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

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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