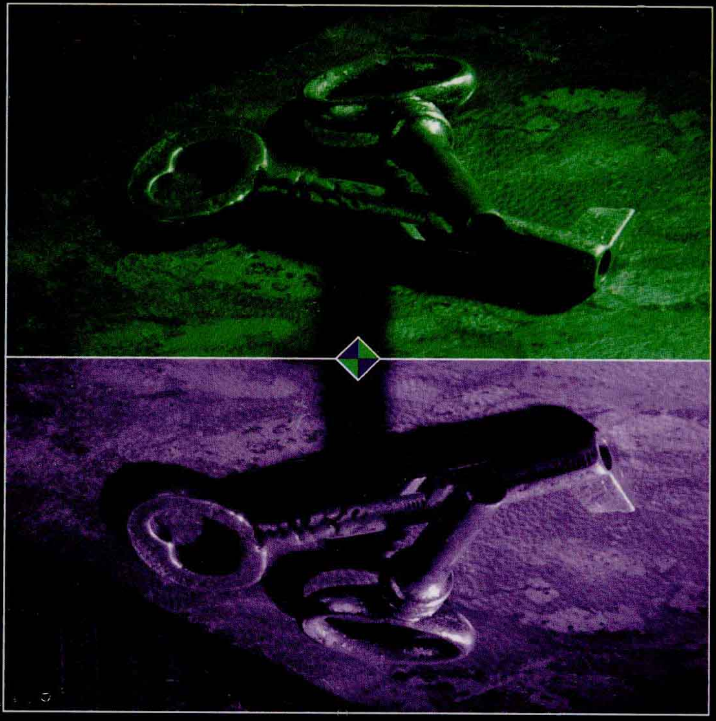
Heterodox Analysis of Financial Crisis and Reform

HISTORY, POLITICS AND ECONOMICS

EDITED BY

Joëlle J. Leclaire
Tae-Hee Jo   Jane E. Knodell



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Joëlle J. Leclaire

Buffalo State College, USA

Tae-Hee Jo

Buffalo State College, USA

and

Jane E. Knodell

University of Vermont, USA

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Contributors

Tuna Baskoy is Assistant Professor of Politics and Public Administration at Ryerson University, Toronto, Ontario, Canada.

Jörg Bibow is Associate Professor of Economics at Skidmore College, NY, and Research Associate at the Levy Economics Institute, NY, USA.

Robert W. Dimand is Professor of Economics at Brock University, Ontario, Canada.

William T. Ganley is Professor of Economics and Finance at Buffalo State College, SUNY, USA.

John F. Henry is Professor of Economics at the University of Missouri, Kansas City, USA.

Tae-Hee Jo is Assistant Professor of Economics and Finance at Buffalo State College, SUNY, USA and Co-editor of *Heterodox Economics Newsletter*.

Jane E. Knodell is Interim Provost and Senior Vice President, and Professor of Economics at the University of Vermont, USA.

Robert H. Koehn is Lecturer in Economics at Brock University, Ontario, Canada.

Jan Kregel is Senior Scholar at the Levy Economics Institute, NY, USA, and Professor at Tallinn Technical University, Estonia and University of Missouri, Kansas City, USA.

Joëlle J. Leclaire is Associate Professor of Economics and Finance at Buffalo State College, SUNY, USA.

Yan Liang is Assistant Professor at Willamette University, Oregon, USA.

Yeva Nersisyan is a fourth-year interdisciplinary PhD student in economics and math and statistics at the University of Missouri – Kansas City, USA.

Alfredo Castillo Polanco is Professor in the Division of Social Science, Economics and Business at the Universidad de Quintana Roo, Mexico.

Robert Pollin is Professor of Economics at the University of Massachusetts, Amherst and Co-director of the Political Economy Research Institute, USA.

Robert E. Prasch is Professor of Economics, Middlebury College, Vermont, USA.

Ted P. Schmidt is Associate Professor of Economics and Finance at Buffalo State College, SUNY, USA and Co-editor of *Heterodox Economics Newsletter*.

Eric Tymoigne is Assistant Professor at Lewis and Clark College, Oregon and Research Associate at the Levy Economics Institute, NY, USA.

L. Randall Wray is Senior Research Associate at the Center for Full Employment and Price Stability, Professor of Economics at the University of Missouri – Kansas City and Senior Scholar at the Levy Economics Institute, NY, USA.

Foreword

Robert Pollin

The collapse at the end of 2007 of the US housing bubble and the speculative market for subprime mortgage loans demonstrated, yet again, the simple point that financial markets should never be allowed to operate without tight regulations. Over 2008–09, the only thing that prevented the markets from experiencing a 1929-style collapse was a series of massive bailouts of the financial system by the US Treasury and Federal Reserve, along with a level of federal deficit spending at a level unseen since World War II.

American politicians, Democrats and Republicans alike, began deregulating the US financial system in the 1970s on the grounds that regulations devised during the 1930s – specifically the Glass-Steagall system which defined separate spheres for commercial and investment banks – would hinder the effective workings of contemporary financial markets. The 2001 *Economic Report of the President,* the last written under Bill Clinton, unequivocally dismissed Glass-Steagall: 'Given the massive financial instability of the 1930s, narrowing the range of banks' activities was arguably important for that day and age. But those rules are not needed today' (p. 47).

The loud chorus of politicians and economists advocating financial deregulation over the past generation has had one point on their side: that the financial system has become infinitely more complex since the 1930s. This is evident from the fact that something that had been as simple as local Savings & Loans making home mortgages in their communities – recall Jimmy Stewart in *It's a Wonderful Life* – has now been converted into a speculative global market.

But it never followed that, because the old regulations had become outmoded, financial markets should be free to operate unregulated. What we really need is a new regulatory system that, given current conditions, is capable of promoting both financial market stability and widespread access to affordable credit. However, to build an effective new regulatory system is going to be an enormous intellectual and political project. This book, along with the larger October 2009 conference where the chapters in this book along with many other stimulating papers were first presented, succeeds in capturing the range of challenges ahead.

There are several major strengths to this volume. For starters, the contributors to this book, unlike most professional economists working today, do not have to unlearn economic theory. Over the past generation, most economists have embraced variations on the core model of free-market cheerleading, as developed most prominently by the late economics Nobel Prize laureate, Professor Milton Friedman. This model purported to 'prove,' usually through elaborate mathematical models, that unregulated markets are inherently rational, and fair. For Friedmanites, the idea of comprehensive financial regulations made no sense whatsoever.

By contrast, the authors of this volume have been absorbing and developing alternative modes of thinking that build from the works of John Maynard Keynes, Hyman Minsky, Karl Marx, Thorstein Veblen and others, creating what has come to be known as the heterodox tradition. Heterodox economists have stuck to their guns over many years in building these alternative perspectives, amid a broadly hostile professional environment. They have frequently paid a significant price professionally for doing so.

There is certainly a wide range of thinking incorporated within heterodoxy itself, as the chapters in this book attest. But as regards the financial system, the heterodox tradition is unified in the conclusion – developed through generations of research, debate and rethinking – that capitalist economies operating without significant regulations will inevitably produce instability and crisis. This is why Hyman Minsky, certainly a leader in developing this perspective over the past generation, concluded his 1986 magnum opus, *Stabilizing an Unstable Economy*, by observing that 'the policy failures since the mid-1960s are related to the banality of orthodox economic analysis. . . . Only an economics that is critical of capitalism can be a guide to successful policy for capitalism.'

Centuries of historical evidence support Minsky's conclusion. In his classic book *Manias, Panics, and Crashes,* Charles Kindleberger called financial crises a 'hardy perennial,' within the context of unregulated financial systems. Kindleberger documented that, from 1725 onward until the end of World War II, financial crises occurred throughout Western capitalist economies at an average rate of about one every eight and a half years. The only historical period in which this pattern changed significantly was during the first 30 years of the post World War II era. This was when the US financial system operated under the Glass-Steagall system, and the global economy was correspondingly governed by the Bretton Woods regulatory arrangements, including fixed exchange rates.

However, the success of Glass-Steagall and Bretton Woods in delivering a much more stable economy never stopped Wall Street titans from fighting vehemently to eliminate, or at least defang, the regulatory system. Starting in the 1970s and continuing to the crash of 2008–09, they almost always got their way. As a result, the largely unregulated financial system of our contemporary era has operated according to its own self-destructive logic, with serious crises occurring at regular intervals from the mid-1970s onward. Each of these financial crises required a major government bailout operation to prevent an even more severe economic collapse – the wonders of the self-regulating free market notwithstanding.

Building a new viable financial system will require lots of people advancing lots of new ideas. But as John Henry emphasizes in the conclusion of his perceptive contribution to this volume, moving these new ideas into the political arena will also require a healthy dose of outrage. The 2008–09 financial crisis wreaked havoc with the lives of hundreds of millions of people, almost all of whom never invested a dime on Wall Street. This experience has made a mockery of the Friedmanite notion that free-market capitalism is the economic arrangement best equipped to deliver fairness and opportunity to the largest number of people.

Reading this book and absorbing its lessons should yield both analytic insights as well as fresh sources of outrage. The overarching task before us, as conveyed admirably in these pages, is straightforward: to bring together our analyses and our outrage, for the purpose of creating more stable, secure and just economic arrangements, and to succeed in this project before the next financial blow-up wreaks even greater destruction than the disaster of 2008–09.

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Introduction

Joëlle J. Leclaire, Tae-Hee Jo and Jane E. Knodell

In 2008, the American financial structure was put to the test. A financial crisis, the magnitude of which we had not seen since the Great Depression, shook the foundations of stability both financial and economic of the US and world economy. Granted, many underlying issues began to surface in 2006 and 2008, but it was in the fall of 2008 that we saw the most radical declines in financial asset values and the emergence of new tools used by the Federal Reserve to stop losses. This book combines a variety of chapters written to bring forward one fundamental and yet still for the most part, fleeting, truth: that is, that the financial system is inherently unstable. Hyman Minsky, the economist responsible for the financial instability hypothesis, emphasized the importance of basing any analysis of the financial system on the idea of inherent instability. Here we are, now facing overall levels of unemployment of 10 percent, which means they are much higher for certain demographic groups and certain regions, and the relationship between the instability of the financial market and the welfare of the economy has never been more clear. In the fall of 2009, we worked with a team of colleagues at Buffalo State College, to bring together a distinguished group of scholars who were studying the causes, consequences and solutions to the current financial and economic crisis. We took the lead in organizing and hosting the 4th bi-annual Cross-Border Post Keynesian Conference at Buffalo State College, NY. The theme was Financial Crisis and Reform and the response was excellent. We had over 50 scholars presenting their work. Of these presentations, this book contains only 12 chapters, which we feel do a good job of representing the key ideas that were presented at the conference. The book is divided into three parts: Financial Crisis and Reform, History and Political Economy of Financial Crisis, and Theoretical Analyses of Financial Crisis. Our hope is that the book will help contribute something to our knowledge of financial crises, their impact on the economy and society, and through this reading, bring to light policies that can and should be changed to better deal with what is sure to be a recurrent phenomenon.

Part I, Financial Crisis and Reform, regroups articles written by the keynote speakers from the conference. The first chapter by Jan Kregel asks the question of whether financial system regulations can indeed be reformed. Here, Kregel shows that the financial crisis cannot be alleviated by suddenly enforcing existing regulations, or by providing more short-term liquidity to markets for assets whose values have declined. He indicates that in this case, the assets themselves and the institutions that hold the latter are insolvent. An insolvency issue cannot be handled by legislation and tools meant to solve a liquidity shortfall. If Kregel is right, then recovery and effective financial reform will be a long time coming. In the second chapter, Yeva Nersisyan and L. Randall Wray explain that sound retirement income cannot be guaranteed by the market and therefore retirement savings should be invested in treasuries directly. What's interesting is that pensions and retirement plans are historically underfunded and actually need a speculative bubble to be fully funded. The idea that money managers can beat the market leads us to think that Wall Street is capable of generating greater returns for our retirement savings than simple investment in US Treasuries. Nersisyan and Wray show us that on average we would be better served by investing in US government Treasuries directly. Social Security could provide a decent standard of living through retirement for most people.

Part II, History and Political Economy of Financial Crisis, brings together four chapters that deal with the history and underpinnings of financial crises. This part reminds us that financial crises are recurrent, expected phenomena, within the framework of a capitalist market economy. In Chapter 3, Robert W. Dimand and Robert H. Koehn argue that central bankers and financial policy makers of the 1990s and 2000s ignored the lessons that were learned by eminent economists of the early twentieth century. In their chapter, they use a history of economic thought approach to show that any student of economics in the second half of the twentieth century had access to Thorstein Veblen's idea of speculation promotion of the business enterprise, John M. Keynes's insights into the dangers of price deflation for the solvency of the banking system, Irving Fisher's theory of debt deflation, and Graham and Dodd's ideas about value-based investing. Yet none of these lessons were incorporated into either the design of financial regulation or the practice of central banking.

The main reason that these important lessons were not learned is that they were taught by heterodox economists whose writings were largely ignored by the profession at large. Ironically, Ben Bernanke and Mervyn King, head of the US and British central banks at the time of the financial crisis of 2008–09, probably did read some of this literature, because they contributed to it earlier in their careers as economists. Even so, neither of them, in the judgment of the authors, learned their lessons well enough when it came time to apply what they had learned.

In Chapter 4, William T. Ganley compares three major economic crashes in the history of US capitalism. In his story, seemingly unrelated and distant historical incidents become connected to each other and, thereby, instructive to current readers. Traveling from the past (circa 1890s) to the present, Ganley makes his point very clear: 'The illusion that additional liquidity would stop a crisis proved as futile as it had in earlier panics. . . . Financial panics and depressions are a natural part of the capitalist system.' The historical account of crashes thus breaks up orthodox economics that is founded on the illusion of self-adjusting efficient markets.

Ganley's journey begins with the Panic of 1907. He argues that it was the consequence of the era of the speculation economy nourished by the merger movement between 1897 and 1903. As a result, there emerged not only big industrial corporations, but also powerful Wall Street players like J.P. Morgan who organized the Money Trust and in fact kept the US economy from falling into a severe crisis in the absence of the Federal Reserve System. Similarly, Ganley finds that there were three key causes of the 1929 Crash and 2008 Panic that led to the Great Depression and the Great Recession respectively: (1) increasing speculation on securities (in many 'new' forms), (2) deregulation (in favor of Wall Street players) and (3) policy makers' false belief in efficient markets. Due to these systematic factors, Ganley concludes that 'governmental responses to economic crises seldom are effective, or at least, tend to be insufficient,' and *ipso facto* we may add to this that at least a new mode of organizing the capitalist system is needed for the survival of the system. Or, should heterodox economists envision a different system?

As many heterodox thinkers have already noticed, making a better system hardly ever takes place in a human society. It becomes even harder if the established system is founded upon 'artificial stupidity' (Briffault, 1936, p. 50). This is precisely the case for the nearly religious belief in efficient and self-adjusting markets. In Chapter 5, Robert E. Prasch dethrones the efficient markets hypothesis by paying special attention to the assumption of smart money as well as the biased role of credit ratings agencies. Let us go directly into two salient arguments made by Prasch.

First, the efficient markets theory requires imaginary smart money traders (like the Walrasian auctioneer) whose rational behavior brings back spontaneous market equilibrium. Stable markets along with economic growth become the norm and crisis is caused by an unexplained shock in neoclassical economics. The evidence provided by business cycles and repeated crises demonstrate that such an assumption is simply flawed.

Even smart money traders, if they exist, destabilize markets due to their propensity to be contrarian investors. Second, the efficient markets theory was institutionally supported by establishing credit ratings agencies in the USA. It was assumed that by providing neutral and objective valuations of assets, investors would maximize their returns and efficient asset trades would be facilitated. However, Prasch argues, since credit ratings agencies are publicly traded profit-oriented corporations, they have every reason to serve their banker-customers' interests. The outcome is chronic market instability, leading to severe recession.

In Chapter 6, John F. Henry asks heterodox economists an important question: where *is* the outrage at the 'normal, anti-social operation of capitalism' that used to be a major concern of heterodox economists? That is to say, as Henry worries, many heterodox economists of our time are missing something important in their accounts of capitalism and its crisis.

Contemporary heterodox economists of all colors are in one way or another progeny of Keynes's ideas. Keynes, however, was on the side of saving capitalism from its structural malfunctions, whereas his precursors – Sismondi, Marx and Veblen, in Henry's view – were concerned about challenging the status quo for the same reason. Marx's and Veblen's ideas are relatively well known, but Sismondi's are not. Henry thus brings up Sismondi vis-à-vis Keynes. Sismondi and Keynes would agree with each other on particular theoretical points – especially the rejection of Say's law and the adoption of dynamic analysis. But the fundamental difference is that while Sismondi, like Marx and Veblen, called for a new social order because 'capitalism exercises a corrupting, corrosive force on the population as a whole,' Keynes offered a way out of inherent problems of capitalism by means of providing jobs and income for the general population. The reason why Keynes stopped at the existing capitalist order is open to question. Henry's historical account, however, makes one thing clear. The precursors' anger at the predatory nature of capitalism was legitimate and germane. So is Henry's conclusion: 'One should also ask to what extent the influence of Keynes has assisted in the quelling of that outrage.'

Part III, Theoretical Analyses of Financial Crisis, provides the reader with macro, micro and international perspectives on the nature of financial crises and their possible solutions. Chapter 7, by Yan Liang, shows the development of money manager capitalism, which is characterized by the majority of corporate liabilities being held by financial institutions, and a new layer of intermediation being added to the financial structure. Liang shows that the rise of pension funds and mutual funds has created incentives for financial innovation which increases the degree of financialization in the economy. The degree of financialization has now become so great that it threatens the wellbeing of the real economy. She considers that finance should be made to work in support of industrial capital and the social good. Chapter 8, by Eric Tymoigne, argues that creating regulations to stabilize the financial system depends on a strong understanding of Ponzi finance. He looks at the evolution of finance over the past 40 years, brings us to the current time, where Ponzi finance often dominates, and makes practical suggestions for new regulations that are designed to promote economic growth. He finds that Ponzi finance is difficult if not impossible to regulate and for this reason should probably be prohibited. What is most insightful here is the perspective that financial activities should support economic growth; when financial activities threaten economic growth, they should not be allowed. How ingenious to think that the financial system should be made to support the real economy! This idea comes directly from Keynes. In *The General Theory*, Keynes made this often quoted statement:

> Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. (Keynes, 1973, 159)

Tae-Hee Jo and Tuna Baskoy, in Chapters 9 and 10, explore business cycles and financial crisis from a heterodox microeconomic perspective. Such an approach is distinctive from heterodox macroeconomic analyses. Competition between business enterprises is considered to be the main cause of capitalist instability. Moreover, looking at business cycles through microscopic lenses renders what is often untold and unnoticed by heterodox economists visible and explicable.

According to Jo, the instability of capitalism is not only the outcome of economic activities under fundamental uncertainty, but also closely associated with the capitalist social order that is to be protected for the sake of the vested interests of the ruling class. In this regard, 'what is really meant by instability in the heterodox perspective is not the irregularity in quantitative variables (or empirical reality), but the uncertainty/insecurity of life and the unreliability of capitalist market principles.' The account of instability thus requires both micro and macro analysis as well as both economic and social inquiry. To expand the horizon of the heterodox theory of business cycles, Jo argues, the frictionless notion of a capitalist society and the class-neutral notion of the capitalist state received by many heterodox economists (for example, Schumpeter and Minsky) are to be questioned and reconsidered.

The micro-instability qua the vulnerability of the life of agents as well as the macro-instability qua cycles and crises along with the deregulated