Hyman P. Minsky insisted that the proper role of the financial system was to create a financial structure conducive to economic development that would improve living standards. He described a capitalist economy as a set of interrelated balance sheets and income statements. All economic units—households, firms, financial institutions, and governments—take asset positions by issuing liabilities with margins of safety related to income, net worth, and liquidity.

In terms of financial institutions, Minsky distinguished between traditional commercial banking, investment banking, universal banking, and public holding company models. Commercial banks can “force” a surplus in order to generate gross capital income (profits plus interest), and promote capital development by financing the wage bill of workers in the investment-goods sector. An investment bank provides the external finance needed to place capital goods into the hands of the entrepreneur or market. A universal bank combines commercial and investment banking functions (both short-term lending and long-term funding), while a public holding company owns various types of financial firms that are separated by firewalls.

The layering of financial commitments on top of income-producing real assets created a new kind of capitalism, one in which ownership positions must be continually validated. That phase of capitalism—what Minsky called “finance capitalism”—imploded in the Great Depression. The government was too small to offset the collapse of gross capital income that followed the Great Crash of 1929. After World War II, a new stage of capitalism emerged—managerial welfare-state capitalism—with a government so large that its deficit could expand sufficiently in a downturn to offset the swing of investment. In addition, we had an array of New Deal reforms that strengthened the financial system, separating investment banks from commercial banks and putting in place government guarantees such as deposit insurance.

But, as Minsky observed, stability is destabilizing: the relatively high rate of economic growth, plus the relative stability of the financial system, encouraged innovations that, over time, subverted the New Deal constraints. Financial wealth (and private debt) grew on trend, producing immense sums of money under professional management. Minsky called this stage, where we are today, the “money manager” phase of capitalism. Here, the real problem is the erosion of underwriting standards, combined with the government’s endorsement of private obligations. The investment banks are like huge hedge funds, but now with bank charters giving them access to the Fed’s discount window and to FDIC insurance. The simultaneous demise of commercial banking and rise of shadow banking was largely a consequence of this transition to money manager capitalism.

In Minsky’s view, deregulation was secondary to market factors in transforming the financial sector. With help from the government, power was consolidated in a handful of huge firms that provided the four main financial services: commercial banking, payments services, investment banking, and mortgages. Brokers didn’t have a fiduciary responsibility to act in their clients’ best interests, while financial institutions bet against households, firms, and governments. By the early 2000s, banking had strayed far from the (Minskyan) notion that it should promote “capital development” of the economy.

Minsky insisted that banking reforms account for accelerated innovation in both financial intermediation (i.e., relationship banking) and the payments mechanism. He advocated government policies to support a network of small community development banks (public-private partnerships) that would provide a full range of services. Policy should also move to make the payments system a profit center, so that banks can compete with money funds. Transaction taxes could be placed on payments made through managed funds, and banks could be offered lower, subsidized, fees for use of the Fed’s clearing system. Opening the discount window to provide an elastic supply of reserve funding, to a broad spectrum of financial institutions, would ensure that banks could finance positions in as many assets as they desired, at the target funds rate. If the Fed had lent reserves without limit when the crisis hit, it is probable that the liquidity crisis could have been resolved more quickly.

For a more detailed discussion of this topic, go to www.levyinstitute.org/pubs/ppb_115.pdf.