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"Financing Prosperity in the 21st Century": Opening Remarks

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Opening Remarks

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Financing prosperity in the 21st Century is the topic of this conference.[1] Implicit in the topic is the proposition that money and finance matter: that financial institutions and usages (ways of doing business) and financial relations among units help determine whether or not the economy prospers. Implicit in our participation in this Conference is that we either accept that money and financial arrangements matter or at least we are willing to take that proposition seriously.

In what way do finance and financial institutions matter? A market economy can be viewed either as a structure that allocates given resources to alternative ends or it can be viewed as a structure that participates in the creation of tomorrow out of today. From the allocation of given resources perspective the monetary and financial mechanism obviates the need for a double coincidence of wants for trades to take place and the financial mechanism distributes the independently determined savings of an economy, as well as the inherited stock of capital assets, to the appropriate users of capital and investment output.

1. The title of this conference harkens back to FINANCING AMERICAN PROSPERITY: A SYMPOSIUM OF ECONOMISTS that the Twentieth Century Fund produced in 1945 as the Second World War was winding down. The papers in the symposium were by some of senior policy analysts of the time: Alvin Hansen, Summner Slichter, John Williams, Benjamin Anderson, John Bates Clark and Howard Ellis: Paul Homan and Fritz Machlup edited the volume.

From the creation of tomorrow out of today perspective the monetary and financial systems of a market economy play an active role in the dynamic process which shapes the pace of the capital development of the economy. In each period the prices of capital and financial assets and therefor the amount of investment, and therefor savings, that takes place is affected by the performance of the monetary and financial institutions. Furthermore in the tradition of Schumpeter the financial structure is an essential player in the process by which inventions lead to innovations.[2]

Sixty years ago on Saturday March 4 Franklin Delano Roosevelt was inaugurated. This means we are meeting on the 60th anniversary of the Bank holiday. The Bank holiday of March 1933 was forced upon President Roosevelt: at the time of his inauguration the banks in some 30 states had been closed by state Governors. On inauguration day President Roosevelt was told that the New York banks would not open on Monday. The closing of the banks was a preemptive strike: Roosevelt seized the initiative in resolving the bank crisis from the financial "community". Henceforth banking was too important to be left to the bankers.[3]

2. The two perspectives on banking and finance help us understand much of the history of banking and finance in the United States. The conflict between Biddle and Jackson over the Second Bank of the United States was between those (like Biddle) who saw the banking mechanism as providing a safe and secure medium of exchange and those (like Jackson?) who saw the banking mechanism as the proximate supplier of the finance needed for economic development.

3. The lead in the resolution of the financial crisis of 1907 was taken by J.P. Morgan. The resolution helped make the market position of Morgan's steel company more secure.

The "bank holiday" was the climactic event of the great contraction that had dragged on for the 40+ months between October 1929 and March 1933. Much more than the closing of banks because of illiquidity and insolvency was involved in this great contraction for illiquidity and insolvency hit the entire spectrum of financial institutions hard. My favorite characterization of the Great Depression is not that 25% of the labor force was unemployed, not that the price level fell by 1/3, and not that the nominal Gross National Product fell by 50%: it is that the Dow Jones and the Standard and Poors (indices of stock prices) fell to about 15% of their 1929 level. In many ways Building and Loan Societies and brokerage houses were hit harder by the decline in the value of their assets than the commercial banks.

The drastic fall in nominal asset prices between 1929 and 1933 meant that the ratio of the price level of assets to the indices of current output prices and current wage rates fell, It was cheaper to buy a building than to build one: as a result investment fell precipitously. The fall in the nominal value of investment meant that a parallel fall took place in nominal profit flows. As a result of the fall in profits a large proportion of the financial assets of banks and other financial institutions, which normally would be validated by funds derived from the flow of gross

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The lead in the resolution of the bank holiday crisis of 1933 was taken by the RFC's Jessie Jones.

profits, stopped performing. As their assets failed to perform a vast array of banks and non-bank financial institutions - building and loan societies, insurance companies, brokerage houses and investment trusts - became unable to perform i.e. to meet their commitments. The Federal Reserve System, bound by the gold standard rules and constrained by the real bills doctrine, was ineffective in the face of the collapse of asset values and financial institutions for one aspect of the contraction was a marked decrease in eligible paper.

The bank holiday of 1933 put "Create a new financial system on the ruins of the old" on the policy agenda of the New Deal. This new financial system was to be less prone to financial crisis: the financial relations which would amplify an initial disturbance were to be controlled. This was taken to mean that the banking system was not to finance speculation.[4]

Over the weeks that followed the bank holiday the central act in the reopening of the banks was the infusion of equity into many banks by the Reconstruction Finance Corporation. The technique of this intervention was for the RFC to purchase sufficient preferred stock so that the reopened banks had a positive net worths. The banks that were eligible for such an equity infusion were those which

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4. It is worth noting that the ban on thin margin investing in publicly traded stocks is the one qualitative constraint on bank and financial market behavior that has withstood the rush to desegregate of the past dozen years.

would have a positive net worth if their assets were performing as they were expected to perform once the economy was once again a going concern: i.e. if the economy was significantly closer to prosperity than it was in 1933. Even with this loose and flexible standard for determining asset values only some 2/3 of the banks were either able to reopen without an equity infusion or were considered to be eligible for an equity infusion. One outcome of the way the RFC dealt with the crisis was that a large number of independent financing sources continued to be a characteristic of the economy.[5]

There was no deposit insurance in 1933. There was an equity infusion by the RFC. The RFC used its ownership position to install new managements in a significant number of banks. For the banks that did not reopen, depositors received partial paybacks as assets were liquidated over the next several years.[6]

In the one-hundred days that followed Roosevelt's inauguration a round of emergency legislation was passed. There was a general awareness that the emergency legislation, especially in banking and finance, was not

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5. Note that the equity infusion came from the RFC and not from the Federal Reserve.

6. It is worth noting that the 1933 RFC technique for handling failed banks took the form of an equity infusion whereas the deposit insurance technique, especially as modified in recent years looks to the quick liquidation of the failed bank either by a take over supported by government funds or by a payoff of depositors. The 1933 technique maintained the independence of banks, the 1990's technique consolidated banks.

enough. Over the next several years, leading up to the banking act of 1935, a serious discussion of what and how the financial system should be reconstructed took place. One of the groups that participated in the discussion was known as Viner's Freshmen.[7,8]

As a result of the difficulty in getting a recovery going the government budget as a percentage of the Gross National Product increased over the 1933-1939 period and devices like Social Security, which were destined to become very large, began on a small scale. The experience of World War II and the cold war that followed left the United States with a government that was a much larger part of the economy than had been true in the earlier days.

The end result of the New Deal reforms in banking, finance and the role of the government in the economy was that an interventionist big government model of capitalism replaced the largely small government laissez faire model

7. Professor Albert Hart, who we are privileged to have with us for this conference, was one of the Freshmen. In many places the ideas of 100% money received serious consideration: various ideas that separated the payments mechanism from the credit (financing) mechanism were advanced.

8. Ronnie Phillips uncovered memos by AA Berle and Gardiner Means that entered into the discussion. Means in particular put forth a schema of 100% money, where the existing banks operated the deposit mechanism as agents of a government bank. The credit needs of the country that banks now fund was to be operated by banks which either had uninsured fixed value liabilities or conditional valued liabilities. Means' schema also allowed for a government intermediate credit bank which either furnished longer term funds to banks for intermediate and long term credit needs or which took such assets off of the books of the banks. Means' memo would have created a financial system that was ready for the securitization of bank assets.

that had won out in the 1890's. The financial structure of this new model capitalism was changed in significant ways from the financial system that existed prior to the great depression. The banking and financial system that emerged was guided by three principles: compartmentalization, transparency, and central bank flexibility.

Compartmentalization may well be considered to be a legacy of the 100% money movement. Compartmentalization means that institutions are segregated into "compartments", each institution being restricted in the assets they could own and the liabilities they could issue to finance their activities. A compartmentalized structure is a "horses for courses" system: it creates financial institutions that specialize in particular assets or liabilities. The Glass Steagall division of investment and commercial banking, the restriction of the home financing Savings and Loan Associations to pass book share accounts,[9] the array of farm and rural financing organizations and the guarantee of home mortgages by the Federal Housing Authority are among the manifestations of compartmentalization.

At times the compartmentalized organization was a depository institution, at times it was an endorsing (risk absorbing) institution. Some, such as the sales financing companies, raised funds to hold automobile paper by borrowing from banks or issuing commercial paper that were

9. In principle the value of the liabilities of the S & L's could go to a discount if non-performing assets wiped out their equity.

purchased either by banks or by other organizations.[10] Compartmentalization implies financial layering as one set of financial institutions holds liabilities of another set of financial institutions.[11]

As far as banks and savings institutions are concerned compartmentalization reflected a recognition that supervision by examination would not be effective for organizations with complex portfolios and liability structures. Compartmentalizing the financial structure was a solution to the belief that control of a universal bank by supervision by examination would be largely ineffectual.[12]

Transparency is a second rule that emerged from the legislation. Transparency recognized that the corporate form of organization was henceforth to be the dominant organizational form for business and that the success of an economy depended upon the integrity and availability of the information on the operations and the financial condition of publicly traded corporations. It also means that information about the trading of the equity liabilities of publicly traded corporations is available to the public.

10. As the ability of finance companies to raise money in wholesale lots became evident, they diversified their assets. A good number of them experienced significant losses in the shake out of the late 1980's.

11. The growth of securitization of mortgages was a result of the growth of managed money such as the pension and mutual funds.

12. I owe the idea of regulation by compartmentalization to Jan Kregel. Kregel has emphasized that the asset structures of German Universal Banks are tightly constrained by their liability structures: he has argued that the supervision of the German banks is much closer than anything contemplated in the States.

Insider trading and market fixing, aside from periods in which new issues were still in syndication, were deemed to be criminal activities. Both compartmentalization and transparency were compromised during the past decades.

The third rule was central bank flexibility. The Federal Reserves was freed from the constraints imposed by the real bills doctrine. The composition of the assets held by the Federal Reserve to offset currency and reserve deposits of banks liabilities were no longer different. The Federal Reserve was given the power to vary reserve requirements as well as the power to set constraints upon bank activity. The gold standard was abandoned and it has never been revived in its old form.

Federal Reserve responsibilities such as assuring that the exchange of small denomination bank deposits for currency was always at par was passed off to special deposit insuring institutions. Although the Federal Reserve was made more flexible, part of the central bank function became more rigid.

Part of the cost of the failure of banks and Savings and Loan Associations in the recent past is due to the violation of the principles of compartmentalization and transparency. Laxity and a failure on the part of regulators to appreciate the impact of institutional evolution on deposit insurance are largely responsible for the failure of regulatory supervision. Deposit insurance was a great success until it was used as a crutch for, instead of as a constraint upon, bank and S&L activities. When the laxity in regulation and the evolution of the economy's financial structure from being robust to being fragile led to the need for deposit insurance intervention, the deterioration in the quality of the portfolios had gone so far that a large amount of Government funds were needed to pay off the deposits at par. This bailout became a black mark against deposit insurance and led to the revision of the rules for banking .

Deposit insurance was never an actuarial determined insurance system. It was recognized when the schemes were introduced that it was a call on the Treasury. In the climate of the 1930's the alternative to deposit insurance would have been permanent RFC which allowed for the government to participate in the equity financing of banks either permanently or on an ad hoc basis.[13]

Institutions and usages change either by an endogenous evolutionary process or by legislation. As institutions matter and as institutions and usages in finance change in response to profit opportunities that are perceived to exist for those who innovate in financial institutions and usages, a structure of institutions that leads, at one point of time, to a acceptable performance of the economy is likely

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13. Walker Todd has correctly emphasized the distinction between a Central Bank that has monetary policy as its objective and an institution that infuses equity into otherwise negative equity institutions because of the feared consequences of the liabilities of those institution falling below par.

to evolve into an institutional structure that, at a later point of time, leads to undesired results.

The end of World War 2 ushered in an epoch that lasted about 20 years which some have characterized as a golden age of capitalism.[14] Since the 1970's the economy has not performed up to the standard set in that golden age. A slow down in economic growth, a trend of rising unemployment rates, increasing structural Government deficits and breakdowns of financial institutions and markets have characterized the last decade. Over the postwar period there were significant changes in the structure of financial interrelations in the economy. The weight of the various broad forms of financing changed. Technological changes, mainly but not exclusively electronic, changed the way financial business was executed.[15]

Both compartmentalization and transparency were never perfect. They have been attenuated as it became profitable to evade the regulatory rules that were embodied in compartmentalization and transparency. Technological changes affected how markets operate. The revolutions in transporting, computing and communicating has lowered the

14. I prefer to label the years from the end of World War II until say 1968 or 1970 a "practical best" for United States economic performance.

15. Hyman P. Minsky "Central Banking and Money Market Changes" QJE 1957 is an early statement of the thesis that profit opportunity driven endogenous changes in institutions and market usages affect the operations of the economy and in particular the efficacy of the various instruments of economic policy.

costs of dealing at a distance and eliminated a measure of protection that was afforded by such costs.

In particular the transportation and communication revolutions diminished the market power of many domestic firms. One result is that the labor incomes that were made possible by labor sharing in the gains of firms from market power became a smaller part of the total. With the decline in market power of firms the assurance of sustained cash flows that market power furnishes diminished. As a result the incentives to invest also diminished. The performance of the economy changed: a high level stagnation seems to be a likely prognoses.

The years leading up to the bank holiday through the passage of the various acts setting up FDIC, setting up the regulations embodied in the Securities acts and changing the constitution and mission of the Federal Reserve System, were also years of intellectual ferment, years in which the understanding of the roles of finance in Capitalism were examined.

Capitalism was redefined during the 1930's. The largely *laissez faire* small central government economy that won out in the post Civil War epoch was deemed to have failed in the Great Contraction of 1929-33. A new model capitalism with a big central government and active intervention in markets was constructed in the 1930's. This new model was in place during the so called golden age of the 1950's and 60's. The success of the new model was transitory: the economy has fallen from the golden age standard of performance in the past decades.

Not long ago as the viability of banks and other financial institutions were in doubt it seemed as if we were about to embark upon a new age of reform of financial institutions. We are not out of the woods as yet: the longer term questions of the structure of private pensions in an age of mortal corporations is with us.[16] But whereas a year ago an aura of crisis surrounded the financial structure at present that seems to have eased. There is nothing like a sharp fall in interest rates to increase the present value of assets which are expected to perform adequately in the longer run but which are now not performing and which are not expected to be performing in the near future. Furthermore the Great Government deficits, even though they support consumption and not investment, have put a floor under the profit flows of corporations so that instead of the Dow Jones and the other stock indices decreasing they have increased.

The story of the recent recession is that the big government flexible central banking combination once again contained the forces that made for a Fisherian debt deflation process. However the structure of big government

16. The age of corporate mortality means that the defined benefit pension schemes administered by corporations are rendered obsolete. The segregated third party administered defined contribution pension schemes are very much alive but they are dependent upon a privileged position for such payments for income tax purposes.

has to be changed because the cold war, which rationalized much of the spending, is over and the use of the prosperity of corporations for the support of health care and pensions that supplement social security is also over.

Whether they recognize it or not our new administration as well as administrations throughout Europe and in Japan are engaged in an effort to once again redefine capitalism. I hope that before our conference ends we will have addressed the question of the structure of financial institutions which will assure that American Prosperity will be Financed in the 21st Century.

ADDENDUM:

Deposit Insurance and Ponzi Finance

The original deposit insurance was of limited scope and was accompanied with much more stringent examination and supervision standards than was the rule at the time it was put in place. The resolution to the bank holiday of 1933 was by means of equity infusions by the RFC, a government agency, into about 1/3 of the banks and a partial repayment of deposits in the approximately 1/3 of the banks that did not open out of the proceeds from the liquidation of the portfolio of the failed institution.

The gradual erosion of standards of control was accompanied by a rise in the amount of the insured deposit, ending with the $100,000 limit. The misuse of deposit insurance first occurred during the period of practical monetarism - 1979 to 1982 - and the interest rate inversion it brought about. In this period when the meeting the market interest rate on deposits at Savings and Loans exceeded the interest earned on mortgage loans in portfolios.

Savings and Loans like banks credit interest to accounts. Such crediting of interest, when the interest earned is less than the amount credited, is a form of Ponzi finance and is accompanied by a decrease in the equity accounts. If equity was maintained by writing up of the value of assets the in fact erosion of equity could be hidden. Thus 1979-82 was an era of Ponzi finance in which the eroding equity financed a burst of consumption.

The period 1982-88 was an era of massive deficit financing, where the deficits were not only by the government but also by banks and S&L's. Insured bank deposits were used to finance a consumption and construction boom. S&L's and Banks ran huge deficits, taking in deposits at interest rates that the return on their assets could support. In part the banks took a return in fees that were added to the indebtedness even as the banks reported these fees as income. The games Milken in particular paid were pyramid schemes in which new players corrected the equity accounts of older invested players by taking assets from their books at a mark up on their book price. The capital gain offset the carrying losses.

The deficits of the 1990's that are paying off insured liabilities that had their origin in the 1980's do not have the GNP kick of deficits that translate into a current demand for goods and services. The government deficit spending of 1990-1992 that is attributable to the validating of bank and S&L liabilities gave a kick to GNP in the 1980's. The government deficits are in effect validating the deposits that were entered on the books when the banks and S&L's were engaged in a well nigh classic Ponzi financing exercise.

There is kick to the current government deficits that are validating "underwriting" from the days of euphoria: the government deficits are part of the mechanism that is aborting the historic consequences of an euphoric period, a debt deflation and a deep depression. Combined with the Ponzi aspects of the government's deficits, for the government deficit can be interpreted as being due to the interest on the outstanding debt, the budget and the debt of the United States are truly dead weight.

There is a policy implication of the current situation and the above interpretation of the deficit and the debt which is that the role of government spending and deficits in the economy depend upon what drives the spending. Given the large dead weight component to the debt it is important that the spending side of the government, net of what it takes to meet the interest on the debt, be heavily investment.

In the reform legislation prompted by the collapse of the buffer between overt government spending and the failure of banks and S&L's a new principle was established for government regulation of banks and similar organizations: minimize the lilelyhood that the government will have to fulfill its "insurance" role. This principle led to the enunciation of capital asset ratios as guiding the behavior of the regulatory authorities and gave to the regulators the right to tightly oversee bank asset acquisitions. However this improvement ignored the demonstrated ability of the financial institutions to adapt. Is it better for the alchemy of finance to be carried out in the open in regulated and protected institutions or should the alchemy be practiced in new and novel institutions which have neither the underwriting skills nor the awareness of fiduciary responsibilities? The principle of minimizing the prospective cost to the government of its fulfilling its responsibility to protect the viability of the financial system and prevention of a debt deflation and deep depression by restricting one set of players in the game of financing the capital development of the economy is likely to be counter productive, for new players will arise under new institutional forms and the need to intervene to prevent a debt deflation will arise in corners not foreseen. The problem in finance and the regulation of financial practices is that practices that have a new veneer will be but the old with a coat of varnish. Ponzi and Milken are worlds apart in their sophistication, but to mix metaphors, under the skin they are like two peas in a pod.