Approaching Regulation

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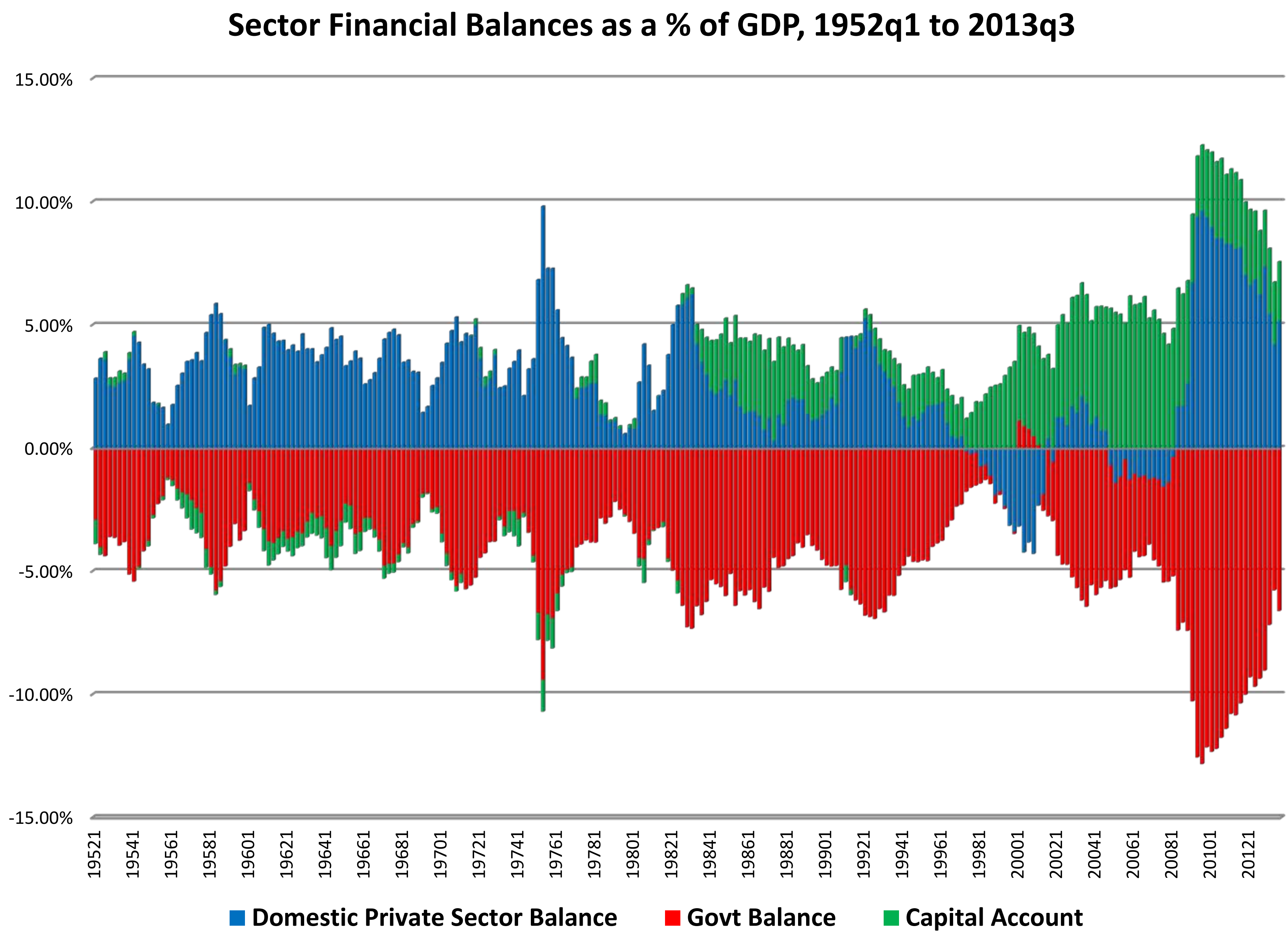
Approaching Regulation

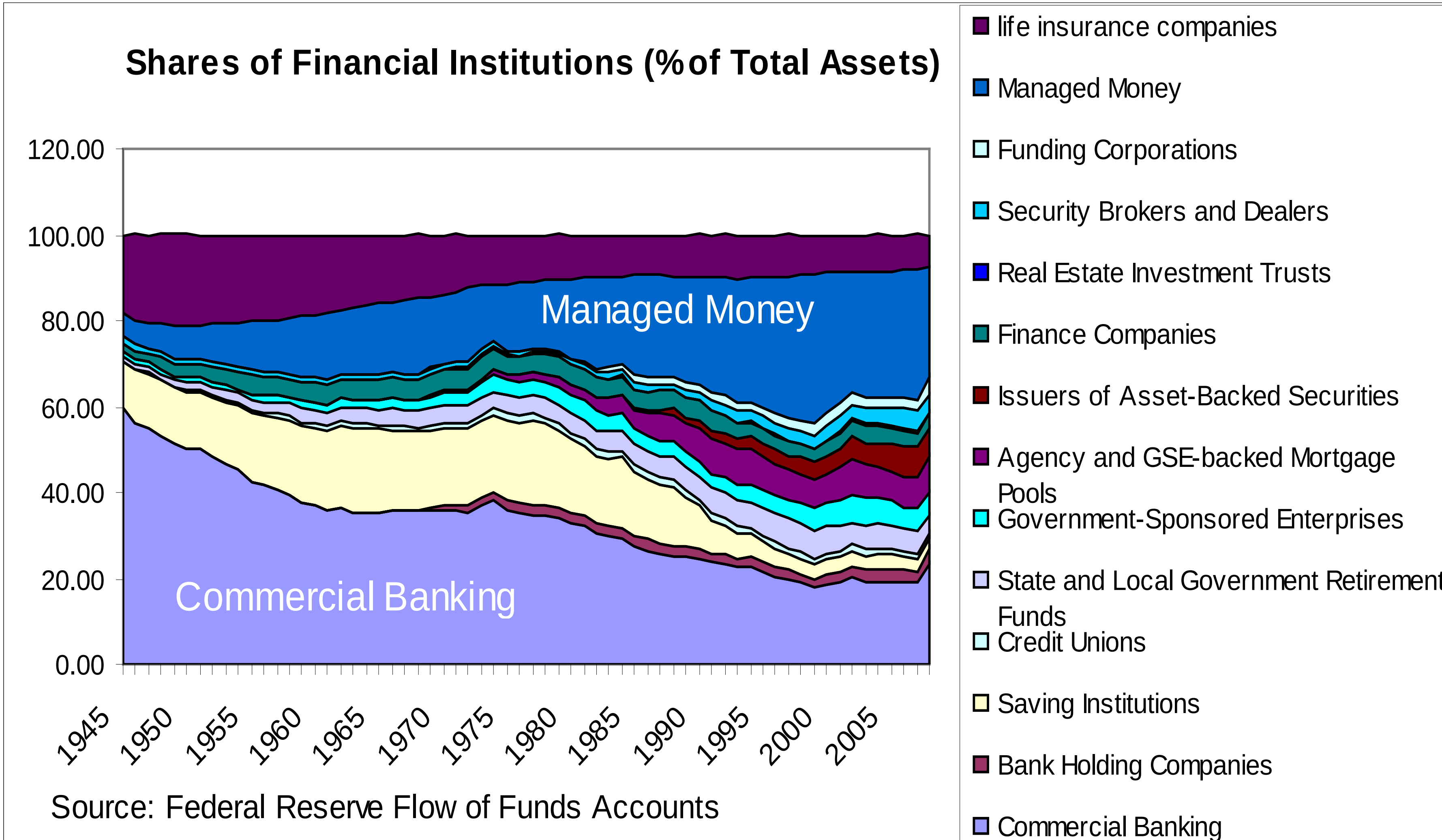
- To Reform the System We must Understand:
  - What is the nature of the financial system today?
  - What is the nature of the crisis?
  - What is the nature of the crisis response?
  - What should a financial system do?
  - How can we reform the system so that
    - It serves a public purpose
    - It can be managed
    - It can be rescued

A Minsky Moment or a Minsky Half-Century?

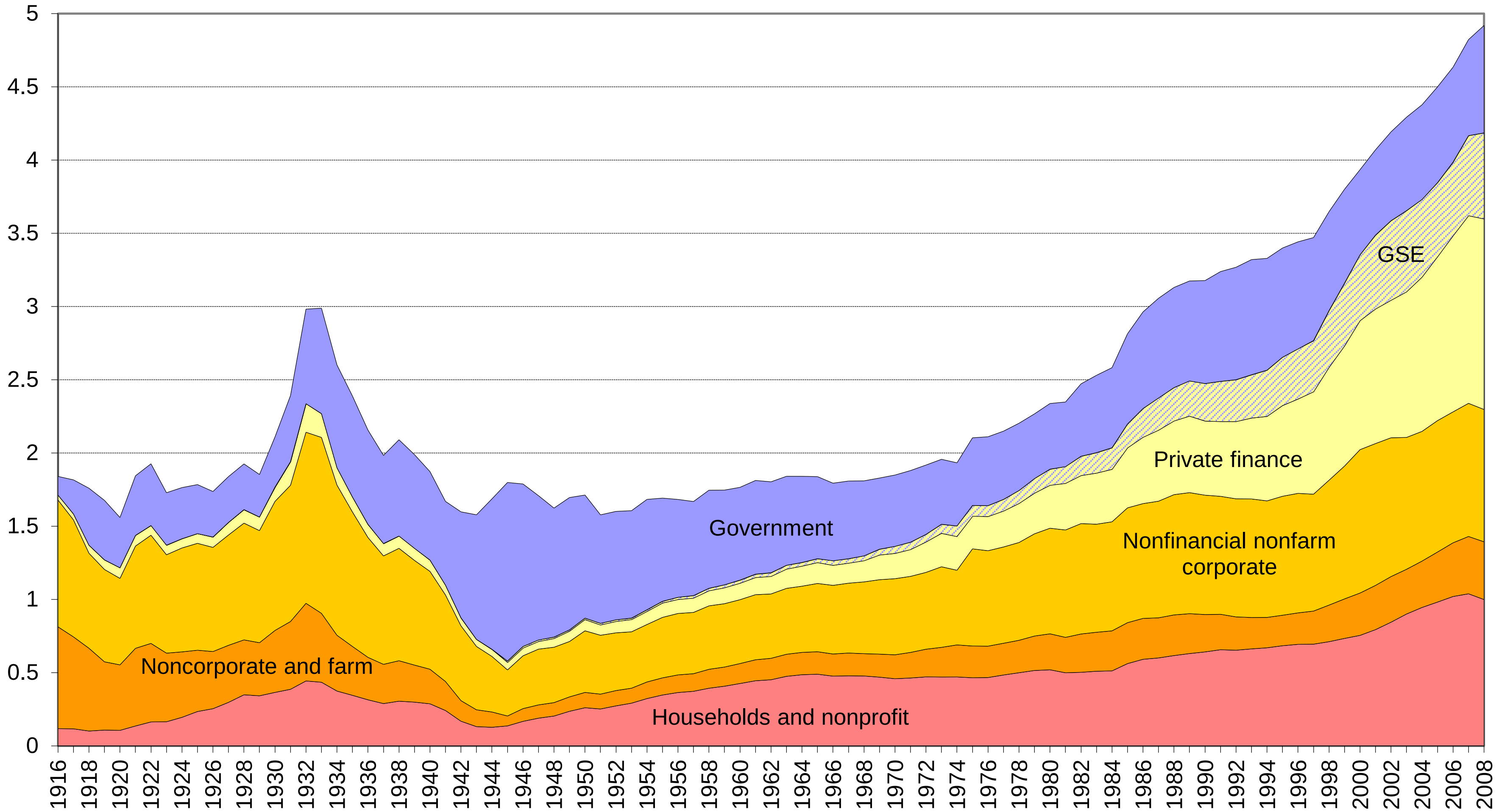
- Stages Approach
  - Commercial capitalism
  - Finance capitalism
  - Paternalistic (Managerial-Welfare State) capitalism
  - Money Manager capitalism (predator state, financialization, ownership society, neoliberalism, neoconservativism, shadow banking)
    - Stability bred instability
    - Accumulation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


Sector Financial Balances as a % of GDP, 1952q1 to 2013q3
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
19521
19541
19561
19581
19601
19621
19641
19661
19681
19701
19721
19741
19761
19781
19801
19821
19841
19861
19881
19901
19921
19941
19961
19981
20001
20021
20041
20061
20081
20101
20121
Domestic Private Sector Balance
Govt Balance
Capital Account

Decreasing Weight of the Banking Sector



Total Financial Liabilities Relative to GDP



Sources: *Historical Statistics of the United States: Millennium Edition* (Tables Cj870-889, Ca9-19, Ce42-68, Cj787-796, Cj748-750, Cj389-397, Cj437-447, and Cj362-374), *Historical Statistics of the United States: Colonial Times to 1970* (Series X 689-697), NIPA, Flow of Funds (from 1945).

Note: The government sector excludes all financial activities of the government (retirement funds, GNMA, etc.). GSE sector includes government-sponsored enterprises and agency- and GSE-backed mortgage pools (includes, among others, GNMA and FHA pools). "Private finance" excludes the GSE sector and monetary authorities (which are both part of the financial sector in the Flow of Funds accounts). Before 1945, data for financial institutions is computed from data of the Census Bureau by taking all the liabilities (excluding equity) of commercial banks, credit unions, savings institutions, life insurance stock companies, and property and life insurance companies, and by removing private banks notes, all deposits, and life insurance reserves. From 1945, the total financial liabilities of the financial sector excludes, net interbank liabilities of commercial banks, liabilities of monetary authorities, private and public pension fund reserves, money market mutual funds shares, mutual funds shares and the items previously cited. The liabilities of monetary authorities are not included anywhere. Data for the households and noncorporate sectors is deduced from Census Bureau data about net increase in liabilities and by computing backward from the 1945 level.

Bubbleonia: 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

No One Saw it Coming

- Two Falsehoods: Unforeseeable and Unpreventable; Black Swans with Fat Tails
- Reality: Financial Crisis Inquiry Report
  - A “Man”-made crisis: Captains of Finance & Public Stewards caused it and ignored warnings
- Reality: Many economists saw it coming
  - Godley&Wray; Baker; Minsky (in the 1950s!)
- Reality: Everyone saw it coming
  - YBG-IBG: you’ll be gone, I’ll be gone
  - Goldman&Paulson
  - Betting on failure: It was Wall Street’s ***desired*** outcome

Let’s name names

- Widespread “failures” in regulation and supervision
  - Treasury, Fed, esp NYFed (Greenspan, Geithner, Rubin, Summers, Bernanke, Dodd, Gramm)
- Dramatic failures of corporate governance and risk management
  - Traders like Hank Paulson and Rubin rise to the top
  - Fannie’s Franklin Raines max’s CEO salary
- Excessive borrowing, risky investments, lack of transparency
- Systemic breakdown in accountability and ethics
- Control Fraud

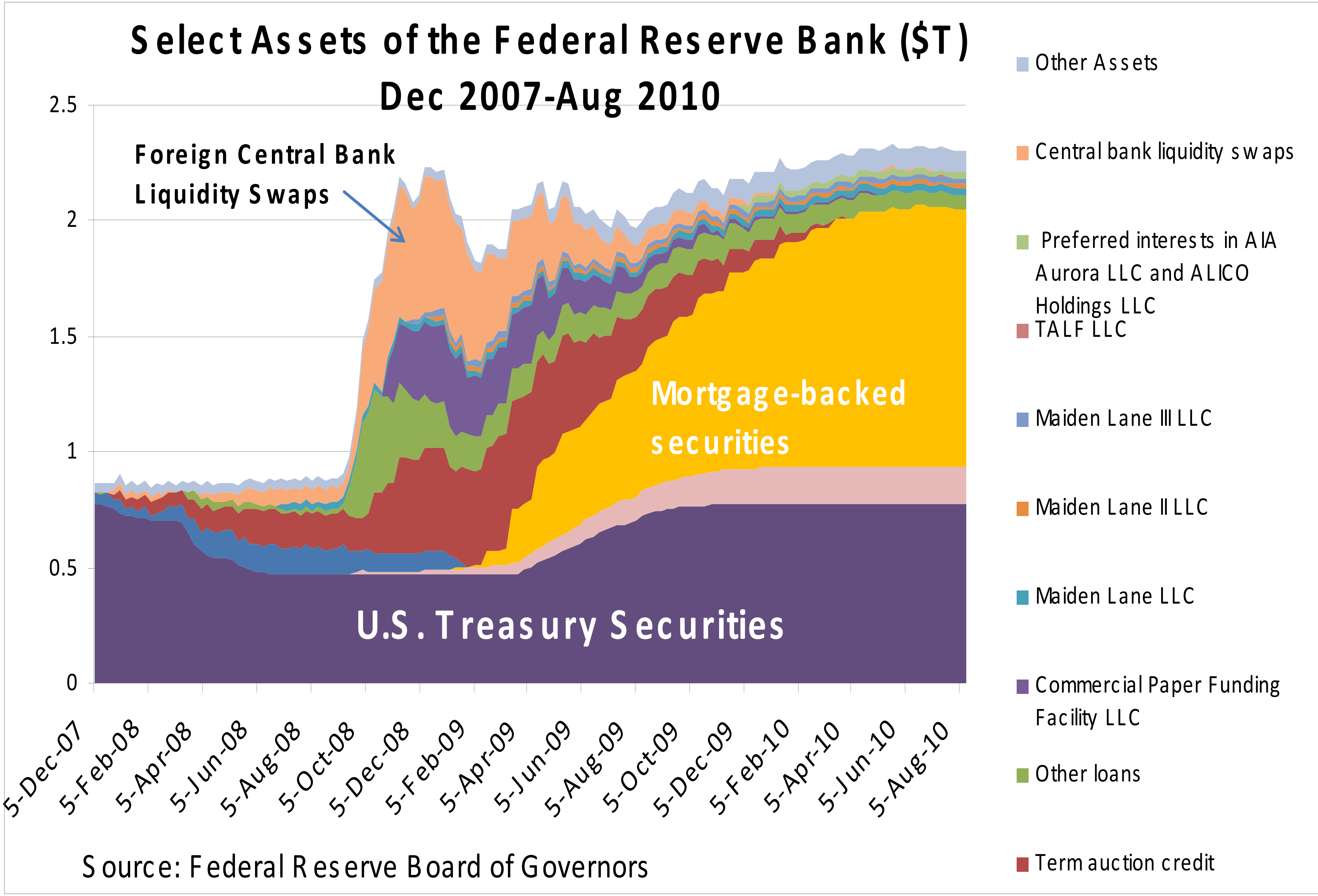
Congressional Oversight Panel: All successful crisis resolutions required:

- **Transparency. Swift action to ensure the integrity of bank accounting, to ascertain the value of bank assets and hence assess bank solvency**
- **Assertiveness. Willingness to (1) take early aggressive action to improve capital ratios of banks that can be rescued, and (2) shut down banks that are irreparably insolvent.**
- **Accountability. Willingness to hold management accountable by replacing – and, in cases of criminal conduct, prosecuting – failed managers.**
- **Clarity. Transparency in the government response with reporting of all forms of assistance being provided and clearly explained criteria for the use of public sector funds.**

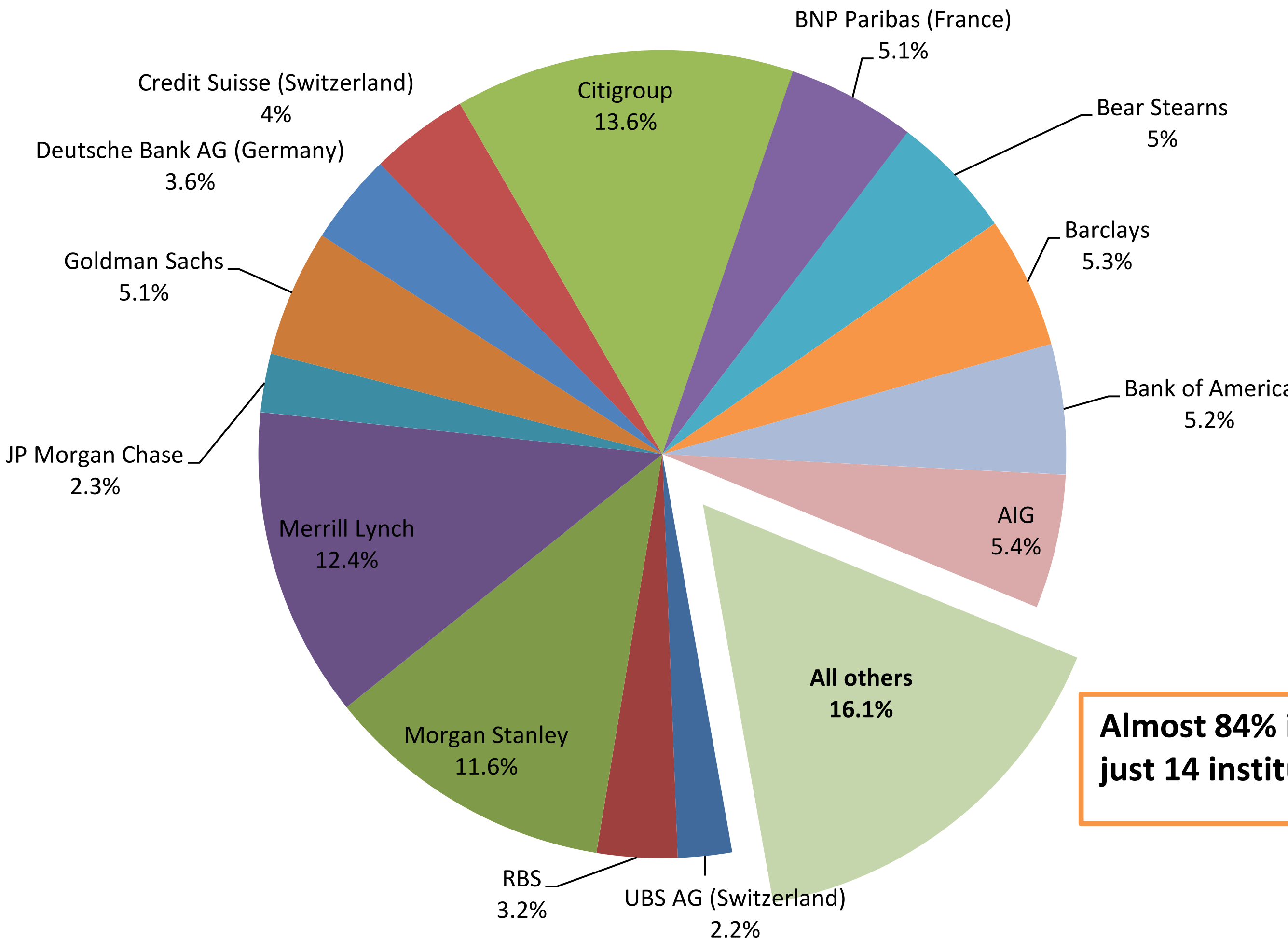
4 strikes and you're out?

Policy Response

- Phase 1: Credit ease
- Phase 2: Let’s Make a Deal!
- Phase 3: Unaccountable $29T+ loan originations
- Phase 4: Quantitative easing 1,2,3,(????) and Confidence Fairies


Select Assets of the Federal Reserve Bank ($T)
Dec 2007-Aug 2010
Foreign Central Bank Liquidity Swaps
Mortgage-backed securities
U.S. Treasury Securities
2.5
2
1.5
1
0.5
0
5-Dec-07
5-Feb-08
5-Apr-08
5-Jun-08
5-Aug-08
5-Oct-08
5-Dec-08
5-Feb-09
5-Apr-09
5-Jun-09
5-Aug-09
5-Oct-09
5-Dec-09
5-Feb-10
5-Apr-10
5-Jun-10
5-Aug-10
Other Assets
Central bank liquidity swaps
Preferred interests in AIA Aurora LLC and ALICO Holdings LLC
TALF LLC
Maiden Lane III LLC
Maiden Lane II LLC
Maiden Lane LLC
Commercial Paper Funding Facility LLC
Other loans
Term auction credit
Source: Federal Reserve Board of Governors

Total Institutional Participation, excluding CBLS



Almost 84% involved just 14 institutions!

Popular Revulsion

- September NYTimes poll: Americans disapprove of the 2008 financial bailout by a 24-point margin, and believe that not enough "bankers and employees of financial institutions" were prosecuted by a staggering 70-point margin.

- Another poll asked more directly about financial regulation, and found a 50-point advantage favoring tougher regulation of financial institutions.

Lessons from the Global Crisis

- Discredited Notions:
  - Efficient Markets, Deregulation, Self regulation, Max Shareholder Value, Great Moderation
  - New Classical, Real Business Cycle, Rational Expectations, Neutral Money
  - New Monetary Consensus, Inflation Targets, Taylor Rule, Quantitative Easing
  - Ricardian Equivalents, Impotent Fiscal Policy, Crowding Out, Optimal Currency Area

- 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)

Revised View of Finance

- Savings Don’t Finance Nothing
  - Saving = Accounting Record of Investment
- Conventional View Confuses “Paying For” with “Finance”
  - The “Finance” Is Created Simultaneously with the Spending (System of Credits and Debits)
- Financialization Is Not Finance; It is Leverage or Layering
  - Financialized Homes, Education, Health Care, Retirement, Death
  - Finance is Not a Scarce Resource
  - Wall St Became the Tail that Wags the Dog

Reconstituting the Financial System

- Minsky Project: Reconstituting Finance to Promote Capital Development of the Economy
- Requires Proper Framework
  - 1. a capitalist economy is a financial system;
  - 2. neoclassical economics is not useful because it denies that the financial system matters;
  - 3. the financial structure has become much more fragile;
  - 4. this fragility makes it likely that stagnation or even a deep depression is possible;
  - 5.a stagnant capitalist economy will not promote capital development;
  - 6.however, this can be avoided by apt reform of the financial structure in conjunction with apt use of fiscal powers of the government.

What *Should* a Financial System Do?: Key Elements to Promote Capital Development

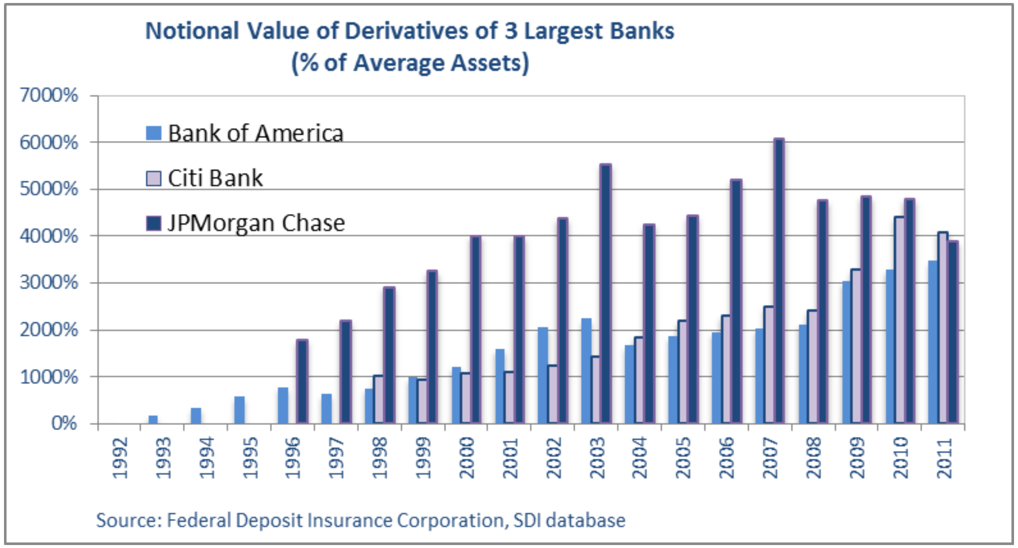
- 1. safe and sound payments system;
- 2. short term loans to households and firms, and, possibly, to state and local government;
- 3. safe and sound housing finance system;
- 4. a range of financial services including insurance, brokerage, and retirement savings services; and
- 5. long term funding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

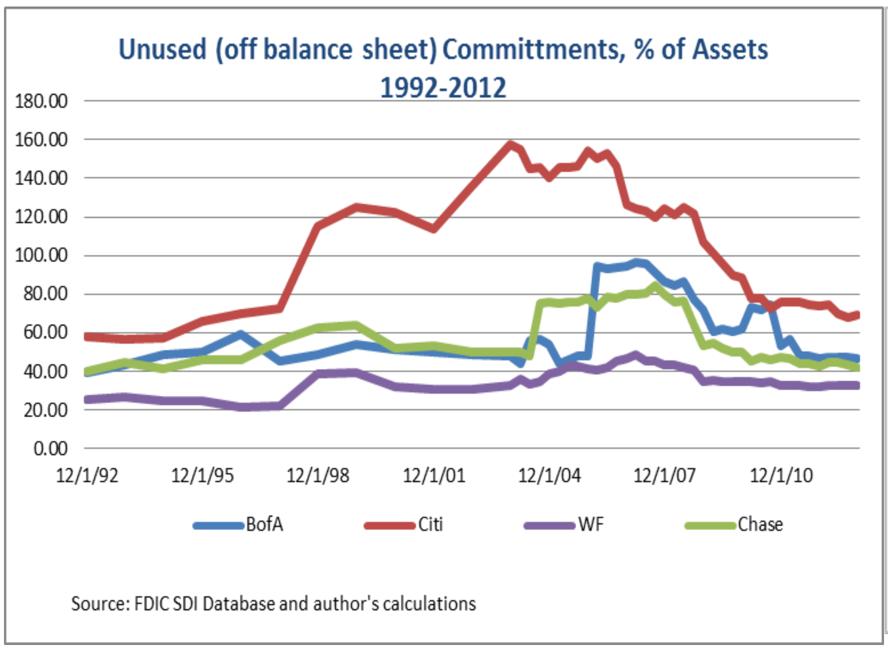
NB: there is no reason why these should be consolidated, nor why all should be privately supplied

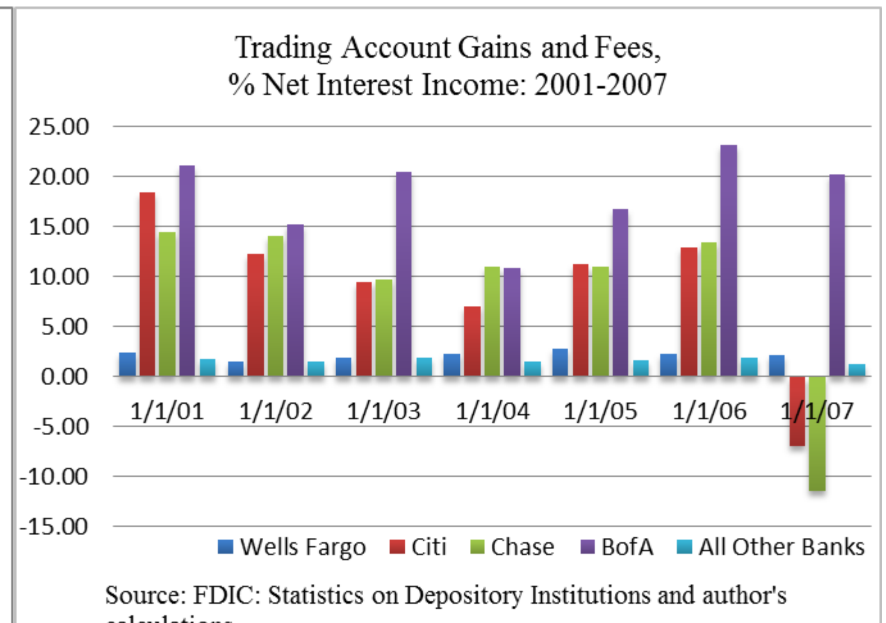
Minsky's Wall St view of money

- Vast majority of monetary transactions have little to do with circulating or producing output
- Many are related to financing positions in assets: M now for more M later; issuing an IOU to get IOUs later
  - -The M now is usually collateralized borrowing: "other people's money"
- Or: changing characteristics of income and outgo streams: r and x swaps
- Many are hedges and bets on contingent outcomes
- Need to redirect finance toward capital development of the economy

The Big 4: Banks or Shadow?







Can we put the Genie back in the bottle? Glass Steagall

- Section 16 accorded regulated banks “all such incidental powers … necessary to carry on the business of banking” (FRB 1933, 396)→undermined separation
- Liquidity creation was increasingly transferred from deposit taking by commercial banks subject to prudential regulation, to securitized structures that were exempt from reporting and regulation because they were considered capital market activities and (usually) exempt from even SEC oversight.
- Kregel: If we re-segment, commercial banks must be profitable
- Morgan Ricks: “term out” to eliminate competition from MMMF

A Modest Proposal

1. Banks lend directly to borrowers, and then service and hold them. There is no further public purpose served by selling loans or other assets to third parties, but there are substantial costs to government from regulation and supervision of those activities.

2. US banks cannot contract in LIBOR, an interest rate set externally with a large, subjective component and subject to manipulation. If not for indexing to LIBOR, the rates paid by US borrowers, including homeowners and businesses, would have come down as the Fed intended when it cut the fed funds rate.

3. Banks cannot have subsidiaries of any kind. No public purpose is served by allowing banks to hold assets 'off balance sheet.'

4. Banks should not be allowed to accept financial assets as collateral for loans. No public purpose is served by financial leverage.

Modest Proposal con’t

5. US Banks cannot lend off-shore. No national public purpose is served by allowing US banks to lend for foreign purposes.

6. Banks cannot buy (or sell) credit default insurance. The public purpose of banking as a public/private partnership is to underwrite and price risk. If a bank relies on credit default insurance it is transferring that pricing of risk to a third party, which is counter to the public purpose of banking.

7. Banks cannot engage in proprietary trading or any profit making ventures beyond basic lending. If the public sector wants to venture out of banking for some presumed public purpose it can be done through other outlets.

8. Use FDIC-approved credit models for evaluation of bank assets. Do not allow mark to market of bank assets. If there is a valid argument for marking a bank asset to market prices, that asset should not be a bank asset in the first place. The public purpose of banking is to facilitate loans based on credit analysis rather, than market valuation.

Conclusions for Reform: Gov’t Role

- Reducing concentration plus retaining risk can reorient banks back to relationship banking
- Role for gov’t to play in re-regulating and re-supervising
  - There are no magic formulas (capital ratios, living wills, skin in the game)
- Role for gov’t in direct provision of financial services
  - Payments system
  - Direct lending to serve public purpose
  - Guarantees for public-private partnerships