

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 financial tranquility from the end of World War 2 until the credit crunch of 1967 or so and then a series of financial trauma and misadventures of increasing severity. These financial trauma required central bank intervention to contain their impact upon the ability of the financial system to continue to finance activity. These central bank interventions combined with the impact of government deficits in sustaining business cash flows contained the impact of this financial instability upon the income employment and price level.

This pattern of crisis or traumas, intervention to contain the 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. The pattern of crises and interventions over the past two decades seems to imply that the viability of the financial and economic system depends upon the government, broadly defined to include the central bank, being able to

reform, ~~providing~~ the pieces either directly as in the S & L case or indirectly by assuring the adequacy of the profit flows that validate the liability structure.

The result has been a pattern of rolling readjustments: of depressions in the rust belt, the oil patch, the hi sci subs, and the financial industries. 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

reform, 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.

reform, agenda~~is~~ the prologue to a~~n~~ 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.