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The Jerome Levy Institute Presents Proposals for Reform of the Financial System.

FINANCIAL STRUCTURE AND THE FINANCING OF THE CAPITAL DEVELOPMENT OF THE ECONOMY.

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Peter Albin's remark: "The agents in the model have a model of the model." is a most perceptive comment on the relation between economic ideas and economic policy. In a world where Central Bankers and various levels of government policy makers exist, the agents in the model include not only those who hold down positions in the government and the central bank, but also their advisors.

In 1966 James Tobin, soon after his stint on the Kennedy Council of Economic advisors, aptly described the role of the advisor as phrasing questions and marshaling evidence for his principal. Tobin pointed out that "..the terms in which a problem is stated and in which the relevant information is organized can have a great influence on the solution."[1]

The model of the model that agents have determines their views on the of the efficacy and goals of government economic policy. The policy makers are agents in the model, as are their economic advisors. The selection of advisors by the policy makers of a government is equivalent to the adoption of the advisor's model of the world as the guide for the making of economic policy. The selection of advisors is analogous to the putting of blinders on a horse: it restricts the doield of vision. Henceforth only those parts of the landscape will be visible, will be deemed to

1. James Tobin The Intellectual Revolution in United States Policy Making, Noel Burton Lecture, University of Essex, (UK), 1966, p.14.

provide "relevant information", that confirm the advisor's priors.

The blinders of conventional theory are nowhere more significant than in the way money and monetary institutions and their relation to the behavior of the economy and the determination of investment are treated. Quite simply conventional economic theory has no place for money.[2] The model of orthodox economists holds that the economy is an equilibrium seeking and sustaining system, and, as between positions of equilibrium both money and the financial arrangements are neutral. This implies that to the orthodox economist nothing fundamental is at issue in selecting monetary and financing arrangements of an economy.

It also means that in the minds of the conventional economists concerns about the stability of monetary and financial relations, which were so evident not more than six months ago, when clear and present dangers of debt deflations were contained by intensive central bank and expensive Treasury interventions along with profit sustaining fiscal deficits, will quickly decay. As a result, to the extent to which orthodox theorists control the agenda, institutional changes to create a financial system that is supportive of enterprise rather than one that is conducive to bursts of speculation will not be on the

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2. Frank Hahn, Money and Inflation, Cambridge, MIT Press, 1983

Robert Lucas, Models of Business Cycles, Yro Jahnsson Lectures, Basil Blackwell, 1987 p. 20.

agenda,. The blinders that theory induces in the advisors becomes the blinders the political leadership unwittingly wears.

As the experience of the Reagan-Bush years shows, in a world where institutions matter, the control of the policy agenda and of the reaction to developments by orthodox economists, no matter how glittering their academic credentials, is dangerous to the health of the economy. The S&L fiasco was largely the result of inept deregulation driven by a blind belief that markets seek equilibrium and somehow both the process and the results are good.

Compared to today's closed access to the corridors of power, the Roosevelt era was remarkable in the access of varied views to the policy makers. Ronnie Phillips has chronicled the access to Franklin Roosevelt of Irving Fisher. Jacob Viner, perhaps the preeminent American economist of his day, was a Treasury advisor through the early years of the New Deal, once again as the war approached and during the war. Henry Simons brought radical ideas of banking reform to the discussions of monetary and financial reconstruction. Laughlin Curry gave up a promising academic career to work as an advisor to the Federal Reserve and later as one of the anonymous young men on the staff of the White House. Gardner Means and Rexford Tugwell brought institutional perspectives to Washington. Commons' people, such as David Saposs, were active at the NLRB.

In the General Theory Keynes contrasted capital development (enterprise), where the returns stretch on through the years as investment yields profits, and speculation, where the return is quick and depends upon a change in the market's valuation of assets. He emphasized that the financial system funds both enterprise and speculation, but when speculation dominates the capital development of the country is likely to be poorly done.[3] The in fact institutional structure affects the efficacy of the financing process in a capitalist economy. One message of Keynes is that the institutional structure is the result of an evolutionary process in which legislation, the decisions by the authorities about the use of their instruments, and the profit seeking activities of agents in the economy transform what was into what is. Furthermore this process, of endogenous and exogenous institutional change, is always ongoing, but its pace varies, largely with the profit opportunities perceived to be available by agents in the model but also with the interventions and attitudes of the regulators: i.e. with the inferences they draw from their model of the model.

In the 1980's a wave of portfolio speculation took place in the United States. As major companies either fell

3. The key citation from Keynes' General Theory is: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." (p.159.)

to a leveraged buy out or encumbered themselves with debt in an effort to hold off a possible hostile take over a huge increase in the ratio of debts to gross capital incomes of corporations occurred. The capital development of the time was mainly in real estate, where the lure to the developer was the speculative gain from the turn over of the project rather than the longer run returns of enterprise in the form of the accretion of rents. The market was not financing activities which made for the progress of the economy as measured by the productivity of labor or the ability to compete in in global markets.

One result of the indebting of corporations was a squeeze on their internal funds because of the need to service debts A stagnation of productive investment was a result.[4] Furthermore the speculation in liability structures and the overbuilding of commercial properties led, with a lag, to a plethora of non performing assets on the books of financial institutions. This, in turn, led to a virtual avalanche of failures of banks and savings and loan associations; the rate was reminiscent of the 1930's. Such developments erect barriers to the financing of projects which advance the capital development of the economy. As a result of the non performing assets it became necessary for the government to fund the validation of the liabilities of bankrupt banks and savings and loan

4. giodordi of Goldman Sachs

Associations at par in order to prevent a collapse of consumer spending and an explosion of business bankruptcies.

As a result of the "banking" crisis of 1989-92 a multitude of banking institutions either closed their doors or were merged into other presumably more secure banks. This institutional breakdown severed many long standing connections between businesses and financing organizations. The disappearance of financing connections is another way in which 1989-92 resonates with the 1930's: the wholesale disappearance of financing connections during the great decline that began in October 1929 and culminated in the bank holiday of March 1993 is a main cause of the stagnation of the 1930's. The financial disruptions of 1989-92 means that a high level stagnation is likely to beset the Clinton Administration for several years.

Alvin Hansen's stagnation hypothesis, which underlay a good deal of the New Deal legislation, laid the stagnation (the incomplete recovery) after 1933 to the end of the frontier and the resultant decline of investment opportunities.[5] This interpretation ignored the massive disruption of financial channels during 1929-32 and the perverse change in financing standards induced by the crisis.

The bank holiday that President Roosevelt was forced to declare on inauguration day essentially recognized that the great debt deflation of 1929-1933 had wiped out the banking

5. Alvin Hansen

system.[6] The resolution of the bank holiday was handled by the Reconstruction Finance Corporation, not by the Federal Reserve System. During the bank holiday The Reconstruction Finance corporation did a quick review of the assets of the closed banks. On the basis of a "liberal" reading by the Reconstruction Finance Corporation of the worth of assets about one third of the banks in the United States were deemed to have positive net worths and were able to reopen on their own, one third reopened with an equity infusion from the RFC, and another third were deemed to have negative net worths that were too great to qualify for an equity infusion. This last group was not deemed not worthy of reopening. About half of the banks that reopened were essentially government owned.

In the discussion of bank and financial system reform that took place between 1933 and the banking and financial legislation of 1935 and 1936 a sophisticated understanding of the role of banking and finance in a modern capitalist economy developed. It was recognized that a three way conflict arises when banking is carried out by profit seeking organizations. These conflicts are between banks as

1) safe repositories of depositor's funds, such banks may also operate a payments mechanism which is a profit center for the bank

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6. On inauguration day, which was a Saturday, Roosevelt was told that the New York banks would not open on Monday. The bank holiday was a preemptive strike.

2) agents involved in financing the capital development of the economy.

3) handmaidens of speculation.

Between 1933 and 1936 one item on the political agenda was the reconstruction of the financial system, the building of a new banking and financial system. One aim of the new legislation was to create a financial system which was not as prone to intermittent breakdowns as the financial system of the United States had shown itself to be over the years since the Civil War. The solution to the problems posed by the experience of the 1930's was to create a compartmentalized financial system: a horses for courses structure in which the various banking and financing functions were carried out be different institutions. The system put in place in 1935 and 1936 served the United States well for some 60 years, which was substantially longer than any prior banking - financial structure had served our economy before encountering serious difficulties.[7]

The compartmentalization of the mid 1930's in part reflected the Hansen view that henceforth the richer capitalist economies will face a relative exhaustion of

7. These earlier banking and financial systems were
1) the national bank eras (1790 1836),
2) state banking only,(1837-1863)
3) the national banking act under a greenback standard, 1863-1877?)
4) the national banking act under a gold standard, (1878-1913)
5) the First Federal Reserve System (1913-32) and
6) The second Federal Reserve System (1935-)

investment opportunities. A shortage of investment opportunities is compatible with a full employment economy only if

1.) the economy is a high consumption economy and

2.) private investment demand is supplemented by public demand for investment.

3.) private financing of investment is supplemented by public financing.

The Savings and Loan Associations of the New Deal days served two purposes. They provided safe and secure repositories for household savings and transaction balances and for a fee they supplied their customers with money orders and checks for payments at a distance. They also financed consumption spending in the form of housing. In their original conception they were mutual associations owned by their depositors. To a small extent they were allowed to deviate from a home financing portfolio and use a small part of their resources to fund local service type businesses.[8] They were an institution for financing local community facilities and for serving local safe keeping and bill paying needs. The present discussion of Community Development banking might be viewed as an attempt to

8) James Stewart, the hero of the Christmas movie "IT'S A WONDERFUL LIFE", was the manager of local S&L (The villain of the movie was a banker). Stewart financed not only houses but also small local businesses.

recreate the banking concept of an "old fashioned S&L" with somewhat broader portfolio choices.[9]

Financing the capital development of the economy was split into three parts in the 1930's. Commercial banks were restricted to the financing of relative short term activities, whereas investment bankers were to do longer term or permanent financing by way of both bonds and shares. Short term financing was through institutions, longer term financing was through markets. The great houses, such as J.P. Morgan &Co, which did both commercial and investment banking before the reform acts, were split into a commercial bank and an investment bank.[10] Commercial banks financed the construction phase of building, whether housing developments or commercial property, whereas the S&L's and insurance companies did the take out financing.[11]

For the sake of policy making the image of the participants on the demand side of the market for long term bonds and shares was the individual portfolio owner: insurance companies and endowment funds were the only

9. Hyman P. Minsky, Dimitri B. Papadimitriou, Ronnie J. Phillips and L. Randall Wray Community Development Banking Public Policy Brief No 3/ 1993 The Jerome Levy Economics Institute

Hyman P. Minsky, "Community Development Banks: An Idea in Search of Substance" Challenge Magazine, March-April 1993.

10. The current successors to J.P. Morgam & Co are Morgan Guaranty, a chartered commercial bank which is currently both a quality operation and the leader in stretching its activities into investment banking and Morgan Stanley a leading investment banking firm.

11. It almost seemed as if there was a conscious policy to limit the complexity of the decisions that the management of the S&L's had to make.

significant institutional investors in the bond and equity markets of the day. The use of bank and other short term credit to finance positions in equities and debts was severely restricted, in line with the then current imputation of both the extent of the stock market boom of the 1920's and the severity of the fall in stock prices after October 1929 to the low margin stock market of the 1920's.

The great innovation of the 1930's reconstitution of the financial structure was neither deposit insurance nor the split between investment and commercial banking. The great innovation was in the governance of corporations and of the markets in which equity and bond shares were traded. The fundamental innovation in corporation governance and market behavior was the doctrine of transparency. One object of the doctrine was to make the information available for decision making by portfolio managers freely available and to place barriers in the way of management's conveying assets of the corporation to their private "purse". A second objective was to place constraints upon the manipulation of the market by the professionals who operate the market.

In the light of the enormous changes that have come over the financial markets in the years since the 1930's, (the computing and communication revolution as well as the shift of the proximate owner of the market equity and debts to mutual and pension funds) the horses for courses system established in the 1930's worked well until a combination of deregulation, slack oversight, and the market knows best ideology permitted the wave of speculation with other peoples money of the 1980's. For a horses for courses financial system to work, the regulators had to sceptical about the efficacy of financial markets in producing stable and desirable outcomes.

A good deal of what happened in the 1980's was due to the shift from the ownership of equities and debts by households to the ownership by funds - mutual and pension. The market with transparent transactions and a floor specialist, who "maintained order" in the market by taking small positions in order to have the market move through every tick, was fine when transactions were dominated by household sales and purchases of securities. But once funded defined benefit and defined contribution pension funds and mutual funds began to dominate the ownership of securities, the retail oriented market form of the New York Stock Exchange was obsolete.

The new dominent players, the funds, were conscious that they moved markets when they traded. Whereas the New York Stock exchange was a broker market, the funds needed a market in which dealers would take multi million dollar positions. In order for such dealer position taking not to move markets, the transactions no longer could be transparent. Furthermore, aside from the specialists, market participants in a broker's market never take title to instruments. They need little capital aside from what their underwriting, which is always a dealer transaction, requires. The move to funds, and the fund's need for dealers that could take large positions, greatly increased the capital required to be a player in finacial markets. But greater capital meant that the profits per dollar of transactions had to increase: the bid asked differential needs to increase. Thus the overall costs of having a market increased, as the massive trading by funds became the norm rather than the exception.

Pension as well as the mutual funds began to have vast amounts of money to place on a regular basis. They became the demand side for a wide variety of instruments: however household sized transactions did not fill their needs. If funds were to become players in the mortgage market, in the financing of automobiles or in the financing of credit card outstandings, it was necessary to develop instruments that were based upon these consumer based assets which could absorb large amounts and to create markets in which positions in these instruments could be adjusted: it was necessary to create at least an illusion of liquidity. The securitization of these instruments, and the shift of S&L's from originating and holding to originating and selling out positions, which may have been accompnied by a deterioration in underwriting standards, is one consequence of the emergence of the funds.

Pension and mutual funds are investors without any commitment to the organizations whose liabilities they own: in particular, in a hostile take over, they, as fiduciaries hesitate to reject bids that offer serious profits over the purchase price of the assets they hold. The hostile bidding of the 1980's could not have taken place without the growth of the institutions which hold massive positions.

The takeover mania was fed by pension funds financing special funds which took the equity position in highly leveraged buy outs. Once again the large pension funds - not so much the mutual funds which were limited in the assets they acquired by their covenant - provided the destabilizing funds.

The intermediaries in these transactions were largely fee driven. In the 1980's a great deal of what in earlier times was called water was pumped into the offering prices of securities that once again were bought by funds or deregulated Savings and Loan Associations. The water paid for the fees, commissions and sundry costs that were the compensation of the lawyers, accountants and brokers. the water was funded by issuing stock and debts in excess of the purchase price of the organizations that were taken over.

The Reconstruction Finance Corporation of the 1930's was part of the horses for courses financial structure. The impact of the collapse of the financial structure and economy between 1929 and 1933 not only led to a very conservative banking posture by the banks that were opened after the bank holiday, there was also a virtual destruction of the securities market and securities firms. Large scale private financing of capital development was not on the immediate horizon. The combination of infrastructure investment by the Public Works Administration and enterprise financing by the Reconstruction Finance Corporation was the major source of investment financing in the 1930's. Furthermore the direct and indirect government deficits, (recall that the FHA endorsed a major part of home mortgages) combined with the low investment by private corporations meant that the gross capital income of corporations exceeded their investment plus their payments on debts and dividends. Corporations were net absorbers of financial assets during this period.

It is often noted that full recovery did not take place until rearmament became a major activity. But rearmament was financed largely by either advances from defense procurement or by the RFC. What the military expansion allowed was a greater use of RFC financing of plant and equipment than was true when what could have been financed was plant and equipment for civilian use.

The situation in 1993 is noway as grim as that of 1933. But in both cases the new administration inherited a financial system that had been compromised and required reconstruction. In the 1930's the reconstruction took the form of creating a compartmentalized financial system. This ultimately proved to be very successful. The attempt by the

Bush administration to reform the financial structure took the form of advocating unrestricted branching that ignored state lines and the end of the division between commercial and investment banking. Neither of these reforms would necessarily have aided the capital development of the economy: the motivation of much of the reform legislation was aimed to prevent another need by the government to infuse funds into financial institutions.

To aid and abet the capital development of the United States a set of banks with comprehensive financing powers which are restricted to small deals because of their small size is needed. In our proposal for Community Development Banking we sketched the contours of just such an institution.

I also believe that the RFC way of handling negative or this net worth banks and financial institutions is superior to the deposit insurance technique, for it preserves the independent sources of financing which the deposit insurance technique liquidates.

The overall lesson from this sermon is that if the model of the model held by the advisers holds that the appropriate capital development of a country is an automatic result of unregulated fiancial marekts, then the advisor and the principle really have nothing to say