WHAT SHOULD THE FINANCIAL SYSTEM DO? A MINSKIAN APPROACH TO PROMOTING THE CAPITAL DEVELOPMENT OF THE ECONOMY

L. RANDALL WRAY
University of Missouri-Kansas City, UMKC
WRAYR@UMKC.EDU
WWW.CFEPS.ORG
WWW.LEVY.ORG
http://neweconomicperspectives.blogspot.com/
Reconstituting the Financial System

• Minsky Project: Reconstituting Finance to Promote Capital Development of the Economy

• Requires Proper Framework
  – 1. a capitalist economy is a financial system;
  – 2. neoclassical economics is not useful because it denies that the financial system matters;
  – 3. the financial structure has become much more fragile;
  – 4. this fragility makes it likely that stagnation or even a deep depression is possible;
  – 5. a stagnant capitalist economy will not promote capital development;
  – 6. however, this can be avoided by apt reform of the financial structure in conjunction with apt use of fiscal powers of the government.
What do banks do?

• Like all economic units, take positions in assets by issuing liabilities
  – Anyone can create money

• Banks are highly leveraged (93-95%), must continually refinance positions
  – If not, make position by selling out position

• Types: commercial banking, investment banking, universal banking, public holding company
  – Skeptical banker; profits come over time; success of lender requires success of borrower
  – Ephor of capitalism
What *Should* Financial System Do?: Key Elements to Promote Capital Development

- 1. safe and sound payments system;
- 2. short term loans to households and firms, and, possibly, to state and local government;
- 3. safe and sound housing finance system;
- 4. a range of financial services including insurance, brokerage, and retirement savings services; and
- 5. long term funding of positions in expensive capital assets.

NB: there is no reason why these should be consolidated, nor why all should be privately supplied
Payments system

• Clearing at par requires access to central bank
• Safety requires gov’t backing of deposits; in a crisis, 100% coverage
• If provided by “private” bank, it plays with “house money”→public-private partnership (PPP); requires close supervision/regs
• Alternative: postal savings banks
Short-term lending

• Small banks appropriate for financing small loans; returns to scale quickly exhausted
• If banks are backstopped by govt, mkt incentives are weak
• Private lending justified only if banks are better underwriters than govt is
• Loans must be held to maturity to induce proper underwriting
• Relationship banking rather than markets
  – Finance is not a scarce resource to be allocated by efficient mkts
  – Good borrowers are scarce, underwriting is reqd to find them
Housing Finance

• If housing (or student loans etc) is high social priority, then underwriting is less important

• US experience: mutuals were best; primacy of interests of owners/shareholders
  – 30 yr fixed rate self-amortizing loan: safe but complex
  – Thrifts devastated by change of ownership rules, then by Volcker experiment → securitization & ARMs

• US experience: adding intermediaries only diverts activity away from public purpose—simplest is best.
  – Direct gov’t lending, or gov’t guarantee of mortgages held to maturity.

• Stability of long-term mortgages requires pact with central bank to keep interest rates low
Range of Financial Services

• Main “synergy” of combining services: enhances ability to defraud customers—from Lincoln Savings to Goldman Sachs; from 1929 to 2007; from bait and switch to CDS bets against customers

• Systemically Dangerous Institutions (SDIs): too complex to manage, regulate and supervise

• Over-compensated top management runs control frauds

• Too Big To Fail → bail-outs, often in secret, and consolidation of power
  – Small enough to fail institutions cannot compete
  – Alternative: stop all growth by SDIs; closely regulate and supervise

• Alternative: Minsky’s Community Development Banks
  – Allowed to offer range of services
  – Community board of directors
  – “intensified” banking, instead of branching and bank holding company
  – Use crisis to downsize megabanks; offer alternative: downsize or give up bank charter
Long Term Funding of Investment

• Investment banks went public pump and dump,
  – “maximize shareholder value” (=run a control fraud)
  – Galbraith’s *The Great Crash* and trusts
  – Must prohibit stock buy-backs

• Role of Pension Funds, other managed money: too much money chasing too few good investments

• Capital development can be ill-done in both Smithian and Keynesian ways
  – Wrong investments
  – Too little investment
  – “TINA”: there is no alternative to “somewhat comprehensive socialization of investment”
Conclusions for Reform: Gov’t Role

• Reducing concentration plus retaining risk can reorient banks back to relationship banking

• Role for gov’t to play in re-regulating and re-supervising
  – There are no magic formulas (capital ratios, living wills, skin in the game)

• Role for gov’t in direct provision of financial services
  – Payments system
  – Direct lending to serve public purpose
  – Guarantees for public-private partnerships
Conclusions for Reform

• Must hold policy-makers and financial institutions accountable
• Push for down-sizing and reform
• Use HMDA and CRA as models: Public Pressure
  – requires banks to report provision of services
  – Reduce discriminatory practices
• Push for state development banks, CDBs, other direct provision
• Cannot prevent risky and fraudulent practices, but can limit who gets screwed
  – Cannot stop fraud—it is concealed, usually complex acctg
• Consumer protection:
  – Warren’s CFPB
  – FDA-type rules: prior approval of new instruments
  – Citizen Utility Boards as model to represent citizens before regulatory proceedings