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Economic Governance and the Political Economy of the 2008 US Financial Crisis: A Taxonomic Essay

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ABSTRACT

This paper analyses the causes of the Great Recession of 2008 from the perspective of political economy. The study shows that it was the sociopolitical process that put in motion the forces which led to the events of 2008. In the wake of the Great Depression of the 1930s, the US government had created a highly effective architecture of financial regulation. These safeguards established legal restrictions and the effective monitoring of financial institutions that kept the greed of the financial sector in check. As a result, the economy was relatively stable for three decades (1960-1991). However, the political process began changing in the 1960s, when social conservatives and religious fundamentalists reacted strongly against the socially liberal policies of the US government. Religious fundamentalists had votes, while Wall Street and big business had money. These groups had a common agenda: to remove government regulation and intervention in economic and social spheres, and weaken the government's ability to spend by slashing taxes and public spending. This shared mission made them natural allies in politics and they threw support behind politicians in elections who would then implement their agenda after being elected. When these politicians gained power, they implemented this agenda. As a result, the financial regulatory architecture was weakened. This paved the way for risky, aggressive behaviour by banks including unbridled lending to subprime borrowers which ignited the Great Recession of 2008. The findings show that an effective architecture of financial regulation can successfully keep the greed of the financial sector in check and hence maintain economic stability as witnessed from 1960 to 1991. However, this requires political will.

Key Words: *Great Recession, Rationality, Public Interest, Investment Banking, Purist Laissez-faire, Mixed Laissez-faire, New Deal, Regulatory Architecture, Glass-Steagall Act, Small Government, Mortgage Backed Securities (MBS), Deregulation, Religious Fundamentalism, Big Business, Economic Governance, Corporate Governance*

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INTRODUCTION

The Historical Debate About Economic Governance

There is long-standing debate about the extent to which private business and society are in conflict. On the one hand, the objective of private business is to maximise profits and single-mindedly pursue its self-interest. Private business is also rewarded for undertaking risk; in doing so it creates jobs and produces goods and services. At the same time, the creativity and innovation of the business sector brings efficiency, quality, comfort, development, and prosperity to society. Indeed, incentive and fairness considerations demand that private business must be allowed to reap the rewards for its contributions to society.

On the other hand, sometimes private business can inflict grave damage on society when it selfishly pursues its own self-interest. For example, in the interest of keeping costs low and profits high, private businesses sometimes prefer to pollute the environment instead of safely disposing of toxic waste, leading to health problems within the population. Damage to society can also be inflicted by deposit-receiving financial institutions if they chase high profits by investing in high risk assets which subsequently fail. In all these cases, there is severe conflict between the self-interest of private business and the interests of the society. Such conflicts must be resolved under a system of economic governance using a criterion that protects the interests of society, while also being fair to all parties involved.

Socialism claimed to resolve this conflict by establishing a system of economic governance which gave the state complete control of the economy and disallowed private ownership of factors of production. Under socialism, the state was assumed to represent and protect the interests of the society. As demonstrated by the fall of socialism, these assumptions turned out to be false in reality.

In Islam, private business and entrepreneurship are encouraged. This stands in stark contrast to socialism. Indeed, at one point Prophet Muhammad (p.b.u.h) was employed by a well-off Makkan businesswoman to manage her business.

The Islamic ethics of economic governance are founded on the principles of Islamic jurisprudence (Shari'ah). It allows private ownership and the free market system, as well as the pursuit of profit and self-interest by the private business. Importantly, the objectives of Shari'ah (i.e. Maqasid of Shari'ah) resolve the issue of the conflict between the interests of the society and private business. According to Zein et al. (2008, p. 13), "the Objectives of Shari'ah are meant to preserve religion, life, reason, progeny and wealth. An overarching principle of all policy making (whether related to the political, legal, economic, social, or environmental spheres) that emerges from the Objectives of Shari'ah is Maslahah (public interest). Public interest can be simply defined as promoting things that are beneficial to the society and preventing the things that are harmful to it". Thus in the Islamic tradition, economic stability, full employment, growth, and socioeconomic justice are integral to public interest (i.e. the greater good of society), which is given priority over private interest.

The inherent logic of the Islamic position is clear. It holds that if society's interests are harmed, the pecuniary and non-pecuniary costs to the society could be extremely high. As a consequence, innocent citizens could suffer irreversible permanent adverse dislocation in their socioeconomic lives. The Islamic position is also concerned that private business, being a subset of the society, will also be hurt in the long run, if it harms the interests of the society. These Islamic principles envision a system of economic governance rooted in free market but at the same time ensures the protection of public interest through government intervention, market regulation, etc. In his book Moral Capitalism Stephen Young (2003) also emphasises the need for reconciling private and public interests.

Using the concepts of rational behaviour, self-interest, and invisible hand, Adam Smith advocated the convergence of the interests of private business and the interests of society. This allowed him to recommend a system of economic governance that had the laissez-faire market system as its cornerstone, free of government intervention and regulation. In fact, government intervention and regulation were seen as causing inefficiency in the system and stifling creativity and innovation. Moreover, advocates of this paradigm argue that a pure laissez-faire market would allow private businesses to utilise their resources and opportunities to the maximum extent - at minimum cost. In their view, such a system would not only enable business to maximise profits, it would also deliver high growth rates, enhance the efficiency and wellbeing of society at large while conforming to the public interest at the same time.

At the time of Smith's writings, Britain was on the verge of the industrial revolution, while many European economies were still operating under mercantilism. The hallmarks of mercantilism were protectionism and heavy-handed government intervention in the economy. Adam Smith's book, The Wealth of Nations (1776), helped marry the idea of laissez-faire market with the industrial revolution which had by then gripped Britain. The success of the laissez-faire market-based industrialisation in Britain led to the birth of laissez-faire capitalism in 19th century Europe.

Interestingly, the spread of the 19th century European idea of laissez-faire capitalism across the Atlantic paralleled the spread of John Locke's social contract theory to the US two hundred years earlier. Locke's ideas of life, liberty, private property, and social contract, developed in 17th century Europe, became a source of excitement across the Atlantic, and helped create the American Revolution in the 18th century. In a similar fashion, the 19th century European idea of laissez-faire capitalism also became a source of excitement across the Atlantic in the early 20th century. Indeed, it was the adoption of laissez-faire capitalism that delivered the 'Roaring Twenties' to the US economy in the second decade of the 20th century.

But, in 1929, the laissez-faire capitalism-based US economy collapsed, and resulted in the Great Depression of the 1930s. Interestingly, the revival of laissez-faire capitalism was the hallmark of the US economy in the 1990s - and again the US economy suffered a severe break down not long thereafter with the financial crisis of 2008. The burning question is: How did the 2008 financial crisis happen, and what lessons can we learn from this tragedy?

The Challenge: Understanding the Ideas and the Process Behind the Events of 2008

While much has been written about the events of the 2008 great recession, little attention has been paid to the ideas that set the stage for the well-known events of the financial crisis. Given the serious magnitude of the crisis, the situation demands a comprehensive understanding of the ideas and philosophical paradigms that generated events of such breathtaking scale. It is for these reasons that this paper attempts to briefly discuss the ideas, the process, and the factors that strengthened the forces which produced the events of 2008. In the absence of such an analysis, our understanding of the crisis would be incomplete, and, in fact, superficial – much in the same way as a discussion of capitalism would be incomplete without understanding the ideas of Adam Smith or a discussion of the American Revolution without understanding the ideas of John Locke and the idea of democracy.

1990s: The Dotcom Boom, Bubble, and Bust

Led by the dotcom boom, the 1990s were a decade of remarkable growth and employment for the United States. The scope of this boom can be gauged by the fact that for more than quarter of a century (1970-1997) the US annual budgets had consistently suffered huge deficits – indeed, the 1992 budget alone had a deficit of $290 billion. Yet, beginning in 1993, the economic boom began generating large revenues that started to reduce the federal deficit. Indeed, in 1998, 1999, 2000 and 2001 the US enjoyed budget surpluses of $69 billion, $126 billion, $236 billion, and $128 billion respectively. However, what started as an economic boom eventually became an economic bubble. In the year 2000, the dotcom bubble burst, causing a serious downswing in the economy. With the tragedy of 9/11, the US plunged into a recession.

The Fed's Response to the Recession and the Rise of Subprime Mortgages

In response to the recession, the Federal Reserve lowered interest rates. These low interest rates were maintained over a number of years to encourage businesses and investors to invest and stimulate the economy.

Banks were particularly eager to take advantage of this low interest rate environment by lending large amounts of money to maximise their profits. As competition among banks intensified, the US banking industry identified the domestic housing sector as a key market with great borrowing potential. Of particular interest to the banks was the so-called 'subprime' market. This market consisted of borrowers who had a high chance of default because they often had low incomes, lacked steady employment, and had poor credit ratings. Banks found it extremely profitable to lend to subprime borrowers, because banks themselves were able to borrow money at low rates and then lend it to subprime borrowers at much higher interest rates. At the same time, subprime borrowers - who had historically found it difficult to borrow from banks - were delighted by the opportunity to borrow easily from banks. Thus, banks and subprime borrowers happily embraced each other. As Akerlof and Shiller (2009, p. 36) note, "lenders were successful in placing these loans among some of the most vulnerable, least educated, and least informed members of society. While such behaviour may not have been illegal, we think the more egregious instances definitely deserve to be called corrupt". While such behaviour may not have been illegal, it is likely that these practices were exploitive.

The Housing Market Bubble Leads to Financial Sector Rubble

For several years, the strategy paid off for borrowers and for banks. The money pumping into the housing market pushed home prices ever-higher. This enabled borrowers to profit by buying houses and 'flipping' them by selling them soon thereafter at higher prices.

All seemed safe - indeed, the underlying conventional wisdom was that housing prices could not fall; they could only rise. Thus, it was rational for borrowers to borrow as much as possible now, and profit when property prices rose in the future. Borrowers were thus encouraged to borrow. The collective result of this activity was the formation of a classic asset price bubble.

Thanks to the creation of exotic credit derivatives markets, banks were also able to record enormous profits. Indeed, banks that made mortgage loans did not want to wait many years and gradually record profits on their lending activities. Instead, their desire was to report enormous profits as soon as possible. The credit derivatives market enabled them to do just that. Using specialised Mortgage Backed Securities (MBS), the original lending banks were able to sell their mortgages to other investors, thereby shifting the risk to third parties locally and around the world.

Credit rating agencies played a key role in certifying these derivative securities. In theory, the role of rating agencies is to evaluate and provide an unbiased opinion on the level of risk and quality of these securities. However, since the banks were paying the rating agencies to rate the MBS, the rating agencies often gave these securities very high ratings. The impact of these high ratings was that buyers bought them with the assurance and confidence that they were sound investments and did not carry high risk. Akerlof and Shiller (2009, p. 37) highlight that, "The subprime packages were in fact rated very highly - 80% AAA and 95% A or higher. These ratings were in fact so high that they would be bought into by bank holding companies, money market funds, insurance companies, and sometimes even depository banks themselves that would never have touched any of these mortgages individually". Since AAA is the highest possible rating, securities marketed as AAA appeared to be extremely low risk. As a result, MBS securities were in high demand, and banks were able to transfer the risk of their mortgage lending to other investors.

These aggressive lending activities resulted in a booming housing market, and property prices shot to unrealistic highs in the United States. Reinhart and Rogoff (2009, p. 207) observe that the Case–Shiller housing price index shows that, "since 1891, when the price series began, no housing price boom has been comparable in terms of sheer magnitude and duration to that recorded in the 2007 subprime fiasco. Between 1996 and 2006 (the year when prices peaked), the cumulative real price increase was about 92% - more than three times the 27% cumulative real price increase from 1890 to 1996!"

The party ended as the Federal Reserve raised interest rates. As interest rates rose, many borrowers found that they could not pay their mortgage instalments to banks. Millions of homeowners declared bankruptcy, and the formerly AAA-rated MBS securities which contained their mortgages recorded large losses. Moreover, since these securities had been purchased by financial institutions all over the world, there was a ripple effect throughout the global financial system. By 2008, the credit crisis was in full swing.

Banks were hit particularly hard, as frightened bank depositors rushed to withdraw their deposits from banks. Liquidity dried up, and the banks themselves ran into liquidity shortages. The problem became even more acute because the banks themselves had borrowed short term to make these long term mortgage loans, thus creating large exposures to short term fluctuations in the cost of borrowing.

As the credit crunch progressed, many big financial institutions faced insolvency and either went bankrupt or taken over by other institutions at very low prices. Household names such as Merrill Lynch, Lehman Brothers, and Bear Stearns vanished, seemingly overnight. This created an earthquake in the global financial system.

Spooked consumers began spending less, triggering a slowdown in the global economy as countries around the world entered recession. The US economy shrank substantially, causing a recession that was so deep and prolonged that there were fears of the repeat of the Great

Depression of the 1930s. Hence this recession also came to be known as the Great Recession. Unable to pay their mortgage instalments, millions of homeowners had to surrender their houses and became homeless overnight.

What happened raises a host of issues from the point of view of economic governance that will be discussed in the following sections.

The Issue of Rationality

A fundamental assumption in economics, business, and finance is that economic agents are rational. Thus, the first question that arises in this episode is whether the economic agents involved were rational. In other words, were the borrowers, lenders, rating agencies, executives, managers, and board members involved in the decision-making that led to the crisis acting rationally?

The evidence suggests that the answer is: yes, they were acting rationally. The definition of rational behaviour is that the agent maximises one's self-interest at the minimum cost. Indeed, for many years, banks were able to report enormous profits by issuing mortgages and then creating AAA-rated derivatives to transfer the risk to other parties. Hence, the behaviour of banks was consistent with rationality and the maximisation of self-interest.

Rating agencies were also acting rationally. The ratings industry was highly competitive since ratings agencies competed for the same deals. If a ratings agency gave poor ratings to the securities of a bank, there was a strong possibility that the bank would simply go to another rating agency and get a better rating. Thus, the agencies adopted a policy of giving inflated ratings, seemingly irrespective of the level of risk involved. It was in the self-interest of the rating agencies to keep their clients happy and ensure that they did not lose their clients. This behaviour, too, is consistent with rational behaviour by ratings agencies.

Executives and managers were also acting rationally. Their incentives were to report increasing profits and growing revenues, and in the process earn lucrative bonuses and promotions to higher positions. Corporate boards were acting as cheerleaders for executives, who were single-mindedly focused on business expansion and profit maximisation. Thus, the boards were also rational. After all, for many years, the strategy worked: business flourished, and everyone prospered.

In a nutshell, all the economic agents acted rationally. The mortgage lending boom and the accompanying explosion in the derivatives could not have happened without the convergence of the self-interests of all parties involved. Indeed, the aggressive, single-minded pursuit of self-interest closely paralleled what had happened in the 1920s, when the rational pursuit of self-interest by economic agents ultimately led to the Great Depression. This naturally begs the following question: Had the US learned any lessons from the devastation of the Great Depression of the 1930s?

The question of learning lessons from past mistakes and improving the economic system is important from the point of view of economic governance in general. We use the term economic governance in the context of capitalism operating in a democratic system. In a democratic society, elected public leaders (i.e. those in the legislative and executive branches of the government) have to make decisions on various economic policies and the nature of the regulatory architecture pertaining to the running of the economy. Thus, when a democratically elected government is involved in legislation, and execution of policies influencing the running of a laissez-faire economy, it is the subject matter of economic governance.

Lessons from the Great Depression for Economic Governance: The Infrastructure of Financial Regulations, Statutes, and Institutions (FIRSTS)

Prior to the Great Depression of the 1930s, the US economy was the closest to the pure laissez-faire model (henceforth "Purist model") which led to an economic boom. This is why the decade of the 1920s came to be known as the 'Roaring Twenties' in American economic history. Yet, from a long term economic governance point of view, one of the major reasons for the collapse of the US financial system and the Great Depression in the 1930s was the dominance of Purist economic policies.

The Purist economic model advocates the view that since economic agents are rational, the public interest (i.e. economic efficiency, growth, stability and employment, etc.) can only be achieved if markets are free of government intervention and regulation. In other words, Purist advocates argue that the self-interest of economic agents and the invisible hand of the free market will always direct resources to their most productive and efficient use, along with a full commitment to the public interest.

Given this vision of universal rationality, a Purist economy would guarantee the greater good of the society by automatically ensuring growth, full employment, and stability of the economy. Hence laissez-faire individualism (LI) rooted in the universal rational behaviour of economic agents is the corner stone of the Purist philosophy of economic governance. In a democratic society where economy is based on the Purist philosophy, the government policy makes sure that the markets are free and deregulated because the economic agents are believed to be rational and socially responsible. The underlying assumption of this philosophy is that there is no conflict between the self-interest of economic agents and the public interest. In fact, the belief is that the rational pursuit of market participants' self-interest always promotes the greater good of the society.

However, the Great Depression brought to light the devastating consequences that Purist policies can have not only on financial institutions, speculators, and producers, but also on innocent citizens and the labour force. Indeed, the prolonged economic downturn of the 1930s seriously challenged the orthodoxy which had strongly advocated economic governance under the Purist system.

This challenge led to a critical review of the dominant Purist paradigm. It was the lack of institutional supervision and regulation of markets that was at the root of the Great Depression. In 1936 John Maynard Keynes published The General Theory of Employment, Interest and Money. Although Keynes believed in private ownership and the market as the fundamental mechanism in the economy, he argued that the market could not be left to itself because it had an inherent tendency to run into disequilibrium and lead to calamities such as the Great Depression.

From the point of view of economic governance, episodes like the Great Depression harm public interest and even threaten the very existence of capitalism itself. It was due to these inherent destabilising tendencies of free markets that Karl Marx (1818-1883) predicted the doom of capitalism. He argued that free market capitalism contained within it the forces of its own destruction. Indeed, catastrophes like the Great Depression could destroy capitalism from within.

Keynes (1883-1946) wanted to save capitalism and protect it from its own self-destructive tendencies. Hence he advocated an activist role for the government in the economy to ensure full employment and stability while maintaining private ownership and the market framework for competition, efficiency, creativity, innovation, and growth. For the sake of simplicity, this study would say that Keynes advocated a philosophy of mixed laissez-faire (ML) model of economic governance.

The US indeed learned valuable lessons about economic governance from the Great Depression. In fact, the US Presidential election of 1932 was actually a referendum on Purist versus ML models. Under the ML the government could adopt activist fiscal and monetary policies to ensure full employment, stability and growth in accordance with promoting the public interest. If the self-interest of the rational private business sector came into conflict with the public interest, the ML allowed the democratic system to regulate and monitor the markets to protect the interests of the society.

In the 1932 Presidential election, Franklin D. Roosevelt, the candidate of the Democratic Party, presented a platform based on ML, which he called the 'New Deal'. Since the New Deal maintained private ownership and the market mechanism, it was evident that Roosevelt was committed to protecting and maintaining capitalism while at the same time adopting ML philosophy. This was to ensure that capitalism would not succumb to its self-destructive forces - as predicted by Marx and experienced under the Great Depression. Roosevelt won the election and implemented the New Deal. The New Deal enacted legislation for regulation of various sectors of the economy. The goal of this exercise was to create a system of economic governance that could rescue and revive the US economy that had sunk deeply due to the Great Depression and ensure that in the future, downward trends could be combated early on through policy activism.

The New Deal was implemented through a combination of activist fiscal and monetary policies. These policies were complemented by a wide-ranging architecture of laws and institutions which regulated various sectors of the economy. Given the focus in this paper on the financial crisis of 2008, we limit our discussion to the highlights of the regulatory architecture of the US financial sector under the New Deal.

The centrepiece of the financial regulation under the New Deal was an infrastructure of Financial Regulations, Statutes, and Institutions (FIRSTS). The purpose of the FIRSTS was to prevent excessive speculation by banks and financial institutions, which had fed the bubble that preceded the Great Depression and resulted in a loss of confidence in the banking system once the bubble burst. While space constraints prevent us from discussing the details of the FIRSTS, it must be noted that the Glass Steagall Act (GSA) of 1933 and the establishment of the Securities and Exchange Commission (SEC) in 1934 were central to the FIRSTS created by the New Deal.

The GSA prohibited commercial banks from participating in investment banking activity. Historically, these two activities had been integrated. This integration had allowed deposit-receiving commercial banks to undertake investment banking by dealing in non-governmental securities and bonds. This exposed banks to high risk, and had led to the failure of several thousand banks during the Great Depression. Kindleberger and Aliber (2005, p. 118) note, "Real estate loans in default, not failed stock brokers' accounts, were the largest single element in the failure of 4,800 banks in the years from 1930 to 1933". The GSA sought to separate commercial banking from investment banking. This meant that commercial banks were not allowed to deal in non-governmental securities. The Act also prohibited commercial banks or their employees from affiliating with investment banking institutions. The GSA also brought commercial banks under the jurisdiction of the Federal Reserve and the investment banks under the supervision and regulation of the SEC.

Thus, in light of lessons learned from the Great Depression, the New Deal established a framework of laws and an infrastructure of powerful institutions to regulate, monitor, and stabilise the financial sector. The purpose of this regulatory architecture was to ensure the protection of the public interest, while keeping the greed of the financial sector in check and simultaneously allowing rational economic agents to pursue their self-interest within the framework of the market system and private ownership. This arrangement, in principle, subjected LI to the public interest of the society, which is the corner stone of ML model.

The Success of FIRSTS Under the ML Model: Three Decades of Rapid Recovery

Following the Great Depression, the US economy functioned reasonably well with the FIRSTS under the ML philosophy. Naturally, there were exceptions, such as the stagflation episode of the 1970s, which had been caused by a supply shock in the form of an energy crisis. Similarly, there were times when the economy boomed - but thanks to the safeguards introduced by the FIRSTS, unstable bubble-like conditions were promptly kept in check. There were also times when the economy went into a downswing (as had been predicted by Keynes), but thanks to the activist role of the government advocated by Keynesians, the government was able to avert deep and long recessions. In fact, while there were recessions over the 30-year period from 1960-1991, recovery from these recessions was generally rapid. As Rajan (2010, p. 14) notes, “from trough of the recession the average time taken by the economy to recover to pre-recession output levels was less than two quarters, and the lost jobs were recovered within eight months”. Hence, the effective implementation of the ML model during these three decades proved to be successful in protecting the public interest.

We are all Keynesians Now!

In the decades that followed the Great Depression, there was widespread recognition that under the ML model, the potent mix of New Deal and Keynesian economics could effectively and quickly mitigate economic downswings. This paradigm won a high degree of legitimacy. Such was the acceptance of the Keynesian activist economics that in 1965, Time Magazine quoted Milton Friedman as saying, “we are all Keynesians now” (Krugman, 2012, p. 101). Milton Friedman’s 1970 paper titled A Theoretical Framework for Monetary Analysis was seen by many economists as very similar to the standard textbook Keynesian theory (Krugman, 2012, p. 101). As we will see, however, this convergence around the New Deal and Keynesianism was short-lived.

Enter the Eighties

Thanks to the revival of the Purist ideology in the 1980s and 1990s, the GSA was gradually dismantled and the FIRSTS were significantly eroded. This culminated with the repeal of the GSA in 1999, which effectively dismantled the safeguards put in place by the FIRSTS. Perhaps not surprisingly, the repeal of the GSA coincided with the creation of a massive financial bubble in the late 1990s, and the US was plunged into a recession shortly thereafter in 2001. Moreover, another, even deeper recession occurred just a few years later, with the bursting of the housing bubble in 2008. There is little doubt that the dismantling of the FIRSTS and GSA safeguards has indeed proven to have had grave and unprecedented global consequences.

The Central Question: Why Were the FIRSTS Weakened?

From an economic governance point of view, the key question is: if FIRSTS had been effective in protecting the economy from instability, then why were they weakened? For example, was it because the argument in favour of the Purist model had gained wide support purely on practical economic merit, like the argument for New Deal and FIRSTS in the 1930s, or were there other factors responsible for the dismantling of the FIRSTS? If so, what were the motives that triggered it? In short, the answer is that the trigger was twofold. First, in the post WWII period the rise of countries like Germany, Japan, etc. was challenging American manufacturing and by 1980s the US auto industry was in severe crisis. There was a strong view that the situation could be improved through Purist laissez-faire policies (i.e. aggressive expansion of the free market) and increased deregulation of the US economy as it would enhance competition, lower costs, and improve efficiency. The second trigger was the distrust of the government activism on social and religious grounds. It was this distrust that became a powerful movement and strengthened the forces in the political arena which ultimately led to the demolition of the FIRSTS. This is explained below.

A Clash of Values and the Purist Resurrection: The Rise of the Right

The ML model and New Deal had a regulatory architecture that was not acceptable to the Purist market advocates right from the beginning. This architecture was opposed by big business, the financial industry, and Purist economists. “Banks began lobbying Congress as early as the 1960s to loosen the restrictions of Glass Steagall” (Sherman, 2009, p. 9). But the collective weight of this opposition to ML model in the American democracy was light - it lacked grass roots support in the country’s democratic system due to the fresh memories of the Great Depression in the minds of the masses. Thus, Purist ideology did not have strong backing in Congress and remained a minority view for nearly half a century since the election of President Roosevelt in 1932. The challenge for big business and Purist advocates was to make it a majority view among the masses at the grassroots level. They knew that if it became a majority view at the grassroots level, it would help more pro-Purist politicians get elected to Congress. Once that happened, it could gain strong support in Congress as well. The events of the 1960s, interpreted as a clash of values, were capitalised on by advocates of Purist ideology to rally mass support in favour of their agenda. Moreover, the lasting impact of the events of the 1960s would change this congressional balance of power in favour of Purist ideology.

First, some background. Since colonial times, slavery was prevalent in America - especially in Southern states. The Southern states even rebelled and engaged in a civil war (1861-1865) against the Union to preserve slavery. However, the South was defeated and Abraham Lincoln (a Republican) emancipated slaves in 1863, and Americans were proud of the abolition of slavery. Although slavery was abolished in the 1860s, a century later, in the 1960s - even after the defeat of the racist Nazi regime in World War II - there was still rampant racism against African-Americans in the US. Blacks were still not treated as equal citizens, and the Civil Rights movement was strongly resisted, especially in fresh water (i.e. inland) states in the South.

Finally, in 1964, President Lyndon Johnson (a Democrat) managed to get Civil Rights legislation passed. The Civil Rights legislation made the Democratic party unpopular in the South. This was acknowledged by President Johnson, who said “we have lost the South for a generation” (Greenspan, 2007, p. 440).

Moreover, matters of church and state contributed to the acceleration of tensions between conservatives and liberals in the 1960s. In the early 1960s the US Supreme Court abolished the school prayer, using the principle of separation of church and state. This practice was a matter of concern to other religious minorities, and debate over this issue had raged for a long time. In fact, since the 18th century, Bible reading and prayer were included in public schools.

The Supreme Court's decision stunned the devout and the fundamentalists in the American Christendom. Around the same time, the federal government approved the commercial production of the birth control pill. Easy access to the pill created a sexual revolution in society and emboldened the women's rights movements. Traditionally, women who performed the same job as men were paid less than men. In contrast, women's rights movements were now demanding the government enact laws guaranteeing equal pay for equal work.

Many saw these developments as hitting the very roots of traditional morality, and this onslaught of liberal ideas led to widespread gloom among the religious right. They realised a clash of values was occurring – a clash in which they felt like an isolated minority in their own home country. Every one of them was struggling with a fundamental question: Am I right? Is the government wrong?

For many, this question was finally answered when, in 1973, the US Supreme Court legalised abortion. This ruling infuriated social conservatives and the religious right, and they concluded beyond doubt that they had always been right and the government had been wrong all along. Hence, the government could not be trusted. They felt that this was the moment for them to stand up and defend their values and religious liberties.

Trust in God, Faith in Religious Fundamentalism and Suspicion of the Government

This distrust of the government made millions of religious fundamentalists, social conservatives and right wing radicals around the nation uneasy. They now came to believe that any kind of government regulation or policy activism was a threat to their way of life and a challenge to their world view. Thus, distrust of the government became an article of fundamentalist faith across religions and denominations in the country.

At the same time, the Republican Party's political strategists - who were committed to pro-business Purist model LI - were watching these developments with keen interest. It was a pivotal moment for them, as they had been championing the cause of Purist laissez-faire market ideology, but had been unsuccessful in generating popular support for this cause. Thus far, LI had only been popular among groups that were pro-business, anti-New Deal, fiscally conservative, and opposed to economic regulation and activism of the government. But collectively, in the American democracy, these groups were a small minority. As a result, the LI advocates had remained on the sidelines due to a lack of mass support.

The Republican strategists realised that LI supporters and religious fundamentalists could be (ideologically) married because of their common distrust of government activism and regulation. These strategists believed that this union would widen the party's mass support, and increase its vote bank – and ultimately enable the party to win elections on a more far-right platform. This would enable the party to have greater influence on the US Congress and the White House, and eventually enact legislation to restore the dominance of Purist laissez-faire ideology in the country's economic governance.

A critical stumbling block was that religious fundamentalists were not united - nor did they have any coordination among them. Indeed, they were scattered and divided due to differences in religion or beliefs. For example, within the religious right, there was little cooperation across religious lines, such as between Catholics, Jews, Protestants, Mormons, Baptists, Evangelicals, etc.

To address these problems, Republican strategists took up the mission of creating a coalition of fundamentalists across faith and belief lines. They set out to convince frustrated fundamentalists to participate in politics on a common Republican platform. The argument was that political success from this platform would empower them to stop or even reverse the government activism that was threatening their values based way of life and vision of America. Thus, the philosophy of Fundamentalist Empowerment (FE) through united political action was developed. In other words, the Purist pro-business LI philosophy was married with the FE philosophy, resulting in the politics of LIFE. To realise these goals, Republican strategists reached out to leading fundamentalist and evangelical figures including Reverend Jerry Falwell, Billy Graham and others. These efforts resulted in the Moral Majority movement which united religious fundamentalists of diverse faiths and shades (Martin, 1997). As predicted, the united fundamentalists became an integral part of the Republican Party, where pro-business LI forces were their natural allies, bound by a common mission. With a support base now expanding beyond Wall Street and encompassing religious fundamentalists around the nation, the LIFE coalition had both mass ballot box political muscle and enormous dollar power. The injection of this new-found elixir rejuvenated the Republican Party - and the Purist model was born again.

The so-called "fresh water states" (i.e. mainly inland states of the South) were the bastion of the rise of religious fundamentalism. Their values clashed with the liberal values of "salt water states" (i.e. mainly coastal states), which celebrated the Civil Rights movement, supported women's rights, and recognised the abolition of school prayer as part of the separation of church and state. It is thus no coincidence that macroeconomics also got divided into two major factions: fresh water economists (mainly at inland universities) advocating Purist ideology and salt water economists (mainly at coastal universities) advocating Keynesian activism (Krugman, 2012). This ideological debate became so polarised that, "in 2005 the right-wing magazine Human Events listed Keynes's General Theory among the ten most harmful books of the nineteenth and twentieth centuries, right up there with the Mein Kampf and Das Kapital" (Krugman, 2012, p. 94).

The fresh water economists refined the Purist model of the economy and advocated lower taxes, government spending cuts, as well as the elimination of government intervention and regulation. Meanwhile, advocates of Keynesian activist economics had natural allies in the social liberals of the salt water states.

Ibn Khaldun, Laffer Curve, and Reaganomics

By the 1970s, the Moral Majority movement had successfully merged religious fundamentalists into the Republican Party and given birth to LIFE politics. In the 1980 Presidential election, Ronald Reagan (Republican) won against the incumbent President Jimmy Carter (Democrat). At that time the US economy was suffering from high unemployment and high inflation. Reagan was influenced by the economist Arthur Laffer's advocacy of the need for tax cuts in the US economy. Laffer was inspired by the 14th century Arab thinker Ibn Khaldun, who in his Muqaddimah, had argued that after reaching a certain maximum a further increase in taxes would generate lower revenue because of its negative impact on the motivation of business and labour. In such circumstances a decrease in taxes would increase total revenue because of its positive impact (Adams, 1981; Laffer, 2004). Laffer had given this idea a graphic form that became known as the Laffer curve and is at the centre of supply side economics. In fact, Reagan campaigned on a platform explicitly advocating trimming the size of the government by tax and spending cuts, deregulation, commitment to balancing the budget, greater reliance on the pro-business Purist model, and support for family values. This platform generated enthusiastic support from religious fundamentalists in the LIFE politics alliance and Reagan won the election.

The pro-LI Purist component of the LIFE alliance pressed for tax and spending cuts, as lower taxes favoured big business and the rich. Meanwhile, the religious fundamentalist (FE) component of LIFE alliance wanted tax and spending cuts for their own religio-cultural concerns. For example, they were concerned that the government would spend their tax dollars to fund birth control or other causes which they opposed.

Reagan implemented tax cuts and deregulation policies and the US economy not only recovered but enjoyed high growth and employment. These achievements popularly came to be labelled as Reaganomics. In fact, although Reagan had promised a balanced budget, under his administration the US accumulated a huge budget deficit due to increased government spending. Thus, he only partially implemented his agenda, although he did reduce taxes and deregulated various sectors of the economy. In addition to tax cuts he demonstrated his support for big business through his administration's strong resolve to weaken labour unions. He took numerous measures to appease religious fundamentalists, including the establishment of full diplomatic ties with the Vatican in 1984.

With the widening fundamentalist power base, increasing ideological zeal, and aggressive role of the LIFE coalition in the South, Republican Party moderates found their ground roots support waning. Over time, increasing numbers of far-right Republicans were elected to the Congress. This transformation of the party bore fruits. In 1987 President Reagan appointed Alan Greenspan as the Chairman of the Federal Reserve. Mr. Greenspan calls himself "...a lifelong libertarian Republican" (Greenspan, 2007, p. 372).

Small Government Congress, Deregulation, and the Demolition of the FIRSTS

The appointment of Mr. Greenspan as Chairman of the Federal Reserve was a clear signal that the Purist model had been revived, and that the banking industry would witness deregulation in the years to come. The tenure of Mr. Greenspan as Chairman of the Fed from 1987-2006 is (so far) the second longest in history. He served four US Presidents (Reagan, Bush Senior, Clinton, and Bush Jr.). It is pertinent to note at this stage that the mission of the Fed is to ensure economic stability and growth (i.e. public interest) via monetary policy and financial stability through the active supervision, monitoring, and regulation of the banking and financial system.

At the same time, through their national network of places of worship, televangelist ministries, and family values based organisations, fundamentalists were actively mobilising public opinion in favour of the Politics of Small Government. Under the small government model, politicians are committed to cutting taxes, reducing government spending, expanding deregulation, and curtailing government intervention in the economy and in social and cultural spheres while at the same time aggressively expanding the Purist agenda.

LIFE politics delivered the goods when, in the elections of the 104th Congress (1995-97), the Republican Party achieved a majority in both chambers of Congress during the Presidency of Bill Clinton (Democrat). It was the first time in four decades that Republicans had gained full control of the entire US Congress. Thus, it was not a surprise that this Congress was committed to small government.

Led by the libertarian Mr. Greenspan, the Fed felt emboldened by these Republican electoral victories. It seized the moment and took a daring step toward deregulation of the financial sector by issuing a ruling in 1996 which reinterpreted the GSA. As Sherman (2009, p. 9) notes, this ruling allowed, "…bank holding companies to own investment banking operations, that accounted for as much as 25% of their revenues. The decision rendered Glass Steagall effectively obsolete, since virtually any institution would be able to stay within the 25% level". After a sixty-year ban under the FIRSTS of the New Deal, this 1996 ruling allowed commercial banks to enter investment banking again.

These developments were not merely a reversal of the New Deal. In fact, it reshaped the US financial sector and was a statement that the Fed leadership was leading the US banking system to return to a Purist framework - similar to the one that existed in the pre Great Depression era.

Thanks to LIFE politics over the 12-year period from 1995-2007, the Republicans continued to enjoy full control of the entire US Congress by maintaining a majority in both chambers. This consistent show of ballot box power in favour of small government advocates eventually led to the complete demolition of the GSA. This was achieved in 1999, when Congress passed the Gramm-Leach-Bliley Act (GLBA). This Act is also called the Financial Services Modernization Act of 1999.

While discussing GLBA, Sherman (2009, p. 10) comments, "The Act repealed all restrictions against the combination of banking, securities and insurance operations for financial institutions. The deregulation was a boon for national commercial banks, allowing for the formation of 'mega banks'. Indeed, the GLB Act was the crowning achievement of decades and millions of dollars worth of lobbying efforts on behalf of the finance industry. The repeal of Glass Steagall was a monumental piece of deregulation, but in many ways it ratified the status quo of the time". Celebrating the passing of the GLBA, a jubilant Greenspan wrote that historians would view it, "…as a milestone of business legislation, and I'll always remember it as an unsung moment of policy making for which there ought to be a little song" (Greenspan, 2007, p. 358). Shortly thereafter, in 2000 Congress passed the Commodity Futures Modernization Act (CFMA) with the Clinton Administration on board. The CFMA "…prevented the Commodity Futures Trading Commission from regulating most over-the-counter derivative contracts, including credit default swaps" (Sherman, 2009, p. 2). The banning of over-the-counter regulation proved to be, "… a key turning point in the march toward the financial crisis" (The Inquiry Report, 2011, p. xxiv).

The status quo of the time was dominated by adherents to the Politics of Small Government model, who were actualising the Purist economy. To them, this was the ideal system of economic governance in the American democracy – one in which every person as a citizen has the right to participate and influence the democratic process to push his or her agenda. Under this model, corporations are treated as persons. Thus, US corporations are allowed to influence the democratic process in the same ways as individual citizens. Short of voting or running for public office, businesses and corporations are afforded the same rights and privileges as citizens, and businesses can lobby politicians and government agencies. It is perfectly legal for them to contribute funds to election campaigns and causes championed by politicians (subject to certain legal guidelines). Hence they spend hundreds of millions of dollars every year lobbying politicians - more so during Congressional and Presidential elections (Mayer, 2016).

The GLBA of 1999 effectively lifted all restrictions on the integration of commercial and investment banking. However, the investment banks found the SEC's regulations and monitoring onerous. In 2004, when Republicans controlled both the chambers of the US Congress and the White House (under the G.W. Bush administration), the banking industry succeeded in convincing the SEC to introduce a system of "Voluntary Regulation" (Sherman, 2009, p. 2).

Under this system the requirements for investment banks to hold capital in reserve were substantially reduced. This meant that banks could increase leverage and take more risk with less reserve capital. In essence, the SEC was convinced by investment bank lobbyists that the investment banks would regulate themselves to ensure that they did not take excessive risk. This retreat of the SEC from its duty as a watchdog and its immediate replacement by financial institutions' voluntary self-regulation was a perfect example of the government's trust in the rationality of economic agents and its faith in the Purist economy.

As a result of this deregulation, by 2007, "…the five major investment banks - Bear Sterns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley - were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as 40 to 1, meaning for every $40 in assets, there was only $1 in capital to cover losses. Less than a 3% drop in asset values could wipe out a firm. To make matters worse, much of their borrowing was short-term, in the overnight market - meaning the borrowing had to be renewed each and every day" (The Inquiry Report, 2011, p. xix). The government's reliance on the voluntary self- regulation of the financial institutions was also in line with the libertarian philosophy of Mr. Greenspan who argued that, "it is critically important to recognise that no market is ever truly unregulated…The self-interest of market participants generates private market regulation" (The Inquiry Report, 2011, p. 474).

Once the SEC surrendered its mission to the market participants, the de-facto outcome was massive and blanket deregulation of the US financial sector. This was celebrated by Mr. Greenspan as follows (Krugman, 2012, p. 54):

> *[R]ecent regulatory reform, coupled with innovative technologies, has stimulated the development of financial products, such as asset backed securities, collateral loan obligations, and credit default swaps, that facilitate the dispersion of risk …These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter century ago.*
>
> Alan Greenspan, October 12, 2005

The supporters of private business and advocates of the small government philosophy believe that deregulation and the establishment of Purist laissez-faire markets are necessary. In addition, they believe that it is equally important to curtail the ability of the government to spend.

An effective way to constrain the government is to lower taxes and cut spending. The unwritten commandment behind this strategy is that if there are budget surpluses, the government should not be allowed to utilise them for public sector agenda items. Instead, any budget surpluses should be refunded back to the tax payers. This is imperative because if the surpluses remain with the government, then the government would spend them, thereby defeating the goal of reducing government activism and spending.

As mentioned earlier, after more than a quarter of a century of continuous annual budget deficits the United States achieved its first budget surplus in 1998 under President Clinton, a Democrat. The Clinton Administration, by working closely with the Congress, was able to maintain annual budget surpluses consistently for four years (1998-2001). The total accumulated surplus for these four years amounted to $559 billion.

There was considerable debate on how to use this accumulated surplus. Many decades of budget deficits had accumulated a national debt of $3.7 trillion and the Clinton administration wanted to use bulk of the surplus to pay down the debt (Greenspan, 2007, p. 332). In 1999, the Republican-dominated Congress proposed tax cuts of nearly $800 billion dollars over the next ten years (Greenspan, 2007, p. 332-336). This ambitious tax cut proposal was based on the projections by the Congressional Budget Office (CBO) that over the next ten years the US would accumulate a budget surplus of $5.6 trillion (Greenspan, 2007, p. 380-385).

The irony was that though the "R" word (i.e. recession) was being commonly used for the state of the US economy at the time, the budget surplus projection of $5.6 trillion was still based on the growth model of the dotcom boom (Greenspan, 2007, p. 380-382). As this debate was taking place, the Monica Lewinsky scandal took President Clinton by storm. The Clinton White House was both weakened and distracted by this scandal. Thus, the debate remained unresolved.

The Supreme Court verdict on the controversial Presidential election of 2000 brought President G.W. Bush (a Republican) into the White House. Besides gaining the White House the Republicans were also able to maintain their control of both chambers of Congress in this election. President Bush had run on a platform to cut taxes. He was inaugurated into the office in January 2001 and on June 7 of that year he signed $1.35 trillion tax cuts into law. According to Mr. Greenspan this was "…record time for a major budget initiative" (Greenspan, 2007, p. 399). Not only was the Clinton Administration's position of using part of the existing surplus to pay down the national debt forgotten, but starting 2002 the annual budgets began piling up deficits again. The persistence of deficits in an economy ensures that the ability of the government to spend would continue to weaken.

Realisation of the Ideal of Small Government and its Aftermath

The well-organised efforts of the small government-focused Congress, religious fundamentalists, big business, the finance industry lobby, the radical right and fresh water economists reversed the New Deal regulatory infrastructure of the financial sector. This successfully actualised the ideal of the Purist paradigm. Sherman (2009, p. 11) points out that "In a completely deregulated market, derivatives trading expanded quickly, increasing from a total outstanding nominal value of $106 trillion in 2001, to a value of $531 trillion in 2008".

One of the chief objectives of financial regulation was to ensure the protection of the public interest by preventing excessive risk-taking in financial asset creation. This was done by implementing the New Deal-based ML model of economic governance. Once the regulations were abolished, it was left to the rational behaviour of the individual economic agents to pursue their respective self-interests in such a way that the greater good of the society, including macroeconomic and financial stability, full employment, and growth were also protected.

Most of the legal framework (i.e. the FIRSTS) to regulate the financial sector had been demolished in the 1990s. Since 2004, the SEC had also relaxed restrictions on the investment banks by allowing them to voluntarily regulate themselves. Thus the LI under the Purist framework was in full swing. Under this model the greater good of the society was supposedly fully secure, since the self-interests of the economic agents were assumed to be in harmony with the public interest.

In reality, however, there may be situations when there is a clash between the micro-level interests of economic agents and the macro-level interests of society. The motivation of economic agents to maximise micro-level interests became infinitely high because of the incredible short term reward structure in the financial sector. As Rajan (2010, p. 8) notes, "in 2007 the hedge fund manager John Paulson earned $3.7 billion, about 74,000 times the median household income in the United States". Short term reward structures and incentives often dwarf considerations of the long term consequences of one's actions. In the absence of a robust regulatory infrastructure, the short term maximisation of profits was the driver of the poor quality subprime mortgage loans made by the banks. The same forces were at work in the creation of trillions of dollars of derivatives and their aggressive marketing, which was aided by the short term perspective of the rating agencies who rated these derivatives overoptimistically. Once interest rates were eventually raised and borrowers found themselves unable to pay their mortgage instalments, the self-destructive forces of Purist laissez-faire capitalism demonstrated their power beyond doubt by wrecking the global financial system within a relatively short period of time.

Governance in a Purist Economy: For Whom, and By Whom?

While the 2008 financial crisis can be studied from a variety of perspectives, this paper focuses on the perspective of economic governance in the context of political economy. Indeed, it is the politics, corporate culture, institutional framework, and rules and regulations of the governance of the economy as a whole that determines the nature of corporate governance in an economy. It is worth noting that corporate governance is only a subset of the overall governance of the economy as a whole.

This is exactly what happened in the case of the US starting in the 1980s when the LIFE politics dominated the US political scene. This politics translated the Purist laissez-faire philosophy into legislation and policies that determined the level of institutional vigilance and accountability in the entire economy. The dominance of Purist philosophy and its execution through LIFE politics was taken as a signal by the finance industry that it was "tone at the top" (The Inquiry Report, 2011, p. xxiii) that mattered. The rationality of the players in the finance industry told them that actions at the top speak louder than the golden words written in the corporate governance manuals.

From a corporate governance perspective, it is true that corporate boards of directors had their mission and vision, and corporate executives were trained to perform their duties professionally with a sense of corporate social responsibility and a consciousness of accountability. However, in this case, few adhered to the principles of corporate social responsibility (and ethics of corporate governance) that they were required to uphold and follow. This happened because legislation had either lifted or weakened safeguards and withdrawn institutional monitoring built into the system by the New Deal to protect the public interest. This irony is acknowledged by the Economics Noble Laureates George Akerlof and Robert Shiller when they write, "The old story about capitalism is correct: it gives us what we think we want. But capitalism does not act as its own policeman if we fail to watch over it and give it proper direction. It actively, competitively, seeks the most profit-maximizing opportunities. Capitalism will follow such opportunities wherever they lead us" (Akerlof and Shiller, 2009, p. xi). In the light of the above discussion, we can now identify the following universal issues that have serious implications for corporate governance:

i) A system of governance where funds from corporate entities and financial institutions can exert enormous influence on legislation and political leaders has the potential to be abused by big business. Such a system can lead to breaches of ethical principles and good corporate governance practices. In other words, corporate governance is subservient to the system of political governance of the country. If big money from big business can systemically influence Big Brother (i.e. the legislative and executive branches of the government) then the private sector would not hesitate to violate the rules of corporate governance and business ethics to maximise its profits.

ii) A lack of sense of personal responsibility and accountability. The financial sector operates in a highly skewed manner. When financial institutions earn high profits, there are huge rewards for individuals making those decisions. But when wrong decisions are made, the individuals who made those decisions are often not held responsible. The pain and sacrifice is instead often borne by shareholders, lower level employees, and society at large (Rakoff, 2014).

iii) A lack of professionalism by the rating agencies. In theory, rating agencies should provide unbiased, credible assessments of the risk and value of financial securities. As the financial crisis revealed, however, the rating agencies were often highly biased in their opinions, and issued overly optimistic judgements of security values which aided in maximising their profits.

iv) Opponents of government activism also know that they may not always have the political clout to force Congress to cut taxes and government spending. Hence, they endeavour to establish a system of economic governance on the basis of the Purist model so that the government activism will be permanently disabled.

Findings and Conclusions of the Financial Crisis Inquiry Commission (FCIC) Report (2011)

The US federal government appointed a 10-member Financial Crisis Inquiry Commission (FCIC) to investigate the causes of the 2008 financial crisis. They reviewed millions of pages of documents and interviewed more than 700 witnesses. The commission produced a comprehensive report consisting of more than 500 pages. Some highlights of the report's major findings and conclusions are as follows (The Inquiry Report, 2011, p. xv-xxviii):

i) This financial crisis was avoidable: It was caused by human action and inaction. Neither mother nature nor computer models were responsible for it. It would be a great tragedy to believe that nobody could have seen it coming and hence nothing could be done. If this argument is accepted, the tragedy would repeat itself. "The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the wellbeing of the American public. Theirs was a big miss, not a stumble" (The Inquiry Report, 2011, p. xvii).

ii) Widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets (The Inquiry Report, 2011, p. xviii).

iii) The use of dollar power by the financial industry: The report says that if the regulators felt they lacked authority, they could have sought it, but they lacked political will to do so. The inquiry found that the financial industry had used its wealth and power to bend the system in its favour. The report says, "… the financial industry itself played a key role in weakening regulatory constraints on institutions, markets, and products. It did not surprise the commission that an industry of such wealth and power would exert pressure on policy makers and regulators. From 1999 to 2008, the financial sector expended $2.7 billion in reported federal lobbying expenses; individuals and political action committees in the sector made more than $1 billion in campaign contributions. What troubled us was the extent to which the nation was deprived of the necessary strength and independence of the oversight necessary to safeguard financial stability" (The Inquiry Report, 2011, p. xviii).

iv) The claim that under Purist laissez-faire market system rational decisions by economic agents to promote their self -interest will always be in harmony with the public interest was proven untrue: "There was a view that instincts for self-preservation inside major financial firms would shield them from fatal risk-taking without the need for a steady regulatory hand, which, the firms argued, would stifle innovation. Too many of these institutions acted recklessly, taking on too much risk, with too little capital, and with too much dependence on short–term funding. In many respects, this reflected a fundamental change in these institutions, particularly the large investment banks and bank holding companies, which focused their activities increasingly on risky trading activities that produced hefty profits" (The Inquiry Report, 2011, p. xviii-xix).

v) Failures of corporate governance and risk management including reward for short- term gain without proper consideration of long term consequences were a key cause of this crisis.

vi) According to the report, the 'avoidable' disaster resulted from widespread failures in government regulation, corporate mismanagement, and reckless risk-taking by Wall Street (including shoddy mortgage lending and the excessive sales of risky securities to investors).

vii) Numerous financial institutions including rating agencies demonstrated greed, ineptitude, social irresponsibility, and a lack of professionalism all of which contributed to the crisis. "This crisis could not have happened without rating agencies" (The Inquiry Report, 2011, p. xxv).

viii) The report concluded that a combination of excessive borrowing, risky investments, and lack of transparency set the system on the course of crisis. The report identified that the main policy making institutions: the Treasury Department, the Federal Reserve Board, and the Federal Reserve of New York which were best positioned to monitor the markets were ill prepared for the crisis as "They thought risk had been diversified when, in fact, it had been concentrated" (The Inquiry Report, 2011, p. xxi).

ix) The report identified a systematic breakdown in accountability and ethics, and erosion of standards of responsibility and ethics as factors that further aggravated the crisis.

x) The report found that collapsing mortgage lending standards, mortgage securitisation, and over-the-counter derivatives ignited and spread the contagion and crisis.

xi) The report found that the SEC, "failed to require big banks to hold more capital to cushion potential losses and halt risky practices..." (The Inquiry Report, 2011, p. xviii). As such, there was a shadow banking system with heavy reliance on short term debt deliberately hidden through off-balance sheet entities and an overall lack of transparency.

xii) The report concluded that the Federal Reserve "neglected its mission" (Chan, 2011).

xiii) Mr. Greenspan was criticised for his negligence in checking the flow of toxic mortgages. The report was also critical of Mr. Greenspan's advocacy of deregulation.

xiv) The report acknowledged that once the crisis broke out and the economy was destabilised there were many who worked hard to stabilise the US economy and the financial system, among them the report identified the following by name: Secretary Paulson, Chairman Bernanke, and Timothy Geithner who later served as Treasury Secretary.

xv) The decision in 2000 to shield the over-the-counter derivatives from federal and state regulation was criticised. The report called it "a key turning point in the march toward financial crisis" (Chan, 2011).

Concluding Remarks

A scientific investigation deals with questions like: What? When? How? Why? When it comes to the financial crisis of 2008 there is plenty of literature available on what happened, why it happened and when it happened. Economists and experts in finance have contributed invaluable studies on how it happened. As far as the timing of when it happened, everybody knows that it happened in 2007-2008. However, it would be prudent to keep our focus on the following two central issues:

i) Why did it happen in 2007-2008, and not before?

ii) Studies in economics, finance or corporate governance, when analysing the crisis, use the factors from those disciplines only. The studies in these or similar disciplines give excellent analyses from their respective perspectives. However, they fall short of explaining the *greater reality* behind principles of economics, finance or corporate governance that led to the crisis. The basic scientific fact is that our failure to identify and understand that *greater reality* would inhibit our ability to take the measures that would be effective in successfully preventing the repeat of such disasters in the future. Consequently, our response to such crises could be any of the following (or a mix thereof):

a) The crisis could not have been seen by any one and was thus unavoidable (Chan, 2011).

b) The crisis was caused by human greed which is innate to humans and therefore unavoidable.

Any understanding of the crisis along the above lines (i.e. (a) and (b) above) would keep the doors wide open for a repeat of these events, because it fails to identify and recognise the *greater reality* behind the forces of economics, finance, and corporate governance that was the major cause of this crisis. In fact, an effective system of economic governance enshrines checks and balances on human greed while simultaneously maintaining an efficient market mechanism.

The report identifies, in no uncertain terms, those responsible for failing to account for human weakness (The Inquiry Report, 2011, p. xxiii). It says:

> *"We do place special responsibility with the public leaders charged with protecting our financial system, those entrusted to run our regulatory agencies, and the chief executives of companies whose failures drove us to crisis. These individuals sought and accepted positions of significant responsibility and obligation. Tone at the top does matter and, in this instance, we were let down. No one said 'no'.*
>
> *But as a nation, we must also accept responsibility for what we permitted to occur. Collectively, but certainly not unanimously. We acquiesced to or embraced a system, a set of policies and action, that gave rise to our present predicament."*

The above conclusion of the report places a special burden of responsibility on public leaders. In a democratic system 'public leaders' are elected members of government. The Inquiry Report specifically acknowledges the role and influence of the dollar power of the Wall Street on the elected politicians in removing the legal safeguards that had been protecting the greater good of the society for decades. In this regard the Inquiry Report (2011, p. xviii) says:

> *"The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe. This approach had opened up gaps in oversight of critical areas with trillions of dollars at risk, such as the shadow*

> *banking system and over-the-counter derivatives markets. In addition the government permitted financial firms to pick their preferred regulators in what became a race to the weakest supervisor".*

While studies of the 2008 financial crisis in the domains of economics, finance, and corporate governance are essential, a key problem arises when advocates of good economics and good finance assume the existence of good and responsible politics. If this assumption were true, The Inquiry Report would not have placed special responsibility of the crisis on public leaders and officials entrusted to run the regulatory agencies (The Inquiry Report, 2011, p. xxiii). Thus, if the root causes of the crisis are to be eradicated, it is imperative that our understanding and analyses should take into account the overall dynamics of the link between the power of big money and politics (Polifinance). This point is underscored by Rajan (2010, p. 19), as follows:

> *"We also have to recognize that good economics cannot be divorced from good politics: this is perhaps a reason why the field of economics was known as political economy. The mistake economists made was to believe that once countries had developed a steel frame of institutions, political influences would be tempered: countries would graduate permanently from developing-country status. We should now recognize that institutions such as regulators have influence only so long as politics is reasonably well balanced. Deep imbalances such as inequality can create political groundswell that can overcome any constraining institutions. Countries can return to developing -country status if their politics become imbalanced, no matter how well developed their institutions."*

It is for these reasons that this study addresses the causes of the 2008 financial crisis within a wider framework. This approach enables us to see the roots of the problem. It should be noted that this study in no way claims to be exhaustive. The spirit of this study is to widen the scope of analysis to capture the political economy dynamics of society (i.e. the greater reality) that brought the American economy to near-collapse. This approach allows us to identify a number of important factors that played a key role in setting in motion the forces that systematically brought down a system of checks and balances that had been put in place on the basis of lessons learned from the Great Depression of the 1930s.

Unfortunately, conventional wisdom today suggests that the crisis happened because of free market forces and human greed. The argument goes that since markets should be kept free and since greed is part of human nature, such events are inevitable. It is true that greed was a factor and will remain a factor as long as humans are humans. But to say that nothing can be done about it is overly simplistic. The combination of Purist market philosophy and human greed caused the Great Depression of the 1930s. But the lessons learned from that crisis had led to the creation of an architecture of regulation and supervision of financial markets within the framework of the ML model. This regulation and supervision kept the markets stable for more than three decades (1960-1991) despite natural fluctuations. But, as discussed above, most of these regulations were repealed in the 1990s, and the ban on over-the-counter derivatives was removed in 2004. Given the dismantling of the regulatory architecture that had kept markets effective while keeping greed in check, what happened next was only natural. To underscore this dimension of economic governance the study attempts to address relevant questions such as: When and why were these restrictions created in the first place? Why were they removed? What was the process by which they were removed? What justification was given for their removal? Who were the immediate and ultimate economic beneficiaries of their removal? Who were the immediate and ultimate victims of their removal?

Besides the belief that humans by nature are greedy, there is also the belief that humans are rational beings. However, some take the assumption of rationality too far and argue that the rational pursuit of self-interest by individual market participants is always in harmony with the public interest. Advocates of this position argue that any governmental regulations or restrictions on Purist laissez-faire markets harm human creativity, innovation and motivation, thereby causing inefficiency and suboptimal outcomes. Hence, politicians and regulators who believed in the Purist laissez-faire ideology as the most efficient way to realise the potential of capitalism ensured that regulations were lifted. The fall of socialism in 1989 had further deepened their faith in Purist capitalism. They were now committed to ensure the full and speedy implementation of the Purist model on the American financial sector. In some ways the Federal Reserve also apparently took a similar path. The Financial Crisis Inquiry Commission set up by the US government to investigate the causes of the financial crisis in its report (2011, p. xxiii) commented on the Fed's role as follows:

> *"As irresponsible lending, including predatory fraudulent practices, became more prevalent, the Federal Reserve and other regulators and authorities heard warnings from many quarters. Yet the Federal Reserve neglected its mission 'to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.' It failed to build the wall before it was too late."*

Thus many leaders and regulators were more committed, knowingly or unknowingly, to implementing their ideology of Purist laissez-faire markets than to fulfilling their mission of protecting the public interest. Naturally, the dollar power of Wall Street lobbyists and the push from the radical right and religious fundamentalist groups for anti-regulation policies also rolled the legislative and executive branches of the government down the slippery slope of deregulation and cutting the size of government. As shown here, this deregulation opened the floodgates of unintended abuse. This created a new structure in which, according to the Inquiry Report (2011, p. xx), "We had a 21st century financial system with 19th century safeguards". Even today, the situation remains grave, as the American financial sector "…is now more concentrated than ever in the hands of a few large, systemically significant institutions" (The Inquiry Report, p. xxvii). Indeed, markets are still largely deregulated. If effective regulatory and supervisory measures are not adopted, the next crisis could be colossal on a global scale and may severely undermine the world's trust in the US economy.

Hence there is a dire need to restore, adopt, and implement socially responsible regulations and supervision of the US financial sector to ensure economic stability and protection of long term interests of society. As the 21st century progresses the US would face even more severe challenges in the global economy due to the increasing multi-sectoral competition from the rise of new economic power houses starting with BRICS countries. The challenge before policymakers is to maintain a fine balance between Purist market efficiency and responsible monitoring and regulation to ensure the protection of the public interest (i.e. stability of the financial system and the economy, etc.).

In the 20th century, socialism was condemned because it suppressed human nature and caused inefficiency. This criticism was valid, and that is why it fell. Both capitalism and democracy were applauded for their potential of making the best of human rationality, creativity, innovation, and entrepreneurship through the market mechanism working in parallel with liberal democracy. Humans are the best of all creations (Qur'an, 95:4). They are created in the image of God (Hebrew Bible, Genesis 1:27). At the same time, humans have wild and selfish instincts too, which sometimes clash with the greater good of society. A failure to create a system of economic governance to discipline, monitor, and check these instincts can harm the entire society. For millennia, the world's great religions and moral philosophers have recognised the need for this discipline both at the individual and societal levels. In response to the 2007-2008 financial crisis, the US Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which became law with the signature of President Obama in 2010. The Dodd-Frank Act establishes new sets of regulations to ensure the stability of the financial system. But its critics say it does not go far enough. In a recent article Mr. Gordon Brown, former British Prime Minister (and Chancellor of the Exchequer) warned the world of the next global crash in the absence of new regulations (Brown, 2013). In order to ensure effective regulation of financial markets, Senator Bernie Sanders, the Democratic hopeful for the 2016 US Presidential election, promises to separate investment banking from commercial banking if elected to the White House (Eskow, 2015). At this juncture, it is pertinent to remind ourselves of the advice - and warning - of the Inquiry Report, "this is our collective responsibility. It falls to us to make different choices if we want different results" (The Inquiry Report, 2011, p. xxviii). Thus in the final analysis it boils down to the choices we make as a society. We conclude with the following two pieces of advice on the issue of making choices. The first is from the authors of the Inquiry Report, who warn that "if we do not learn from history, we are unlikely to fully recover from it." (The Inquiry Report, 2011, p. xv). The second is from the Qur'an, which says: "Verily never will God change the condition of a people until they change it themselves (with their own souls)" (Qur'an, 13:11).

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