THE NATURE AND NECESSITY OF FINANCIAL REFORM

A Public Policy Forum of
The Jerome Levy Economics Institute
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The Jerome Levy Economics Institute of Bard College, founded in 1986, is an autonomous, independently endowed research organization. It is nonpartisan, open to the examination of diverse points of view, and dedicated to public service.

The Institute believes in the potential for the study of economics to improve the human condition. Its purpose is to generate viable, effective public policy responses to important economic problems. It is concerned with issues that profoundly affect the quality of life in the United States, other highly industrialized nations, and countries with developing economies.

The present research agenda includes such issues as financial instability, poverty, unemployment and problems associated with the distribution of income and wealth. Other research interests include the issues of public and private investment and their relationship to productivity, competitiveness, and the prospects for growth and employment. In all its endeavors, the Institute places heavy emphasis on the values of personal freedom and justice.
On April 4-6, 1991, more than one hundred prominent economists, bankers, policymakers and experts on the financial industry met at the Jerome Levy Economics Institute to address the serious problems confronting the financial markets. The conference on "The Crisis in Finance" was organized by Hyman P. Minsky, Distinguished Scholar at the Institute and research director of its public policy program on The Reconstitution of the Financial Structure.

As is characteristic of the Levy Institute conferences, the three-day gathering concluded with a roundtable discussion of the major public policy issues raised during earlier, more formal presentations. The participants in this Policy Forum on "The Nature and Necessity of Financial Reform," transcribed here, included the following distinguished representatives from academia, business and the public sector:

Richard Aspinwall, Chief Economist, The Chase Manhattan Bank

Benjamin Friedman, William Joseph Maier Professor of Political Economy, Harvard University

Albert Hart, Professor Emeritus of Economics, Columbia University

S. Jay Levy, Chairman of the Board of Governors, The Jerome Levy Economics Institute

Hyman P. Minsky, Distinguished Scholar, The Jerome Levy Economics Institute, and Professor Emeritus of Economics, Washington University in St. Louis

Gary Stern, President, Federal Reserve Bank of Minneapolis, and Member of the Federal Reserve’s Open Market Committee

James Tobin, Sterling Professor Emeritus of Economics, Yale University; Nobel Prize in Economics, 1981

Albert Wojnilower, Senior Advisor, First Boston Asset Management

Minsky described the conference as one which brought together academic economists who are specialists in one aspect or another of finance, as well as “workers in the vineyards of finance” who have been trained as economists, in an attempt to reach a consensus theory of what determines the performance of the economy. The complete conference program is provided at the end of this booklet.
April 6, 1991

A Policy Forum on

THE NATURE AND NECESSITY OF FINANCIAL REFORM

JAY LEVY: This morning is one which draws together a great deal of what has been said during the previous two days and, indeed, a great deal has been said. By coincidence, today happens to be the 24th anniversary of the death of Jerome Levy, whose ghost I think is increasingly infiltrating this building. I can’t let the moment go by without speaking in a way for Jerome Levy, who would not have been entirely in agreement with everything that he would have heard had he been here. I would say that he would have disagreed most strongly—and I interject that he and Hy Minsky look at a lot of things in the same way—to the idea that the crisis we are discussing is systemic. He would say that we don’t operate the system properly, and therefore we get into trouble.

In the course of the discussions, particularly when we went back looking at history with Professor Sylla, it was pointed out that in the early part of the 19th century, the price of cotton was going up, which led to speculation in land, which created a financial crisis. I think many of the references to financial crises have had to do with speculation in land. Jerome Levy, who was really in most respects an ardent capitalist, didn’t believe that we should have private ownership of land, so we would have had no speculation in it.

Well, we have a number of topics to cover. I thought that what we would do first is give all of those on this panel who have not been heard from previously a chance to catch up, so to speak, or let us catch up with their thoughts. Then we will try to reach a consensus of opinion about some of the topics that I think have come up in every session, such as too-big-to-fail, deposit insurance, and so forth. Al, would you like to begin, please?

ALBERT WOJNILOWER: Thank you. Because I only have a few minutes, I can be even more brief and more dogmatic than in that little essay which I hope all of you picked up outside, called “Financial Institutions Cannot Compete.” The principal point of that essay is that any economic system that wants to have an unquestioned payments system—in which when you get a check you don’t need to look at the amount and the bank name before you know whether you can deposit it or not—and any economy that wants to control the quantity of money for the purpose of limiting inflation or deflation, will have to be regulated so as to restrict the production of these payments and monetary instruments.

In other words, these attributes—of unquestioned payments and a stabilized value of money—are a public utility, like electricity and water. Unauthorized production is prohibited and the authorized producers are regulated. Unlike ordinary public utilities, however, financial utilities are particularly handicapped in obtaining capital. This is (1) because they are not granted a full monopoly and (2) because their growth—the monetary and credit growth of the economy—is suppressed as a matter of national policy to a rate less than the potential growth rate of GNP. Such a growth “cap” is applied to avoid inflation, and to take account of increased productivity in the financial mechanism, which should, in principle, reduce the quantity of monetary instruments needed for any given GNP.

Ordinary public utilities—electricity and water and so forth—are able to raise capital because we effectively guarantee them a low but secure rate of profit and essentially perpetual life. I believe there is no hope for our financial problems until we recognize this must also be done for our financial institutions, as essentially all other developed countries are doing.

A regulated financial system implies continual tension between the “core” utilities and “outsiders” who are trying to invent new quasi-monetary instruments that will somehow become free riders on the safety net extended to the “inside” public utilities. All new technologies will be conditioned by the regulatory structure. Some will be genuine improvements, others mere dodges. It always requires a partly political judgment to decide which to incorporate into the monetary system. The ones that are not incorporated have to be stamped out, because left to grow they will cause the core utilities to fail.

The regulatory system, like the tax system, has to be a living organism, always changing with the times. The growth of money market funds provides a good illustration. These offer the public a payments instrument on a scale such that they have taken away much of the business of banks and other institutions. The Federal Reserve has recognized the monetary role of money market fund “deposits” by incorporating them in M2, the chief monetary target. This means that, regardless of their legal status, money market funds are in the safety net, because if something
happened that threatened a rapid destruction of money market funds, this would have to be countervailed by the monetary authorities so as to maintain the desired level and growth of M2.

As a practical matter in today's world of too-big-to-fail and de facto near-universal deposit insurance, money market funds are even more secure from the consumer's point of view than are deposits in the biggest banks (about whose safety the authorities are deliberately leaving some uncertainty in the public's mind). But, unlike depository institutions, money market funds do not have to pay for deposit insurance or maintain offices accessible to their customers.

What I have said thus far applies to any monetary system. In the U.S., we have special complications because of our history. We had a kind of zoo with well-defined separate cages of highly specialized financial institutions. Within each cage, we provided enough subsidies to allow everybody to live. Animals in one cage were not allowed to compete with the animals in the others. Then, financial deregulation came along and smashed the barriers between the cages, making every animal both prey and predator, and forcing all into environments for which their evolution had not adapted them.

It's no surprise to any economist that there were too many animals, from a free market point of view, in every cage, and there are now far too many animals in the zoo. But because it is dangerous to depositors when an animal dies, most are somehow kept alive with public support. We have no provisions for dealing with these moribund, neither dead nor alive, animals, whose desperate struggle for survival makes it virtually impossible for their competitors to be profitable.

Dealing with our financial predicament depends, first and foremost, on facilitating "exit" in a way that doesn't jeopardize the system. Those animals that are moribund, or on the way to becoming so, must be bribed to close down. They have to be bribed because otherwise their incentive is to linger as long as possible and then die as bloodily and noisily as they can.

None of the proposals now on the table deal with this exit problem because it entails large budgetary burdens. Only for the savings and loans is there such a program, which is costing many times what it would have cost to "bribe" them to close ten years ago. (These outlays do not, however, involve significant expenditures of real resources and thus are not a real burden to the economy. The waste occurred when the loans were made and expended. Economists owe it to the public to emphasize this fact.)

One of the many devices we used to prevent competition among the various caged animals was deposit insurance. Limiting deposit insurance is particularly difficult because there are other means by which the public can obtain its full equivalent. One way is from foreign institutions. Another, even more important, is from U.S. Treasury bills.

We don't have the option of significantly limiting deposit insurance, desirable as that might seem, because, absent "deposit insurance on demand," depositors will run to Treasury bills with every tremor in the private financial market. The result would be lower Treasury interest rates, while interest rates on private securities or uninsured deposits would rise. The differential would set up political pressures guaranteeing the virtually complete socialization of our credit process. In fact, the differential that already prevails between private and Treasury interest rates has gone a long way towards accomplishing that.

In principle, the cost of deposit insurance should be borne by the depositors. Therefore, the level of interest rates that may be paid on de facto insured deposits—including money market funds, life insurance contracts, etc.—should be limited to slightly below the Treasury rate. That way the public would in effect pay the deposit insurance premiums, and there would be no need to limit the quantity of insurance. If I want to have billions of insured deposits, but am willing to accept the lower rate, then I should be allowed to do that. But the interest rate shouldn't be much below the government rate, because then I would be diverted into government securities, as almost all of the other proposals being considered to deal with this problem are already having the effect of doing.

Well, I promised that I would restrain myself as to time. I could easily say more, but that is the bottom line.

JAY LEVY: Thank you, Al. Jim Tobin is the other member of this panel whom we have not previously heard from. Do you have any general comments that you would like to make, Jim?

JAMES TOBIN: I sure do! If you wanted to have a dichotomy of opinion from the first two speakers, you couldn't have done better. It gives me pause that I disagree with Al [Wojnilower] so sharply, since I respect his wisdom about these things.
I was going to comment on the administration’s proposals for financial reform. Like most administrations in my memory, they have come up with their own most important, most comprehensive, most fundamental, financial reform in history. It happens every few years.

One way to characterize the current proposal is the following. I think: Banks, especially big banks, have made a mess of commercial banking, so now let’s invite them into new lines of business. That seems to be the theory of their major recommendations, namely to allow banks to undertake security issues and engage in other investment-banking activities, to sell insurance and other non-bank financial products, and to branch and merge and operate nationwide.

The administration’s perestroika wants to give bankers, especially big bankers, what they want, namely a chance to revive their sagging profits in greener pastures, a decade of and games, for which they have been envying their investment banking brethren these many years.

One lesson of the S&L fiasco, beleaguered taxpayers might have thought, is that it’s a bad and costly idea to make an industry’s wish list the government’s own priorities. Remember the Rose Garden scene, in 1983 I think, when a beaming Ronald Reagan signed the Garn-St. Germain Bill and announced the dawn of a great new day for free enterprise and the thrift industry.

If banks’ mainstream activities become unprofitable unless they beat the odds on risky loans, then I don’t see how adding even profitable ancillary functions is a solution to that problem. I wouldn’t think new activities would attract new capital if the profits of the new activities are going to be siphoned off into meeting losses in the banking business. Anyway, we are always told that there will be strong firewalls between banks proper and the affiliates that are handling other activities. They are supposed to prevent diversions of capital from the banking activity to the other ones, and I suppose they would prevent the reverse flow as well.

As for encouraging big banks to become still bigger, the troubles that their adventures of the last 15 years—all recited yesterday (oil drilling loans, Latin America, commercial real estate)—have brought upon themselves and the rest of us are not reassuring.

You may remember that when FIRREA was passed in 1989 one of its provisions was that the Treasury should look into deposit insurance and make a report and recommendation to the Congress on that subject in 1991. Part of what the administration is doing now, or did this winter, is to obey that injunction from the Congress.

But it turns out that the Treasury is not proposing any fundamental reform of deposit insurance at all. There are a few small reforms, to be sure. An individual wouldn’t be allowed to own more than two accounts insured up to $100,000 in any one bank. So that means if you wanted more insurance, you’d have to go across the street to one of the 13,999 other depositories in the country.

Brokered deposits are at last long to be restricted, and regulators will be supposed to keep depositories with bad balance sheets from bidding for deposits with above-market interest rates. (By the way, a long time ago I did propose one thing that Al [Wojnilower] proposed here, which was that insured deposits should not be allowed to bear more interest than the Treasury bill rates, or at least that if they did the part that was in excess would not be insured.) Also, the pass-through of individual insurance rights into large pension-fund deposits is to be wiped out.

Those are desirable measures, but they don’t really meet the challenge. I think the challenge obviously is to protect taxpayers from guaranteeing deposits when neither the depositories nor the depositories have adequate incentive to make sure the banks’ assets will be worth enough to meet the deposit liabilities.

The Treasury, then, has redefined the priority of 1991, away from being a reform of deposit insurance and toward profitability—making banks profitable, especially big banks. That means it has ruled out reforms that might cost the banks money, such as meaningfully higher capital requirements and meaningfully higher insurance premiums, or combinations of those things, or risk-adjusted capital requirements with enough magnitude to have a bite.

Indeed, I notice the banks are rousing considerable sympathy for their demand that the Federal Reserve pay them interest on the reserves they’ve been required to hold. Since that law has been in effect for all of living memory, and some not-living, that’s a pure windfall, a gift of about $4 billion a year from taxpayers to banks.
Yesterday we had a lot of discussion of too-big-to-fail. I think that is an extremely costly policy, enlarging the federal government's contingent liability way beyond the statutory limits on deposit insurance, and assuring both big banks and their big depositors that they will be bailed out. Under the Treasury proposal, there will be still more deposits in that category, as the average size of deposits becomes bigger from the mergers.

I think a good bit of the discussion about deposit insurance is based on a misleading analogy to the bank runs of the 1930s. Bank runs of the 1930s were indiscriminate runs from bank deposits in general—what? To greenbacks, to currency. For a variety of reasons, some of which were just discussed yesterday, the Federal Reserve was unable or unwilling, or a combination of the two, to provide the currency that the public was asking for. The monetary base in dollars was increased during the 1930s, all the way from '29 to '33—by the way, although Milton Friedman said it was not, it fact it was—but since each dollar of the monetary base supports only one dollar of currency, whereas it supports eight or ten dollars of deposits, the shift from deposits to currency is equivalent to wiping out a lot of the monetary base.

We no longer have reserve requirements on the Fed, so there wouldn't be any problem about their printing money in any quantity that is demanded by the public, and I think is emancipated from the doctrinal constraints that probably prevented them and President Hoover from asking for a change in the law, or from doing anything if they had obtained a change in the law. A run from deposits to currency is not our problem these days. But if it did prove to be a problem, it's one that the Federal Reserve could and would take care of very easily.

When people run away from suspect, insolvent, or soon-to-be-insolvent institutions, banks or S&L's, they are not running to currency, they're running to another bank. I don't consider the shift of deposits from one bank to another to be a macroeconomic problem, one that the Federal Reserve needs to worry about as a matter of national, economy-wide monetary policy.

I've never been able to understand what people have in mind, friends of mine like Jerry Corrigan, president of the Federal Reserve Bank of New York. Frank Morris, the former president of the Federal Reserve Bank of Boston, had a session a few years ago at the bank in Boston. He invited a bunch of Federal Reserve people, private economists and academics to discuss this question, and I listened very carefully to find out what was the rationale, what was it they were afraid of, and they just said, we have to prevent whatever might happen if we didn't assure all the deposits of big banks. It is an unfair policy, among other things, because if the actual $100,000 limits are abided by for small banks that go bust, as they were in the case, of all things, of the Freedom Bank of Harlem, it looks pretty bad when they are not followed in other cases.

I think the ultimate solution to this problem is what some people call the narrow-bank proposal, or what might be called the two-bank or twin-bank proposal. That is the following. Require that insured demand, savings and time deposits be invested solely in safe assets, or 50 percent in safe assets. (We could argue about the percentage, and by safe assets, I mean Treasury obligations or their equivalent.) Also require the maturity structure of the narrow bank's asset portfolio not to be appreciably longer or divergent from the maturity structure of its liabilities.

A narrow bank could be a department of a bank, or more likely it could be a separate subsidiary of a bank holding company. The essential requirement, whatever the legal arrangement, is that the assets in which the insured deposits are invested be segregated, to be available only for meeting withdrawals and redemptions of insured deposits.

If this were done, there would not be a need for any limit on the insured deposits. All the deposits in this department of a bank would be insured. All of them. You say, "Why do you need any insurance?" In a sense, the insurance would be redundant, and only for fraud, swindling, theft, etc.

Go back to the original purpose of deposit insurance which was put into place in 1933. It was to protect the transactions accounts and small savings of unsophisticated ordinary people, not large corporations, not Japanese conglomerates, but ordinary people's savings and transactions accounts, and the limit on it was $2,500. It's now $100,000. Relative to wages or prices, the limit has been about quadrupled.

Currency is a means of payment. In fact, it's still used to a surprising degree by the public as a means of payment. It bears no interest. It has certain obvious conveniences. It has some inconveniences: it is available only in certain denominations, it can be stolen or lost. The concept of what you might call deposited currency, which has essentially the characteristics of currency but the convenience and security of a deposit account, is an old idea. It would be implemented by the narrow bank proposal.
In a separate department or subsidiary, a bank could accept uninsured deposits and invest them at its discretion—subject, however, to normal banking regulations and supervision. Insolvency on this balance sheet could not impair the claims of the insured depositors on the assets of the narrow bank.

Of course, uninsured deposits would bear higher interest rates than insured deposits, because they would have some risk attached to them. To avoid misunderstanding, the two operations have to be unmistakably distinct, perhaps carried on in separate locations or even under separate or differentiated names. One idea I read by somebody who was buying this proposal was that all the deposits and checks on the uninsured deposits be red and those for the insured deposits would be blue or white.

It's often said, "Well, would anyone hold the uninsured deposits?" I think unsophisticated and risk-averse people would hold insured deposits, and many other people would hold the uninsured deposits for the higher yield. Some would hold both.

It's sometimes pointed out that money market funds already perform the function of uninsured deposits. But they actually do not provide a separate means of payment. In my money market fund, I am allowed to write checks on Fidelity's deposit in a bank in Boston.

A two-bank proposal would have to be phased in over several years, while the eligibility of conventional deposits for insurance is gradually reduced. It couldn't be done all at once.

In the Treasury report itself, the narrow or two-bank idea is given a favorable review, I would say, in the appendix which is devoted to it. In the New York Times of February 21, some of you may have seen a very long piece apparently based on an extensive interview with Treasury Under-Secretary Glauber. He was reported to say that the two-bank set up was the wave of the future, his eventual scenario of what the banking system would look like. Well, it's too bad that the administration passed up the opportunity for beginning a fundamental reform of this kind.

Once President Bush, Secretary Brady and Congress have provided a safe, convenient medium for the transactions balances and small savings of the general public, without putting the general public in its taxpayer role at risk, then it will be time to consider what other activities banks should undertake, and how large the banks and financial-supermarket chains should be allowed to be. But let's not put the cart before the horse, or invite the horse to greener pastures before he learns to pull his cart.

JAY LEVY:

In the discussions of the past two days, we've had expressions of proposed policy based first of all on the fact that we are in a financial crisis, we're in a recession, we’re in what David Levy described during the first event of the conference as a "contained depression." So there were proposals that seemed to be aimed at getting the economy straightened out in general. Let us return to an era of expansion, and that will help solve the problems.

I think that Al Hart, who is sitting over there, had something like that in mind when he was talking about a program to invest in the nation's infrastructure. Hy, I think, had similar concerns, particularly in his comments about the government's fiscal policy and the way the expenditure side of the government's fiscal activity would be directed.

I don't know which comes first, and I think that is part of the discussion. Which is the chicken and which is the egg, the financial crisis or the economic non-financial crisis? But they certainly interact. I think the recovery is based on a recovery in both areas.

Leading up to a question for this group, something rather hard for me to understand has happened. I'll give you an example. In the spring of 1980, I had a letter from a professor from the University of Minnesota who accused me of not paying any attention to the agricultural sector of the economy, although he softened his accusation by saying, "I admit it's only 3 percent of GNP." Well, anyway, I was going to be out in the Twin Cities, so I met this man, and he said, "Look, I happen to own two farms. One farm is in Indiana, where farm land is as expensive as anywhere in the country. The price is $4,000 an acre and, if everything goes well for the farmer, his gross receipts are $400 an acre." I soon found out that with the price of acreage at, let's say, $2,000, the farmer would be fortunate if his gross receipts were $200. (This was 1980.) Well, his final comment to me was, "I hope the farmers who are buying land at these prices know what business they are in."

I'm sure a few years later, Sherman Maisel, who I believe is in the room somewhere, was aware of the excesses in real estate, particularly the commercial real estate market. Knowledgeable people, not people with any arcane source of information, were aware of all the excesses that were developing even from their inception. Yet no one in
as lofty a position in our government as, say, the chairman of the Federal Reserve would ever make a public statement calling this to the attention of the people. I suspect that had such voices been raised, things might be a little bit different than at present. I think it's worth looking into these issues. Shall we begin again from this end with you, Dick?

RICHARD ASPINWALL:

Yesterday somebody used the term “the snake of finance in Minsky's macroeconomic Garden of Eden.” In my view, the snake consists of hidden subsidies of the U.S. banking system and the consequences of these hidden subsidies. Specifically, the banking system has been permitted to operate with capital that is substantially less than the capital of companies doing comparable business through non-bank entities. For example, the recent Treasury study contained a table showing equity positions of insurance, securities, business finance, and consumer finance companies. All maintain median ratios of equity to assets in the range of 15 to 25 percent. For banks the ratio is 5 percent.

The reason banks can operate with 5 percent is that the public perceives there is some kind of government support for them—one term for this being safety net (and a special case being “too large to fail”). The safety net substitutes both for insufficient capital and uncertain access to liquidity.

The operation of this safety net, for which there are few rules and little accountability, has been exceedingly costly, and the cleanup bills now being presented are far from a final reckoning. Furthermore, implied government assurances create incentives for forbearance on the part of the regulators, which I reviewed yesterday, and also for risk-taking proclivities in the covered entities themselves.

The safety net is often connected to the amorphous arrangements called “the payments system.” Surely there is no reason to permit undercapitalized institutions to engage in large-scale transfers of funds. We are assured this form of forbearance is in the public interest, but it is hard to suppress a suspicion that regulators don’t want to find out what happens if it is not.

Moreover, problems in the life insurance sector are now unfolding, and expressions of concern are again being issued by the Federal Reserve, just as was the case with securities firms several years ago. In fact, it seems that almost every time a financial problem arises, the federal safety net is extended to provide support. Such actions impose public costs, some of which are not immediately visible or measurable. Unfortunately, the financial villainy of the safety net is not very widely comprehended.

Unfortunately, the financial villainy of the safety net is not very widely comprehended.

JAY LEVY:

My last point is on the question of narrow banks. The shortcomings of narrow banks are roughly two in nature. First, it is difficult to see how they can be profitable. Profitability ought to be at the heart of incentives for institutional structures. Taking asset positions in riskless securities and paying a rate close thereto on deposits is not likely to yield a viable return.

A second and more difficult problem is that the narrow-bank proposition ducks the safety net ambiguity. That is, liabilities of banks other than narrow banks are likely in practice to continue to enjoy de facto regulatory assurance. The eligibility of “non-narrow banks” for discount window access, contained in many proposals on this subject, indicates that narrow banking will not resolve the status of bank liabilities—especially those issued by large institutions. Thus, shifting a function to a new box will not solve an old problem.

BENJAMIN FRIEDMAN:

I would like to address three sets of issues. First, why do we care about all this? So far, people have emphasized matters like the safety of deposits and the need to prevent disruptions in the credit intermediation system that might sharply depress nonfinancial economic activity.

There is another issue that we want to keep in mind, however. The credit intermediation system ought not merely to function smoothly, in the sense of avoiding catastrophic disruptions. It ought also, over time, to achieve sensible economic allocations of credit so that, given the role of credit in our society, it will therefore achieve sensible economic allocations of our society's resources.

The fact that the savings and loan industry lost $200 billion in the last decade, and that reasonable estimates of what the banking industry lost come to $60 billion in addition, means that more than one-quarter of a trillion dollars, not just of paper losses by financial institutions but of real resources in our economy, were dissipated. How did that happen? Resources were allocated to projects that never should have been undertaken in the first place—
for example, the empty condos and office buildings that one now sees everywhere. $260 billion is an amount approximately equal to 5 percent of an entire year’s income, or approximately equal to one-third of the United States’ net indebtedness abroad. In this era of shrunken capital formation, it is also approximately equal to three entire years’ worth of net additions to our stock of productive plant and equipment.

So, it isn’t merely that we want to avoid disruptions to the credit system and maintain the ability to pay depositors. We also want a system that will preserve the incentives to allocate credit, and therefore society’s resources, properly.

Second, what to do? Like Jim Tobin, I favor the narrow-bank proposal. I favor it most in the form in which Bob Litan, for example, has advocated it. On the side of the narrow banks, I think of those as being required to adhere to something corresponding to what people used to call 100 percent reserve banking.

Dick Aspinwall raises the question, how can this activity be profitable? The answer is, it isn’t going to be very profitable, but that doesn’t mean that there won’t be an adequate supply of it. Many mutual funds are in the business of holding money market instruments and offering liquid liabilities. Once those liabilities have to be closer to perfectly transactable, the service charge that comes out of the spread between the Treasury bill rate and the rate paid to deposit holders will presumably be wider than the small number of basis points that a money market mutual fund now conveniently earns. But even at today’s low spreads, there is no absence of firms willing to be in the money market mutual fund business. The fact that it is not a wide margin business doesn’t mean that there won’t be an adequate number of competitors in it.

These narrow banks ought also to have very rigid capital requirements. Again, the existence of the capital requirement means, of course, that the rate offered to the deposit holder will be yet again a few basis points below the Treasury rate. The narrow banks will have assets that one can mark to market at any interval one wants—weekly, daily, or by the hour. The competent authorities ought to mark those portfolios to market regularly and, if the market value of the portfolio falls below the capital requirement, then the institution ought to be shut down right away. With a small-percentage capital requirement, a liquid institution like that can be shut down instantly, with zero cost to the insurers of the deposits.

Third, I would like to broaden the discussion by pointing out that there is a very fundamental issue in all this that we don’t talk about very much, perhaps because as economists it makes us uncomfortable to do so. The issue arises most clearly in the context of thinking about what the non-narrow banks would do—that is, the banks that under this scheme would not offer insured deposits, and therefore might very plausibly have broad powers, and might even have an industrial or commercial firm as an owner in part or in whole. The issue is most sharply defined by asking whether those non-narrow banks would evolve into either universal banks as in Europe or Japanese-style keiretsu banking.

The reason that we are so uncomfortable in addressing this issue, I think, is that the possible advantages of a European-style universal banking system or a Japanese keiretsu system strike very directly at the economist’s conventional presumption in favor of arms-length dealings in an open, auction-type market setting. To be sure, as Hy Minsky’s paper has already pointed out, the role of banks, like that of any other middleman, is already suspect in economic terms. Intellects honed on Walrasian exercises find it awkward at best that all these middlemen are in the way, rather than having an auction-type market in which ultimate savers provide their capital directly to ultimate investors. Evidence that banks not only exist, but might even be quantitatively important for the level of economic activity or for its allocation is even more troubling.

What makes this awkwardness all the more galling in the current environment is the increasing amount of evidence that these economies in which banks play a greater role vis-à-vis open auction-type securities markets than banks do in our economy might be doing better than ours. Indeed, they might be doing better than ours for reasons that go right to the heart of what these banking institutions that keep the financial transactions out of the auction-type markets are doing.

This may be galling for economists, but I think we have to address the issue for several reasons. One, of course, is simply that it is fundamental to the discipline. In addition, it is a current policy issue, especially in just this context of bank reform. And, finally, as a policy issue that is more than just a current one, once we confront challenges to the presumption that arms-length dealings in auction-type market settings in which individual utility or profit-maximizing entities interact might not be the optimal way to go about allocating the society’s resources, then we have to admit that we have at least opened up the possibility of a role for public policy, not only in the sense of
establishing the ground rules within which these individual entities will then interact with one another, but also the prospect of on going interventions of a more dirigiste nature.

In sum, the subject is more fundamental than most people are letting on. But, for that reason, it is also much more interesting than people are letting on.

**JAY LEVY:** We will skip Hy for the moment, because the purpose of this conference is, as you've all discovered, to talk about him. Gary?

**GARY STERN:** I think maybe I'll start by talking about Jim [Tokin]. I agree with everything he said, except maybe for the endorsement of narrow banks. [Laughter from audience.] Up until that point, I think, consistent with what I said yesterday, we see eye to eye on it all.

I do think Dick Aspinwall raises certainly a legitimate concern about what happens to the safety net in the non-narrow bank, and Gene Rotberg made a couple of comments in his talk about the value of fire walls, particularly when there is a fire, which I think are accurate and appropriate.

I'm not hung up, by the way, on the profitability, or lack thereof, of this so-called narrow part of the two-bank proposal, but I would observe that, at least the last time I looked at the data, the turnover in money market mutual funds is far, far different and far, far lower, I mean it's not even in the same league, as the turnover of demand deposits. I don't have an entire explanation for that, but there is an interesting aspect of money market mutual funds that I think we haven't talked about yet, and that is that demand deposits are, of course, payable on demand at par.

Money market mutual funds don't guarantee you payment at par. They mark those things to market every day, and there have been some cases, not many, where, on a given day with a given interest rate movement and that marking to market exercise, the fund actually goes down. In fact, I would bet that most people, being aware of that, spend more time when they get the quarterly statement of the holdings of their money market mutual fund looking at the assets in their fund than they do trying to understand what it is that their bank is up to—and for good reason.

**The wise thing to do is to work as hard as we can and as smartly as we can to narrow the safety net.**

A word of caution. I always find these international comparisons interesting but dangerous, in the following sense. I mean, I don't know what we can conclude by looking abroad. We have an agricultural policy in the United States. It's not very good, but I think we would agree it's worse in Europe and Japan. The fact that Europe and Japan have chosen an even worse policy doesn't mean that we ought to emulate them. Similarly, if I am in London, and I look at the price of gasoline in the U.S., do I conclude that because the U.S. has a low-gas-price policy that that's the appropriate policy for the U.K.? I just don't know what you get out of these international comparisons.

I think the differences between Al Wojnilower's views and mine can be summarized, if I understand them correctly, as follows. Al's view is that the safety net underpinning not only depository institutions but all sorts of things in the U.S. economy is broad, and that in all likelihood it is going to get broader, and the best we can do is accommodate ourselves to that. My view is that indeed the safety net is broad, that it is in fact too broad and the wise thing to do is to work as hard as we can and as smartly as we can to narrow that safety net, before it costs the taxpayers even more money than it has already.

**JAY LEVY:** Okay, I relent, Hy. Your turn.

**HYMAN MINSKY:** I want to begin by pointing out something that Dick Aspinwall instructed me on many years ago. Banks do not charge households anything like what it costs them to furnish payment services to households. I'll start my argument in a roundabout way.

There is a profitable and growing business that is providing banking services that is almost always ignored in discussing banking. I refer to the currency exchanges or check-cashing services which exist mainly, but not exclusively, in the ghettos of our cities. These currency exchanges sell money orders, thereby facilitating payments at a distance, and, for a fee, they exchange one form of money, checks, into another, currency. The fees they charge are graduated to allow for the risk involved. They charge more, much more for a personal check than they do for government welfare and social security checks. In Illinois, I believe, welfare checks can be sent to the recipients care of a currency exchange. As part of the deal which brought this about, the currency exchanges charge only 1 percent for exchanging such checks into currency.

Another part of our modern payments system is the credit card, which discounts the vendor's chits. As American
Express shows, the discount makes this part of the payments process profitable to the providers of the service. The interest charged on unsecured balances adds icing to an already profitable line of business.

"Free checking" contributes to the current crisis of bank earnings. When interest rates were controlled, and there were no serious rival banks, saving and loan associations and credit unions as suppliers of household liquid reserves, the costs to banks of furnishing households with "free checking" was paid for by the spread between the rates earned on assets and the rates paid to depositors. The furnishing of check services was subsidized by bank fund income. Competition has reduced the spread. If competitive pressures lead to a fee-for-service checking system, then not only will bank profitability improve but the move towards a more complete and more efficient payments system will be facilitated.

The legislation recommended by the administration is mute on the conditions of entry into banking. The essentially free-entry, check-cashing, banking service firms are growing. (In some states they are registered, in others they are not.) Banks in part want to get out of furnishing "free checking" to those with small balances. If these check-cashing operations were allowed to take passbook savings deposits which they could only invest in government securities with less than three years to maturity and with restrictions on composition, so that their assets average out to a six-month duration, a parallel narrow banking system would emerge. Incidentally the Jimmy Stewart Savings and Loan was a narrow bank in an economy where government debt was scarce. We need to recall that, before the Great Depression, federal government debt was scarce in the United States.

I believe the discussion of financial system reform should be broadened from that laid out by the administration. Ben Friedman’s remarks to the effect that we are really interested in the financial structure because it affects the functioning of the economy were right on target. We are interested in employment, price stability, growth, the efficient selection of investments, and the adequacy of the aggregate volume of investment. We are interested in the flow of profits being sustained, for these are the funds that validate business debts. The emphasis on the cost to government in the discussion of deposit insurance refinancing is misplaced. The emphasis should be on what it takes to avoid a deep and protracted recession/depression and what needs to be done to make our financial system a strong link in the partnership between business and government in fostering the capital development of our economy.

The main question we face is, what characterizes a financial system that advances the capital development of the economy? In using the phrase "capital development of the economy," I am echoing Keynes's well-known comment to the effect that if the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. It seems almost self-evident that, in their involvement with the financing of commercial real estate and corporate restructuring, the banks, as well as our financial community in general, were not assuring that the capital development of the economy was done well.

In the past several days Professor Hart, as well as a number of others, have pointed out that we have an "infrastructure problem"—that this part of our capital development has been especially ill-done. It is not wholly true that we have not done infrastructure investment well, for the telephone system is part of the infrastructure, and that we have done well. The telephone system's capital development is financed because it is believed that the fees that will be paid for telephone services will be adequate to meet the payments on the debts undertaken to finance the system's capital development.

I advocated a fee-for-services solution to one aspect of the crisis in banking, the provision of transaction services. It may well be that the solution to the highway and bridge infrastructure deficiencies will be a greater use of fee-for-services. But even in the United States fee-for-services is not a universally valid solution to shortfalls in economic functioning—witness the crisis in our fee-for-service medical care system.

I would like to put another point, which I raised in my earlier talk, on the floor during this Policy Forum. In Chicago, before the Great Depression, the ownership of a four-flat apartment house was promoted as a way an ordinary worker could prepare for retirement. The scheme was that during one’s working life you lived in one apartment and the rents from the other apartments paid off the mortgage. During the retirement years you were to live in one apartment and the rents from the other three apartments provided income. Those who started such a program in, say, 1927 found themselves in 1933 with no job, no rent-paying tenants and mortgage payments due every month. This scheme was a victim of the Great Depression.

Today's retirement schemes that supplement Social Security typically involve taking positions in funds that invest in a wide variety of financial instruments. As a fiduciary, these funds presumably act in the interests of the prospective
pension recipients. These funds are today’s big owners of corporate liabilities. They became major players in the corporate takeovers and restructurings of the 1980s. The term “junk bonds” entered into the financial lexicon to describe instruments that were not eligible for the portfolios of fiduciaries. Yet, in the 1980s, pension funds not only became major buyers of less-than-investment-grade bonds, they also became major investors in the equity funds that furnished the base for the leverage in junk bond deals.

I therefore see two directions in which the discourse should be broadened. One is to transform the payments system into a fee-for-service system, which may or may not take the form of narrow banks. The second is to recognize the change that has taken place in the nation’s financial structure with the massive growth of not only pension funds but also mutual funds of various types.

The question raised by Bill Janeway, on the level of the individual operating unit, is of fundamental importance for the total economy. The question Bill raised is, what is the appropriate liability structure for a particular set of capital assets with a conjectured cash flow that depends upon the operating environment? A parallel question has to be raised for the economy as a whole. In addition, we need to investigate what instruments of public policy can be introduced that simultaneously assure that apt investments are financed and that the financial structure does not fall into the disarray that is now a clear and present danger.

JAY LEVY: The name of this session is “The Nature and Necessity of Reform.” Implicit in all the discussions is that there is some need for reform, and there have been a number of comments about the nature of the reform.

Perhaps we can get more specific if we use as our stalking horse the Treasury’s proposals for bank reform, which in fact we’ve been doing. Of course, part of those proposals concern deposit insurance, but in the discussion the issue of “too-big-to-fail” also comes up.

If a bank is too big to fail, we in essence have deposit insurance regardless of what the specific statutes might say. I suspect that everybody on this panel believes that we should not subscribe to the idea that any bank is too big to fail. [Objectives are heard from some of the panel members:] You’re not in agreement? [A panel member asks, “What do we mean by fail?”] Well, that’s part of the question. I think, then, we should discuss too-big-to-fail, because obviously we are talking about a de facto kind of deposit insurance.

In previous times we not only bailed out banks, we bailed out Lockheed, and we bailed out Chrysler on the theory that these were big and important, that they employed many people and were necessary for the national defense. Whatever the case may be, there was big political support for not allowing these institutions to fail.

In general, when we start to get to the financial institutions, I think there are some kind of feelings, although I don’t know if they can be quantified in any way, of what this does to everybody’s confidence. If Citibank were to go under, would this precipitate all kinds of trauma on all kinds of financial markets? That sort of thing.

So let us, if we can, focus on these two issues for the moment. Oh, you have a question, Al [Hart]?

ALBERT HART: I would like to say, before we plunge into details, I would hope we could ask about the criteria for meaningful reform. It seems to me we ought to be paying a lot of attention to fundamentals of the sort which Al Woinilower was getting at, and above all the externalities.

I yield to nobody in my enthusiasm for designing gadgets. I think gadgets are lovely. I’ve learned so much about gadgets, hearing about what’s wrong and right about them, at this gathering, that I want to begin by expressing my gratitude.

But, before we go into particulars, there are several crucial externalities to consider. One is that we want to have a monetary system which will function as to allocate capital sensibly, as was said by several participants.

A point which was mentioned several times, but which has faded out of the last part of the discussion, is that the banks have really been what we had to channel capital to small new businesses. This is the seedbed of a large part of what’s good in the American economy, and we want somehow or other to save that. The notion that they can be put onto an auction market won’t fly. You can’t start with commercial paper for the kind of thing that Silicon Valley represents. So this is an important value to maintain.

We have other externalities of the first magnitude. In the first place, we have to see if we can do something to restore the focus and potency of monetary policy. We used to think of a partnership in stabilization policy between
monetary and fiscal policy. But in fiscal policy everybody has given up on tactical flexibility (as distinct from built-in flexibility, which still functions more or less). So stabilization policy is left to work with monetary policy alone.

Monetary policy used to be thought of as control of the quantity of money. But who knows today just what “money” means? Having given up on M1, we are offered some hopes that some broader aggregate (M2, M3 or what have you), with some lag pattern, may be powerful in steering the economy. But even if such an aggregate is powerful, how can policymakers find a handle on it?

By default, many of us conclude that monetary policy consists in control over interest rates. But here again there is a “handle” problem. The Fed, of course, able to give a nudge to short-term rates in the United States. But this is by no means the same thing as steering the long-term rates which are believed to be a major determinant of fixed investment.

The number or roles assigned to interest rates makes them the most over-employed policy instrument one can imagine. Interest must dissuade holders of liquid assets from tapping these assets for current spending. Interest must encourage saving (not at all the same thing as the first, in view of wealth effects). Interest must encourage and stabilize fixed investment. Interest must go easy on governmental budgets. Interest must bring about an appropriate international value for the dollar. And what else yet? Such frequent and varied up-nudges and down-nudges are called for that internal economic stabilization cannot be served for much of the time. Can we redesign the financial system in such a way as to get away from having only one stabilization instrument—and that one mortgaged to numerous other objectives?

Then there is a third externality which is tremendously important, I think. We are headed toward the federalization of everything. What it comes down to is that we yield to all the pressures generated by U.S. politics, and we design beautiful gadgets which interest groups can distort and exploit. If we yield to these pressures, we are in a position where the role of the federal government is to guarantee everybody’s fond hopes and to say, yes, you have an entitlement to such and such. We will now guarantee all these hopes and put an escalator clause on them.

We’re getting to the point where we are in danger of not being able to tell the difference between the government and the banking system. We are headed in the direction of Argentina—and curious things happen in a society where the public purse and the banking system are one entity.

We want a real monetary reform, a financial system such that we can avoid underwriting all these fond hopes. Speaking as a beneficiary now of Social Security and Medicare, I think it is outrageous that we are not economizing by raising the Medicare deductible, and that we are not raising more revenue by making Social Security benefits fully taxable. This is just a “for instance,” but a very representative one. We just can’t have as good a society as we had hoped for, if we go on this footing.

In this connection, we should think hard about a question raised by Hyman Minsky. Why do we assume that there have to be Treasury bills? The question whether there is any difference between the payment system and the obligation of the federal government to underwrite everything is related to that. When this process goes sufficiently far, then either the banking system becomes an instrument for putting out the equivalent of Treasury bills, or the Treasury bills become currency.

The fact is there is no very special reason in the logic of the economy why these very short-term instruments should exist. Their existence is a horrifying link between the financial problems of the private economy and the problem of preventing the federalization of everything. A large part of our gadgetry hinges upon the assumption that it is necessary and desirable to have Treasury bills. I don’t think we’ve gone into the question whether this is a useful instrumentality in our society, or whether there should be a taboo on it. I’d be inclined to say the latter.

So, I do hope we can ask ourselves, what is the reform for? What are the criteria as to what constitutes a good reform package? And let’s not get too exclusively involved in particularities, even as important as to whether we can afford “too-big-to-fail,” which is merely one part of this federalization mechanism. [Applause from audience.]

JAY LEVY: Thank you very much, Al. I think what Al has really asked, and which is beyond the scope of this panel, is let’s look at our whole economic system, and certainly when we are talking about the financial part of it, it’s perhaps the veins running through the body.

But I think we can and should discuss one point, which is, how is our banking system allocating the financial resources of the economy? This raises other issues. For example, we look at the banking system and say it financed
many office buildings that should not have been built. But this also occurred during a period when there was industrial downsizing, when the automobile industry, the steel industry, and many other major industries were shrinking. So I think we had a whole Pandora’s box of problems.

Let us try and focus on something that maybe we can get our hands on, keeping in mind, certainly, the first aspect of Al’s point: how are we allocating resources? I don’t see that that’s particularly explicit in any of the specific proposals made either here, say by Gene Rotberg the other night, or by the Treasury Department, and I suspect, by the way, that given the general view of the state of the economy and where it’s going, we are going to be getting very much more into the areas that Al Hart has been talking about. Al [Woijnower], would you like to pick this up?

**ALBERT WOJNOWER:** Well, I don’t know where to pick it up exactly. I’m stunned and saddened by some of what I’ve heard. We want to have a well-functioning monetary system, and we’ve opted to have a central bank. It was not easy to create one. It was a very dispassionate venture. Why should we believe that the benefits of a central bank can be costless?

For a long time, we operated with a system in which the various moral hazards were kept in check by all sorts of regulatory restraints. Then, in the 70s and 80s, we took away the restraints, but we kept the temptations.

I think it’s fair to assert that literally every homeowner in this country, and literally every holder of a savings, pension, or money market account has benefited from this implicit subsidy, the costs of which are now becoming explicit. Now I find that some of us are upset that, after having enjoyed all these subsidies for so long, we may be called upon to pay for them.

Just as for dependable electricity or water, there is a price for dependable money. We may debate on whom the incidence should fall, but it’s absurd to think that the cost can be avoided. To eliminate this cost, either the moral hazard (that is to say, the existence of the central bank) will have to be abolished, or it must be curbed by restrictive rules that will bother many people.

On another level, echoing Al Hart, I’m amazed that people I greatly respect should propose that the U.S. government, which already has its grasp on practically everything in the financial structure, be given principal and preferred access to all the funds that people in the world want to keep safe and insured. Any kind of adverse ripple in the stock market or the financial structure would trigger an enormous move into this guaranteed safe area.

And what difference does it make whether you or I buy the Treasury bills, or whether it’s the “narrow” bank that gets our deposits and buys them? Maybe the bank will extend maturities a little further than would individuals, but the impact remains the same. It would become utterly certain that the U.S. government will have a far lower cost of capital under these circumstances than any other instrumentality, public or private, in the world. The ability to get a U.S. government guarantee will become the principal factor that determines whether private ventures go or don’t go.

I’d like to suggest further that these problems of too-big-to-fail are not limited to depository institutions. That’s a shortsighted view. When we have the new financial system toward which we are headed, namely the one in which the General Electrics and the IBMs issue commercial paper to money - market funds, and themselves become the dominant lenders, we will eventually face the same problem. Free competition will eventually undermine even these giants, so long as monetary policy succeeds in limiting the growth of financial assets and liabilities to a noninflationary rate. Then we will have still bigger giants that must be propped up.

To abrogate too-big-to-fail is to deny the monetary authority the ability to intervene on behalf of a financial institution that it deems to be important, in circumstances the monetary authority regards as exigent. I can see libertarian arguments in favor of this proposition. But the die was cast against this view when the Federal Reserve system was founded precisely to serve as a lender of last resort. There is no way back to the world as it existed before the Federal Reserve system. A sizable portion of all the capital accumulation we have experienced since the Fed was born has been undertaken based on the reduced sense of risk instilled by having an unquestioned payments system as well as a stabilized economy and purchasing power of money. An enormous downward revaluation would take place if the Federal Reserve’s powers now were abolished.

There’s a nostalgia here for going back to the small agriculture, the small banks, of the pre-Federal Reserve world, to an old world not of auction markets or giant firms but of little shops. It can’t be done. To the extent we try, we will fall further behind the rest of the world, which is becoming more, not less, financially centralized.

There is no way back to the world as it existed before the Federal Reserve system.
JAMES TOBIN: Do I get to reply to that? I hope so!

JAY LEVY: Surely, Jim. Go ahead.

JAMES TOBIN: The narrow-bank or two-bank proposal does not envisage getting rid of the Federal Reserve system or of the lender-of-last-resort function of the Federal Reserve. That would be continued for the "red" banks as it is now. The lender-of-last-resort function would still be there. The uninsured banks would still be subject to reserve requirements, and, as members of the Federal Reserve system, they would still have the right to borrow from the Federal Reserve Bank, etc.

So that proposal does not bear any relationship to going back to pre-Federal Reserve days. The Federal Reserve system existed for twenty years before there was federal deposit insurance. The purpose of the lender of last resort, as I have understood it, is to let banks or other depositories borrow from the central bank to meet their liabilities when they have perfectly good loans which are illiquid and not marketable.

That was the old idea of commercial banking, that the commercial banker made loans to local entrepreneurs or businessmen who didn’t have access to a national market for commercial paper. Bankers were the specialists at judging the quality of these loans. But if you mark them to market every day, they would be of zero value until the time of maturity. So if bankers faced withdrawals for any reason while they still had good loans on the books, the central bank existed to lend them the money to keep them going. Temporary illiquidity of that kind would not cause them to fail to meet their demand deposit obligations or other obligations.

This system would still exist. Abolishing too-big-to-fail does not mean getting rid of the important essential function of “lender of last resort” for individual banks. Nor does it get rid of the macrotconomic function of monetary policy as a supplier of reserves to the banking system as a whole, and as a supplier of whatever currency the public wants to take out of the banking system. Let me point out that a shift from a red bank to a blue bank, from (in my suggestion) an uninsured deposit bank to an insured deposit bank, would not be like a shift to currency. Since the reserve requirement would be the same in either case, there would not be a destruction of reserves by that shift, as there is when there is a shift to currency itself.

I’m torn between the two ends of this panel. On the one hand, Dick Aspinwall says that nobody will want to have an insured deposit because its interest rate will be so low, and Al Woinilower says that nobody will want to have an uninsured deposit, that everyone will want to have an insured deposit because it’s safe. The idea is that people who want safety and want to handle their transactions and small savings in that way will have the one opportunity, and the other people who want to go for higher interest rates and take a bit of risk will go for the other.

There’s no reason why higher capital requirements couldn’t be applied in the uninsured category, to get back to the 15 to 25 percent that was characteristic of banks before deposit insurance and, as was pointed out, is characteristic of other financial intermediaries now. The one purpose of the proposal, and of other proposals that are made relative to deposit insurance and the banking system, is to avoid the perversion of incentives as well as the contingent liability to taxpayers involved in the system now. I agree you could perhaps get a long way in that direction by raising capital requirements on insured deposits now from 6 percent to 20 or 25 percent. I have no belief that this is a political possibility, but if you tell me that it can be done, I’ll vote for it.

The avoidance of perverse incentives, and the avoidance of the burdens on taxpayers from the liabilities those incentives create, is almost 100 percent correlated with avoidance of the misallocation of resources that Ben Friedman spoke about. The reason that taxpayers have to come in and bail out the depositors of failed S&Ls is precisely because the capital was misallocated in the first place. The larger purpose is to avoid misallocations of real resources.

I guess what I said earlier should also relieve Al Hart’s fear that this kind of policy means you are giving up on monetary policy. Base money would still be a quantity that the Federal Reserve controls. It would still be the fulcrum of monetary and interest rate policies, which is the quantity of base money or the quantity of bank reserves, however you want to look at it. That still would be true.

Alaric Hart is properly concerned about how the Fed can control long-term rates more effectively and directly than by its control of short-term rates. That’s a problem right now. It has nothing to do with these reform proposals. It arises, among other things, from the Federal Reserve’s determination (which I think is a mistake in itself, but that
would get us into a different range of subjects) to make all its interventions in the money markets in the shortest instruments available and never to play the game of buying longer terms rather than shorter. I think that is a mistake in policy, but it is independent of the reorganization of the deposits of banks and the banking system.

Finally, I have to say that there are financial intermediaries that perform the function of bringing savers and investors together, intermediating between them, that are not banks. They are increasingly important in the system. Some of the technological or entrepreneurial changes in available instruments have increased non-banks' comparative advantage relative to banks themselves, but I don't think there are any reasons for us to be concerned by that fact. If securitization of mortgages makes mortgages more tailored to the portfolios of insurance companies than to banks than they were before, well then there is going to be a shift in the relative sizes of those industries, and I don't think there is any reason to say it should not happen.

**JAY LEVY:**

There is a point that seems to me to get a little bit obscured in all the discussion, which is basically why financial institutions made a plethora of loans which were ill advised or worse, and caused savings and loan bankruptcies, problems with commercial banks and so forth. When we bring up the idea of insured and uninsured deposits, what we are saying, I think, is that if we don't have insured deposits, either de facto or otherwise, the depositors will be more interested in how the places where they put their money behave, and they are not going to want to deposit money in institutions that take unwise risks with their money.

This is a kind of simple question which seems to bring forth a complex response. So maybe the question should be asked differently. Going back to H y, if this kind of financial instability is systemic in the economy, as certainly a lot of evidence we've heard in the last few days would support, we're going through a phase of deterioration. However we resolve it, whatever kind of deposit insurance we have or we don't, somehow or other the banks will have a whole change of attitude imposed upon them by their own mistakes. They are going to be very careful about lending money. The regulators are going to be watching much more closely, as they already are, whether we have four kinds or two kinds of regulators as the Treasury proposes.

And everything will straighten out, and twenty years from now this experience will be forgotten, the regulators will not be watching closely, the banks will be taking chances that they shouldn't be taking. So maybe what we do isn't going to make very much difference.

Would you like to make a closing comment on that, H y, and then we will open up the discussion.

**HYMAN MINSKY:**

In terms of the specific weaknesses of banks and the S&Ls, I never understood why the S&Ls took on making their liabilities subject to check or why the authorities put up with this. This was going to cost the S&Ls some 2 or 3 percent of the liabilities subject, without any offset in revenues. This was a regulatory oversight and contributed to the breakdown of the industry.

The deeper issue, beyond the immediate need to take care of the crisis in the deposit insurance funds, is that the liability structure that is proper for carrying particular kinds of operating assets depends upon the size and the presumed security of the cash flows these assets will earn, which in turn depends upon the views of market participants on how the institutional structure will evolve. There have been profound changes in the institutional structure of finance and business over the history of our economy. Some of these profound changes matured over the past decade. These changes—and the pension funds I mentioned earlier—are just on such institutional change—have affected, to put it generically, how businessmen and bankers interact.

Is there some flaw in, some characteristic of the financial structure that became evident after the 1960s that is responsible for the retardation of investment in the United States? If so, is there an alternative structure which can be put in place that can overcome the flaw? These are the deep questions that in time we will have to confront.

This requires that we develop an understanding of how flaws in the institutional structure can develop. Institutional analysis, relegated to the back burner in the research program of economists for well-nigh half a century, now moves to the front burners.