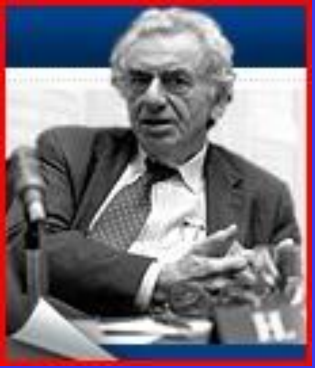

22nd Annual Hyman P. Minsky Conference
on the State of the US and World Economies

Building a Financial Structure for a More Stable and Equitable Economy

We Need a "New Q": Replace Quantitative with Qualitative Monetary Policy

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The Old Q: "Quantitative" Monetary Policy

- The "Old Q": Based on the Quantity Theory
  - "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 (2000:158)
  - "I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we {The Federal Reserve} did it. We're very sorry. But thanks to you, we won't do it again."
  - "one could make an economic case that the balance sheet of the central bank should be of marginal relevance at best to the determination of monetary policy." (Bernanke (2003)
  - And the Fed's Balance Sheet has expanded from less that $1T in 2007 to over $3 T (around 1.75T bank reserve balances)

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The "old" Q

- Based on the "widely held view that the banks create or provide credit, independently of the borrower, … based on their reserves, for which borrowers compete. The control of credit thus becomes a problem of adjusting the total quantity of credit to the quantity of goods." (Dunkman, 278)
- Banks passively transmit Central bank monetary policy changes in reserves and/or interest rates into changes in monetary creation.
  - Money multiplier is stable
  - Banks remain fully loaned up
- Minsky: The narrow view that banking affects the economy only through the money supply led economists and policy makers to virtually ignore the composition of bank portfolios." (Stabilizing, 252)

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This Old Q has been proposed before !

- Keynes' *A Treatise on Money* challenged Central Banks to take "deliberate and vigorous "extra-ordinary," "unorthodox" monetary policy action *à outrance*" to control …investment and the level of prices".
- The *extra-ordinary methods "in the event of the obstinate persistence of the slump would consist, therefore, in the purchase of securities by the Central Bank until the long-term market rate of interest has been brought down to the limiting point … It should not be beyond the power of the Central Bank to bring down the long-term market-rate of interest to any figure at which it is itself prepared to buy long-term securities.*
- If the effect of such measures is to raise the price of equities … no harm in a time of slump will result from this; for investment can be stimulated by its being unusually easy to raise resources by the sale of ordinary shares,"
- Without "extra-ordinary' policies, "the thing will never cure itself by the lack of borrowers forcing down the rate; for it absorbs just as much savings to finance losses as to finance investment."
- "It might be sufficient merely to produce a general belief in the long continuance of a very low rate of short-term interest. The change, once it has begun will feed on itself"

Why Old Q doesn't work

- Keynes (1936): It has an impact on asset prices, but not on liquidity preference for **both** Banks and households: "many a slip twixt the cup and the lip"
- Need to generate an exogenous demand for credit to finance expenditure on production
- Dunkman (1933) " central bank credit (Base Money) is not in the hands of the community to be spent for commodities so that the first necessity is to show the effects of central bank policy on the volume of bank credit."
- "in order to get the bank credit into the hands of the public, someone must borrow from the banks, since no technique has been devised for placing bank credit directly at the disposal of the community without a reciprocal claim being established."

Dunkman, *Qualitative Credit Control*, Columbia University Press, 1933

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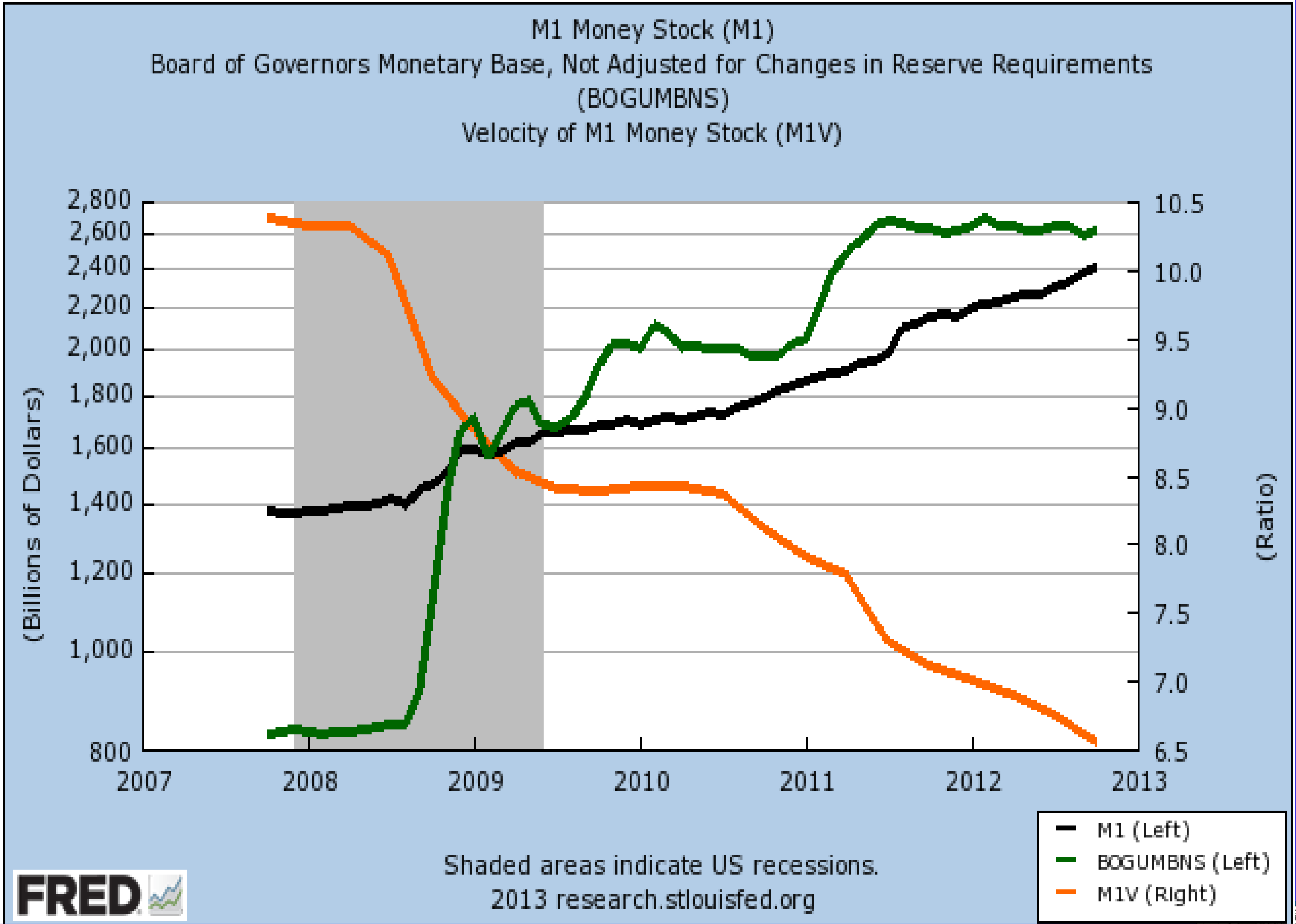
M1 Money Stock (M1)
Board of Governors Monetary Base, Not Adjusted for Changes in Reserve Requirements (BOGUMBNS)
Velocity of M1 Money Stock (M1V)
(Billions of Dollars)
2,800
2,600
2,400
2,200
2,000
1,800
1,600
1,400
1,200
1,000
800
10.5
10.0
9.5
9.0
8.5
8.0
7.5
7.0
6.5
(Ratio)
2007
2008
2009
2010
2011
2012
2013
M1 (Left)
BOGUMBNS (Left)
M1V (Right)
Shaded areas indicate US recessions.
2013 research.stlouisfed.org
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Old Q Response to Financial Crisis

- "The problem faced in a depression is to deal with debts which cannot be paid. … **The usual method of treating the situation through credit expansion is as a rule the worst method**.
- it assumes that the source of credit lies in the action of banks and that this credit should be extended to those in difficulties."
- Generated Stock Market boom (Keynes predicted this)
- But no new lending, no new investment, no sustained recovery

New Q view of QE

- The New Q View of QE: Yes It is Necessary, but not to support lending
  - Richard Kahn on liquidity preference:
    - The Banking System must hold the financial assets that the public does not want to hold
    - But, the impact of monetary policy depends on the objectives of actors in the market
      - Widows and Orphans seeking income versus bond traders seeking capital gains
      - Minsky believed that the rise to dominance of money managers influenced the behaviour of the system
  - Keynes on Monetary Policy: Put Green Cheese in the Liquidity Trap
    - The Central Bank must hold the financial assets that the public, including the banking system does not want to hold
    - **Who would hold bonds if the expected rise in rates is greater than the square of the prevailing interest rate**
      - capital losses if expected Δ i > $(.0175)^2 = 0.00037$
    - Minsky believed the lender of last resort function should be available to the entire economy

We need a New Q

- To formulate the New Q we must "reverse ... the concept of the lending the "funds" of depositors" and recognise the importance of "the concept of establishing liabilities through the acquisition of assets"
- "extensions of credit add to the total volume of credit, rather than … lending something already in existence
- ***--we must learn to think of bank's balance sheets from assets to liabilities, rather than from liabilities to assets.***
- We must come to the realization that banks are the handmaids of business and not its master. They can finance trade if there is trade, but they cannot force trade where there is none.

Minsky's New Q View of Banking

- "Banking is not money lending
  - to lend, a money lender must have money.....
- A bank loan is equivalent to a bank's buying a note that it has accepted
  - When a banker vouches for creditworthiness or authorizes the drawing of checks, he need not have uncommitted funds on hand. He would be a poor banker if he had idle funds on hand for any substantial time.…
- It is the generation of assets by business sector productive activity that provides the basis for the creation of bank liabilities
- It is the cash flows from business activity that provides the income to validate (service and repay) the loan
- Financial stability emerges when the income from operation of assets validate the servicing of the liabilities that financed them

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But Modern Banking is Different

- We now have "Moving Company" banks
  - Bank originate loans to fill CLOs
  - and then find institutional investors to fund the loans
  - In place of a bank acceptance or guarantee we now have Ratings Agencies' personal "opinions"

  - Or shadow banks who have only market access (or their mother bank in case of crisis) to funding as guarantee
- In both versions :
- Minsky: "Banker's activism affects not just the volume and the distribution of finance, but also the cyclical behaviour of prices, incomes, and employment

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Minsky on the New "Q"

- If the disrupting effects of banking are to be constrained, the authorities must drop their blinders and accept the need to guide and control the evolution of financial usages and practices.
- In a world of businessmen and financial intermediaries who aggressively seek profit, innovators will always outpace regulators; the authorities cannot prevent changes in the structure of portfolios from occurring.
- What they can do is keep the asset-equity ratio of banks within bounds by setting equity-absorption **ratios for various types of assets**.
- If the authorities constrain banks and are aware of the activities of fringe banks and other financial institutions, they are in a better position to attenuate the disruptive expansionary tendencies of our economy.

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The New "Q": Qualitative credit control

- Some Old New Q Recommendations (Dunkman)
- "Bankers should first of all develop and improve the analysis of the financial condition of individual borrowers" (instead of using computer algorithms)
- "It is important to know some facts about the industry" to which the bank lends (as was the case with traditional German Universal Banking)
- "Use of composite balance sheets and income statements"
- "The study of clearing balances"
  - to identify "debts not being repaid on time"

International Application of New Q

- "Looked at from the point of view of the creditor countries, it is evident that if they gave full attention to the condition of the debtor country, they would take these factors into consideration in making loans and thus would reduce the volume of credit extended."
- Qualitative credit control implies control on the financing of different categories of imports and exports
- It also implies controls on different types of investment flows

Current Reform Proposals & New Q

- The New Q Clearly requires smaller size:
- Break up the banks into smaller units
  - Proposals from Dallas Fed, former President of KC Fed
    - Exercise with Living Wills has shown this to be difficult
  - Simply making banks smaller does not necessarily make them less risky
    - Lehman was not large, but it was extremely complex (and internally conflicted)
- Would not facilitate Qualitative Control

Minsky’s version of the “New Q”

- In 1995 Minsky proposed a reform of Glass-Steagall based on bank holding companies
  - He noted that in the 21st Century there are now alternatives to banks for all but their provision of the ‘ultimate’ payment system”
  - Because banks operate the ultimate payments mechanism those liabilities of banks which serve as the “medium of exchange” also serve as the standard in which domestic public and private debts are denominated… and whose value cannot be compromised by market events”
  - This is what makes banks “special”
  - And this is why they have “guarantees’ of their liabilities provided by preferential access to the Fed Discount window and FDIC insurance
  - But these guarantees come with limitations on the composition of their balance sheet assets

Minsky's proposed "New Q"

- In 1995 Hyman Minsky proposed a bank holding company system
  - Recently supported by Sheila Blair
  - Subsidiarieswith special functions, defined asset structures and independent capitalisation
  - One would deal with the bank provision of payments system
    - A narrow bank with transactions balances as liabilities and government debt as assets
      - No need for deposit insurance
  - Another funding business lending with certificates of deposit
    - And a government insurance fund
- Another sub does investment banking
- And "merchant banking" (venture capital and private equity)
- And another for insurance activities

Qualitative Control and Minsky's Bank Holding company proposal

- Sheila Bair supports the proposal because it makes resolving banks under Living Wills feasible
- But is has a more important advantage
  - It reduces the size of the units to be supervised and managed
  - Lending restrictions can be applied to the different specific activities of separate subsidiaries
  - Separate equity absorption (leverage) ratios can be set
  - Avoids regulatory arbitrage
  - Makes it easier to identify bubbles in specific areas
- Avoids the pitfall of 100% banking by allowing banks to create liquidity

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Thank You

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