
Transforming the U.S. Financial System

**Equity and Efficiency
for the 21st Century**

**Gary A. Dymski
Gerald Epstein
Robert Pollin**
Editors

Economic Policy Institute

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—The Editors

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Transforming the U.S. Financial System

CHAPTER ONE

Introduction

GARY A. DYMSKI, GERALD EPSTEIN, AND ROBERT POLLIN

The U.S. financial and monetary system is broken and needs to be fixed. The collapse and bailout of the savings and loan industry—which, as of the latest government estimate, will cost U.S. taxpayers \$300 billion and has crippled what was once the most accessible source of housing credit for nonwealthy households—is the most visible sign of failure. But problems in our financial system are far more extensive than this. The banking industry, for example, has also experienced unprecedented instability. Over the 1980s, banks failed at an average annual rate of 78 per 10,000, whereas for the period 1947–1979, the annual failure rate averaged 4 per 10,000. These weaknesses in lending institutions have been matched by rising levels of defaults and bankruptcies by nonfinancial businesses and households. Real interest rates, meanwhile, were sustained at historically high levels throughout the 1980s and early 1990s. From 1980 through 1989, long-term rates averaged 7.2 percent, whereas from 1947 through 1979, the average figure was 1.2 percent. Even between 1875 and 1941, an era prior to the development of extensive government stabilization policies, the average long-term rate of 4.4 percent was significantly lower than for the most recent period.¹

More important still, our poorly functioning financial system has had a major impact on the overall performance of the economy. It affects our job prospects and chances for starting businesses. It is a major determinant of our income level, our opportunities to obtain decent housing, and the security of our retirement. It affects the long-term growth and stability of the economy and, thereby, the prospects for our children and future generations. It also has a major influence on who gets what from the economy—whether economic well-being will be distributed widely and fairly or, as has been the recent trend, increasingly concentrated among the wealthy few.

For generations, prevailing economic theory claimed that the financial structure was irrelevant to the performance of the overall economy. We argue just the opposite. The financial structure is the economy's circulatory system: it transmits material sustenance through the economy just as our bloodstream distributes oxygen, hormones, and cell-building nutrients through our body.

This book seeks to accomplish two basic tasks: to explain the underlying

4 INTRODUCTION

problems of our financial system and to propose a new policy approach for addressing these problems in ways that will promote fairness, efficiency, and a more productive economy. The book ranges widely in pursuing these ends. The first section examines monetary policy. It considers how monetary policy has contributed to the high interest rates and instability of recent years. It also explores the prospects for pursuing a monetary policy focused on restoring a low-interest-rate environment rather than concentrating almost exclusively, as it has in recent years, on controlling inflation.

The second section examines banks and other intermediaries as well as the government programs that regulate these institutions. In the 1930s, the U.S. developed an ambitious and largely successful regulatory system. But this regulatory structure is now in shambles. We explain how this breakdown has occurred and propose new approaches to regulation.

The final section focuses on the relationship between the financial structure and nonfinancial productive investment. It considers the mergers, buyout, and takeover movements of the 1980s as an important experience for understanding how an unregulated financial structure is capable of dramatically misallocating investment funds and thus inhibiting the growth of productive activity. It also considers the role of pension funds in fostering long-term investment and discusses the role the Federal Reserve can play in promoting financial stability, long-term investment, and increasing accountability within the financial system.

The volume offers a broad approach to policy, though not a uniform set of proposals. The chapters focus on various questions, and the proposals that flow from each therefore vary in emphasis and sometimes in substance. Nevertheless, seen from a wider angle, the essays do offer a consistent set of proposals. In the rest of this introduction, we summarize the main analytic points and policy approaches that form the core ideas of this book.

What Are the Problems?

The fundamental economic problem in the United States is that living standards for the majority have stagnated or declined for the past two decades. As a first approximation, we can cite five basic reasons for this decline in living standards:

- Low productivity growth and declining ability of the economy to generate good jobs;
- Decaying living conditions in our major cities;
- Worsening inequality of income, wealth, and opportunity;
- Increased debt dependency by corporations, households, and the federal government and;
- The declining ability of the government to control the destructive cycles of boom and bust.

All of these problems, in turn, are closely associated with weaknesses in our financial system. Consider the following connections: First, the private financial

structure is biased against financing productive investment in favor of unproductive expenditures, such as corporate mergers and buyouts and real estate speculation. This leads to inadequate and inappropriate public and private investment, which contributes to low productivity growth. Moreover, by contributing to excessive debt dependence and speculation, this bias in the financial system also leads to more severe cyclical fluctuations of recession and unsustainable expansion.

Second, the financial structure reflects the highly inequitable distribution of wealth and power in our society and itself contributes to wealth inequality. Through redlining and other forms of discrimination and neglect, the financial system biases credit flows against communities that have relatively few resources but can use funds productively. At the same time, the system showers credit on the well-off, who already have more than enough, even when they have no productive use for the funds. This contributes to worsening living conditions in cities and worsening inequality.

Third, the Federal Reserve's monetary policy adds to these problems by helping to keep real interest rates inefficiently high. These high interest rates contribute to low rates of productive investment, high budget deficits, continuing dependence on debt, and worsening inequality by redistributing income to those who already have the most wealth.

Fourth, the financial regulatory system has at best failed to help solve these problems and increasingly has contributed to them. For example, the system of pension fund regulation has inhibited the channeling of pension money toward projects that would yield higher-paid and more productive jobs within the U.S. economy. And as is by now well known, bank regulators stood by while real estate speculation swept the country in the 1980s. Taxpayers are now paying the price of this neglect through the savings and loan fiasco, with the prospect of a similar bailout of the banking system threatening on the horizon. Such bailouts in turn contribute to the federal budget deficit, diverting scarce public funds away from education, health, and the public infrastructure.

Not all economists will agree that private financial institutions are responsible for these difficulties. Indeed, many regard the government's involvement in the financial sector as the problem and financial deregulation as the solution. But we know that government regulators did not force U.S. institutions into a reckless lending boom to Latin America in the 1970s; or into throwing egregious sums of money at real estate speculators, who overbuilt office towers and luxury condominiums; or into paying Drexel, Burnham, Lambert's "junk bond" king Michael Milken \$500 million in one year (1987) to engineer mergers and leveraged buyouts that left nonfinancial corporations overburdened with debt. Private institutions accomplished these ends on their own.

Free market purists acknowledge that private institutions make mistakes. A free market system, in the purists' view, simply requires that those who err be punished: market participants must be forced to sink or swim. The problem with this argument is that if too many financial institutions sink, then we all drown

with them. The reason is that the activities of banks and other financial institutions almost always have a far wider impact than the activities of firms in nonfinancial industries: they both hold our life's savings and lend these savings to others, whose investments will construct our economic future. The bank runs that helped to produce the 1930s Depression and the bank-financed real estate boom and bust of the 1980s, leading to the long recession of the 1990s, both demonstrate the capacity of destabilizing private financial activity to reverberate powerfully throughout the economy. This is why the financial system must be regulated and the public must have some protection from the private market's mistakes.

The problem we face, however, is that the financial regulatory system we now have—created in the Depression, beginning with the passage of the Glass-Steagall act in 1932—no longer works. Conditions have changed dramatically in the past 60 years, but the regulatory environment has never been renovated properly to keep up with those changes. The Glass-Steagall system was designed to promote financial stability and efficiency by limiting competition and by offering public protection. But this approach was based on a set of conditions—including low interest rates, low inflation, low global integration, and relative lack of financial innovation—that prevailed in the 1930s but that no longer exists today. What is needed now is neither deregulation nor a mere defense of the old regulatory approach. Nor do we simply need more regulations. We rather need *better* regulations and, more broadly, a new approach to financial restructuring. The aim of the new approach should be not simply more credit for more people, but a more equitable and efficient allocation of credit—an allocation that promotes socially productive rather than wasteful and destructive ends.

The individual chapters in this volume present critiques of a variety of restructuring proposals that are bound to fail, either because they overestimate the efficiency of private markets or because they rely excessively on the existing regulatory framework. Most important, we also advance our alternative policy agenda. In many ways, our proposals break decisively with conventional approaches to reform. At the same time, we have taken care to offer ideas that are feasible and workable within the existing set of political and regulatory institutions.

Our agenda is built on the following four principles:

- *Rig markets but do not smother them.* We support vigorous private activity in financial markets and also recognize that there are limits to what governments can administer competently. We therefore favor proposals that would, at most, require insignificant increases in administration as well as low levels of public outlay. Our purpose is to reorient the main currents, but not every eddy, of existing market practices.

- *Accountability from below.* We recognize that government agencies can be readily captured by the institutions they are supposed to regulate and that the more there is at stake, the greater will be the efforts of the regulated to control the regulators. The only mechanism to control for this is to establish broad and ongoing institutions of democratic accountability.

• *Level the playing field upward.* One of the primary problems of the Glass-Steagall system was that unequal regulatory demands were placed on different types of institutions. The result was that business flowed from highly regulated intermediaries to less regulated ones. One obvious approach to resolving this problem is deregulation, that is, leveling the playing field downward. This approach has been tried since 1980; the dismal results are before us. The logical alternative is to create consistent regulations for all institutions.

• *Renew the social contract.* The activities of financial institutions have a large impact not only on their depositors and shareholders but also on the communities in which they operate and on the overall economic environment. In exchange for receiving public protection such as publicly insured deposits, financial institutions must take more responsibility for the effects they have on communities. In particular, when public funds are used to support or stabilize private financial institutions, the public must receive clear and direct benefits from its investment.

Let us now sketch out the way we apply these principles in the three areas of monetary policy, banking and regulatory policy, and the financing of investment.

Monetary Policy

The operations of the U.S. financial system are intimately bound up with the Federal Reserve's monetary policy. Most simply put, a healthy financial system is unattainable without an effective monetary policy, but achieving an effective monetary policy is more difficult when the financial structure is unstable. With the federal deficit having immobilized fiscal policy as a macroeconomic policy instrument, monetary policy has become the federal government's primary policy weapon. Monetary policy errors have thus become very costly. In the late 1980s, for example, an excessively tight monetary policy instigated the long recession of the early 1990s.

The experience of the 1980s also showed how an unhealthy financial system undermined the Federal Reserve's ability to conduct monetary policy. In the mid-1980s, when monetary policy was loosened somewhat to encourage an economic expansion, much of the credit created failed to support productive investments. Instead, a substantial share of new funds flowed to hostile takeovers and real estate speculation. This weakened the link between expansionary monetary policy and economic growth.

Then, in the early 1990s, when monetary policy was loosened to fight the recession, the excessive debts that nonfinancial firms and banks accumulated in the 1980s became an obstacle to expansionary policy. Rather than lend to firms, banks tried to rebuild their capital, and, rather than borrow to invest in new plant and equipment, nonfinancial firms used the low interest rates to work the debts off their balance sheets.

Given the structural imbalances in the financial system in the 1980s and early 1990s, including of course the burgeoning federal deficit, even the best monetary