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The Jerome Levy Economics Institute of Bard College
April 4 - 6, 1991

"The Crisis In Finance"

LESSONS FROM HISTORY - OPPORTUNITIES FOR REFORM

Contrary to conventional wisdom, reducing deposit insurance isn't the best way to induce market discipline in the wake of the massive failures of banks and Savings & Loans, according to one financial expert who addressed a meeting of prominent economists in early April. A better approach, and one that would protect both depositors and taxpayers, noted Eugene Rotberg, an international investment banker and former vice president and Treasurer of the World Bank, would be to require all banks to issue uninsured bonds. "The buyers of uninsured bonds would assuredly watch over the deployment of their funds," he said. "Depositors, on the other hand, provide no market test whatever of the quality of management, or the wisdom of the investments."

Rotberg's idea was one of several proposals that emerged from a three-day conference at the Jerome Levy Economics Institute of Bard College, on the current financial crisis. The conference, which took place in Annandale-On-Hudson, New York, debated everything from the deposit insurance controversy to warnings of a 1990s depression. The gathering of prominent economists, bankers, and experts on the financial industry did agree, however, on a few points: Many of the participants delivered scathing indictments of the Treasury Department's proposals for

banking reform, while at the same time offering a bleak assessment of the U.S. economy.

Several of the economists presaged a prolonged recession that could eventually turn into a depression. Indeed, one of the key questions raised during the conference concerned the events leading up to the crisis of the 1990s, how they compare with the crash of the Great Depression, and what conclusions and solutions can be drawn from that analysis.

A "Contained Depression"

Although the current financial crisis differs from the Great Depression in a number of ways, the 1930s and the 1990s share common characteristics: Excess debt, a credit crunch, and a sharp drop in fixed investment, especially in construction. "A depression is qualitatively different from a recession--it is not brought about by short-term overproduction and excess inventories but rather by long-term over-investment in fixed capital assets," notes David Levy, director of forecasting for the Jerome Levy Economics Institute. From a peak office occupancy rate of nearly 100 percent following World War II, the rate now has dropped to just 82 percent, well below the occupancy rated needed, on average, to maintain profitability. Rents have dropped, as has new construction. Indeed, as a percentage of GNP, investment in construction and business equipment is at a 45-year low today. And unlike ordinary recessions, which are relatively short term and reflect excessive interest

rates and the need to liquidate overbuilt inventories, declines in fixed capital investment usually last much longer and are much more serious. That's because they tend to reflect a fundamental imbalance between the debt used to pay for an asset, and the asset's ability to generate the returns needed to pay for itself. Moreover, gluts of fixed assets can take years to be absorbed, while most product inventories can be worked off within a matter of months.

Debt's Impact

Indeed, according to several conference participants, the nature of the 1980s credit binge, which financed both the construction and the LBO booms, signals a systemic problem with the economy that cannot be fixed by tinkering with any single part of the financial system. At the root of this "systemic breakdown", according to Hyman Minsky, Distinguished Scholar at the Levy Institute, "is the evolution from an [economic] system of no debt to one of lots of debt." In real estate, for example, an oversupply of credit in the 1980s led lenders to ignore the law of supply-and-demand. Banks and Savings & Loans, fueled the runaway construction boom because competition from non-bank financial institutions ate into many of the best deals, according to Sherman J. Maisel, an economic consultant and former member of the Board of Governors of the Federal Reserve System. The fee structure of both LBO's and many real

estate ventures were such that dealmakers had no incentive to avoid unprofitable transactions because they could make money as long as a deal was concluded.

Now, the ensuing debt crisis, aggravated by the current credit crunch, could snowball into what David Levy refers to as a "contained depression" that will require a serious look at the overall economy, and probably government intervention. The most imminent problem is that, in the current economic environment, highly indebted companies cannot get the capital they need to service their debt.

More Bankruptcies Ahead?

"There's been an extraordinary change in the debt to cash flow ratio of U.S. companies," said Benjamin Friedman, a professor of political economy at Harvard Business School who spoke on Friday evening, April 5. Friedman notes that today an average company pays 57 cents on each dollar of earnings to service debt, nearly four-times the level just 25 years ago. That means that even a routine recession, which generally squeezes earnings by about 20 percent, can make it difficult for many of today's firms to service their debt. Without new cash infusions, these highly leveraged companies face bankruptcy and could lead the economy into a downward spiral.

The credit crunch carries with it other dangers, as well. In the absence of sufficient credit, LBO's are beating a path to the equity markets in a stampede that

could end the current bull market--the last resort for many over-leveraged companies, notes William H. Janeway, head of the venture capital high technology team at E.M. Warburg, Pincus & Co. Tight credit also damages consumer confidence and, more importantly, "entrepreneurial confidence," says Minsky, who notes that entrepreneurial companies make up one of the most productive segments of the economy.

The Need for Innovative Government Initiatives

Solving the crisis will depend on some innovative government initiatives that will address the underlying structural problems of the economy, according to several conference participants. To restore investment in productivity-enhancing fixed assets, the U.S. government, which accounts for nearly a quarter of GNP today, up from less than three percent in the 1920s, is in a position to fill the gap left by private investors--specifically, by investing in public-sector projects that would indirectly foster private-sector growth. Washington would get the most bang for the buck, according to Albert Gailord Hart, professor emeritus, of economics at Columbia University and an expert on the Great Depression, if it were to invest in new infrastructure. Rebuilding roads and bridges, for example, would be ideal vehicles for transferring the technical know-how and teamwork recently demonstrated by the military establishment in the Persian Gulf to the private sector. And, invoking the example of public works projects of the 1930s, Hart

notes that the government could fuel productivity by awarding construction loans only to companies that are prepared to invest in capital equipment. The scheme could be entirely paid for, according to Hart, by a tax on petroleum.

If there was a single issue that most of the conference participants agreed on, it was the weakness of the Treasury Department's proposal for banking reform. Summing up the sentiment of his colleagues, Friedman quipped: "The banking reform proposal reminds me of something Mae West once said: 'When given a choice between two evils, I always pick the one I haven't tried yet.'"

Eugene Rotberg, detailed the objections to the Treasury Department's two principle proposals:

**Permitting banks to engage in businesses now reserved for the traditional securities industry would only increase the risks and problems facing today's banks. Rotberg notes that banks already are allowed to participate in mergers and acquisitions and leveraged buyouts, the most profitable areas of the securities business. Allowing banks to offer the initial loans for such transactions and to underwrite junk bonds are unlikely to solve the banks' underlying profitability problems, while at the same time risking more of the taxpayers' money in the form of deposit insurance.

**Moreover, letting non-financial corporations acquire a substantial equity interest in commercial banks is to invite serious conflicts of interest. "The reason banks

cannot raise capital is because informed investors aren't interested," says Rotberg. Therefore, the only reason for an industrial corporation to buy a bank would be to provide a financing vehicle for the corporation and its suppliers. In addition, the acquired bank is likely to be pressured by its parent to withdraw credit from competitors. "The conflicts of interest, breach of fiduciary duty, unfair business practice, insider trading suits (would) keep lawyers very busy," notes Rotberg, a former SEC attorney.

Even Gary H. Stern, president of the Federal Reserve Bank of Minneapolis, seemed to agree with Rotberg's assessment: "What principally concerns me is preservation of the independence and integrity of the credit decision-making process, something I fear could be compromised, at least to a degree, if commercial and banking firms unite."

The Too-Big-To-Fail Dilemma

A discussion of the problems and solutions to the banking crisis drew little consensus at the conference, although several participants argued that the "too-big-to-fail" doctrine is too costly. "We want to strike against the system's fragility," said Richard Aspinwall, chief economist for The Chase Manhattan Bank. "We want to get away from paying off the weak. (Otherwise we are extending) an invitation to raid the public purse in the guise of

sustaining weak institutions."

In another camp, Albert Wojnilower, a senior advisor and former Managing Director of First Boston Corporation, suggested that the best solution to the banking crisis might be to treat banks like utilities. Utilities, which by their nature are few in number, are able to attract capital because "they are assured a nominal profit and their existence is guaranteed," says Wojnilower. "There is no hope for the financial system until we do the same." At the same time, Wojnilower acknowledged that there were "too many animals in the zoo," but insisted that the single biggest failure of the banking reform proposals was that they failed to offer any "provisions for the moribund animals" to exit the zoo. Left inside the zoo, dead animals, he noted, can be just as dangerous as too many.

Reforming Deposit Insurance

Deposit insurance also was a subject of heated debate. James Tobin, a Nobel prize laureate in economics and professor emeritus at Yale University, championed a "twin-bank," or "big-bank-little-bank" proposal, in which banking functions would be split between insured, low-interest-bearing banks -- which invest in Treasury or similar obligations -- and uninsured, high-interest bearing institutions. The little banks would be closely regulated so as to "make insurance virtually redundant." The uninsured banks would

have more latitude in terms of their investments. Such a system, Tobin said: "Would go back to the original purpose of deposit insurance, which is to protect the savings of unsophisticated people."

However, most of the conference participants favored solutions that would continue to protect most deposits. Stern, for example, suggested that the Treasury could encourage large depositors to be more vigilant about the health of their banks if 10 percent of all deposits of over $100,000 were left uninsured; although technically, deposit insurance isn't supposed to cover more than $100,000 today, Stern pointed out that by shifting money into different accounts and different banks, depositors now can secure 100 percent FDIC insurance.

Probably the most novel idea for deposit reform was Rotberg's proposal for how the government could simultaneously encourage market discipline and protect depositors. The Treasury could do that by requiring that banks obtain a substantial amount of their overall funding from medium- to long-term bond markets, without government insurance banking the debt. Bondholders are "a demanding lot" and would do a better job at overseeing the activities of banking institutions than either depositors or shareholders, Rotberg asserted.

New York State Comptroller Points To Growing Power Of Pension Funds

By Saturday, the focus of the meetings had come full circle as Edward V. Regan, comptroller of New York State, delivered a luncheon address on the events in corporate America that already are bringing inexorable systemic change to the U.S. economy, via the boardroom. "Today the 20 largest pension funds and the 10 largest money managers control 25 percent of the stock of the 10 largest corporations," says Regan. Such concentration makes it more difficult for pension fund managers, most of whom are state officials, to trade large blocks of blue chip stock, and encourages managers who are inherently "more long-term oriented," according to Regan, to exercise more control over management. In a bid to take better control of boards of directors, both Regan and Richard Breeden, chairman of the SEC, have floated proposals that would give pension fund managers space in a company's proxy statement to voice their opinions on specific board nominees. More control over corporate boards by fund managers who harbor a more long-term outlook could be instrumental, for example, in providing the sort of systemic disincentive to future debt binges that many of the conference participants believe is necessary to ensure a stable economy in the future.

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