Financialization and Policy Responses

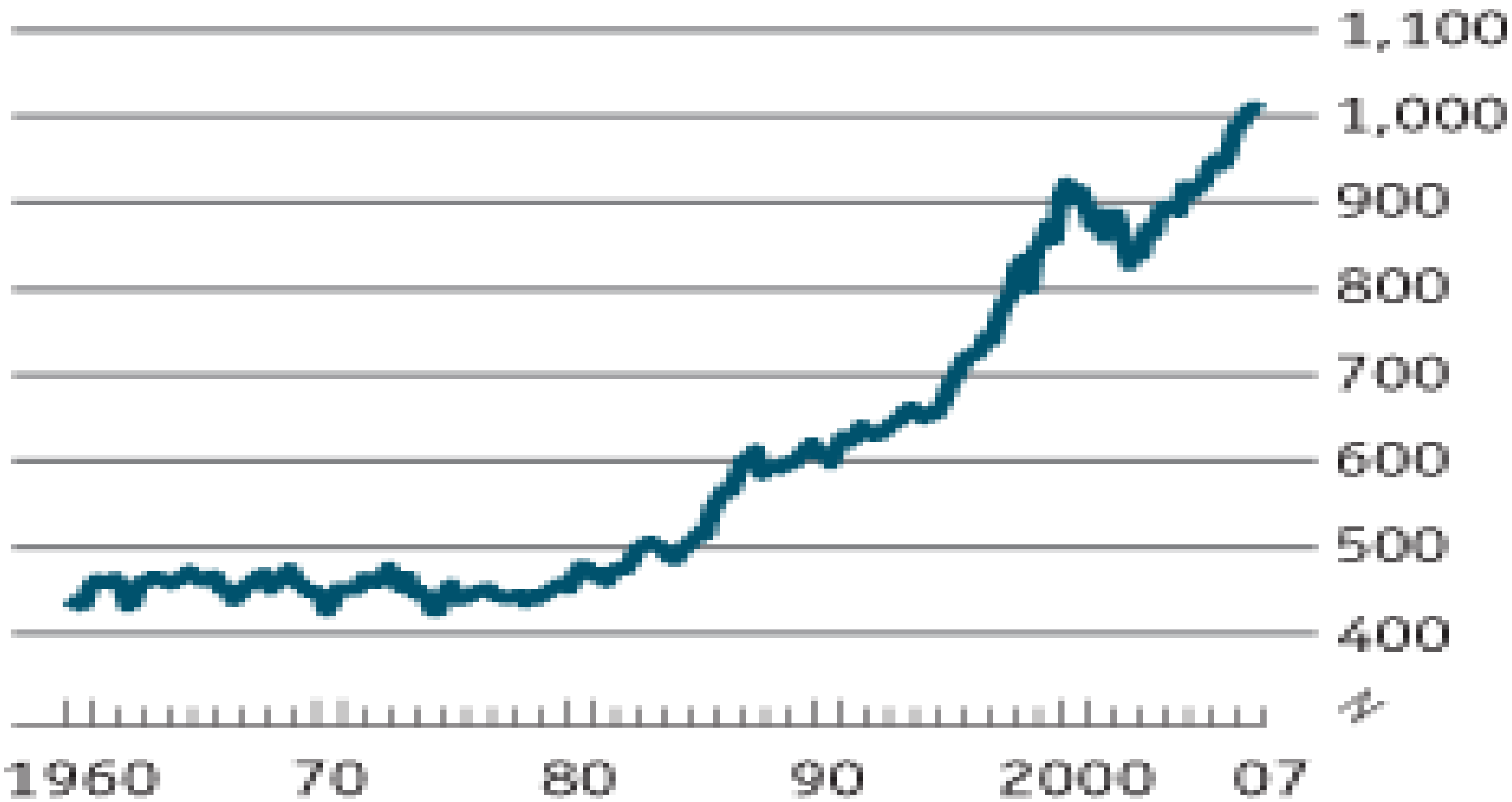
Presentation to Americans for Financial Reform
Damon Silvers
Policy Director, AFL-CIO
June 28, 2011

What is Financialization?

Financialization is the growth of the size and importance of financial markets and institutions compared to other economic activity, and the increase in the power of financial interests over other interests within firms and within the larger economy and society.

Up, up and away

US financial assets as a % of GDP



Sources: Thomson Datastream; Federal Reserve

How Did the New Deal Regulate Finance?

- Financial system divided into banks, insurance companies and securities markets (Glass-Steagall Act).
- Banks and insurance companies were guaranteed by the government, and their activities were restricted to lending for operating businesses, housing, and commercial real estate. Regulators effectively limited the returns they could pay their investors.
- Securities and commodities markets were regulated to require disclosure but also to limit certain types of activity that had proven in the Great Crash to be destabilizing– borrowing money to invest in securities (margin), short selling, and in the case of commodities, the amount of financial as opposed to end user activity in the markets as a whole (position limits).

What Happened to the New Deal System?

- Limits on banks paying interest to depositors repealed.
- Distinction between banking, insurance and securities undone by Gramm-Leach-Bliley.
- Loopholes open up allowing unregulated money managers (hedge funds and lbo funds) to use unlimited margin and engage in short selling.
- Regulation of commodities and derivatives crippled by Commodities Futures Modernization Act.

What Dodd-Frank Did

- Dodd-Frank restored the principle that financial instruments and financial institutions should be regulated for what they are, not what lawyers call them– so derivatives regulated now like their underlying assets.
- Dodd-Frank gave regulators some power over previously unregulated pools of capital– hedge fund and private equity registration.
- Dodd Frank required banks no longer trade securities on their own account (the Volcker rule) and gave regulators the authority to restore more of the Glass-Steagall structure, but did not require them to do so.

What Dodd-Frank Did Not Do

- Did not in general substantively limit the behavior of hedge funds, private equity funds, and banks.
- Did not address the scale of financial involvement in commodities compared to end user involvement.
- Other than the Volcker Rule, did not require banks limit their activities in a manner akin to the way the New Deal did.

The Problem of Bigness

- The New Deal effectively limited the size of banks through Glass-Steagall, by limiting interstate banking and intrastate branching.
- New Deal system founded on the experience of the Reconstruction Finance Corporation, which put failing banks through a resolution process that removed failed executives and wiped out shareholders.
- Repeal of geographic and activities limits on bank size combined with TARP and Federal Reserve bailouts—result– an implicit government guarantee for equity and bondholders of large banks.
- Dodd-Frank resolution authority and capital requirements of limited utility if bank regulators, the Federal Reserve and the Financial Stability Oversight Council avoid resolving big banks at any cost.
- Financialization is when government puts the interests of big bank stockholders and bondholders above all else.

The Problem of Tax Policy

- The tax system subsidizes financialization.
- Key ways are low rate for capital gains (15% after one year), the tax deductibility of corporate interest on corporate taxes, and the carried interest exemption which allows personal income of hedge fund and private equity managers to be taxes at capital gains rates.
- Despite efforts in 2009 and 2010, all of these subsidies are still in place, costing the federal government and state governments hundreds of billions of dollars a year in revenue, and incentivizing the flow of capital into financial speculation and the over-leveraging of firms of all kinds.