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Financing and The Payments Mechanism in The Modern Environment

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The Jerome Levy Economics Institute has organized two prior conferences on financial markets in crisis and the need for reform. The first was in April 1991 and the second in November 1992.

These conferences were motivated by the emerging crises in the financial system and the agenda for reform that the administration proposed in the 1991 legislative year. On the whole the economy rode out the crises of the financial system: a recession but not a depression followed. The events of 1990 - 1992 can be viewed as a test of the structure of institutionalized intervention that was put in place in the 1930's. On the whole the system worked: a full debt deflation akin to that which took place in the 1930's did not happen. The decentralized lender of last resort and refinancing operations of deposit insurance, the federal

reserve, and the treasury prevented the pass through of financial institution negative net worths to depositors and the financing of enterprise may have undergone crunches but it never really ceased.

Nothing really came of the proposals of reform - whether sponsored by the administration or of congressional origin during the 1991 legislative year. The 1992 legislative year was lost because of the coming election and the disruptive effect of the so called House Banking Scandal. The crisis of 1990-1991 that was due to the negative net worths of many financial institutions was resolved by government funding of the insurance mechanism that had been set up in the 1930's.

The only significant reform may have been inadvertent. The wording of the legislation that accompanied the funding of deposit insurance was interpreted as allowing the recapitalization of bankrupt Savings and Loans and banks by an infusion of government funds. An approach to negative net worth institutions that was analogous to that of the Reconstruction Finance Corporation of the 1930's was available to the authorities even though there was no legislative history for this approach and there were no specific institutional safeguards.

In the policy oriented discussions of 1990 and 1991, the emphasis was largely on the deposit insurance mechanism and how it was abused. Many of the reform proposals focused on the cost to the government of "bailing" out the savings and

loan associations and banks. Little of the discussion was on how the activities of these institutions impacted the functioning of the economy and the costs in terms of a longer and deeper recession that were forestalled by the insurance payoffs to depositors.

March of 1933 is the sixtieth anniversary of the Bank Holiday that accompanied Franklin Roosevelt's inauguration. The great contraction of 1929-1933, the bank holiday and the long and deep depression that followed triggered a great burst of interest in the nature of the financial system and the way finance and industry were linked.

The emergency legislation of 1932 and 1933 and the reform legislation of the New Deal put in place a radically different financial structure than that which had broken down in the great contraction. Two principles can be said to have guided the financial structure that was in place when the economy recovered in 1939, and whose institutional contours remained largely unchanged until the crises of the late 80's and 90's - although relationships changed within the contours. These principles were compartmentalization and transparency.

The financial structure provides the payment mechanism of the economy and determines the ability of particular institutions and individuals to draw from the common pot of resources and outputs. Whereas the draws of households from the common pot were traditionally determined by on hand

financial instruments which had been recieved in payment for labor, artisan output or capital incomes of various kinds, the draws of firms to finance activity were prior to the putting of outputs into the common pot. This is especially true of investment, where finance has to be forthcoming often long before output is available to be exchanged for means of payment. The banks as the units which keeps track of the ability of units to draw from the common pot and the banks as the units which allocate rights to units to draw from the common pot in anticipation of future put ins to this pot