Introductory Remarks by Dimitri B. Papadimitriou

25th Annual Hyman P. Minsky Conference

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I want to welcome you to the Levy Economics Institute's 25th Annual Hyman Minsky conference. This conference is made possible with the generous support of the Ford Foundation and is part of the Levy Institute – Ford Foundation research project on "Financial Instability and the Reregulation of Financial Institutions and Markets," offering policy proposals that are drawn from Minsky's many years of research and writings on the subject. I thank the Ford Foundation for their generosity.

My sincere thanks for the organization of this conference also go to my longtime friend and colleague Jan Kregel, the Institute's senior scholar and director of research who heads our research program on Monetary Policy and Financial Structure.

As my letter in the conference program indicates, this year's conference marks 25 years since it began. Minsky conceived this annual conference back in 1991–92, when the United States was confronted with pressing economic and financial issues that were in need of a policy response. The American economy's financial structure was at center stage, unable to cope with the continuing S&L crisis, the explosion of consumer and other private debt, the aftermath of a housing bubble, and an economy in recession, the result of restrictive monetary policy aimed at reducing inflation. Minsky thought that the Levy Institute conference would bring together economists from the academy and those who professionally confront real world problems, either in private finance or in public policy. This year's conference theme is to explore the connection between what appears to be a global slowdown in a period of very relaxed monetary policy, fiscal policy conservatism, and ongoing financial structural reform.

Twenty-five years ago, Minsky was well aware of the connection between financial regulatory reform and the performance of the real economy, which in turn was dependent on the existing

regimes of monetary and fiscal policy. He was known for advocating big roles for both government (fiscal policy) and the central bank (monetary policy) and an efficient financial structure that would ensure the economy's capital development. Having carefully studied previous periods of economic slowdowns and crises, he was concerned about the dire consequences of not fixing that which was in need of fixing. In his mind, the financial structure in the United States needed fixing, and choosing the design of policies to fix it was crucial. He worried about the tendency of policymakers and economists to choose the Smithian view, succinctly described in a passage from the *Wealth of Nations* that he was fond of quoting—"Every individual necessarily labours to render the annual revenues of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it … and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention"—rather than choosing the Keynesian view, which states that "as the organization of investment markets improves, the risk of the predominance of speculation does increase…. Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes by-product of the activities of a casino, the job is likely to be ill-done."

Minsky questioned the Smithian theory in maintaining that markets always lead to the promotion of the public welfare, in contrast to the Keynesian view that market processes may lead to the capital development of the economy being ill-done.

If the choice for designing policy is the former, then intervention and regulation can only lead to mischief. However, if the choice is the latter view, which assumes that the capital development may be ill-done, then intervention and regulation would be beneficial. Minsky was, of course, a Keynesian, and what he proposed and advocated was derived from Keynes.

His mission was to offer an alternative policy for the modern, financial, capitalist economy. His views diverged from the well-known “Keynesian” mainstream prescriptions that emphasized “fine-tuning” aggregate demand, promoting investment, and instituting “welfare-statism” to provide a safety net. In his writings, he emphasized that fine-tuning is impossible; relying on investment-led growth to promote rising living standards generates destructive instability and inflation; and, finally, welfare institutionalizes unemployment. His alternative strategy relied on consumption, employment, and the use of institutions and regulations to constrain financial and economic instability.

Observing the evolving financial structure, Minsky was concerned with the transformation of the traditional banking system into a highly levered financial system that was fragile and consisted primarily of nonbanking institutions, including mutual funds, pension funds, and other shadow banking funds. Minsky maintained that these funds needed to be managed, and that the managers of these funds, who presumably operated in the interest of the owners or beneficial owners, also had their own interests. They were hungry for higher returns, and with more and more monies available for placement, they outgrew the traditional portfolios of high-quality stocks and bonds.

As we have seen and as Minsky predicted, managers of these funds became buyers of specialized instruments such as securitized mortgages and other highly leveraged securities. The results of the explosion of such instruments, together with the gradual adoption of the Smithian view of the infallability of markets by the central banks and private banking institutions, created a self-regulated financial system that culminated in the global financial crisis of 2007–08 and the subsequent Great Recession, from which many countries have yet to recover.

The crisis forced the US Congress to get to work on reforming Wall Street by proposing new rules and regulations for financial institutions and giving enhanced responsibilities to the Federal Reserve through the passage of the Dodd-Frank Wall Street Reform Act. Similarly,

financial reforms have taken place in Europe and elsewhere, but a lot more work is needed with respect to global integration and regulatory harmonization, and the required policy coordination that will reverse the trend toward fragmentation. In general, what we observe is that the eagerness to fix what was broken has lost steam.

To be sure, some important regulatory changes have been put in place, including the Volcker rule aimed at prohibiting banks' proprietary trading; requiring big banks to submit "living wills" detailing resolution plans for regulators to follow should a bank fail, so as to prevent the need for another government-funded TARP; and, finally, establishing the Consumer Financial Protection Bureau at the Federal Reserve in an effort to prohibit misrepresentation in the selling of risky financial products to inadequately informed consumers. More work by the bureau will be necessary to protect consumers in an evolving world of faster and technologically sophisticated payments. Strong federal oversight is needed to absolutely ensure the safety, transparency, soundness, and access of the technology-guided payments system.

Yet, even with the implementation of many measures, many other important reform issues dealing with unregulated money manager funds, systemic and idiosyncratic risks of financial derivatives, and the "too big to fail" conditions of banks remain almost as they were before the global financial crisis occurred, raising the specter that the current structure may be unable to prevent a financial crisis from happening again. As Sheila C. Bair, the former FDIC chair, put it, "The regulators should take very seriously the fact that the public is still overwhelmingly skeptical of whether these reforms have fundamentally changed anything."

To be sure, there are voices from policymakers, particularly those of Thomas Hoenig at the FDIC and, more recently, Neel Kashkari, the new president of the Minneapolis Fed and a key architect of Wall Street's 2008 bailout, calling for the breakup of the largest US lenders, which are still "too big." Peter Eavis of *The New York Times* recently reported that four US banks have more than $1 trillion in assets and two have more than $2 trillion. There are also dissenting

voices among the captains of the banking industry, like Jamie Dimon of JPMorgan, who recently argued in the annual letter to his bank's shareholders that "the
US financial services industry does not conform to simple narratives. It is a complex ecosystem that depends on diverse business models coexisting because there is no other way to effectively serve America's vast array of customers and clients," and that banks like his perform "mission-critical services … that regional and community banks simply cannot do."

It is no secret that banks carry an urge to evolve in a way that maximizes revenue, and they often underprice risk to achieve it—as the cases of JPMorgan's "London whale" and Deutsche Banks's risky positions have shown.

Banks, in concert with markets, quickly create newer, riskier, and more profitable products. It is the very nature of modern finance to transform its structure in response to prevailing regulation, and to evade it successfully. And this, I believe, will continue, notwithstanding the significantly large fines levied on banks for the sale of risky mortgage-backed securities, their money-laundering practices, and colluding in the fixing of LIBOR.

Banks' continuing risky practices fuel danger and instability in our economic system and will ultimately lead us to another financial crisis. The regulatory structure, Minsky advocated, must be constantly evolving and always subject to sophisticated reexamination as the world of finance develops.

The key role of banking is financing the economy's capital development, and this should also be the concern of the central bank.
In his first interviews since becoming president of the Minneapolis Fed, Neel Kashkari urged the Federal Reserve to work harder and do a better job in responding to the increasing economic anger for sluggish growth since the 2007–08 financial crisis. As reported in last November's American Values Survey, 72 percent of the population considers the US economy to be in recession even though the Great Recession officially ended in 2009. Reflecting on this anger,

some of the presidential candidates are advocating for new barriers to protect US industry. Trade barriers can be a recipe for worsening the global slowdown.

Minsky proposed that a place to start, in enhancing financial stability and the integrity of the markets, would be to reconstitute the financial structure by forcing banks to perform their traditional role and for regulators to begin by breaking them down into smaller units performing their designated functions. In Minsky's view—and, in a sense, providing an answer to Mr. Dimon's concerns to serving his customers complex needs—a bank holding company structure with numerous types of subsidiaries, each subject to strict limitations on the type of permitted activities, would be a valuable deterrent to risky behavior. Most of us would agree that we need banks that can earn competitive rates of return, banks that focus not on big risks but on financing the economy's capital development.

We need, therefore, reforms that limit profiting without producing but instead promote enterprise and industry over speculation. They will have to be as innovative, flexible, and opportunistic as the markets they aim to improve.

These reforms are also necessary, as I indicated earlier and Minsky long argued, because of the connection between financial stability and sustainable economic growth and employment. He would have been very concerned about policy increasingly turning to promoting investment for fueling economic growth rather than relying on growing consumption financed out of growing household incomes that were stabilized by full employment.

To be sure, private sector investment is crucial, but government policy has little influence in stabilizing it. Even in a period of subzero interest rates adopted by the central banks in the eurozone and countries such as Sweden, Switzerland, Denmark, and Japan, which together produce a quarter of the world's GDP, the ability to stimulate growth through investment has proven to be very limited. Easy monetary policy is usually celebrated by the markets, but it seems that, currently, markets appear uneasy with the negative-rates policy. Economists and commentators talk about the dwindling firepower of central banks, and that the negative

interest rate policy may be even more dangerous. As PIMCO's Scott Mather recently put it, "It seems that financial markets increasingly view these experimental moves as desperate and consequently damaging to financial and economic stability." It would not be difficult, then, to conclude that policymakers have run out of options.

Stability of consumption, however, can be influenced by government policy that targets full employment, and Minsky proposed an employment policy that can ensure a level of full employment.

The Levy Institute continues to focus on strategic issues of economic policy relating to achieving financial stability, long-term higher economic growth, and employment in a period of sluggish growth, low inflation, severe income and wealth inequality, and alarmingly decreasing public spending in the name of fiscal conservatism.

This year's conference will explore some of the issues and linkages mentioned.

We invite you to take a look at or take with you some of our publications available at the desk in the back of the room, and would very much welcome your comments.

We welcome you. Enjoy the conference. We hope you will find the presentations and discussions thoughtful.

Thank you very much for your attention.