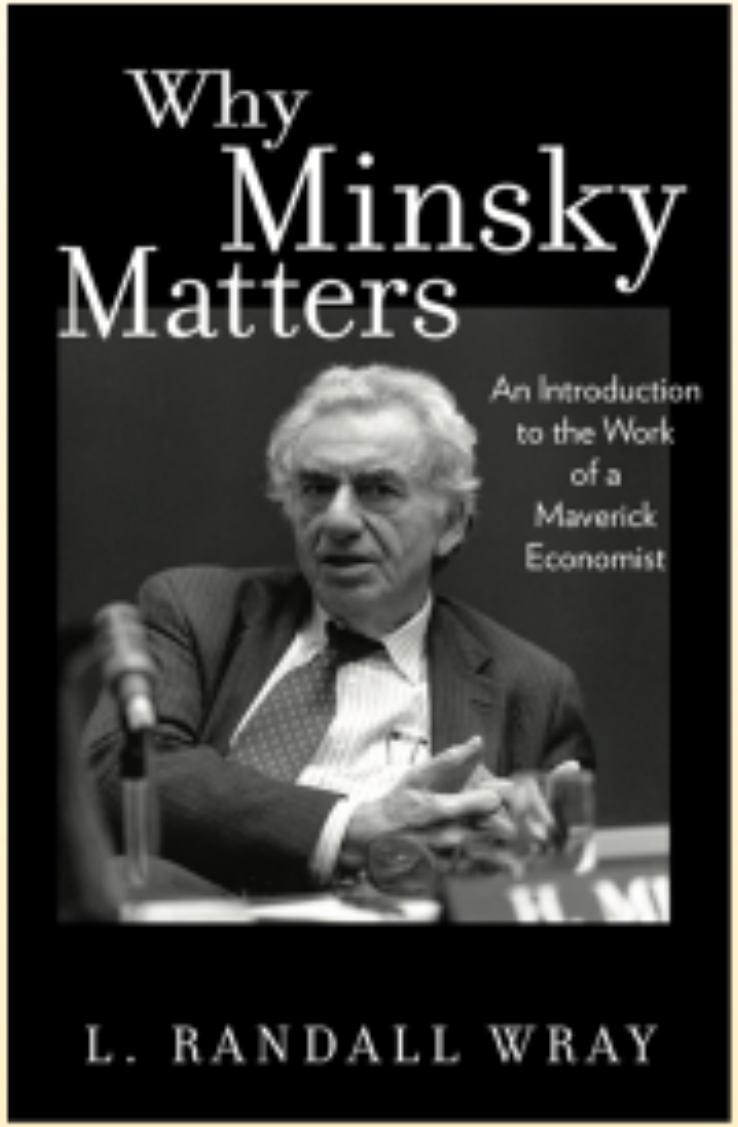

Reconstituting the Financial System

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The 25th Minsky Conference: Setting the Agenda

- 25 years ago Minsky introduced this series of conferences: "My aim is to broaden the discourse, to put ideas on the agenda which are deeper than those that now enlighten the discourse."
- "As the United States struggles with the problem of fixing the financial system, advocates of any particular proposal need to address three questions:
  - What is it that is taken to be broke?
  - What theory about how our economy works underlies the proposal?
  - What are the dire consequences of not fixing that which you assert is broke or, alternatively, how does the change you advocate make things better?"
- The topic of concern was the payments system, and the probable insolvency of the FDIC and all the big financial institutions.

What is broke today?

- Better question: What isn't broke?
- The financial system doesn't promote the capital development of the economy.
- Monetary policy is impotent.
- Fiscal policy has been abandoned.
- Money Manager Capitalism was bailed-out and rebooted.
- We appear to be headed full steam ahead to another crisis.

The Rise of Monetary Cranks

Money matters most of the time, at some rare but important times it is all that matters, and sometimes money hardly matters at all. (Minsky 1969)

- The crash of 1929
  - Money Matters!
  - 100% money
  - Functional finance
    - Friedman's Monetary and fiscal framework
    - Lerner's Money as a creature of the state
- The crash of 2007
  - Money Matters!
  - 100% money
  - Functional finance
    - Debt-free money
    - Modern money theory

Banking is broke? Two camps.

- "Too much": Banks created too much money; need to eliminate private lending and return rights of seigniorage to government.
  - Positive money
  - Greenbacks
- "Too little": Banks aren't creating enough money; need to encourage more lending.
  - QE
  - Negative interest rates
  - Broaden acceptable collateral

Chicago Plan: Narrow banking, 100% money

- 1930s Fisher, Simons, Friedman
- 1990s Ronnie Phillips
- Martin Wolf, Adair Turner
- Minsky: worth considering, but fixing what ain't broke

Friedman's Monetary and Fiscal Framework

- 100% Reserves Narrow Banking
- All government spending financed by currency; removed through taxing
  - No government bonds
- Surpluses reduce money supply, Deficits increase it
- Fiscal rules; budget to balance only at full employment
- Powerful automatic stabilizers

Lerner's Functional Finance and State Money

- Two principles of functional finance:
  - If there is unemployment, cut taxes or raise spending; if there is inflation, cut spending or raise taxes
  - If the interest rate is too low, sell bonds; if too high, buy bonds
- Money is a creature of the State: state chooses money of account, imposes taxes in that unit, and spends currency used to pay taxes
  - Affordability is not the issue
- Knapp, Innes, Minsky: Taxes drive currency

Positive Money, Debt-free Money

- Separate money from lending
  - *Banks could only "…loan money actually invested by customers. They would be stopped from creating such accounts out of thin air and so would become the intermediaries that many wrongly believe they now are." (Wolf, 2014)*
- End franchised seigniorage
- Greenbackism: spend debt-free currency, all seigniorage to the state!
- Déjà vu all over again
  - Debt-free private money and Debt-free currency
  - A non-sequitur in search of a policy: all money is debt?

What do banks do? Minsky's views.

- Krugman vs Minsky.
  - Thin Air money creation: *As I read various stuff on banking I often see the view that banks can create credit out of thin air…. Any individual bank does, in fact, have to lend out the money it receives in deposits. Bank loan officers can't just issue checks out of thin air…"* (Krugman 2012)
- Minsky: "Anyone can create money, the problem lies in getting it accepted."
  - It's all out of thin air
- Bank money is more acceptable because we all owe the banks.
- Banks make payments for their customers.
  - Loans create deposits.
  - Deposits make reserves

Commercial banking and the payments system

- Minsky: *A bank is not a money lender that first acquires and then places funds…a bank first lends or invests and then 'finds' the cash to cover whatever cash drains arise.* (1975)
- If all else fails, the central bank provides HPM (reserves+cash)
- Commercial banking and Real Bills
  - Commercial loans to finance economic activity
  - Deposits and the payments system
  - Backstopped by Lender of last resort and Deposit insurance
  - Since central bank targets overnight rate, it must accommodate demand for reserves at that rate; it uses discount window and open market operations to meet demand.
  - Deposits and reserves accommodate economic activity that requires loans to begin

What broke the banking system?

When we go to the theater we enter into a conspiracy with the players to suspend disbelief. The financial developments of the 1980s can be viewed as theater: promoters and portfolio managers suspended disbelief with respect to where the cash would come from.. (Minsky 1992)

- Volcker and all that: the Experiment in Monetarism
  - Maturity mismatch: thrifts
    - Reg Q and disintermediation
  - Originate to distribute: "*That which can be securitized will be securitized*." (Minsky 1987)
  - Rise of shadow banking/Money Manager Capitalism
- Early 1990s insolvency and FDIC→ this conference
- The Global Financial Crisis and the run to liquidity
  - Northern Rock
  - US no runs, but…
    - Extension of protection to MMMF
    - $29 Trillion…..
    - Extend and pretend

Innovations and the Spectre of Banking

"A spectre is haunting American business and government: the spectre of banking." (Martin Mayer 1975)

- Lending based on cash flow generated by economic activity was replaced by lending against assets, and financing positions in markets:
  - Martin Mayer (2010 Minsky Conference): *In years past, loans were funded from the deposit base of the bank. Bank deposits are the transaction balances of the economy. Banks had the use of this money because they provided the plumbing of the payments system. Their size was determined by the needs of enterprise.*
  - *The late Hyman P. Minsky… liked to say that there was a morality to the lending officer's work, because his prosperity depended on the success of his clients.*
  - *Once the banks could grow by tapping the money markets they controlled, the government was not well equipped–or, to be honest, well motivated – to stop them. What slowed the march of finance was the fact that the profits came at the end of the loan, which had to be financed as long as it lived. Enter "securitization." Instead of keeping their loans in their vaults, banks could contribute them to packages of like instruments, for sale to investors. Now the money came back to the bank long before the borrower repaid his loan.*
  - *…all these "innovations" were wildly successful. Their triumph, Michael Lewis suggests in his new book The Big Short, was that the whole world became willing to lend money to instruments–not to business or houses, not to land or labor or enterprise, but to artificial contracts created behind closed doors…. The share of the financial sector in the profits of corporate America grew …rapidly to more than 40 percent. The rest of us didn't do so well.*

A payments system separated from production?

- Turn to markets: collateralized lending
  - Rely on credit ratings
  - Treasuries, MBSs, Munis?
  - Financialized, leveraged, layered: Financial system's debts to itself: 125% of GDP; share of value added reaches 20%; share of corporate profits hits 40%.
- Real bills, Commercial paper, Trade credit, Factor companies
    - Then: held to maturity or discounted at banks; linked to deposit payments system
    - Now? Distributed, securitized, derivatives squared and cubed
      - Fictitious liquidity
- Alternative payments systems: PayPal, WalMart, Bitcoin, IPhone? Unregulated; currency?
  - Not linked to production system?
  - Wojnilower: growth requires growth of credit and debt with real GDP

Reforming finance requires a proper theoretical framework

- *One can read almost all of the textbooks, and most of the current journal literature without being made aware that the overriding issue in monetary economics is whether capitalism is flawed in that it is inherently subject to booms and busts. However this was clearly the concern of Keynes and the Chicago school of the 1930's.* (Minsky 1972)
- The critical problem is to "*create a monetary and financial system which will facilitate economic development, the emergence of democracy and the integration with the capitalist world.*" (Minsky 1992)
- The narrow banking (100% money) proposal loses "*sight of the main object: the capital development of the economy. The key role of banking is lending, or, better, financing. The questions to be asked of any financial system are what do the assets of banks and other financial institutions represent, is the capital development of the economy better served if the proximate financiers are decentralized local institutions, and should the structure lean towards compartmentalization or broad jurisdiction institutions.*" (Minsky 1992)

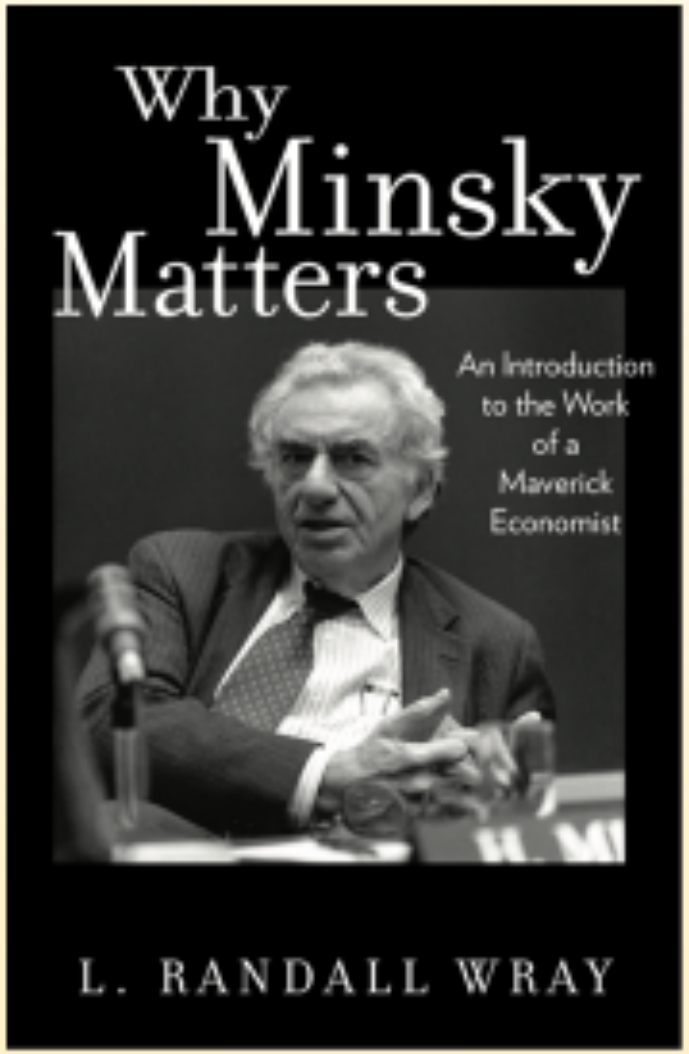
What *Should* Financial System Do?: Key Elements to Promote Capital Development

- 1. safe and sound payments system
  - Alternatives: 100% money; Insured deposits; or Go "Postal"
- 2. short term loans to households and firms, and, possibly, to state and local government
  - Alternatives: Underwriting; Govt guarantees; Govt loans;
- 3. safe and sound housing finance system
  - Alternatives: Jimmy Stewart thrifts; Plain vanilla with Fannie&Freddie; Skin in the game
- 4. a range of financial services including insurance, brokerage, and retirement savings services
  - Alternatives: One-stop shopping (synergies to dupe the dopes!); GS.2
- 5. long term funding of positions in expensive capital assets.
  - Alternatives: State development banks; Investment banks; BHC; Universal banks

NB: there is no reason why these should be consolidated, nor why all should be privately supplied: Community Development Banks (public-private partners)

Resuscitating Fiscal Policy: Sovereign Currency

- Ruml: Taxes for revenue are obsolete
- Colonial America: Taxes are for Redemption
  - The laws that authorized note issue also authorized new taxes to redeem the notes
  - The notes must be issued before the taxes can be paid!
- Creation precedes Redemption
- You cannot Redeem debts that do not exist!
  - Bank loans drive demand deposits
  - Taxes drive currency
  - Sovereignty not seigniorage
  - "Out of thin air" to finance government; to finance business



Thank you

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