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FINANCIAL INSTABILITY AND THE DECLINE (?) OF BANKING: PUBLIC POLICY  
IMPLICATIONS

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I. Definition of the Problem

This is a session on the policy implications of the decline of banking, in a conference on "The Declining (?) Role of Banking". Banking plays two roles in a modern capitalist economy: it supplies the means of payments and it channels resources into the capital development of the economy. On both scores these banking functions are being performed to a decreasing extent by organizations that are chartered as banks and it seems, *caeterus paribus*, that the trend will continue.

These developments suggest that the role in the economy of government organizations (Central Banks broadly defined), which supervise, regulate and examine banks and also operate to "control" the growth of bank money and to assure that those bank liabilities which function as part of the payments mechanism are always available at par, needs to be reviewed. The "declining" role of banks has significance for the efficacy of monetary policy operations. The channels by which Federal Reserve operations impact upon the economy may no longer be through the availability or cost of financing but rather by affecting uncertainty, by affecting the evaluation by portfolio managers of the viability of enterprises and the stability of markets. When Central Bank operations affect the evaluation of uncertainty by financial market agents, market reactions will often be out of line with the size of the operation.<sup>1</sup>

The decrease in the weight of banks in financing the capital development of the economy tends to increase the significance of the Securities and Exchange Commission relative to that of the Federal Reserve System. That some major organizations which are chartered as commercial banks operate more like investment banks is an issue bond rating firms are facing up to, even as our regulatory structure for banks remains frozen and unchanging. The policy problem that emerges from the decline in the relative importance of institutions chartered as banks is whether the existing institutional structure of regulation and supervision of financial institutions needs to be changed in a serious way.

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In general we can discuss policy on two "plains". One plain is the day to day operations of the "authorities" and the rules if any which should guide them. The second plain is the from time to time legislating that affects the structure and operations of the private banking and financial institutions and usages and the government involvement in banking and finance. This paper concentrates on policy on the second "legislating institutions and usages" plain.

## II Theoretical Background

Every economic policy argument reflects a maintained economic theory. It behooves anyone who analyses and advocates economic policy to make "where he is coming from" clear. This is especially true if the maintained theory of the analyst is significantly different from the conventional or orthodox theory of the day.

This comment is written from the perspective of the financial instability hypothesis interpretation of The General Theory of Keynes. This interpretation holds that in The General Theory Keynes set out the foundations of an investment theory of business cycles and a financial theory of investment for capitalist economies. Interactions among processes which determine investment demand, financing conditions, aggregate demand and the distribution of income determine the path through time of the economy.

This Keynesian view differs quite radically from the orthodox "neo classical" economic theory, which leads to propositions about the properties of the static equilibrium of an abstract economy which is fully specified by production functions, utility functions over "real variables", and maximizing behavior. One proposition of the "neo classical" theory is that money is "neutral". Keynes described the effort that went into the creation of The General Theory as a process of escaping "...from the confusions of the Quantity Theory, which once entangled me."<sup>2</sup>

In the theory Keynes developed, upon which the financial instability hypothesis is built, money and finance are in general not neutral. In particular changes in monetary and financial institutions will affect the path of the economy through time. This non-neutrality of money is not the result of special circumstances such as rigid wages but rather because money enters in quite different ways into the determination of the money prices of current outputs and the money price of capital assets.<sup>3</sup>

In the financial instability hypothesis the economy is viewed as a set of interacting interdependent processes that generate the path of the pertinent economic variables through real time. The results of multi market interactions are most often tranquil, but from time to time the cumulative effect of the interacting processes generate turbulent conditions as well as incoherent behavior. This theory holds that periods

of incoherent behavior occur as a natural outcome of the interactions between flows of income and the payment flows due to financial commitments. These interactions reflect the essential characteristic of a capitalist economy, that it is simultaneously an income generating system and a financial system.<sup>4</sup>

Economic turbulence and incoherence are associated with both deep depressions and severe inflations; they lead to serious systemic deviations of output from potential output. Whereas the orthodox theory finds that decentralized market processes lead to optimums, the financial instability hypothesis holds that the outcomes of capitalist market processes are often seriously flawed. However the full effect of these flaws, such as deep and long depressions, can be contained by apt economic policies.<sup>5</sup>

In the financial instability hypothesis, business cycles mainly result from interactions between payment commitments, which arise in the process of financing investments and positions in capital assets, and the flows of gross capital incomes, which are determined by the structure of aggregate demand: business cycles are endogenous in capitalist economies. Gross capital incomes can be either more than sufficient, sufficient or insufficient to fulfill payment commitments made during prior financings. In the simple skeletal case investment spending determines the cash flows available for validating the prices paid for capital assets and financial instruments, as well as fulfilling commitments embodied in liability structures which were entered into in order to finance investments and positions in assets.

In our complex world households, government units as well as foreign governments and enterprises have outstanding debts and debt finance some of their activities internationally. They too need to validate debts inherited from the past, even as they finance some current demands for goods and services with new debts.<sup>6</sup>

### III Debt Deflations

The financial instability hypothesis as an interpretation of Keynes starts with two observations:

1. The General Theory was written during and shortly after the great contraction of the American Economy that culminated in the collapse of the United States' banking system in the winter of 1932-33.<sup>7</sup>
2. Keynes was familiar with Irving Fisher's Debt Deflation Theory of Great Depressions.<sup>8</sup>

In Fisher's argument "over indebtedness" is an initial condition for a debt deflation. This arises out of the changes in the way investment and positions in capital assets are financed as the economy enjoys an extended period of good times. Institutional changes, in the form of new institutions, new instruments and market innovations, are one aspect of the

way financing changes over extended periods of good times. In addition, as is especially evident these days, financial practices adjust to new technologies of communicating, computing and access to files.

Fisher did not explain how overindebtedness developed. It is now clear that over an extended period of good times, during which the use of debt leads to well advertised gains, prior wariness of the use of debt attenuates. The subjective evaluation of the likelihood of project failure diminishes even as the margin of safety in liability structures diminish, as ever larger proportions of expected cash flows are pledged by outstanding contracts to service debts. Subjective views about the uncertainty being carried decreases even as the closer articulation of debt payments and the income to fund these payments increases the objective chances of contracts not being fulfilled.

#### Impact of the Great Depression

After 1933, when the pieces left behind by the great contraction of 1929-33 had to be picked up and put together, the current interpretation of the great depression emphasized weaknesses in the financial structure, running all the way from the information that corporations provided to their investors and their potential investors to the organization and powers of the Federal Reserve System.

The Federal Reserve System was created in the aftermath of the panic of 1907. One motive for its founding was to make future financial crashes impossible. As the Federal Reserve was unable to stem the wave of insolvency of banks and firms over the 1929-33 period it became apparent that a retooling of the Government's interface with the banking and financial system was needed: some devices, other than the Federal Reserve had to be put in place to handle solvency crises.

The banking and financial legislation of the era of the great depression had two phases: first came emergency provisions and then after a period of study and debate reform, the setting in place of a "permanent" structure. The second phase took place mainly in 1935 and 1936. The object of reform was to set in place a structure so that a financial collapse leading to a great depression could not happen again.<sup>9</sup>

#### IV The Reforms of the 1930's

Much of the economic history of the United States could be written in terms of attempts to get money right. After a particular monetary, banking and financing structure had failed, either economically or politically, a new structure was put in place. This history of reform and subsequent failure followed by another round of reform reflects the two not completely compatible requirements placed upon the monetary and banking

system: to provide a safe and sound medium of exchange and to furnish channels for the financing of the capital development of the economy.

#### Compartmentalization and Transparency

Two principles, compartmentalization and transparency, can be said to have governed the legislation in the mid 1930's which created the private monetary, banking and financial systems and the government's regulatory structure. The basic structure set in place in the mid 1930's is still largely in place.

Compartmentalization means that the financial "industry" is divided into compartments within which special purpose or limited domain institutions have protected market positions in particular types of financing, in the financing of particular industries or in the provision of particular types of assets for other units. One aspect of compartmentalization is the separation of commercial from investment banking, what is commonly referred to as Glass Steagall act. In addition special financing arrangements were put in place for home ownership, agricultural credit, exports, and rural electrification. The Reconstruction Finance Corporation, a government investment bank, supervised the refinancing of banks, railroads and other industries and acted as a financing backstop for a myriad of government resource development programs.

In the same spate of legislation the Federal Reserve System was reorganized. The real bills doctrine was removed from the rules which determined the currency supply and access to Federal Reserve credit. Furthermore government debt became eligible as an asset to offset Federal Reserve currency liabilities.

Deposit insurers, a new set of agencies, were created to take over the responsibilities for assuring that bank deposits were always available at par from the Federal Reserve. The various deposit insurance funds carried an implicit Government endorsement or guarantee of their commitments up to limits set by Congress. One principle of the initial legislation, which was not honored in our recent experience, was that small deposits were and large deposits were not so guaranteed.

The doctrine of transparency really reflects a recognition that the United States is a capitalist economy in which the corporate form of organizing business dominates. The transparency principle holds that truthful information on the financial condition of corporations and of the action in those markets in which initial underwriting takes place and in which securities are sold, was to be publicly available. In addition the markets in which financial instruments were sold and bought were to be free of manipulation, either by market makers, corporate management or third parties.

The transparency principle is necessary for the operation of a market rather than an institution based financial system. Revelations of

scandals in investment banking combined with the losses of investors as the Dow Jones fell to some 15% of its pre crash value meant that by 1933 public confidence in the integrity of investment markets was low. The revival of confidence in banks and saving institutions was facilitated by federal government deposit insurance. There was no possibility of a similar government endorsement of asset values. Revival of confidence in a market based debt and equity financing required some guaranty of integrity of both corporate management and the operations of financial markets.

The New Deal legislation founding the Securities and Exchange Commission set standards for corporate reporting and governance, for the information that needs to accompany a public security offering, and for the operations of and the flow of information from second hand markets for securities. One difference between economies with "universal banking" and economies with a division between what banks finance and what markets finance is in the public confidence in the integrity of markets and corporate governance. The securities and exchange legislation may well be one of the most successful reform efforts of the New Deal era: without it today's market oriented financial system would not be feasible.

The cadre of loan officers of banks are "professionals" skilled in the evaluation of privately submitted and often confidential information about the operations of businesses, households and government units which require financing. The loan officer joke, to the effect that he has never seen a *pro forma* that he did not like, accurately reflects the loan officer process, which seeks to transform the optimistic views of profit expectations put forth by potential borrowers into realistic expectations which can be submitted to and endorsed by loan oversight "committees" of the bank. The underwriting process combined with the input of security analysts plays a similar role for publicly traded securities.<sup>10</sup>

The remark about *pro formas* cited earlier identifies the role of loan officers in the chain of financing: loan officers are the designated sceptics of the economy who nevertheless make their living by accepting risks that they understand. In market based financing underwriting and security analysts are assumed to play roles similar to that of banker, but the continuing commitment to both the borrower and the lender that often characterize a bank's relations with borrowers and depositors is in general lacking in market based financing arrangements.

#### The 1930's reorganization.

When the Federal Reserve was created after the crisis of 1907 the belief was that the problem of the instability of the banking system was put to rest. As the Federal Reserve was not able to take an equity position in an otherwise bankrupt bank, the Federal Reserve was unable to contain the solvency crisis of the banking system that climaxed in 1933. The resolution of the crisis of 1933 involved an infusion of equity by the Reconstruction Finance Corporation into banks that were bankrupt on a mark to market basis.

The creation of Federal deposit insurance institutions for commercial banks, savings and loan organizations and credit unions diluted the authority of the Federal Reserve System. A natural and normal result of deposit insurance is the setting of standards for coverage and a mechanism of supervision, regulation and examination which assures the insurer that the insured conforms to set standards. Regulation, supervision and examination are natural functions of an insuring authority.

The original Federal Reserve act based the reserves of member banks on bank rediscounting of eligible paper at the discount window of the district Federal Reserve Banks. Rediscounting was not just a lender of last resort activity reserved for a crisis, it was the mechanism by which part of the normal reserve base of banks was brought into being. By being the channel through which the demand for reserves by banks led to the creation of reserves, the discount window made the ability of banks to lend responsive to the needs of trade. In the original Federal Reserve act **bank reserves were** endogenously determined.

The underlying theory was that the responsiveness of the banking system to the needs of trade, made possible by the endogenously determined reserve base of banks as determined by the rediscounting of eligible paper at the district Federal Reserve Banks, combined with The Federal Reserve's generalized oversight of the banking system, would result in a banking and financing structure that was not only safe and secure but which also facilitated the capital development of the economy. Changes in the posted rediscount rate at a District Banks were to take place only as the Banks suffered a loss of gold either through the foreign exchanges or through an internal drain of coins and bullion. Managing the economy or fighting projected inflation were not to determine Federal Reserve actions.

In the original structure the district banks were lenders to member banks. As lenders the district banks had a right to information about the prudence of their customers who were regular borrowers. The normal operating use of the discount window as a source of financing for member banks legitimized the regulation, supervision and examination of member banks by the Federal Reserve.

It is reasonable to assume that making government debt eligible as an asset for the currency department of the Federal Reserve Banks was viewed as an emergency provision, when it was first introduced during the crisis atmosphere of 1932, and not as a change in the normal times operating procedure. The Federal Reserve System was still expected to be based on the discount window. The Federal Reserve had been created because in the first decade of the century the government debt was too small to be the basis of a currency supply and a banking system that responded to the needs of trade *i.e.* facilitated the capital development of the economy.

The bank currency of the United States under the National Banking Act was based the upon Government debt that banks deposited with the Comptroller of the Currency. The fiscal policy of the United States after the civil war led to a shortage of government debt which, in turn, meant



that the creation of bank money and the financing available from the banking system were not responsive to the needs of trade.<sup>11</sup>

Legislation of 1932-35, which allowed the use of government debt as asset offsets for currency, did not abolish the rediscount facilities at the District banks. The expectation was that after recovery a resumption of fiscal orthodoxy would once again make government debt scarce. This would enable the discount window to resume its rightful place as the source of the ability of the banking system to be responsive to the needs of trade.

This expectation was falsified by the enormous growth of Government debt during the Second World War. In spite of the Korean, Vietnam and Cold wars, over the 1946-1980 period government debt as a percentage of GDP fell, ratifying the expectations of the 1930's. As a result of the destruction of the Federal fiscal system following the election of 1980, the government debt relative to GNP increased dramatically. Today, and for the foreseeable future, policy dealing with the structure of government supervision, regulation and examination of financial institutions has to reflect expectations that a government debt based money supply will be the rule.<sup>12</sup>

Whether the structure of the Federal Reserve System that created district Reserve Banks to process eligible paper and to create thereby the reserve base for commercial banks is an apt structure for a Central Bank that operates by way of open market operations has never been faced.

#### V. Today's Capitalism

The financial systems of today's capitalisms are not the financial systems of 1907 or of 1936. Over the well nigh half century since the end of World War II there has not been a traumatic collapse of financial markets, such as had often occurred during the century prior to 1940. Historically such collapses had marked the beginning of a deep and long lasting depression. One reason this change is that the government debt based reserve base, as well as the availability of government debt for bank portfolios, has meant that the reserve base and bank deposits were sustained even as bank lending to business and households decreased.

An additional and equally important reason for the absence of a deep depression is that the collapse of capital incomes, such as typically occurred in deep and long depressions, did not happen in spite of a number of major disruptions of financial markets and institution. This happened because government deficits sustained aggregate capital incomes and the stabilizers that were built into the legislated government spending and taxing programs kicked in whenever income tended to fall.<sup>13</sup>

Stabilization policy.

Stabilization policy is effective as it stabilizes aggregate profits. The great collapse of asset values in the 1930's (recall that whereas the price level of current output and the wage level of employed workers fell by about 1/3 over 1929-33 the Dow Jones, the second price level, fell by some 85%) occurred primarily because capital incomes (current, recent and expected) had fallen and only secondarily because the discounting factor had risen. The numerator in the present value formula's (capital asset pricing relation) had decreased at an even greater extent than aggregate incomes had fallen.

In today's American capitalism the main stabilizing device that prevented the financial fiascoes of the late 1980's early 1990's from turning into a depression was the government's deficit rather than central bank operations. One reason for the above is the increasing importance of security's markets, in the form of managed monies in pension and mutual funds, in portfolios.

These funds are contingent value instruments. The day to day value of these funds depends upon a daily marking to market of the portfolios. A run from these funds will lower asset values, as the need to liquidate assets to satisfy redemptions may force the market price of securities down but, aside from the rather rare case of fraud, the portfolio's value would go down by some minor fraction of its initial value. In an earlier epoch the assets in a failed bank would be frozen and then doled out as cash flowed from the liquidation of the portfolio of the failed bank. Even though there is no margin of safety such as is provided by bank equity for the asset value of mutual funds there is also no danger that the front of the line can withdraw 100% of a deposit but those who are further back in the "Q" receive only the value that can be achieved through the time consuming process of asset sales.

A stabilization policy, that relies mainly upon government deficits to sustain profits and stimulate private investment and government surpluses to constrain profits and contain exuberant investment, requires the discipline of a fiscal policy which does not allow the qualitative properties of government debt to be compromised. This implies that at normal times the fiscal posture of the government leads to a substantially greater percentage increase of gross domestic product than of outstanding debt, but that the rate of increase of debt can become substantially greater than of the gross domestic product when gross domestic product falls by a significant amount from the "full employment level". The tight reign that an income sensitive fiscal policy imposes also acts as a significant constraint upon inflation.

Monetary policy in a big government capitalism has only one arrow to fire: for a short period of time it can make financing through banks very expensive or relatively scarce, i.e. monetary policy can be effective as it induces a crunch. A policy that operates through crunches, in order

to increase portfolio conservatism by threats of serious debt deflations, will lead to a lowering of the overall ratio of attained GDP to potential GDP.

#### VI Policy

As my colleague Ronnie J. Phillips recently pointed out, few believed in 1935 that the agenda of banking reform was completed.<sup>14</sup> One unfinished item on the agenda was to clean up bank examination by unifying examination under the independent government corporation, the FDIC. As Phillips reports the argument was that the FDIC, and the Treasury (as the guarantor of the ability of the FDIC to pay off depositors as necessary), had resources at hazard in the guarantee of the nominal value of bank deposits. This made them the appropriate organizations to carry out bank examination.

#### Liquidity and Solvency Crises

In 1935 only one "solvency" crisis, that of 1933, of the American banking and financial structure had occurred since the Federal Reserve System was in place. In that experience the Federal Reserve System had been unable to contain the collapse of the banking and financial system. Furthermore the reopening of the banks after the holiday was under the auspices of the Reconstruction Finance Corporation which was able to supply equity funds and not the Federal Reserve System.

We now have had a second experience with a solvency crisis. Once again the Federal Reserve, which carries some responsibility for the emergence of solvency problems after 1979, was not a main player in paying off and sustaining at par the value of bank and Savings and Loan Association liabilities. The major placers were the insurance funds and the Treasury.

Whereas the Federal Reserve has been the main player in inducing and containing liquidity crises (in setting off and offsetting financial crunches), and sometimes in preventing liquidity crises from impairing the solvency of financial institutions, in both 1929-33 and in 1988-92 the Federal Reserve was not the main player in resolving these solvency crises. The Federal Reserve has not been able to contain and offset crises that were due to the compromising of equity by non-performing assets on the books of banks and financial institutions.

The resolution of solvency crises, which are characterized by non-performing assets, requires an equity infusion so that liabilities can be paid off at par. This requires that either a government investment bank infuses equity into negative net worth institutions or a government

"liquidator" puts up enough equity funds into failed institutions so that their guaranteed or insured liabilities are paid off.

The government investment bank route leads to the continued operation of the failed bank and often of the debtor whose liabilities are the non performing assets of the failed bank. On both the bank and the debtor score the problem of non performing assets is treated as a work out situation. On both the bank and the bank customer's side the government investment bank route leaves "valuable organizations" intact even if it the management at the time of failure leads is replaced.

The "government liquidator" route pays off depositors, closes down the failed bank, forecloses on debtors, and then proceeds to sell the assets of the failed bank and bank customers as rapidly as is deemed feasible . The government investment bank work out route may be a more effective way to deal with a crisis that is due to non performing assets than a "liquidator" route.

In the aftermath of the bank holiday the Reconstruction Finance Corporation placed equity in some 1/3 of the closed banks (1/2 of the banks that reopened.) As recovery took place the equity injection by the RFC was undone, either by the sale of the equity interest in the market or by a repurchase of the RFC's investment out of retained earnings. On the whole the investments in failed banks yielded sufficient funds so that the costs to the government were nil: no permanent increase in the government debt occurred to the recapitalization exercise. It seems as if there will be a permanent increase in the government debt due to the costs of the bankruptcies of savings and loan associations and banks in the 1988-1992 period. It is worth investigating whether a permanent government investment bank, such as the Reconstruction Finance Corporation, is a desirable feature for an economy where solvency crises are likely to occur.

#### 100% Money or The National Banking Act Redux.

The National Banking act provided for a currency that was based upon United States Government bonds that the currency issuing banks deposited at the Office of the Comptroller. Today the books of the Federal Reserve System could be rearranged so that our currency is based upon Government bonds that are held by The Federal Reserve System. The "great experiment" of basing the currency supply upon private debts that are monetized by the Federal Reserve System was terminated by the great depression.

Furthermore the government debt is big enough so that the deposit liabilities of the commercial and savings banks can be offset by government bonds. We can now have a banking system in which the banks hold interest bearing reserves at the Federal Reserve Banks equal to 100% of their deposits subject to check and the Federal Reserve banks hold government bonds to offset these liabilities. This would give us a monetary system in

which currency and deposits are fully equivalent in the assets by which they are offset and the conditions for 100% money are satisfied.<sup>15</sup>

We are rapidly moving towards an economy where money will take on new forms. We not only make purchases by electronically setting up debits on various credit card accounts, but we can expect the currency in our pockets to soon take the form of a smart card with an encoded value which we run down by transferring credits by way of a smart "cash register" to the vendors account.

As they transfer purchasing power from one agent to another payments systems use resources. The great innovation in the payment and credit card revolution was the vendor's discount as the way to pay for the costs of this payments system. One way to pay for the payments system in a world of 100% money is by using the interest on the government debts owned by the banking system to cover the costs of the system. But this would mean that the safety and security that goes with a default free income yielding would not be available to the general public. The alternative would be for the banks to pay a competitive rate on deposits and "check and electronic transfer system a fee for services system. There may be no issue of principle in the choice except that a fee for services system can yield an open access system which would treat large and small asset owners equally. This consideration may weigh the choice towards a combination of fee for services and vendor's discount to pay the costs of the payments system.

One aspect of the 100% money schemes was that debt financing of businesses and households was to be divorced from the payments and default free assets systems. This can be accomplished by making contingent value assets the standard for the indirect holding by households of paper that finances business and household debts. Current trends are running in favor of mutual funds, where fund liabilities have values based upon the market value of a portfolio, becoming the principle vehicle by which households own business equities and debts. This mutual fund financing technique is now mainly used for instruments which are purchased upon the basis of generally available information.

Banks, through their loan officer function, are specialists in making loans on the basis of their "hard reading" of private information, which they obtain in the process of deciding whether and on what terms to accommodate a potential borrowing client. As a substitute for bank lending such loans can be the province of special mutual funds which break down the flow of funds from business and household financing into tranches, such that there is a fixed income portion with a relative fixed market value and a variable income and market value portion. These funds would be so structured that the variable income portion would have a high expected return but would also absorb the first say 10% of losses due to non performing assets: interest rate risk could be finessed by making all credits floating rate credits.

Thus as the 21st century is about to be ushered in an idea which was on the table during the 1930's discussion of reform can once again be on the table. One virtue of the 100% money scheme is that it separates the two functions that the monetary and banking system has to perform: the provision of a safe and secure means of payments and to provide for the capital development of the economy. By separating these functions it makes us aware that an economy can have too little as well as too much government debt.

We now are in a position to realize the dual set up of 100% money: financing of the capital development by contingent valued liabilities and a money supply based upon a portfolio of government bonds held by an authority responsible for the payments scheme. The weakness of the mutual fund way of financing business is that the position taker, the manager of a mutual fund, does not hazard his capital in order to protect the fund holders against loss of principle. A surrogate for bank capital in the form of a high risk high expected return tranche in the portfolio will need to be developed.

In a capitalist world other peoples money is put at risk by corporate management and portfolio managers of various kinds. This is true to a greater extent now than ever before, because of the wider spread of wealth, albeit mainly in small accumulations, that has been realized. One way of protecting asset owners is by broad public information widely disseminated, by transparency.

#### Compartmentalization and Transparency for the 21st Century

Like every application of principles, compartmentalization and transparency need to be adjusted for the realities of institutions and usages. The compartmentalization of institutions by function, so prominent in the 1935 structure, has largely been eroded. As we prepare for the 21st century we have to adjust the still valid concepts of compartmentalization and transparency to the technology and the understanding of how our economy functions of the 21st century.

The securitization of home mortgages and automobile loans, an adjustment that reflected the increase in the weight of mutual and pension funds as the proximate holders of market instruments reflecting primary loans, has diminished the significance of both savings banks and consumer sales finance companies. Furthermore the holding company format which now allows commercial banks and mutual funds to be under the same corporate umbrella and which we can expect will be opened to allow commercial and investment banking to co-exist under a holding company format, has virtually erased the functional segmentation of commercial and investment banking.

Legislation and administrative decisions which eliminate most of the barriers to nation wide branch banking are now being implemented. This paves the way for the elimination of geographical segmentation.

One element in the stagnation of the British Economy over the past century has been the ever greater concentration of banking into a small number of national branch systems, even as a rich mix of fringe banking organizations, such as exist in Germany and Italy, never arose. The prudent banker rule of thumbs, often made part of the regulatory structure provides for the distribution of credits so that no more than 10% or 15% of equity (in principle capital, retained earnings and undistributed profits) can be allocated to any one credit.

This 10% to 15% of capital rule determines the natural loan size habitat of a banking group. For example an eight percent capital to total assets rule means that a 100 million dollar bank would have 8 million dollars in capital. The maximum credit line of such an institution would be from \$800,000 to \$1,200,00. In the American scene as it now is any bank with \$1,000,000 or less as its maximum credit line is a bank for smaller business. By the same rule a 1 billion dollar bank will have an 80 million dollar capital and a maximum credit line of 8 to 12 million dollars and a 100 billion dollar bank would have a maximum credit line of 800 million to 1.200 million dollars.

The opening of the gates to nation wide branch banking will see an amalgamation of smaller banks into state, region and national banks. Every case of amalgamation will increase the capital and therefor the maximum line of credit that can be given to any one customer. A movement of banks to higher natural habitats will take place. The progress to a small number of banks, each one of which is too big to fail, with maximum credit lines so large that the conditions of supply of credit to large borrowers will improve relative to the conditions of supply of credit to small borrowers seems to be a most likely outcome of what is now taking place.

A series of rules that segments banking by bank size seems in order if small businesses are to receive adequate financing as the in process consolidation proceeds. The idea of special rules as well as special support organizations for Community banks needs to be explored.<sup>16</sup>

#### VII A Modest Proposal

The time has come to open a national inquiry into the structure of the banking and financial system. The radical changes now underway in technology, computing and communication means that much of what we now have may be obsolete. The sluggish economy of the past decades combined with the apparent reluctance of the Federal Reserve to give full employment a chance can mean that our financing structures are not consistent with the needs of a progressive democracy.

In the past serious changes were the result of serious public inquiries. I suggest that enough is amiss in our financial and banking structures so that it is time to go back to the drawing board and determine

what the monetary, financial and financing arrangements should be in the 21st century. A late 20th century National Monetary Commission should be on the public policy agenda.

#### Endnotes

1. The behavior of the foreign exchange markets after the recent Federal Reserve actions may well reflect increased uncertainty by agents of how these actions work their way through the changing international financial markets. For an argument about how monetary policy operates by through the channel of affecting uncertainty see Hyman P. Minsky "The New Uses of Monetary Powers" pp 179 to 191 in Hyman P. Minsky "Can It Happen Again?" M.E. Sharpe 1982.

2. Introduction to the French edition of John Maynard Keynes, The General Theory of Employment Interest and Money as reprinted in Volume VII, pp. xxxiv of Collected Works of John Maynard Keynes. (Macmillan, London and Basington, 1973)

3. This two price level interpretation of Keynes' non neutrality of money is stated in Hyman P. Minsky John Maynard Keynes, Columbia University Press, 1975 as well as in Stabilizing an Unstable Economy, Yale University Press 1982. One way of making the idea of the two price levels clear is to note that a capitalist economy has both a "CPI" and a "Dow-Jones".

4. Turbulence may be of fairly long duration but incoherence is almost always of short duration. In the turbulent great contraction of 1929-33, incoherence dominated no more than the last 10 weeks before the inauguration of Franklin Roosevelt. Decisive action by the government over the first hundred days of Roosevelt's term combined with promises of reforms to come ended the incoherence.

5. The perspective on our economy to which the financial instability interpretation of Keynes leads has much in common with the stress upon the evolutionary properties of capitalist economies that enlightened the work of economists, such as Schumpeter and the American institutionalists, who were prominent in the first half of this century.



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6. In the core case "profits equals investment". In the world as it is gross capital incomes equals investment plus the government deficit minus the international deficit of trade, with corrections for savings out of labor income and consumption financed by capital income.

7. Keynes visited the University of Chicago in 1931 to participate in the Harris Foundation lectures on Unemployment as a World Problem. While in Chicago he noted that a preference for liquidity was rampant among banks, businesses and persons. It seems that Keynes came to Chicago to sell the analysis of his quantity theoretic Treatise on Money and left Chicago with the liquidity preference germ of his revolutionary The General Theory.

8. Fishers article appeared in the first (1993) volume of Econometrica.

9. One aspect of the process of reform was the assembly, in the summer of 1934, by Jacob Viner of a gaggle of bright young economist in the Treasury Department: they were labeled Viner's Freshmen. Their charge was to design a banking and financial system from scratch. One of these young economists was Laughlin Currie another was Albert hart. Both of them friendly towards 100% money, a doctrine usually associated with Henry Simons of the University of Chicago. See Ronnie J. Phillips, The Chicago Plan and New Deal Banking Reform, M.E. Sharpe, 1994 forthcoming.

10. William Janeway's law "Entrepreneur's lie." is a parallel statement about the determination of whether a project is bankable. The importance of the institution of "security analysis" for the functioning of a transparent market based financial system is one reason why it is easier for a newly capitalist economy to replicate a universal banking system than a market based financial system.

11. The original Federal Reserve act replaced a currency which monetized government debt with one that monetized private debts (and gold). The period of the National Banking Act (1863 to 1913) was characterized by falling prices. The William Jennings Bryan "Cross of Gold" speech was a response to the chronic deflation of the post civil war era.

12. If the trend decline in the ratio of government debt to Gross Domestic Product of 1946-1980 had continued through 1993 we would now be concerned about the shortage of government debt to satisfy the needs of the financial

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system and we would be debating what the structure should be of a banking and financial system in which the currency and the reserve base for deposits furnished by the Federal reserve would reflect private obligations which the Federal reserve obtains either from an open market or through the discount window.

13. For the concept of a contained depression see S.Jay and David Levy, Outlook for the 1990's: The Contained Depression, Jerome Levy Economics Institute, 1991,

For an explication of the relations between the composition of aggregate demand and profits see S. Jay and David Levy Profits and the Future of the American Economy, Harper and Row, New York 1983 and Hyman P. Minsky, Stabilizing an Unstable Economy, Yale University Press 1986.

14. Ronnie J. Phillips "New Deal's Unfinished Work: Merging the bank regulators", The American Banker, April 18, 1994

15. Some of the main references for 100% money are:

Albert Hart, "The Chicago Plan" for Banking Reform. Review of Economics and Statistics Vol. 2 (1935): 104-116

Irving Fisher, 100% Money 3rd Edition, New Haven: The City Printing Company 1945 (First Edition 1935)

Henry Simons et al 1933 "Banking and Currency Reform" Manuscript Reprinted in Research in the History of Economic Thought and Methodology, Archival Supplement, Volume 4, edited by Warren Samuels. Greenwich, CT Jai Press, Forthcoming.

The general reference to Henry Simons is Economic Policy for a Free Society, Chicago: the University of Chicago Press.

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