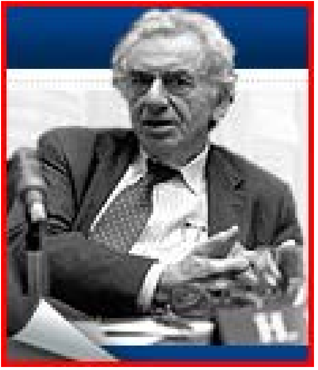

21st Annual Hyman P. Minsky Conference
on the State of the US and World Economies


## Debt, Deficits, and Financial Instability

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# "Using Minsky to Simplify Financial Regulation"

# Implementing Dodd-Frank

- Some two years after adoption implementation is still incomplete.
- A major objective to remove the threat that "too big to fail" banks would require a taxpayer bailout support has not been achieved,
- The financial system has become even more concentrated and the largest banks even larger.
- Top five financial conglomerates now account for over 50 percent of total industry assets,
- Three are over or near the 10 percent limit on the share of national deposits set by the 1994 Riegle-Neal Act
- According to the President of the Dallas Federal Reserve Bank:
  - "Dodd-Frank ... may actually perpetuate an already dangerous trend of increasing bank industry concentration." (Fisher, 2012, 1)

# Impediments to Implementing Dodd-Frank

- A Court of Appeals ruling has vacated a Securities and Exchange Commission (SEC) rule because its formulation involved insufficiently extensive analysis of the costs of the regulations.
- A second suit has been brought against the Commodity Futures Trading Commission's (CFTC) rule on derivatives position limits.
- A recent report suggests that a large majority of the rule proposals currently under discussion do not meet the court's requirements and could be successfully challenged

# Is there a simpler alternative to Dodd-Frank?

- Difficulties have led to call for a more fundamental review of the framework of financial system legislation.
- Some have even suggested that a return to a regulatory framework closer to Glass-Steagall legislation separating types of institutions by function.
- Last year's Levy Institute presentation called specifically for a review of (GLB) Act
  - one of the main causes of the creation of financial conglomerates that are "too big to fail."
  - Allowing the creation of financial holding companies to deal with the full range of financial services made them not only much larger, but also much more complex, and thus more difficult to regulate and supervise.

# Unnoticed Benefit of Glass-Steagall

- Hyman Minsky noted one benefit of the 1933 Act:
  - "the scope of permissible activities by a depository institution was to be limited to what examiners and supervisors could readily understand. . . .
  - "it was not so much the differences and riskiness as it was the ease of understanding the operations that led to the separation of investment and commercial banking"
- Glass-Steagall's limits on the size and activities of financial institutions would enable supervisors, examiners, and regulators to understand the institutions' operations.

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# Small is Beautiful is not enough

- Dallas Federal Reserve Bank Proposal:
  - Simplify supervision by breaking up large, complex financial institutions.
- But this proposal deals only with the size of institutions;
  - it does not indicate the structure of the smaller institutions
- Creating smaller, independent institutions would not simplify supervision if they still deal in multiple types of complex, interconnected financing activities involving structured lending instruments.
- In the absence of effective antitrust legislation, breaking up the larger institutions would in all likelihood simply engender another process of concentration by merger and acquisition similar to that seen after the suspension of branching restrictions.
- A recommendation on the structure of the Smaller banks is required

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# Two Possible Simplificatons

- In 1995 Hyman Minsky proposed a reform of Glass-Steagall based on bank holding companies
  – Narrow Banking
- Reverse the creation of “fictitious” liquidity produced by the erosion of Glass-Steagall
  – Regulate Liquidity creating Institutions
  – rather than set liquidity ratios (BIS)

# Minsky’s Reform Simplification

- Speculating in 1995 on the post Glass-Steagall Reforms:
- “once the distinction between the payments and financing operations of banks is recognized, it follows that post Glass Steagall banking firms will be structured as bank holding companies in which the payments subsidiary is clearly separated from the financing subsidiaries
- the assets of the payments banks will not include business and household liabilities”
- The “holding company structure of post Glass Steagall banking **quite naturally leads to 100% money”**

# Benefits of Narrow Bank 100% money

- If bank holding company subsidiaries are sufficiently and separately capitalized no problem of “bailing out” the speculative activities to save the payments system
- there would be no possibility of using customer deposits for proprietary trading and speculation,
- with appropriate balance sheet restrictions on the transactions subsidiary moral hazard of deposit insurance could be eliminated.

# Narrow money = Neutral Money

- In a perfectly separated, dual system there would be no
  - deposit-credit multiplier,
  - no leverage,
  - no creation of liquidity.
- The financial system mimics Hayek's idea of "neutral" money
  - investment decisions are the result of the voluntary savings decisions of individuals.
  - Wicksell's alternative: equality of nominal and the "real" rate
- There are no "monetary" disturbances to real equilibrium of the economy
  - savings determine loanable funds that limit investment.

# Narrow money: S => I

- Household savings allocated
  - to investment fund shares financing real investments,
  - to the holding of deposits in the narrow banks backed by government debt or currency and coin,
  - to holding government-issued coin and currency.
- Business sector savings allocated
  - to retained earnings financing,
  - deposits in narrow banks, or
  - government issues of currency and coin.
- Private saving would exceed investment by holdings of deposits and government currency,
- creating a tendency toward deflation or recession.
  - Price and/or output stability require exogenous demand such as might be provided by government expenditures financed by the issue of either currency or government bonds
  - Or  central bank could engage in the direct financing of public or private sector investment expenditures.
- Narrow Banks Also Require  Big Government and Big Bank

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# GLB was not narrow banking

- The post–Glass-Steagall system that emerged in 1999 GLB Act not only preserved the creation of liquidity by the deposit-taking subsidiaries of the holding companies, it validated a plethora of diverse liquidity creating structures introduced as a result of the competition between commercial and investment banks.
- Dodd-Frank confirms Minsky’s belief that rescue of the financial system validates the practices that originally created the crisis
- the recent crisis was a collapse of “fictitious” liquidity and the failure of the banking sector to provide sufficient liquidity to prevent the onset of a “debt deflation”
- The Alternative: **Regulate Liquidity Creation**

# Who creates Liquidity?

- Minsky defined the basic activity of banks as "acceptance" :
- "Banking is not money lending; to lend, a money lender must have money. The fundamental banking activity is accepting, that is, guaranteeing that some party is creditworthy. A bank, by accepting a debt instrument, agrees to make specified payments if the debtor will not or cannot. . . . A bank loan is equivalent to a bank's buying a note that it has accepted" (Minsky 2008 [1986], p. 256).
- A "narrow bank" on this definition is not a bank, but simply a safe house or piggy bank..

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# Creation of “Fictitious” Liquidity

- Minsky noted that “[o]ur complex financial structure consists of a variety of institutions that lever on owners’ equity and normally make on the carry, that is, borrowing at a lower rate than their assets can earn.”
- These institutions engage in the same activity as banks without the ability to accept deposits from the general public, and thus without the ability to offer their own insured liabilities as a substitute means of payment.
- Their “fictitious” liquidity depends on bank liquidity
- In a consolidated view of the financial system, every liability in the nonbank financial system, as well as the short-term liabilities of the nonbank nonfinancial system, are all ultimately dependent on the liquidity created by the deposit-taking, insured banks.

# Where did the Creators of Fictitious Liquidity Come From?

- They were the result of the “competition” between commercial and investment banks under Glass-Steagall
- GLB was to eliminate this competition
- Why do we still have them?
- Do We Still Need them?

# Who Creates “Fictitious” Liquidity?

- Money market mutual funds
- Structured Investment vehicles SIVs
- Securitisation: ABS, CDOs
- Repo markets
- Derivatives
- Rehypothification
- Securities lending

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# Does it finance Capital Development?

- Dodd-Frank does not eliminate these liquidity creating structures –
  - it tries to make them safer
- But it does not make them more likely to finance economic development
- And it cannot guarantee their “liquidity”
- Because this ultimately depends on insured banks’ willingness to “accept”
- Or the Central Bank LLR function

# Why don’t we regulate fictititious liquidity creations instead of setting fictitious “liquidity” requirements?

- Do we need any of the fictitious liquidity creators?
- The FSOC could get rid of all of them
- or the legislation/administrative decisions creating them could be reviewed or revoked