Introductory Remarks
20th Annual Hyman Minsky Conference
Dimitri Papadimitriou
April 13-15, 2011

I want to welcome you to the Levy Institute's 20th Annual Hyman Minsky conference on "Financial Reform and the Real Economy". This year the Institute celebrates its 25th year of existence. In one sense twenty-five years is an arbitrary period of time, but the end of that period is a traditional moment for pause. This quarter of a century anniversary is an appropriate point at which not only to review our programs over the past twenty-five years, but also to look to the future.

Our attention, over these past years, has been focused on strategic issues of economic policy with far reaching implications including problems in achieving long-term economic growth and higher employment in an era of low inflation, decreasing public expenditures on intellectual and physical infrastructure resulting from federal budget procedures, the relationship of monetary and fiscal policies to wage stagnation, and most importantly, the systemic risks in the financial services sector derived from technological innovation and diffusion. We plan to maintain our commitment to these issues and to increase their relevance in the years ahead.

The research and policy program of financial sector reform was conceived and led by Hyman Minsky when he joined the Institute in 1990 until his untimely death in 1996.

I want to thank the Ford Foundation and especially Leonardo Burlamaqui for supporting this program and these Minsky conferences –not only in financial terms, but also hosting them here at the Foundation's headquarters. I also want to thank Jan Kregel, the Institute's senior scholar who directs our research program on Monetary Policy and Financial Structure.

The Levy Institute –Ford program on Reregulation of Financial Institutions and Markets has undertaken an investigation of the causes and development of the recent financial crisis from the point of view of Hyman P. Minsky. It draws on Minsky's extensive work on regulation to review and analyze the recent Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in response to the crisis in the US subprime mortgage market, and to assess whether this new regulatory structure will prevent "a debt deflation on the order of the Great Depression" from happening again. It seeks to assess the extent to which the Dodd-Frank Act will be capable of identifying and responding to the endogenous generation of financial fragility that Minsky believed to be the root cause of financial instability.

An understanding of the nature and the dynamics of the crisis may provide the framework within which the pressing issues presently facing the banking and financial system can be addressed. The pre-Dodd-Frank regulatory structure was designed for a financial system that no longer exists. Today, the main sources of private sector financing are not commercial or investment banks, but rather private investment vehicles such as hedge funds, pension funds, and sovereign wealth funds –the prime movers of what Minsky called "money manager capitalism." Many of these vehicles are highly leveraged via securitized loans originating from financial holding companies, making the ultimate risk holders difficult to identify. Moreover this porous financial structure allows the crossing of multiple lines of regulatory jurisdiction as well as national borders, as evidenced by how quickly the US subprime crisis became systemic and global. The overextension of the safety net because of the government de facto underwriting of institutions deemed "too big-to-fail," the lack of market discipline, and lax supervision were the main culprits in the banking and financial disruption of 2008.

Minsky also believed that regulation should be linked to the structure of the financial system. One of the major drawbacks of the current legislation is that it does not propose an alternative to the financial structure that produced the recent crisis. Indeed, Minsky viewed the "decline of traditional banking" as one of the causes of financial instability, and he had very clear views on what the ideal structure should look like. For Minsky, any regulatory regime must be consistent with, and sensitive to, the evolving nature of financial innovation, and should seek to foster two critical structural objectives: (1) ensuring the long-term stability of the financial system, and (2) promoting the capital development of the economy.

The monograph included in your conference folder draws from Minsky's views found in his published and unpublished work, his official testimony, and his unfinished draft manuscript on the subject. In particular, his views are in concert with those who believe that the only way to make the large, "too big to regulate, and too big to fail" banks is to break them down into smaller units. In 1990 the 10 largest US financial institutions held about 10 percent of US financial assets. Today, the corresponding number is 70 percent. This extraordinary concentration of assets held by a small number of large financial institutions is one of the more vexing problems of our financial system. And, there is a close correlation between the "originate and distribute" model of banking that produced the crisis and large bank size. Smaller banks, more closely linked to their borrowers and the community, would provide the possibility of restoring the "originate and hold" banking model that concentrated on the loan officer's "hard reading" of private information obtained in the process of deciding the creditworthiness of borrowers, rather than maximizing the generation of doubtful assets to be sold via securitization.

Irrespective of the emergent financial structure, regulators will have to be more cognizant of the endogenous processes that, in Minsky's view, are the root of the instability that produces crises. Indeed, one of the tasks of the new Financial Stability Oversight Council is to identify and take measures to present financial instability. The monograph offers suggestions on how Minsky's analytical framework can be used to develop measures of financial instability, in the form of fragility indices for various sectors of the economy to help regulators detect emerging crises.

Whether the Dodd-Frank Act "to promote the financial stability in the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes" will be able to fulfill the promise of its title is an open question. Minsky repeatedly pointed out that a financial crisis, rather than being a peculiar event, is the natural response of markets to a period of relative stability and innovations in risk management. He argued that issues of financial instability were not important simply because of their impact on the financial system, but because a stable financial system is central to the productive investment needed for income growth and full employment.

Indeed, this was the main object of Minsky's research at the Levy Institute. His proposal for financial stability was to shift the emphasis from capital-intensive investment in growth to investment in jobs as a means of ensuring both stability and an equitable income distribution. Employment, Minsky argued, should be the major objective of economic policy, with government acting as employer of last resort (ELR). A direct, federally funded employment guarantee program, one providing a job opportunity to any individual willing and able to work, would act as an automatic economic stabilizer, enabling households to meet their financial commitments and substantially reducing the impact of financial shocks.

As Minsky put it in his landmark work *Stabilizing an Unstable Economy*, "A new era of reform cannot be simply a series of piecemeal changes. Rather, a thorough, integrated approach to our economic problems must be developed; policy must range over the entire economic landscape and fit the pieces together in a consistent, workable way: Piecemeal approaches and patchwork changes will only make a bad situation worse" (2008 [1986], 323). This has been one of the organizing principles of the project that has generated this monograph. We invite your close scrutiny of it and would welcome your comments.

Thank you very much for coming and enjoy the conference. We expect that you will find the presentations and the discussion thoughtful and we hope thought provoking.