

What the Financial Crises Hath Wrought

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I am delighted to address this forum again. I knew Hy Minsky. We sought out each other from time to time. He sought me, I believe, because he wanted to understand financial markets beyond what was visible to him from his academic perch. His fertile mind was sharp and inquisitive; his hallmark was to probe beyond the conventional wisdom.

As a result, in his day Minsky operated outside the mainstream of economic and financial thought. He labored in the shadow of the dominant fashions and modes of analysis, most notably monetarism, rational expectations, econometric modeling, and financial deregulation. His work began to attract some attention during the travails of the 1970s and 1980s. But it took the recent massive financial crisis to bring Minsky's ideas into prominence.

Some are even calling the crisis a “Minsky Moment.” This observation is incorrect, as Minsky would be the first to point out. A Minsky Moment comes at the peak of a typical financial bubble, when some kind of shock to lender and investor confidence triggers a reversal and downward spiral. Fairly soon thereafter, financial markets return to normalcy, setting the stage for another phase of investor enthusiasm. Minsky's central insight was that credit overexpansion, followed by overcontraction, were endemic to financial markets.

Even though there are now signs that economic expansion has returned, this does not mean financial normalcy has returned. The financial and economic crisis of 2008 ushered in fundamental changes that will persist for years to come. That is my topic today.

To begin with, consider household debt. We know that the expansion of household debt helped drive the pre-2008 economy. The contraction of household debt, which began in 2008, now appears to be over. However, household debt remains at historically high levels. And the conditions favorable to renewed household borrowing – such as low unemployment and rising household income – are not yet in place. The housing sector, with its continuing debt write-offs and huge inventory of unsold homes, is another restrictive force.

Business debt, which expanded at double digits before the crisis, is also unlikely to return any time soon. Businesses might borrow heavily again to finance new capital investments or rising inventories, except that excess capacity remains very high, both domestically and abroad. More broadly, new economic activity is faltering not only in key parts of Europe but also in much of the developing world. None of this bodes well for expansionary business borrowing.

Compared with many previous expansionary cycles, the quality of both household debt and business debt is well below par. So in spite of indications that the economy is beginning to expand again, the quality of credit will not match that in previous recoveries. And if the expansion falters, credit quality will degrade even further. Here are a few points of reference. In the 1970s, about fifteen major financial institutions boasted AAA credit ratings. Today there are none. In 1982, Standard and Poor's rated sixty-one non-financial corporations Triple-A. Today, there are only four Triple-A non-financials. Indeed, many of today's key financial institutions have credit ratings far below those of their borrowers.

What also sets apart the current crisis in the post World War II period is the huge overhang of sovereign debt. For much of this period, sovereign debt problems were confined mainly to the developing world. Now they are endemic throughout the industrialized developed world. Recently, markets have focused most of their attention on Europe, where a flaw in the structure of the European confederation contributed to large-scale debt overload. Even though continental Europe possesses a centralized monetary authority, it lacks a centralized fiscal authority. As a result, in making lending arrangements, monetary authorities failed to recognize rather stark differences in the credit worthiness of member nations, which in turn led to some European countries borrowing well beyond prudent limits.

The undeniable fact is that the European central bank – the ultimate guardian of the Euro and of the institutions operating within the Euro framework – failed to pursue policies to rein in the excessive growth of debt. So now we have this extraordinary conflict between debtors and creditors within Europe. There is no easy way out. If the European currency is reconstituted with mainly strong countries as members, the costs will be incalculable. If the discipline imposed by creditors prevails, Europe's economic recovery will likely be tepid at best. If creditors accept major debt reductions, leading financial institutions will be forced

to absorb losses on a scale that will severely limit their capacity to finance economic growth.

Europe's financial conundrum insures that the U.S. dollar will remain the world's key reserve currency for some time to come. Japan will not assume that role. Along with trying to extricate itself from a decade-long economic slump, its sovereign debt is very high and its currency does not float freely. None of the leading emerging economies yet possess the kinds of legal, financial, and political institutions that would enable their currencies to displace the U.S. dollar. To be sure, U.S. sovereign debt is a serious matter. But it is currently a less intractable problem than in other leading nations.

The much more pressing challenge for the developed world going forward is whether or not the monetary approach to restoring economic growth will succeed. The major central banks in Japan and the West have embarked on new tactics and in some cases very aggressive measures compared with previous periods of monetary accommodation. We have ventured into a monetary no man's land. While the previous record of monetary policy was checkered, the new approach is decidedly untested.

This is not to say that previous monetary tactics remained constant over the years. In the early post World War II years, the principal approach in the U.S. – called “bills only” – confined open market operations to U.S. Treasury bills and was generally unobtrusive rather than interventionist. In the early 1960s, operation “nudge” and operation “twist” were designed to influence the yield curve in order to defend the U.S. dollar's international role while also encouraging economic recovery. After that, monetarism was popular for a while, but failed because financial innovation blurred the definition of money. All the while, the Fed tried to encourage price stability, foreshorten recessions, and ward off financial mishaps. Its record on inflation and recession has been generally positive, with the notable exception of the 1970s. Its record on restraining the overexpansion of debt – the central cause of most financial crises – has been poor.

Now central bankers are embarked on an aggressive monetary strategy. The central tenets of this strategy are, first, official economic forecasts stretching several years into the future; second, an inflation target of 2 percent; and third, quantitative easing through the purchase of longer-dated Governments. Considering the enormity of the financial and economic problems that the U.S. faced in 2008, the Fed's actions have accomplished a great deal. They have slowed the fall in housing prices, narrowed the yield differential between low and high credit quality bonds, lifted stock prices, and improved the balance sheets of financial institutions. So far so good.

Nevertheless, these monetary tactics come with some vexing issues and underlying uncertainties. The basic approach is analogous to dosing a patient with steroids. Financial markets have become weaned on these doses. Going forward, whenever a financial or economic crisis arises (however minor it may seem in hindsight) investors will expect another dose of central bank accommodation or other monetary stimulation. Even a policy of holding short-term yields in place and ending the purchase of coupon issues will probably steepen the yield curve and constrain financing that would help revive the housing market. In short, like going cold turkey, it will be no easy matter for financial markets to return to normal conditions after years of monetary dependency.

I also question the efficacy of the Fed's embrace of inflation targeting. Central bank officials claim there is no need to worry about a return of inflation any time soon. They point to cost containment by high unemployment and to excess production capacity. True enough. Still, a portion of our high unemployment is the result of structural elements, such as barriers to labor mobility, elements that cannot be cured by monetary measures alone.

Moreover, the Fed's inflation targeting aims at the core index for personal expenditures, excluding the cost of energy and food. This is dubious at best. It is worth remembering that this approach dates back to the 1970s, when then Fed Chairman Arthur Burns excluded energy and food to minimize public perception of an outbreak of inflation at the time.

Even if food and energy are more volatile than other cost indices, it is risky and misleading to exclude them. Prices of these essentials clearly affect household spending. Moreover, by excluding the price of energy – especially oil – the Fed's monetary policy serves to support the pricing practices of the international oil cartel by supplying sufficient bank reserves to justify those prices.

The value of the Fed's Summary of Economic Projections that underpins its inflation projections is moot. These projections – for economic growth, unemployment, and inflation – extend three years into the future. But the fact is, since these projections were introduced, they have not been very accurate.

Timing shifts in monetary policy has always required considerable judgment. When specific inflation targeting is added to the mix, the challenge of correct timing becomes especially acute. How long will the Fed allow inflation to breach the 2 percent level before it pulls back on the monetary reins? For one quarter, two quarters, or longer? Suppose the unemployment rate falls to 8 percent but the inflation rate reaches 3 percent? What then? At a minimum, the new Fed approach will increase financial market volatility.

Acceptance of a 2 percent annual increase in inflation raises a financial volatility issue. Even more importantly, Fed actions to encourage or even allow inflation could seriously undermine public trust in the central bank, as Americans are forced to accept a substantial depreciation in the purchasing power of their currency. A 2 percent annual depreciation equals a compound loss of 22 percent over ten years, or a 33 percent loss if the inflation rate is 3 percent. So we are confronted with a dilemma. The current monetary accommodation, aimed at encouraging economic expansion, is at the same time encouraging us to become greater risk takers. But while the Fed promotes risk taking, it does not at the same time underwrite our maturity and credit quality risks.

Other major central banks have embarked on far greater quantitative easing than the U.S. Federal Reserve. The Japanese central bank, for example, has included all kinds of private securities, including equities. The European Central Bank's latest accommodation includes three-year loans to member banks. These funds are being deployed at a favorable spread within the European debtor nations. Through this mechanism, the ECB is indirectly assuring the survival of the borrowing institutions and the weaker debtor nations in Europe. That is a heavy burden to bear, for the outcome is far from certain. But the ECB is now so entangled in the process that it cannot easily withdraw. In essence, the European Central Bank has on its balance sheet massive assets of questionable value. The borrowing institutions in the aggregate are protected by the ECB and, indirectly, so are the new investments of the borrowing institutions.

This enlarged central bank role in the financial markets is an integral part of a broader transformation in the structure of the markets both here in the U.S. and around the world. This is the impact and future consequences of financial concentration. In the United States, financial concentration increased sharply in recent decades. It got a substantial boost with the demise of the Glass-Steagall Act in the 1990s.

The Federal Reserve neither opposed – nor recognized the long-term consequences of – the end of Glass-Steagall. In the days leading up to the 2008 crisis, financial conglomerates gobbled up many financial institutions. Once the crisis hit, many smaller institutions failed, while larger ones were bailed out by the government. A very high proportion of U.S. financial assets are now held by a mere handful of conglomerates that are deemed “too big to fail.” On the margins, smaller firms hold a declining share of financial assets. Several figures help illustrate how far we have lurched toward financial holding concentration:

- In the 1980s, the five largest banks accounted for 29 percent of total banking assets, or 14 percent of GDP. Today they account for more than half of total assets, or 86 percent of GDP.

- Five banks – JP Morgan Chase, Bank of America, Goldman Sachs, Citibank, and Wells Fargo – currently represent 96 percent of the notional amount of all derivatives.*
- In 2009, the four biggest banks originated 58 percent of all mortgage loans and controlled 57 percent of credit card purchase volume.*

In investment banking, many of the most prominent heritage names are no longer independent, or have disappeared altogether: E. F. Hutton, Kidder Peabody, Paine Webber, Dean Witter Reynolds, Merrill Lynch, Salomon Brothers, First Boston, Shearson Lehman, Drexel Burnham, Bache & Co., and Bear Stearns.

One notable example of consolidation through merger is J.P. Morgan. Its holding company structure now includes such prominent former institutions as Chemical Bank, Manufacturers Hanover Bank, Chase Manhattan, Bank One, Bear Stearns, Washington Mutual, and First Chicago.

Now, how can anyone state with reasonable objectivity that these amalgamations have improved the efficiency of financial intermediation – that is, the effective allocation of credit? The market-making power of these few remaining institutions is staggering. Consider how many dealers are available to execute a trade today as compared with a decade ago. And as the number of market makers decreases, so does the depth of the secondary market. Meanwhile, market volatility increases.

Financial concentration has other unwelcome consequences as well. It privileges large-firm over small-firm financing. The incentives for branch managers to serve their local community are relatively weak. Managers with ambitions to climb the corporate ladder will seek out big-firm financing, even if it means jumping ship for a larger employer.

Financial concentration also complicates monetary policymaking. When conditions call for monetary constraint, which firms will be affected the most? Surely not the too-big-to-fail giants, which will be largely insulated from central bank restraint. Rather, the smaller firms will feel the brunt of Fed tightening, and as a result, some will fail or be forced to consolidate with their larger counterparts. The result: greater concentration.

The official designation “too big to fail” places much of our financial markets under the direct control of government authorities. A very large and complex official supervisory network is now being put in place. These bureaucratic networks will

* Ira M. Millstein, “Should Regulation Supplant the Applicability of Competition? Antitrust Principles in Dealing with Systemic Risk (March 27, 2012).

have great influence over the allocation of credit, and in the long run large financial institutions will essentially become financial public utilities. The many provisions of Dodd Frank legislation certainly point in that direction.

So the trend is toward constraining the judgment of leading financial institutions. This is because their structure and decision making conflict in many ways with the public interest. These institutions operate on both sides of the market – as portfolio managers and institutional investors on the buy side, as underwriters and dealers on the sell side, and as financial advisors on both sides.

The Dodd-Frank legislation calls for the orderly dissolution of a too-big-to-fail institution that might become financially vulnerable. The law stipulates that a government organization will manage the process. But this process will be much more difficult to orchestrate than the authorities imagine. These conglomerates hold securities and participate in markets with other institutions around the world. How would their millions of positions be unwound to the satisfaction of all parties? It is also reasonable to assume that most of the assets and liabilities of the failing firm will be acquired by one or more of the surviving behemoths – that is, by one of the too-big-to-fail institutions – or by the government itself. Again, the result will be greater concentration.

It is possible that new technologies will erode some of the dominance of the huge financial conglomerates. Perhaps in the future the entire deposit function will be handled by some giant cloud computer facility controlled and guaranteed by the government. At a minimum, I do not expect children born today will write checks, make deposits, or withdraw funds as most of us do today. The thousands of bank branches that dot the landscape will be converted into other kinds of businesses. The armies of financial advisors will be disbanded if lasting financial recovery fails to materialize and boost the savings of the entrepreneurial middle class.

These remain real possibilities. Major governments around the world continue to favor financial concentration while failing to actively oppose concentration in non-financial sectors as well. At the same time, new regulatory constraints on financial conglomerates could encourage them to seek out opportunities in developing economies, where securitization and derivatives are allowed to flourish with little or no restrictions.

Ironically, excesses in foreign relatively unregulated financial markets cannot be insulated from more closely supervised markets here and elsewhere in the developed world. A defining feature of recent financial crises is the degree to which they have been genuinely global. More than ever, financial markets know no national boundaries.

For the moment, we can all breathe a sigh of relief that the economic recovery has taken hold. Looking down the road, however, we will be forced to contend with a financial structure that will constrain both our financial freedom and the effective allocation of credit. It seems more and more likely that the future will be one in which credit is socialized and our major financial institutions are financial public utilities.