



HIGHLIGHTS

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## IT'S THAT "VISION" THING

### Why the Bailouts Aren't Working, and Why a New Financial System Is Needed

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#### **Introduction**

Despite the creation of a myriad of Federal Reserve (Fed) special discount window facilities, unlimited swap lending to central banks worldwide, and the creation of the Troubled Asset Relief Program (TARP), there appears to be no improvement in financial market conditions. In particular, it is widely lamented that, even with massive capital injections, the banking system is not lending to support the private sector. Comparing the current government response with official reactions to the Great Depression in the 1930s and the Japanese crisis in the 1990s reveals surprising similarities—and the absence of at least three crucial factors. The similarities lie in the initial reliance on monetary and exchange rate policy to reflate asset prices and prevent deflation in goods prices, in order to restore normal functioning of the financial system. The differences relate to the absence of (1) direct measures to support bank incomes through interest rate policy, (2) an understanding of the failures of the “modernized” financial system, and thus (3) a clear design for the shape and structure of the financial system that is to replace the current one. The third factor may be the most important deficiency related to attempts to emerge from the current crisis.

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## A Diagnosis Is More Important Than a Cure

The prevailing diagnosis of the difficulties involved in reviving the financial system is based on the idea of a “liquidity trap.” This explanation is similar to the response during the Japanese equity and real estate market bubble, which was eerily similar to the recent bubble in the United States. It was evoked to explain the decision by the Bank of Japan (BoJ) to introduce a zero interest rate policy (known by the acronym ZIRP) in light of its failure to increase lending by Japanese banks through massive increases in bank reserves. To the frustration of the BoJ, Japanese banks simply accumulated the reserves, without further lending.

”Liquidity trap” initially referred to the creation of high-powered money by the central bank that was “trapped” on the asset side of banks’ balance sheets, without expanding deposit liabilities representing loans to businesses. This could be viewed as a collapse of the money multiplier, or the velocity of circulation. If the rate of interest is zero, it cannot by definition be reduced.<sup>1</sup> In this version of the liquidity trap there is no increase in lending, because it is implicitly assumed that the rate of interest at which the demand for loans equals the supply (given by the money multiplier) is negative. Equilibrium is thus blocked by the positive constraint on interest rates.<sup>2</sup> Indeed, in conditions of deflation, it is possible that real interest rates would rise, pushing the economy even further away from equilibrium.

This ZIRP version of the liquidity trap led commentators such as Paul Krugman<sup>3</sup> and Fed Chairman Ben Bernanke to propose that the BoJ carry out a policy of reserve expansion (i.e., “quantitative easing”) as a means of generating inflation (or at least raise inflationary expectations) sufficient to drive the expected real interest rate into negative territory. Indeed, Bernanke (2000) argued that if such a policy carried on for a sufficient period of time, as a matter of logic it would inevitably lead to an increase in lending and rising prices.<sup>4</sup> He also suggested that a significant yen depreciation would go a long way toward jump-starting the reflationary process in Japan. This was actually attempted in July 1999 but resulted only in yen appreciation, largely because the United States was unwilling to allow the value of the dollar to rise.<sup>5</sup>

## Some Measures from the Depression Era

This approach to policy echoes Irving Fisher’s proposal for dealing with the Great Depression: reflation through monetary expansion.<sup>6</sup> Fed regulations then in force, however, made it dif-

ficult to carry out this policy. A change in legislation (the Glass-Steagall Act of 1932) was required in order to allow District Reserve Banks to increase the outstanding supply of Federal Reserve notes through the purchase of Treasury securities (i.e., what is now the normal policy of open market operations). The Fed embarked on a policy of buying Treasury securities that successfully increased bank reserves, but this policy was suspended after a short time, largely because the banks were not eager to expand lending when there were few qualified borrowers, or to see lower interest rates when their major source of income was interest on Treasury securities. Thus, the Fed’s expansionary policy rapidly reduced bank incomes to a level where they were insufficient to cover operating expenses.

Monetary expansion was not the only policy supporting price “reflation.” The Roosevelt administration suspended the gold standard and devalued the dollar to raise commodity prices,<sup>7</sup> and introduced legislative support to raise prices and wages in agriculture and manufacturing, and to allow firms to act as a cartel and set prices. The basic idea behind this approach was to use every means to reflate prices and incomes to precrisis levels, so that debtors could meet their commitments.<sup>8</sup>

## The Fed’s Response to the Current Crisis

It is telling that the Fed’s response to the current financial crisis has been praised, mainly because it introduced ZIRP more rapidly than the Bank of Japan and embraced massive quantitative easing. In the absence of eligible borrowers, however, the only impact of lower interest rates is lower household and bank incomes.

As yet, there are no proposed measures to support bank earnings. The change in legislation that allows interest payments on Fed deposits does not offset the impact of lower incomes, since interest rates are paid at a discount to the Fed funds rate: under ZIRP, this rate is effectively zero. Quantitative easing could support household disposable incomes by allowing mortgages to be refinanced at lower interest rates. It seems clear, however, that tightening loan standards means that any beneficial impact will be more than offset by the decline in interest income on household deposits.

The resulting swap arrangements by various term-lending facilities, through which the Fed exchanged impaired bank assets for Treasury securities, affected the composition and credit quality of investment portfolios while having little or no

impact on bank earnings. This differs, in a fundamental way, from the policies adopted in the 1930s and those of former Fed Chairman Alan Greenspan, who produced a sufficient spread between short- and medium-term government security rates to allow banks to earn enough income from riding the yield curve to partially restore their balance sheets.

### **The Change in Financial Structure . . .**

Although the New Deal policies included direct income and employment support, active Keynesian-style deficit spending in support of incomes was introduced only after the ill-fated decision in 1937 to balance the budget after the recovery was under way. On the other hand, the approach at this time included another crucial element absent from present discussions—a fundamental change in the financial structure through a series of regulatory measures and new regulatory institutions. New Deal measures and institutions are glaringly absent in the current rescue packages, as is any discussion about the desired post-crisis structure of the financial system. Indeed, policy has changed course so frequently that there is complete uncertainty over any clear strategy to reregulate and reform the financial system.

### **. . . Is a Key Element Missing from Current Policy**

The U.S. banking system in the aftermath of the Financial Modernization Act (1999) was based on principles that differed radically from those of the New Deal legislation. The “modernized” system was founded on intermediation by financial institutions between borrowers and capital market lenders. Banks minimized loans held at risk on their balance sheets in order to conserve capital and increase pure intermediary activities by maximizing fee and commission incomes. Banks had already ceased to lend in the new system and losses had reduced their own capital, requiring a reduction in the size of their balance sheets. The fact that capital markets stopped buying the loans originated by banks (because of a lack of transparency concerning risk) meant that credit ceased for the entire system.

The second element supporting bank earnings was leverage under the “shadow banking system.” Many of these institutions and instruments have sharply reduced their exposure and, in concert with exhortations from regulators to reduce leverage, suppressed the availability of credit to the private sec-

tor. Although current policy appears to be designed to resurrect the “modernized” financial structure, it is unlikely to do so, since it would only lay the groundwork for the next crisis. The lessons of the Great Depression suggest that structural reform has to be part of any successful policy that restores financing to the productive sectors of the economy. But creating that system requires an understanding of how the current system failed.

### **Why the Current System Failed**

To understand this failure, it is important to recognize how the (now collapsed) originate-and-distribute system differed from the traditional originate-and-fund system. Under the New Deal financial structure, bank loan officers would originate loans and the reserve desks would find the deposits or interbank lending needed to satisfy the statutory reserve ratio. If the system came up short, the Fed provided the reserves. For an individual bank, however, there are secondary reserve assets (i.e., liquidity cushions) when shortfalls arise. Loans initially funded by creating a bank deposit liability thus represented an unfunded liability that had to be hedged by a bank’s liquidity policy (see Minsky 2008).

In the world of origination and securitization after 1999, there was little concern for holding negotiable assets against a loan commitment, no visible backup credit lines, and no need for money market connections to provide funding. Not only was the capital backing removed, the function of the reserve desk was replaced by financial engineering. This replacement eliminated the loan officer’s normal due diligence process and replaced it with an analysis of the capital structure of special purpose entities. No one assessed the quality of the underlying assets purchased by the entities. Even the structure’s due diligence was outsourced to private rating agencies, whose interests were those of the issuing banks who paid the fees—not the loan officers or final buyers (see Kregel 2008).

But, more importantly, the liquidity cushion of secondary reserves, along with the access to market financing that was normally held by banks in the originate-and-fund system, disappeared in the new financial order. Moreover, the weakest link in the new system was that a large portion of the subprime and Alt-A loans were programmed to become insolvent at their reset date if the collateral could not be sold at a profit. The secondary liquidity based on bank reserve assets such as Treasury securities (the safest assets traded in the most liquid market) was

replaced by the secondhand real estate market (one of the least liquid and most fragmented markets in the financial system).

An additional perverse impact was that bond insurers and issuers of credit default swaps were even less capitalized, and had even lower liquidity cushions, than the structures they insured, while also creating an additional demand for liquidity in a system that was virtually devoid of it. In normal circumstances, a liquidity crisis creates the need to sell position in order to make position, and this response leads to insolvency. In the current crisis, the recognition that the securitized structures were insolvent set off a rush for liquidity that engulfed the entire system. At the same time, rising loan-to-value ratios and the failure to verify borrowers' income meant that the liquidity cushion all but disappeared.

If the price readjustment had been restricted to the buyers of liabilities associated with securitized mortgage entities and the underlying subprime borrowers, the financial collapse would have produced a loss of wealth for the entities and borrowers alone, while possibly lessening the wealth effect on consumption and economic activity—in other words, there would have been a short slump. But the current slump will not be short.

When the securitized entities became insolvent, there was a direct and negative impact on banks. In combination with the demand for liquidity to provide margin on credit enhancements, these circumstances produced what Fisher and Hyman P. Minsky called a “debt deflation”—that is, it became necessary to sell position to make position. In a market where there are only sellers, however, there is by definition no liquidity or market price. Thus, not only private sector lending came to a halt, but lending amongst financial institutions (which normally supports liquidity) also came to a halt. This result was simply exacerbated by the Fed, which had no clearly enunciated principle to determine who would receive support and who would be allowed to fail. The threat that every institution is a potential Lehman Brothers means that banks will not lend to one another, leaving the entire provision of liquidity to the Fed as the only secure borrower. The problem is not that the banks are not lending; it is that they are lending only to the Fed. While the bailout of financial institutions has prevented insolvency from turning into bankruptcy, it has done little to increase the willingness or ability of banks to lend to private businesses or to one another.

A well-defined road map for a new financial system is more important than a replacement mechanism that removes impaired assets from bank balance sheets. The Roosevelt admin-

istration designed a new system in a very short space of time (1933–35), but there is no clear vision of what the “New Deal” will be for the financial system. It is also obvious that policy attempts to return prices to precrisis levels and save the existing system have not worked.

### **The Final Lesson from the New Deal**

The current response to the financial crisis does not appear to acknowledge the importance of the negative impact of low interest rates on incomes, while it embraces Fisher's idea for a resolution through ZIRP and quantitative easing to restore asset and goods prices. These policies did not work in the United States in the 1930s or in Japan in the 1990s. The most important aspect of the New Deal—a rapid assessment of financial system failures and the introduction of a new financial structure that corrects these failures—is absent.

Today's insistence on restoring asset values and removing “impaired” assets from the balance sheets of institutions (and restoring them to health) suggests that these institutions will be able to generate incomes much as they have in the past. This seems to be an impossible outcome.

Fisher, not John Maynard Keynes, dictated New Deal policy. Keynesian-style deficit spending was adopted only in an emergency, after tax increases (which look disturbingly similar to those discussed by the Obama administration) produced an economic downturn. As important as increasing employment may be in the current stimulus bill, the initial focus of government expenditures should be to provide income and cover losses sustained by banks and households in order to resolve the liquidity problem (a lack of liquidity is causing the productive sector to contract due to a lack of financing). The best way to reduce liquidity demands is to ensure that the cash flows of firms and household incomes are fully employed. In the absence of write-offs, only increased earnings can restore balance sheets.

Minsky pointed out a better way to solve both the liquidity and the income problem, while also providing full employment: by channeling government expenditure through an employer-of-last-resort program. The current crisis could have been avoided if increased household consumption had been financed through wage increases and if financial institutions had used their earnings to augment bank capital rather than employee bonuses. In addition to financial reform that underwrites productive investment and increases labor productivity,

policies are needed to ensure that increased productivity is reflected in increased real wages for households, and that financial system earnings are directed more toward capital than toward labor. The current system has failed because it was built on an incentive system that did just the opposite.

## Notes

1. This is not the way that Keynes explained the liquidity trap. For Keynes, the liquidity trap was a price relation—the failure of the central bank to bring about a reduction in market interest rates by increasing the supply of money. It was thus an expression of absolute or complete liquidity preference. The public was willing to hold as much cash as the central bank would create at a constant interest rate. Keynes’s explanation was linked to expectations of the future course of interest rates. If investors believe that interest rates have fallen so low that they may rise by more than the square of the currently prevailing rate, then the loss in value of a coupon security would more than offset the coupon yield. In such conditions, it would be rational to sell securities at the current interest rate and hold on to the money.
2. Although the interbank deposit bid rate was negative for some periods in 1998 due to the perceived risk of insolvency of Japanese banks and the preference for holding deposits in foreign banks operating in Japan.
3. His best-known article on the subject is Krugman (1998).
4. “The general argument that the monetary authorities can increase aggregate demand and prices, even if the nominal interest rate is zero, is as follows: Money, unlike other forms of government debt, pays zero interest and has infinite maturity. The monetary authorities can issue as much money as they like. Hence, if the price level were truly independent of money issuance, then the monetary authorities could use the money they create to acquire indefinite quantities of goods and assets. This is manifestly impossible in equilibrium. Therefore money issuance must ultimately raise the price level, even if nominal interest rates are bounded at zero. This is an elementary argument, but, as we will see, it is quite corrosive of claims of monetary impotence” (Bernanke 2000).
5. According to Richard Koo (2003), then U.S. Treasury Secretary Lawrence Summers actively opposed the move after the Bank of Japan had spent three trillion yen without

clearing the move with the United States. The attempt to intervene in the exchange markets did, however, earn Eisuke Sakakibara, Japan’s former vice minister for international finance, the title “Mr. Yen.”

6. Fisher was in step with Chicago economists, who also favored an increase in the money supply as the basis for a recovery of prices but they diverged from Fisher, and argued that this could take place only through an increase in demand for loans for productive purposes. It would require public deficit spending to generate this demand. See Davis (1968).
7. This is undoubtedly the source of subsequent recommendations made to Japan in the 1990s and a plausible explanation of the clear decision by the United States to abandon its strong dollar policy. Market strategist Frank Veneroso (2008) clearly outlines the similarities between Bernanke’s policy recommendations for Japan and the conduct of Fed policy in this crisis, in particular drawing dire conclusions for the value of the dollar.
8. Fisher’s position was supported by recognition of the impact of deflation on the real value of debt that could create an incentive to sell despite falling prices, and a process that Fisher called a “debt deflation.”

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