THE LEVY ECONOMICS INSTITUTE OF BARD COLLEGE

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Meeting the Challenges of Financial Crisis

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Minsky and the Regulation of the Financial System

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Outline

1) The "Minsky Moment" has become Folk History
2) But Minsky is not only Diagnosis of the Crisis
3) Minsky Also Provides Guide to Regulation
4) Based on Alternative Diagnosis: What Went Wrong?
    1) Market as Provider of Bank Liquidity
    2) But there is no "liquidity" for the market as a whole
5) Based on Alternative of How the System Works
    1) Minsky Fragility of Balance Sheet Approach
6) What Can We Do To Regulate Inherent Instability
    1) Macro Provision of Liquidity
    2) Macro Provision of Incomes
    3) Central Bank Provision of Liquidity
    4) Balance Sheet Intervention

Minsky: Basic Characteristic of Capitalism

- Financial instability: Ownership of capital assets acquired through the issue of debt
- The financial system in a capitalist economy
  - represented by a series of **balance sheets** in which the assets reported on the credit side are supported by the financial liabilities issued to acquire them that are represented on the debit side.
  - These assets and liabilities will generate a complex maze of "**money in/money out**" transactions representing cash receipts from the assets and the cash commitments on the liabilities.
- Since the household sector must own the liabilities the Financial system provides an interface between HOUSEHOLDS who acquire
  - liabilities of financial institutions in order to make payments
  - liabilities of corporations and financial institutions as a method of holding their wealth,
- … and BUSINESS FIRMS
  - who issue liabilities to acquire productive capital assets and to provide income and employment to households.
- A well-functioning capitalist economy requires a financial system that provides
  - a safe and secure means of payment
  - and a reliable store of value
  - that insures the finance of a level of investment in capital assets sufficient to provide near full employment.
- **Financial Stability Requires Guarantee that Cash Commitments can always be met**

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Minsky: Alternative View of Finance

- "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....
- Banks make financing commitments because they can operate in financial markets to acquire funds as needed; **to so operate they hold assets that are negotiable in markets and hold credit lines at other banks.**
- The normal functioning of our enterprise system depends upon a large array of commitments to finance, which do not show up as actual funds lent or borrowed, and money markets that provide connections among financial institutions that allow these commitments to be undertaken in good faith and to be honored whenever the need arises."
- Banks are : "Short" Cash to fund lending to Firms and Housholds
- Business Firms are "Short" Cash to pay Banks and Households
- **Who Can Cover "Short" Position since Neither can Create Cash?**

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How Minsky's System Works?

- Banks Do Not Have to Fund/Reserve to Lend
- Reserves Are Endogenous
- Only Central Bank can Create Cash
  - Bernanke's Computer Key Strokes
- How Is Cash Created? Govt Net Deficit
- But This Also Means that Government Does Not Have to Borrow To Deficit Spend
  - Only Borrow to Set Interest Rate
- "Cash" to Cover Short Position:
  - Macro Condition: Government Deficit
  - Micro Condition: Discount Window Open to All Financial Institutions that are "short" Cash
  - Minsky proposed this in 1960!!

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Is there a Simple Government Solution?

- Since Government Creates Cash Why let Private, Unstable Financial Institutions do it?
- Extend Government right to Coin Money, to Electronic Means of Payment
  - A Government Giro– Perfectly Safe and Secure
  - Better than Nationalising or 100% Banking) – Old Postal Banking System
- Net Giro Balances Could be Held in Treasuries
  - A Perfectly Safe and Secure Store of Value
- **How To Finance Productive Sector?**
- Finance System: Interface Between Households and Firms
- In a Capitalist System the Instability will Always Exist
- Only Eliminated by Nationally-Owned Banks – National Development Banks
- BUT: **How to Control Private Settlement/Finance Systems?**

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All Business Models Are Speculative

- All sell assets to finance activity
- Real Sector Production –
  - Buy before you sell
  - Issue Liabilities to Finance Production
  - Crisis: Excess production and inventory
  - Unsold Inventory leads to Forced Sales and Decline in product prices relative to costs
- Financial Sector –
  - Sell Loans before you fund
  - Purchase of Liabilities Accepted
  - Liquidity Crisis: Excess sales that can't be financed
  - Decline in value of assets relative to Liabilities

How Can We Regulate Instability?

- Cannot be Done!!
- Provision of "Cash" Liquidity -- LLR
  - Fed to Support Financial Asset Prices BEFORE Crisis
  - Lending to ALL Financial Institutions (Minsky 1960)
    - 2007/8:FED did it too late, and too Aleatory
  - Fed Cannot Be Lender of Last Resort & Control Economic Activity (Minsky 1960)
    - 2007: Slow introduction of QE to Calm Inflation Hawks
  - Fed Cannot Be Lender of Last resort and Instability Regulator and Control Economic Activity
    - Paulson Blueprint Gives Fed Contradictory Role

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A View on New Financial Structure

- Glass Banking Act: Determined Structure
- G-B-L Financial Modernisation Act: Determined Structure
- So Far NO Discussion of New Structure
  - "Temporary" Lending Facilities
  - Return to Normalcy, Save the Banks,
  - Increased Concentration:
    - Too Big To Fail/To Big to Regulate?
- Regulation By Function or By Institution?
  - Bank Holding Co. or Universal Bank
    - Different Regulatory Model for Each
    - US Never Introduced Special Regulation for FMA Holding Company Model

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Minsky on New Financial Structure

- Minsky Favoured Unit Banking Model
- But in 1990s Favoured Bank Holding Co.
- Believed that Banking Unit could be Independently Capitalised and Isolated by Chinese Walls
- "A Bank holding company will allow banks and other businesses to be joined in an enterprise which has a wide range of subsidiaries, each subsidiary having its own assigned capital. A failure of a particular subsidiary would not impair the capital and ability of other subsidiaries to operate."
- The support for this was the Barings Bankruptcy.
- But also argued"Financial institutions with wider scopes than the Glass Steagall act allows are likely to emerge in the aftermath of the repeal of Glass Steagall. The evidence from history indicates that such wider scope for institutions are not necessary for the United States' economy to do well"

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New Financial Structure

- Today the separation Between Commercial banks is Gone
  - Bank Holding and Financial Holding Companies and Investment bank Broker dealers
  - But there are no Longer and Investment banks – only Bank Holding Companies
- Can we Restore Glass Functional separation in a Holding Company Structure?
- To Separate the basic functions of the financial system:
  - Provision of a safe, secure transaction system, and store of value,
  - Provision of sufficient financing at a reasonable cost for productive investment.
- Bank Holding companies providing transaction services, a store of value, or financing (for housing, consumers, or related activities) would then be limited to closely related activities only.
- A separate group of Financial holding companies, with the appropriate related sets of activities (No Means of Payment or store of value), would provide
  - underwriting and capital market services for the financing of productive investment.
- The aim would be to limit each type of holding company to a range of activities that were sufficiently linked to their core function and to ensure that each company was small enough to be effectively managed and supervised.

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But First Restore Stability

- **German Approach:**
- Direct Balance Sheet Restructuring
  - Ausgleichsforderungen (Equilibrium Bonds)
    - Used in 1948 Currency Conversion,
    - Used in 1990 German (Mark) Unification
  - a government Security to Plug Hole in Banks' Assets
  - Can Be Applied to Households
    - For Value of Negative Equity
    - or Simply as Exit to Repay Mortgage
  - If All Mortgages are Repaid, the Toxic MBS disappear
    - Have to suspend repayment Penalty on SubPrimes