individual-choice oriented society.

However, six years after the rise of the crisis, it is worth noting that the limits of massive rescue policies to cure the current disarray and to insure a welfare creating growth show that socio-economic stability cannot be reached through free market mechanisms and calls for institutions able to guide individual decisions/actions through consistent objectives. The systemic nature of the current crisis casts doubt about the ability of liberal capitalist finance<sup>2</sup> to ensure social efficiency. So, the main characteristics of capitalist market economies require the organization and implementation of a system-consistent economic environment to be framed through collective objectives/constraints and then make social control relevant to improve social efficiency for economic sustainability. Institutional economics precisely appears to be an appropriate approach to deal with today's major economic issues since it relies on the threefold characteristics of capitalist market economies which are:

-Monetary economies in which financial relations (rules, mechanisms and markets) play a central role;

-Complex societies requiring specific institutions. Their evolution relies on the consistency of institutional patterns that shape (private/public) actors' behavior and then determine systemic stability/viability;

-Those conditions are mainly macro concerns and cannot rest on private objectives-related micro-regulatory mechanisms. Institutional analysis puts indeed the emphasis on the crucial importance of monetary and financial relations (Mitchell 1916; Veblen 1919)<sup>3</sup>, of institutions and institutional change in shaping economic evolution (Hamilton 1919; Commons 1931) and systemic stability/viability through collective (macro) mechanisms (Clark 1919)<sup>4</sup>.

Institutions can be defined as “systems of established and prevalent social rules that structure social interactions” (Hodgson 2006) in order to make them globally compatible with the survival of a given society. They are “central to economic structure as they both constraint and mold human behavior” (Rutherford 2010, 49). Their design intends to make relations among people sustainable in order to allow the society to evolve in a coherent way<sup>5</sup>. Veblen ([1899] 1915, 188) maintains that institutions are also efficient factors of selection: “So that the changing institutions in their turn make for a further selection of individuals endowed with the fittest temperament and a further adaptation of individual temperament and habits to the changing environment through the formation of new institutions”.

Institutions make ordered decision and action possible by framing human activities in a consistent way, the “complex of institutions which make up the economic order” (Hamilton 1919, 315)<sup>6</sup>. Thus their durability matters as they allow actors to have stable expectations of the behavior of the others by offering a continuum of choices and social relations (North 2003). They then act “not merely as constraints on the behavior of individuals and concerns but as factors shaping the beliefs, values, and preferences of individuals” (Rutherford 2009).

Also from the perspective of improving systemic performance of the economy (Hall and Soskice 2001; Kenworthy 2006), the search for innovative/alternative institutional forms to frame and to guide the economy in socially desirable directions seems to be of utmost importance. Such a research agenda is obviously related to the issue of social control as this

latter means the design and control of institutions in the interest and welfare of the whole society.

### ***Social control and collective viability***

In its strict definition, social control is related to social order to be implemented in a complex society: “It is in the composite society, then where the need of control is most imperative and unremitting, that the various instruments of regulation receive their highest form and finish. Here has been perfected the technique of almost every kind of control” (Ross 1901, 57). Ross also argues that when one deals with the idea of society –*as a something distinct from a bunch of persons* but as a living thing actuated by the instinct of self-preservation-, social control appears “as one of the ways in which this living thing seeks to keep itself alive and well” (Ibid, 67). This relies on the idea of social order resting on different branches of regulation according to a “social ego” which emerges in the degree to which collective opinion is elaborated and organized (Ibid, 74).

Institutional economics is closely related to the problem of control as it is closely related to some systemic issues such as social adjustment process, welfare enhancing policies, etc. As noticed by Rutherford (2010, 49) social control was a central idea in the formation of Institutional economics in the interwar period and understood as the *intelligent guidance* of the functioning of the economic order (Mitchell [1937] 1950). Claiming that economic theory should be relevant to the modern problem of control, Hamilton (1919, 313) states that “A shift in problems and a general demand for control has made institutional economics relevant. This shift has been due partly (...) to the bad taste which laissez faire has left with us”.

In a similar way, J. Commons (1931, 648) argues that: “Sometimes anything that is “dynamic” instead of “static”, or a “process” instead of commodities, or activity instead of feelings, or mass action instead of individual action, or management instead of equilibrium, or control instead of laissez faire, seems to be institutional economics”. Commons then defines

an institution “as collective action in control, liberation and expansion of individual action” (Ibid, 649). Thus the “collective action of control” is directed towards the establishment of some rules and mechanisms expected to be suitable to give individuals stable means of action respecting duties and credits of everyone enforced collectively. That is a positive perception of social control as regards the individual action: “(...) collective action is more than control and liberation of individual action –it is *expansion* of the will of the individual far beyond what he can do by his own puny acts. The head of a great corporation gives orders whose obedience, enforced by collective action, executes his will at the ends of the earth. Thus an institution is collective action in control, liberation and expansion of individual action” (Ibid, 651)<sup>7</sup>. The rationale for this approach is the assertion that market mechanisms are not panacea for social development and it may be suitable to anchor markets to social targets. Economic and financial viability is one of them as it is also related to social stability and to economic development. In times of turmoil, this assertion becomes more or less a general agreement without implying a radical change in dominant theoretical and political circles. The expected results of the functioning of the whole society depend closely on the philosophical (and then political) choice implemented in the design and working of institutions that frame the real life. From this perspective, it seems to be relevant to study the evolution of modern economies in terms of regulatory-policy choices having dominated capitalism since the last quarter of the twentieth century.

### ***Financial regulation as a social control design***

There is no other domain in capitalism which calls for socially guided and controlled institutions than money and finance. This is related to the peculiar nature of money. Money is *transversal* because all economic transactions rely on monetary relations. Monetary and subsequent financial issues do structurally matter to all other sectors since they affect the whole economy irrespective of actors who are involved (or not) in financial relations. Money



is also *ambivalent* as it has a twofold nature that lies both in private decisions and public rules. As the “distilled exchangeability of objects” (Simmel 1978, 122) and the “separation between subjectivity and objectivity” (Ibid, 126-127), its creation is related to private economic decisions (mainly of banks and entrepreneurs) and allows economic agents to undertake profit expectation-based decentralized plans. At the same time, money rests on general (non individual/non private) rules (payment system rules) (Ülgen 2013b). It mainly relies on publicly/collectively supported trust, i.e. on “*non aes sed fides*” (not money but trust) principle studied by Simmel who emphasizes the central role of “the guarantee for the continuous usefulness of money, which is the essence of the relation of the contracting parties to the whole social group” (Ibid, 177-179).

Therefore, money must be studied as a social institution, a set of social rules that allow private economic units to undertake decentralised activities thanks to debt relations supported by the banking system. Such debts circulate as money through the entire economy under the general constraint of repayment at the end of financing contracts<sup>8</sup>. Involving the whole society, the stability of monetary and financial relations determines systemic viability conditions and then requires regulation: “The postulation of a political authority and its contribution in the constitution of money can be defended ontologically against methodological individualists by using the notion of collective intentionality and the respective analysis of the ascription of social status through constitutive rules. The fulfillment of the function of money is founded on a structure of normative and constitutive rules that support currency and regulate the behavior of its users. Political authority constitutes and enforces these rules, safeguarding at the same time the collective intentionality of its subjects. The identity of money should be understood in terms of these rules and consequently money should be defined as an institution” (Papadopoulos 2009, 966-967).

Thus one can point to some policy implications for the stability and to the crucial role of the institutional frame of financial markets in the occurrence of crises. The issue is a lasting one. The Commodity Exchange Act in 1936<sup>9</sup> states that some transactions in commodities such as futures are affected with a national public interest since sudden or unreasonable fluctuations in their prices frequently occur as a result of speculation or manipulation which are detrimental to the producer or the consumer. That makes measures of control over such activities judicious in order to protect the national public interest from “speculative excesses”. Unfortunately, from the early 1980s New Classical (new liberal) agenda dictated conservative economic orientations through the neutral fiscal and monetary doctrine and supported extensive financial liberalization resulting in loose regulation. This environment fuelled several bubble-based growth areas without enhancing real job-creating growth. The 2007 crisis temporarily stopped this evolution and enrolled governments in public-spending-increasing rescue plans to save several too-big-to-fail banks and financial institutions. But the recovery seems to be mainly left to chance without structural institutional changes. Policy choices still remain related to the belief that liberal markets are efficient at long-run and do not make public interventions necessary to lead economies to work efficiently.

At the same time, in the aftermath of the 2007 crisis, numerous analyses emphasized that tight oversight and reframed government regulation is the key to preventing capitalist finance’s systemic crisis in the future. A thorough analysis of such an issue may be suggested through some Minskyian assumptions on the endogenous nature of capitalist finance instability (Minsky 1984, 1986). Putting the emphasis on the allocational, stabilization and distributional efficiency of policy and institutional regimes in capitalist evolution, Minsky (1984, 10) gives a precise definition of social control according to social aims: “The deeper significance of the socialization of investment is not that industry or a sector of industry is nationalized but there is social control over the aggregate of profits available for business. These profits will not

collapse when private investment collapses nor explode when private investment expands”. The necessary social control over the economy relies on the endogenous instability of capitalist finance as “In a world with “euphoric” behavior, liability structures are transformed so that an increasing proportion of units can meet contract terms on their liabilities only by issuing new liabilities. (...) Using debts to pay interest –or dividends- creates fictitious assets and the laws of compound interest indicate that in time such assets will not be an acceptable basis for liabilities. When this happens as a systemic affair the entire financial structure, and with the financial structure investment can collapse” (Ibid, 11).

Such an analysis calls for radical modifications in the institutional structure of financial markets at two levels: designing and implementing tight macro-regulation that gives priority to prudential supervision schemas and prevents short-sighted speculative activities in the aim of broadening functional finance to fund productive activities (Ülgen, 2013a). Recalling the case studied by Hamilton in the 1920s when the existing system of social control was inadequate to cope with new economic conditions and problems, Rutherford (2010, 60-61) maintains that the existing methods of regulation and control of business in the public interest are inadequate and new forms are required that may “take the form of regulation or of more direct government involvement in the economy”. This results in a state-oriented systemic stability/viability schema relying on a big government that sustains domestic demand and long-term productive activities and an effective central bank that acts as a lender-of-last-resort as well as a “social organizer” of financial markets.

### ***Conclusion***

After the 2007 catastrophe, financial liberalization is not anymore beyond question. This paper then questions whether the liberal organization of capitalist finance can ensure a suitable working and a sustainable evolution of the economy and the whole society. In the wake of the “Great Disarray”, which began in 2007 in advanced market economies and then

extended to a large part of the world without having been cured through massive economic rescue policies, the question of economic stability/viability to improve living standards of people around the world comes, once again, into the theoretical and political debate.

In light of this worldwide issue this paper brought to the fore the crucial role of the institutional/regulatory frame of money/financial markets for macro-stability and systemic viability. In an institutionalist analytical framework, it showed that capitalist market economies are monetary/financial economies that rely on the consistency of systemic rules and mechanisms. In such a context, economic development depends on systemic consistency of institutions. In Veblenian terms, the development of institutions is the development of society (Veblen [1899] 1915). It appears that, given the main (threefold) characteristics of capitalist market economies, liberalized and loosely regulated monetary and financial systems are prone to systemic crisis and are not able to deal with cumulative excesses without social control mechanisms directed towards planned, conscious social order. Following the analyses offered by the forerunners of Institutional economics such as Clark, Commons, Hamilton, Mitchell and Veblen, but also by some contemporary institutionalists such as Rutherford, and post-Keynesian theoreticians such as Minsky, it seems to be possible to elaborate consistent monetary capitalist economy analysis and to suggest relevant policy implications to keep systemic stability and viability under control.

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### Notes

<sup>1</sup> We define stability as the working of the economy without systemic crisis that provoke unbearable consequences on the society (runs, unemployment, poverty), and viability as the ability of private and related public mechanisms/practices to ensure the reproducibility of

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economic relations without calling into question, in the event of crisis, the main rules/principles of the dominant system.

<sup>2</sup> We define capitalist finance as all forms of financing of profit-seeking private activities and related public policies through market mechanisms without the guidance of collective objectives. The core incentive is the expectation of net monetary returns.

<sup>3</sup> W. Mitchell (1916, 161) advocates for fostering “The current tendency to make money the center around which economic science clusters” and argues that “From the use of money is derived not only the whole set of pecuniary concepts which the theorist and his subjects employ, but also the whole counting-house attitude toward economic activities. In its use are found the molds of economic rationality, and the clues to economic explanations” (Ibid, 149). T. Veblen (1919) notes that the businessman’s place in the economy is to make money which is a pecuniary operation and remarks the dominant role of money and finance in the economy: “The material welfare of the community is bound up with the due working of this industrial system (...). It should accordingly have seemed expedient to entrust its administration to the industrial engineers, rather than to the captains of finance. The former have to do with productive efficiency, the latter with the haggling of the market. However, by historical necessity the discretionary control in all that concerns this highly technological system of industry has come to vest in those persons who are highly skilled in the haggling of the market, the masters of financial intrigue” (Ibid, 89).

<sup>4</sup> J. M. Clark criticizes the neoclassical free market theory which treats social efficiency as a sum of individual efficiencies and states that social and individual valuations differ because the range of alternatives open to society is different from that open to individuals: “The individual may escape from costs that society has to bear, or vice versa; the individual may

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choose under the pinch of want or under bad bargaining conditions, when it is not socially necessary that he should be confined to such a stern choice of evils” (1919, 287-288).

<sup>5</sup> This issue is also studied from a New Institutional perspective to state the importance of sanctioning institutions in order to enforce outcomes that maximize group welfare in social dilemma situations (Kosfeld, Okada and Riedl 2009).

<sup>6</sup> Hamilton (1919, 317) maintains that the neo-classical theory “neglected the influence exercised over conduct by the scheme of institutions under which one lives and must seek his good”. In that line Rutherford (2010, 50) argues that “what institutionalism offered was an invitation to detailed study and participation in the intelligent direction of social change”.

<sup>7</sup> From this angle, quoting some eminent American institutionalists such as Clark and Hamilton, Novak (2010, 395) maintains that “Well before the economic catastrophe known as the Great Depression, these legal and economic thinkers had formulated an ambitious plan for the public social control of the American economy through ongoing administrative governance and economic planning. They envisioned the state not as an economic policeman or even as a countervailing force to private economic power, but as a full, interactive partner in a legal-economic vision of modern state capitalism”.

<sup>8</sup> Wennerlind (2001, 566) notices that “money serves as a general claim on social wealth and confers the privilege to exercise power over other people. As such, money becomes the supreme representation of social power (...)”.

<sup>9</sup> See Edwards (1981) for a specific analysis of the evolution of regulatory acts in the United States since the Great Crisis.