WHAT SHOULD THE FINANCIAL SYSTEM DO? A MINSKIAN APPROACH TO PROMOTING THE CAPITAL DEVELOPMENT OF THE ECONOMY

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Lessons from the Global Crisis: What the financial system should NOT do

- Crisis represents
  - an institutional failure (banks mutated from utilities to casinos);
  - an intellectual failure (dangerous view of efficacy of mkts);
  - and moral failure (system built on money values)

A Minsky Moment or a Minsky Half-Century?

- Stages Approach
  - Commercial capitalism
  - Finance capitalism
  - Paternalistic (Managerial-Welfare State) capitalism
  - Money Manager capitalism (predator state, financialization, ownership society, neoliberalism, neoconservativism, shadow banking)
    - Stability bred instability
    - Accumulation of financial assets/liabilities
    - Globalization
    - Securitization
    - Self-supervision

Boom and Bust

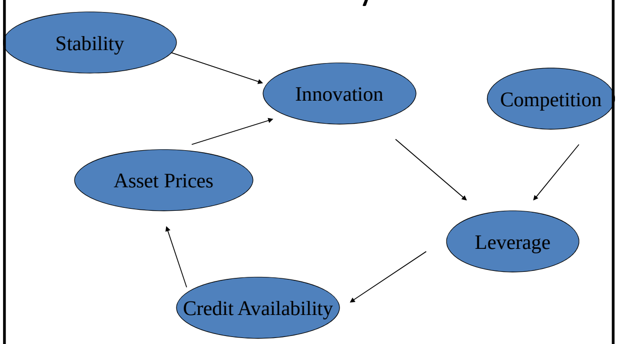
- 1980s Thrift & Bank Crises
  - Thrifts and Commercial real estate
  - Banks and LDC debt
- 1980s Leverage Buy-outs
  - Michael Milken and Junk Bonds
- 1990s New Economy and Nasdaq
  - "Irrational Exuberance"
- 2000s Residential Real Estate
  - Subprimes; foreclosures
- 2000s Commodity Markets
  - Quadrupled oil prices; food riots; starvation

Each crisis worse than the previous

Stability is Destabilizing

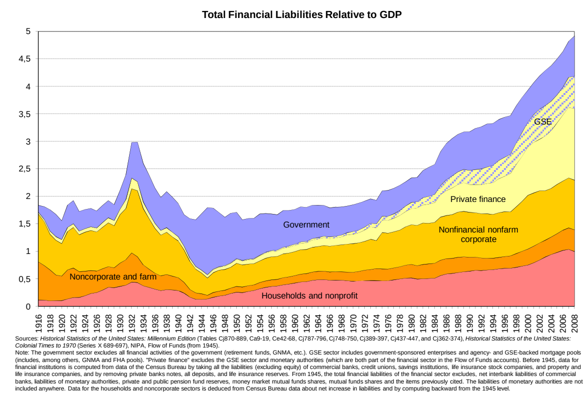
- If risky innovations had led to losses, they wouldn't have been retained
- But Big Bank and Big Gov't constrained instability; allowed fragility to increase
- And allowed managed money to grow
- Shifted weight of financial system away from regulated/protected banks to pension funds, mutual funds, hedge funds, sovereign wealth funds, university endowments: Managed Money
- Evolved to much riskier financial system: Hedge→Speculative→Ponzi

Virtuous Cycle

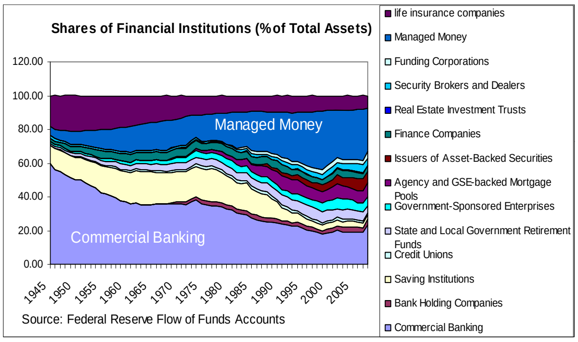


Rise of Managed Money

- Two aspects of note:
  - Volumes of assets and liabilities ("financialization"→increases finance's share; and increases debt burden)
  - Competition with banks ("shadow banking"→innovations, leverage, and deregulation)



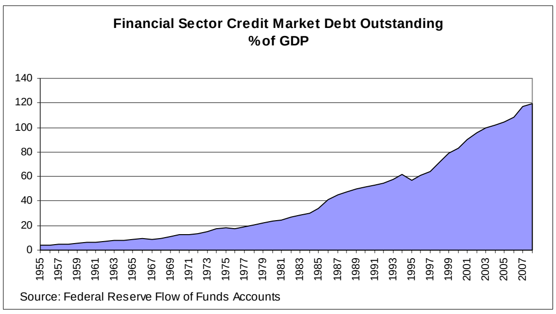
Decreasing Weight of the Banking Sector



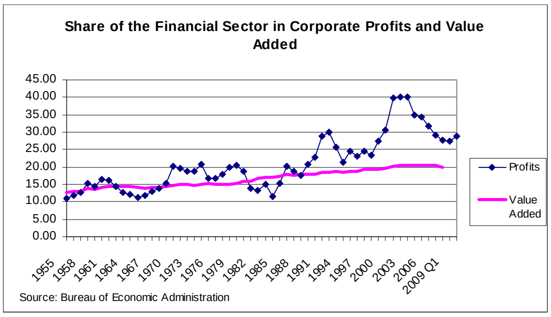
Financialization

- Layering, leveraging.
- Prior commitment of future flows
  - Each $1 of income flows services $5 of debt
- Cannot be serviced out of income flows: Ponzi
- Requires capital gains: prices must always rise
- Much of that debt is owed by financial institutions

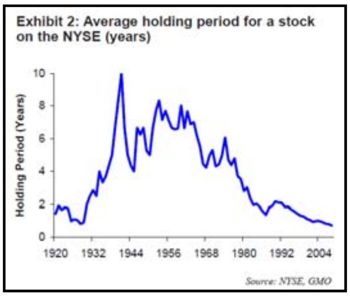
Financialization of the US Economy



Financialization of the US Economy



Keynes: When speculation dominates enterprise the job is likely to be ill-done



Policy Response

- Policy actions are directed at saving the system, not reforming it
- Mergers and acquisitions against rules; Too big to fail institutions even bigger today than they were before the crisis; share of corporate profits back to peak level
- Few criminal prosecutions of those responsible for the current crisis
- Reliance on Wall Street to reform itself, belief that gov't only needs to get the incentives right for market discipline to work

Paulson/Geithner Plans: Trying to restore Money Manager Capitalism

Minsky's policies to promote stability

- High consumption, high employment
  - Greater equality, rely on income, not debt
- Favor small to medium size banks; CDBs, not predatory lending; debt relief
- Don't waste a crisis: De-financialize; downsize. Resolve
- Enhanced oversight; strengthened regulation
  - Nothing off-balance sheet
- Institutions and practices to favor stability
  - Automatic stabilizers: countercyclical budget
  - Institutional Circuit breakers
- No "final" solution to fundamental flaw of capitalism

What *Should* Financial System Do?

- 1. safe and sound payments system;
- 2. short term loans to households and firms, and, possibly, to state and local government;
- 3. safe and sound housing finance system;
- 4. a range of financial services including insurance, brokerage, and retirement savings services; and
- 5. long term funding of positions in expensive capital assets.

NB: there is no reason why these should be consolidated, nor why all should be privately supplied

Payments system

- Clearing at par requires access to central bank
- Safety requires gov't backing of deposits; in a crisis, 100% coverage
- If provided by "private" bank, it plays with "house money"→public-private partnership (PPP); requires close supervision/regs
- Alternative: postal savings banks

Short-term lending

- Small banks appropriate for financing small loans; returns to scale quickly exhausted
- If banks are backstopped by govt, mkt incentives are weak
- Private lending justified only if banks are better underwriters than govt is
- Loans must be held to maturity to induced proper underwriting
- Relationship banking rather than markets
  - Finance is not a scarce resource to be allocated by efficient mkts

Housing Finance

- US experience: mutuals were best; primacy of interests of owners/shareholders
- Thrifts devastated by change of ownership rules, then by Volcker experiment
- If housing (student loans) is high social priority, then underwriting is less important
- US experience: adding intermediaries only diverts activity away from public purpose– simplest is best.
  - Direct gov't lending, or gov't guarantee of mortgages held to maturity.
- Stability of long-term mortgages requires pact with central bank to keep interest rates low

Range of Financial Services

- Main "synergy" of combining services: enhances ability to defraud customers—from Lincoln Savings to Goldman Sachs
- Systemically dangerous institutions, too complex to manage, regulate and supervise
- Over-compensated top management runs control frauds
- Too Big To Fail → bail-outs, often in secret, consolidation of power
  - Small enough to fail institutions cannot compete
- Alternative: Minsky's Community Development Banks
  - Allowed to offer range of services
  - Community board of directors
  - "intensified" banking, instead of branching and bank holding company
  - Use crisis to downsize megabanks; offer alternative: downsize or give up bank charter

Long Term Funding of Investment

- Investment banks went public→pump and dump,
  - "maximize shareholder value" (=run a control fraud)
  - Galbraith's *The Great Crash*
- Role of Pension Funds, other managed money: too much money chasing too few good investments
- Capital development can be ill-done in both Smithian and Keynesian ways
  - Wrong investments
  - Too little investment
  - "TINA": there is no alternative to socialization of investment

Conclusions for Reform: Gov't Role

- Decentralization plus retaining risk can reorient banks back to relationship banking
- Role for gov't to play in re-regulating and re-supervising
- Role for gov't in direct provision of financial services
  - Payments system
  - Direct lending to serve public purpose
  - Guarantees for public-private partnerships

Conclusions for Reform: Civil Society

- Must hold policy-makers and financial institutions accountable
- Push for down-sizing and reform
- Use HMDA and CRA as models
  - requires banks to report provision of services
  - Reduce discriminatory practices
- Push for state development banks, CDBs, other direct provision
- Cannot prevent risky and fraudulent practices, but can limit who gets screwed
  - CSOs cannot stop fraud—it is concealed, usually complex acctg
- Consumer protection:
  - Warren's CFPB
  - FDA-type rules: prior approval of new instruments
  - Citizen Utility Boards as model to represent citizens before regulatory proceedings