The question of financial reform

notes by HPM

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The savings bank fiasco is just one of a series of financial misadventures that have occurred since the late 1960's. If one wished one could write a history of the financial system which emphasizes that financial tranquility ruled from the end of World War 2 until the credit crunch of 1967 or so which was succeeded by an era of financial turbulence characterized by financial trauma and misadventures of increasing severity. These financial trauma required either central bank interventions to refinance particular sectors of the financial market or central bank actions which increased the available financing. In both cases the aim of the Central bank was to attenuate the connection between the financial trauma and financing conditions so as to contain the impact of the trauma upon the level of economic activity.

In the post war economy such central bank interventions combined with government deficits to sustain business cash flows. In this way the impact of financial instability upon income and employment was contained although the price may well have been to make the economy more susceptible to inflation.

This post 1970's pattern, of financial crises or traumas, interventions to contain financial market repercussions and government deficits that sustain profit flows, is not unrelated to the chronic not quite good enough functioning of the American Economy since the 1970's. This interpretation of the pattern of crises and interventions over the past two decades seems to imply that the viability of the financial and economic system now depends upon governmental intervention. Government intervention is defined to include central bank interventions which pick up the pieces either directly, as in the S & L case by validating private liabilities by purchase refinancing or capital infusions, or indirectly, by monetary policy measures that assure the availability of financing and fiscal policy measures that assures the adequacy of aggregate profit flows so that the liability structure is validated, so that payment commitments are fulfilled.

The result has been a pattern of rolling readjustments: of depressions in the rust belt, the oil patch, the hi-sci suburbs, and the financial industries that occur The question is whether the rolling readjustments will give way to a more comprehensive decline. It is clear that the relative power of the United States in the world economy has declined even as the European and Japanese belief that the Soviet threat is rally a thing of the past has made the currying of American support less important.

The United States furnished Europe and Japan with two umbrellas during the firs 45 years after World War 2: the nuclear umbrella against the (believed) superior Soviet land forces and the potential nuclear blackmail and the economic umbrella in that the United States, and with the United States the rest of the Capitalist world, was able to avoid a serious depression.

It is now clear that the two umbrellas no longer exist or they have little value. Ignoring the military changes, the European and Japanese economy now have the fiscal independence that was so long the monopoly of the United States and the question of whether global profits are sustained in the next recession may very well depend upon whether these two economies will run large deficits in their trade balance. The United States is in position analogous to Britain and France in that an attempt at an independent expansionary policy will be brought to a halt by a decline of the dollar on the exchanges.

The working hypothesis for the following proposal is that the Levy Institute should take as a major project the getting together of a working group of economists and knowledgeable professionals in finance to prepare an "Agenda" for the reform of the financial structure. The premiss is that well functioning finance cannot be guaranteed by unregulated markets: there are profit prospects that lead to the development of fragile financial structure and that such financial structures will lead to serious and even great depressions unless there is an effective system of intervention and controls that prevent such an outcome.

Central banks as we know them have been the essential instrument for intervention in financial markets. The reason for Central banks is the belief that without intervention financial instability is inevitable.

Is there a need for a serious study of the financial system to prepare for a burst financial reform.

The prologue to an agenda for reform of the financial system.

The structure put in place in the 1930's has been compromised. Simple minded views of what makes the system go have lost their credence as the system misbehaves.