An Alternative View of the Financial Crisis
April 22, 2019
by Robert Huebscher

The Levy Economics Institute of Bard College may be “ground zero” for modern monetary theory (MMT), but at its annual conference last week the focus was on financial regulation. The institute, in Annandale-on-Hudson, NY, is where Hyman Minsky, who developed the intellectual underpinnings of MMT, taught at the end of his career.

On April 17, it was the site of the 28th annual Hyman P. Minsky Conference, which coincided with the 100th anniversary of Minsky’s birth.

While some of the presentations focused on MMT, such whether the “green new deal” is affordable, the most interesting contributions were on financial regulation. This was fitting for a conference dedicated to Minsky, who theorized that asset bubbles would breed financial instability, ultimately resulting in a “Minsky moment.”

Paul McCulley, a speaker at the conference, coined the term “Minsky moment” when he was the chief economist at PIMCO. He used it to describe the collapse of housing-debt financing as the underlying cause of the financial crisis. That has been the conventional wisdom over the last decade, and has driven calls to more effectively regulate banks and other systemically important financial institutions.

I’ll summarize two presentations that echoed the conventional wisdom around financial regulation, and then discuss a contrarian talk that argued against the traditional view of the causes of the financial crisis.

The conventional wisdom

Michael Greenberger, a professor at the University of Maryland, made the case that the Dodd-Frank regulation is inadequate when it comes to reducing the risk of a repeat of the great financial crisis. According to Greenberger, “most serious analyses of financial crisis point to unregulated derivatives, like credit default swaps.” The same mortgage was “bet” on multiple times, he said, sometimes as many as nine times, to fail. Swaps were unregulated and there was no transparency or collateral.

Citibank, Goldman Sachs, JP Morgan and the Bank of America control 90% of the swap market, he said. “A lot of taxpayer money was put on the table to rescue those banks,” Greenberger said.

“Dodd Frank regulation of swaps is dead in the water.” The problem, according to Greenberger, is that
banks can assign swaps to foreign subsidiaries and escape Dodd Frank and other regulation. “There is a vast lack of knowledge in the political arena,” he said, “and banks know what they are doing and will escape regulation.”

Ron Feldman, a first vice president at the Federal Reserve Bank of Minneapolis, focused on the question of too big to fail (TBTF). He argued that the most effective way to regulate large banks was to require them to hold a large amount of equity.

According to Feldman, TBTF is hard to solve because every government commits to not bailing institutions out. But when the time comes to make a bailout decision, it is not optimal to make good on that promise. Instead, regulators would make things worse by not bailing out big players. According to Feldman, regulators should strive to make bailing out not optimal and change the circumstances on the ground so that one does not need a bailout.

Feldman addressed whether Dodd Frank-type reforms end the specter of TBTF. Dodd Frank raised the equity funding needed by banks and bank holding companies so they had to be more liquid. There were also changes around holding requirements for certain instruments and there were “living will” provisions, he said. “All were in the right direction,” Feldman said, “but the essential need was to control the total loss absorbing capacity (TLAC).” TLAC determines how much resources an institution needs to absorb losses, whether those resources are held in equity or debt. “It avoids a bailout, and is the lynchpin to do that,” Feldman said.

The problem is that debt holders have an expectation to be protected and this violates that expectation. This is because the debtholders would become equity owners, and forgo the repayment of the money they had lent.

What is a credible way to address TBTF? Feldman said we need much higher equity funding. Banks should be required to hold three-times as much equity as they do now, he said. He called for banks with more than $250 billion in assets to hold 23.5% of their assets in equity. “Banks need enough to cover the cost of bailout,” he said, “but the cost is that banks would be able to make fewer loans.” Systemically important banks would have a surcharge and need more equity, according to Feldman. “That would pressure them to move from being systemic to non-systemic,” Feldman said.

Feldman acknowledged that no country has ever required banks to hold that high an amount of equity, and that the adverse consequences of reduced lending are untested and unknown. “As we ratchet up equity holdings,” he said, “we'll get a chance to see if it works. The alternative is to bet that the current system will work.”

A contrarian theory

An alternative view of financial regulation was provided by Bruce Greenwald, the Robert Heilbrunn Professor of Finance and Asset Management at Columbia University.

The first issue, he said, is whether fragility is a cause or a symptom. “The overwhelming evidence is that it is a symptom, not a cause,” said Greenwald. One of the problems with policy is too much
attention is paid to fragility.

To underscore the argument that financial fragility was not a cause of the financial crisis, Greenwald said that, in 2008, the incidence of trouble internationally was not in “finance-heavy” countries. The U.K. and U.S., financial capitals, did relatively well; but Japan, France, Italy, Spain and to some extent Germany, Ireland, Finland, Denmark and Greece had a lot of trouble – and those were countries without large financial centers. Looking outside the U.S., he said that the banking crises happened “late in the game” – in Europe in 2010 or 2011, after a period of poor economic performance.

“There is no question that financial stability has improved dramatically, and the incidence of crises has been low, but the real economy has not recovered,” Greenwald said. “If fragility were the issue, then correcting the problems would have had an impact.”

If 2008 was a finance-centered crisis, then monetary measures would have had more effect. But those measures did not, he said, and called the Fed’s economic forecasts “hopelessly optimistic.” “We are dealing with the wrong problems,” Greenwald said.

Indeed, we have seen crisis before. The poster child was Japan in 1989-1990, and it has not recovered 30 years later. The conventional wisdom around Japan was about zombie companies and bad demographics. But what Greenwald claims is not discussed is the lack of underlying productivity growth. Productivity growth, according to Greenwald, is what led to the loss of output per man hour. Productivity growth in Japan has been 0.5%, which is 1% slower than in the U.S. The problem in Japan is productivity, he said, which is not a financial problem and not related to investments.

Japan, unlike the U.S., has not transitioned from a manufacturing- to a service-based economy. Service-based economies no longer face the vagaries of traditional corporate profit cycles. As an example, Greenwald cited John Deere. It has transitioned from a tractor-manufacturing business to a company that sells software, information systems and repair and maintenance services. As a result, it is a local service company with local monopolies. In the face of demand fluctuations, it will still be profitable. This provides an extraordinary degree of stability, according to Greenwald.

When you move to services, he said, you move to compete in local and not global markets. Those are easier to dominate.

“The issues with fragility are structural, not financial,” Greenwald said.

If the focus on TBTF and Dodd Frank is misguided, what does Greenwald recommend? One measure he called for was a “massive earned income tax credit” that would correct problems with income distribution. If you work 1,000 hours at $9/hour, the government should “make up difference” and raise your income several-fold, he said.

Another policy goal should be to raise the savings rate in the U.S. Greenwald said that 20% of households have 50% of the income, and save 20%; the bottom 80% are “dissaving” 5% of their income. If you combine the 10% savings from the top 20% with the -5% savings from the bottom 80%, you get the current savings rate of 5%. But the fact that the bottom 80% are spending 110% of their
income breeds instability and is highly deflationary, he said. The instability is due to an unsustainable degree of spending, and not because of fragility.

Other problems are harder to solve. The problem in the U.S. labor market is a mismatch of skills, according to Greenwald. Service jobs require human interaction. That skill set is not the same as what is needed for infrastructure investment. According to Greenwald, “demand stimulation” won’t make a significant difference.