

# Arenas ekonomiska råd

Rapport 3

Axel Leijonhufvud

## Crisis Policies and Crisis Politics

**arena**idé

**Axel Leijonhufvud, professor emeritus UCLA and University of Trento**

# **Crisis Policies and Crisis Politics**

Publicerat i oktober 2011

©Författaren och Arena Idé

Arena Idé är en del av Arenagruppen  
[www.arenagruppen.se](http://www.arenagruppen.se)

Arenagruppen  
Drottninggatan 83  
111 60 Stockholm  
Tel (vx) 08-789 11 60  
Fax: 08-411 42 42

*Arenas ekonomiska råd är en verksamhet inom tankesmedjan Arena Idé. Syftet är att utifrån en radikal och progressiv utgångspunkt bredda den ekonomiska och politiska diskussionen i Sverige. Vi vill skapa en oberoende arena för kunskapsutveckling och förnyelse av den ekonomiska debatten.*

*Arenas ekonomiska råd är ett samarbete mellan Arena Idé och Friedrich Ebert Stiftungs kontor i Stockholm.*

Axel Leijonhufvud

# Crisis Policies and Crisis Politics<sup>1</sup>

**Introduction 5**

**Fiscal policy 6**

**Broken promises 9**

**Balanced budgets 10**

**Monetary policy: 11**

*Last resort lending 11*

*Interest rate policy 12*

**Money and Distribution 15**

**Monetary stimulus forever? 17**

**The Shell Game and Central Bank Independence 18**

**Regulation 19**

*Regulating structure 20*

*Regulating behavior 21*

**Escaping ideological simplicities 23**

**Social and Political Consequences of Economic Instability 24**

---

<sup>1</sup> Lecture given at Arena Idé, Stockholm, September 21, 2011.

## Introduction

In yesterday's lecture, I contrasted two ways of understanding present economic difficulties. One "vision" (to use Schumpeter's term) sees the economy as a globally *stable* system in which demands and supplies in all its markets are always working towards bringing the system into the state of perfectly coordinated activities that economists call a "general equilibrium." When macroeconomic problems become evident, this vision of reality tells you that they must be due to "frictions" or "imperfections" that put a brake on the always beneficent working of market forces.

The other vision sees the self-regulating, "equilibrating" capabilities of market economies as beneficent all right – but not without bounds. The economy is a complex dynamical system like, for example, the human body. Your body has periods when it keeps you in perfect health. At other times, it may suffer infections or injuries from which it will recover. But it takes time and it is not pleasant – one is grateful to a doctor whose prescription relieves the symptoms and speeds the recovery. Finally, we are all conscious of the possibility of more serious illness from which there may be no real recovery even with the help of modern medicine.

In the previous lecture, I sketched a similar picture of the economy. In one region of its state space, which I call "the Corridor", markets work well and the "automatic" tendencies towards equilibrium are strong. In a second region, equilibrating tendencies are weaker and stabilization policies may reduce the depth and length of recessions. In the third region, the endogenous tendencies for the market economy to recover are exceedingly weak *and* conventional macropolicies are not very effective. The patient is very sick and the doctor's usual medicines don't help much.

In this vision of the economy, we have to worry about unstable as well as stabilizing processes or, in a different terminology, about positive as well as negative feedback loops. The instabilities of concern in economics are *bounded*. The economy neither

blows sky-high, nor does it implode into nothingness. But the bounds can be rather narrow or very wide. In the narrow category, we would have the multiplier and accelerator feedbacks of standard business cycle theory. In the wide category, the great financial crashes and high or hyperinflations.

In this lecture, I want to discuss three problem areas. You will soon realize that I cannot cover any of them comprehensively. The first two deal with policies and the third with politics.

First: what policies can get us out of Region 3? Which policies do not promise much help?

Second: What kinds of regulations offer the best prospect of preventing a recurrence of financial crisis and deep recession?

Third: What are the social and political repercussions of serious economic instability? What dangers do they pose?

### **Fiscal policy**

An economy in recession has the same real resources, the same production possibilities, as it had just before the downturn. In an ordinary recession, what is needed is to restore the flow of aggregate demand and, in all probability, to move some resources that were misallocated in the boom into different employments. Recessions that result from a great financial collapse are not ordinary, however. What makes them different is the widespread damage to balance sheets in all sectors of the economy. It is still true, of course, that the economy's production potential is basically unchanged – but the problem of how to get it back to full resource utilization is very different and much more difficult.

Arithmetic should not be a matter of political contention – or so one hopes at any rate. A discussion of stabilization policies may usefully start by acknowledging two arithmetical propositions. One refers to *stocks*, which is to say, to balance sheet variables. The other one refers to *flow-magnitudes*, which is to say, to variables in an income and expenditure statement.

The first statement is this: *When the private sector as a whole is bent on shortening its balance sheet by paying down debt, the public sector balance sheet must move in the opposite, offsetting direction.* Otherwise, aggregate income will decline and falling incomes (and falling tax receipts) are likely to cause deterioration of balance sheets in both the private and the public sectors.

The second, flow proposition is familiar: *When the entire private sector is striving to save, the government must dis-save* or income and employment will fall.

Ordinary recessions can be combated with *flow-policies*, that is, with temporary increases in government spending and (less effectively) cuts in current taxes. Balance sheet recessions are more difficult to deal with. Some historical cases are instructive:

Japan saw two gigantic bubbles, one in real estate and one in the stock market, collapse in 1990. For twenty years, Japan has attempted by deficit spending and by a (basically) zero interest monetary policy, to resume vigorous growth. Its public debt now exceeds 200% of GDP as a consequence. While the economy is now in reasonable shape, the general judgment is that these policies have been quite unsuccessful.

The lesson to draw from the Japanese experience, I believe, is that tackling balance sheet problems with deficit spending is not likely to work. Rather than producing a sustained rise in GDP, the deficit disappears into the *sinkholes* in private sector balance sheets. It has no pump-priming effects. It can take a long time before the time-integral

of the flow of public deficits restores the private sector balance sheets to something resembling equilibria. The failure of a genuine recovery to take hold during this period may then undermine investment expectations in the private sector and make the situation increasingly difficult.

The United States did not attempt deficit spending on a scale sufficient to combat the Great Depression – until after Pearl Harbor. War spending did, of course, bring the economy back to full (or over-full) resource utilization. But it also changed the balance sheets both of the federal government and of the private sector. US public debt reached a level relative to GDP never before seen – *but* the balance sheets of the private sector were back in good health at war’s end as a consequence. Simple “Keynesian cross” income-expenditure analysis made economists predict that the economy would slip right back into recession when millions of demobilized soldiers returned and war spending ceased. They were wrong. Ignoring the state of balance sheets caused the infamous postwar “forecasting debacle.”<sup>2</sup>

The lesson to draw from this story, however, is not that deficit spending can cure a balance sheet recession but that it takes a great war to make it do so. One should also recall that the public debt of the United States before it entered the war was relatively modest. That is not true today and, even if it were, it would be difficult to come up with the requisite patriotic reasons to spend on a WWII scale.

The third lesson is the Swedish one which this audience knows more about than I do. Nordbanken and Götabanken were put into receivership and their assets transferred

---

<sup>2</sup> That is not the conclusion that economists drew at the time however. Instead, the debacle focused attention on the simple consumption-income relation as the source of the trouble. This diagnosis led to the development of the “modern theories of the consumption function” of Modigliani-Brumberg, Friedman and Duesenberry. These were important developments – but the real source of the problem was not identified.



into a special fund, later to be sold off to the private sector at almost no loss to the taxpayers. The losses fell on the shareholders of the two banks.<sup>3</sup>

The government had also resisted devaluation with all the means at its disposal including, you may recall, very briefly putting up the interest rate to 500%. But the markets forced a 30% devaluation which has benefitted Swedish exports ever since. Firms or individuals with debts denominated in foreign currencies lost heavily. But also all Swedes without such contractual obligations were made poorer in terms of their command over foreign goods.

### **Broken promises**

The way to understand a balance sheet recession is as follows: At any moment in time activities in a modern economy are determined by an immensely complex web of interlocking contracts. A financial crisis is precipitated by the spreading realization that a great many of the promises embodied in these contracts cannot and will not be fulfilled. This means that a great many agents will find themselves poorer than they had anticipated. The economy as a whole is less wealthy than had been previously realized.

If the incidence of the losses – who will lose how much – can be quickly determined, the economy can get back to full employment of its productive resources relatively soon. In the Swedish case the incidence was determined quickly, partly by government action, partly by the foreign exchange market. Even so, the recovery took about three years.

It is far more common that the incidence of losses cannot be determined quickly but that pervasive uncertainty about it persists for a long time. Firms and households in risk of insolvency will normally have assets that are far more valuable to them than what they would fetch if they had to be sold off. All agents in this position will try very hard

---

<sup>3</sup> Leif Pagrotsky, in commenting on this lecture, made clear that government policy was less clear-cut and consistent than had been my impression.

to spend less than they earn – and this will keep the economy under deflationary pressure and with underemployed resources for the duration.

### **Balanced budgets**

Questions about how to regulate the financial sector so as to prevent a recurrence of crisis I will postpone until a bit later. But one issue fits better in the present context of fiscal policy, namely, proposals to “regulate governments” by imposing constitutional balanced budget provisions.

The great majority of American states already have balanced budget amendments in their constitutions. Adding such an amendment to the federal constitution is now a hot issue, propounded not only by Tea Party legislators but also by other republicans who do not want to offend Tea Party constituents.

I have not read any comprehensive survey of the experiences with balanced state budgets so am not all that well informed, but I believe it safe to say that the experience is anything but encouraging. In California, at least, the state government spends all its revenues in years of economic growth and is then forced to cut essential services in the downturn. In many cases, it has to spend more to restore particular activities than it saved in cutting them back.

So, balanced budget provisions have *not succeeded* in making democratically determined fiscal policies more conservative. The problem of democratic governance is a genuine one. You see the sorry spectacle repeated over and over again where ( 1) a legislature votes a number of programs which combine to a total total expenditure X dollars; (2) the same legislature votes taxes amounting to Y; (3)  $X > Y$ ; (4) legislature then proposes a balanced budget amendment or a debt ceiling! Making the Arrow Impossibility theorem visible for all to see solves nothing!

The resort to balanced budget provisions by the states is now costing us dearly. They have become powerful cyclical amplifiers that increase the social costs of the recession and make it more difficult to deal with. Some candidates for the Republican presidential nomination are now advocating a federal balanced budget amendment. It would be a true self-inflicted disaster!

**Monetary policy:**

Four or five years ago -- not very long ago! – the operating doctrine of leading central banks was interest targeting. Control of some monetary aggregate was considered an abandoned relic of long gone Monetarist days. The lender of last resort function was remembered, if at all, only by people with an antiquarian interest in monetary history.

*Last resort lending*

Things have changed. Central banks have done a lot of last resort lending since 2007 and, in addition, have found themselves in the entirely novel role of market makers of last resort.

At one time, we had a well-established doctrine for how the lender of last resort role should be played. Central banks should only lend against good collateral and should do so at a penalty rate so as to discourage banks from relying on the last resort lender. This old doctrine has been thrown out the window. Central banks have been lending at rates so close to zero as makes no difference and have done so against collateral often of the worst sort.

The extent of these operations would have astounded and frightened earlier generations of central bankers. The balance sheets of major central banks have doubled and tripled in length. The Federal Reserve System insists that it will be able to liquidate these positions without problems if the economy recovers and inflation threatens.

We are used to thinking of price level equilibrium as a “state of rest” in which essentially no tendencies are present that would make it move. The present situation in the United States, for example, has strong deflationary pressures emanating from the private sector (and from state governments) offset by almost equally strong inflationary monetary policy. That is an equilibrium of a far more uncomfortable sort.

### *Interest rate policy*

It is instructive also to consider central bank interest rate policy (including interest targeting) from a historical perspective.

In the era of metallic monetary standards, maintenance of the gold or silver parity served to control the price level. Bank rate was used to regulate domestic credit so as not to endanger convertibility into the standard commodity.

In the era of “inconvertible paper”, as it used to be called, we had first a period of monetarist theoretical dominance. The doctrine then was that control of the stock of money (variously defined) would regulate the price level and – more or less implicitly – that “free markets” would take care of the price and volume of credit.

Monetarist policy doctrine was then superseded by interest targeting. In the key currency country, the quantity of money was now left to be endogenously determined by demand, while the price level was to be controlled by interest policy. The price and volume of credit was left to market forces as before.

Recent events should have caused some consternation among monetary economists of various persuasions. Consider the theories of Friedrich Hayek and Milton Friedman. Everyone remembers them as powerful advocates for economic and social policies

relying as far as possible on “free markets.” It is also worth remembering that on matters of money they could agree *on nothing at all*.

Hayek thought that too low an interest rate would misallocate resources through overproduction of durable real capital *and* cause inflation. Friedman thought too low a nominal rate would cause inflation but have basically no effect on the real interest rate and resource allocation. With regard to the events of the last ten years or so, Hayek’s theory is only half right while Friedman’s seems completely wrong.

Hayek’s theory was right in that the maintenance of very low interest rates did create an “Austrian” boom in housing which eventually proved unsustainable. But it was not associated with significant inflation of consumer prices – or an inflation targeting central bank would have raised interest rates and put a brake on the boom. (Let me postpone the question of why Hayek was only half right?)

Here is an exam question for central bankers: *Does Bank rate control the price level or the real “price” of credit?* The correct answer, of course, is that under present arrangements, *we don’t know* – or, rather, we don’t know how much of each. In the run-up to the recent crisis, central banks thought they were controlling the price level but they were also keeping the real interest rate too low and ended up funding a huge credit boom. The problem is obvious: *1 instrument for 2 goal variables*.

What do we do about it? The DSGE models, that had become increasingly influential in central banks over the ten or fifteen years leading up to the crisis, did not alert policy makers to the problem. In intertemporal GE models markets will establish the right price and volume of credit. But, that solution hinges on the transversality condition which, as I argued yesterday, is a piece of mathematics with no empirical counterpart whatsoever.

Alan Greenspan belatedly recognized the problem. His recommendation was to reserve Bank rate (the repo rate) for interest targeting to stabilize the price level. To prevent bubbles from developing he would use regulation. It is not clear what he would have the central bank do in the case of a collapse of credit. Deregulate perhaps?

Milton Friedman would never have put faith in transversality, I am sure. He would have insisted on holding the growth rate of M2 constant. An incipient credit bubble would come to strain against this nominal anchor and this would cause *real* rates of interest to rise. This might not take all the air out of a bubble but it would surely prevent it from getting very big.

In my view, the complete endogeneity of the monetary base associated with inflation targeting has failed us. Probably the best way to handle the two goals/one instrument problem is to move back towards control of a nominal quantity.<sup>4</sup> We no longer have the trust in the stability of money demand functions that the monetarists once had. Nonetheless, the feedback effect on the real interest rate that I just described would help curbing bubbles.

In the United States, I would have the Fed retake control of the monetary base. I would tie demand liabilities of all sorts – that is, not just bank deposits but also deposits with money market funds – to the monetary base by reserve requirements. To implement this recommendation, starting from the situation as it is today, would not be a trivial task. The tripling of the Fed's balance sheet has left us with an enormously inflated monetary base – which is not a magnitude that we would want to stabilize. Moving back towards quantity control would moreover dictate a complete change in the way that the repo market for federal funds has operated in recent years. So we must first find a way out of our present troubles before these suggestions can be seriously considered.

---

<sup>4</sup> 50+ years ago, Patinkin in his review of Gurley and Shaw argued that controlling the nominal scale of an economy required control of *one nominal quantity and one interest rate*.

## Money and Distribution

The economics of income distribution is a field in which I am rather ignorant. Ignorance should make one cautious in one's pronouncements but I will confess that I think the field is a bit of a mess at least as it relates to macroeconomics.

Macroeconomists who include a neoclassical production function in their models tend to accept the marginal productivity theory of distribution that comes with it. That theory is inconsistent with Adam Smith's division of labor which implies economies of scale. For such a system the marginal productivity distribution theory cannot be true. The distribution of income between Robinson Crusoe and Friday cannot be decided on marginal productivity grounds. It is more likely to be distributed on the basis that Robinson has the gun and knows how to use it.<sup>5</sup> Under more modern arrangements, as I will explain, Robinson might willingly forego resort to arms in exchange for privileged access to a central bank.

If macroeconomists give little thought to distribution, monetary economists tend to believe that since "*money is neutral*" they have absolutely no reason to think about it. But under our present monetary arrangements there are strong reasons why we should pay more attention to it.

A little while ago, I suggested that (with regard to recent events) Hayek's theory was only half right in predicting that below equilibrium interest rates would produce *both* an Austrian overinvestment boom *and* inflation. So why was Hayek half wrong?

In the spring of 2007, I wrote a short piece ("The Perils of Inflation Targeting", VoxEU) which argued that the Federal Reserve had been misled by the stability of consumer prices into creating a great overexpansion of credit and inflation of asset prices. I

---

<sup>5</sup> In recent years, much work has gone into supplementing marginal productivity theory with a theory of "tournaments" as an explanation of the upper tail of the income distribution. This theory has only a very tenuous relation to production theory whether classical or neoclassical.

attributed the absence of CPI inflation to the very elastic supply of consumer goods from China and some other countries and to the refusal of these countries to let their currencies appreciate. I now think that while this may be part of the story, it is not the whole story.

There was also a great change in the American distribution of income underway in this period. A greater and greater share of national income was piling up at the very top of the distribution. To the extent that the people gaining from this shift spent their gains, they did not spend them on the CPI basket. The CPI basket was demanded mainly by middle and lower segments of the distribution and those people had stagnant incomes. So there was not much excess demand pressure on CPI goods.

In Hayek's or Mises' theory, as in Wicksell's, commercial banks "created money" through lending on "real bills". Firms would use the proceeds to finance production. Basically, the money would end up paid out in wages and the wages would be spent on the CPI basket. In today's version, investment banks face an infinitely elastic supply of reserves at the repo rate set by the central bank. That is *not quite the same thing as a license to "print money"* but -- when the repo rate is significantly below the rate on assets that the banks can acquire -- it is the *next best thing*. With a central bank that is practically committed to not allowing the yield curve to go downward-sloping, the banks feel safe operating at high leverage, making lots of money and letting their managers take home big slices of the proceeds.

### **Another modest proposal**

Let me take this argument two steps further. First, suppose we do give the banks the privilege to "print" legal tender! Assume the government charges a fee for the exercise of the privilege -- let's say 0.2%/year or whatever the repo rate is today. Would that make a significant difference vis-à-vis present arrangements? I don't think so. Secondly, then, why reserve the privilege for the banks? Why don't we let ordinary



citizens borrow in the repo market at the same rate as the banks (against good collateral, of course)? The transactions cost of having the central bank engage in this kind of retail lending would be considerable, of course. But they might not be higher than some other government programs, such as agricultural subsidies or oil depletion allowances or a few days worth of war on foreign soil. If subsidizing access to the repo window is found objectionable, the citizen-borrower in the repo market might be charged the transaction cost. He might still consider it profitable to refinance his mortgage in this manner! Admittedly, the operation would not be without risk since the maturity mismatch is rather extreme and the ordinary citizen would know himself to be “too small to save”. But for the time being, housing costs would be very low indeed.<sup>6</sup>

I would not have you take my proposal altogether seriously. But the analytical exercise does, I submit, throw light on our present arrangements. The consequences of the proposal for the banking industry and for the remuneration of bankers are fairly obvious and need not be spelled out here. I will just add the observation that the problem of *reflating* the economy, which Japan never solved, could surely be solved this way. The problem, instead, would be to get control of the inflation once it gets under way....

### **Monetary stimulus forever?**

The Fed has now promised the markets that it will maintain the repo rate where it is, close to zero, for *the next two years*. The idea behind this unconventional measure presumably is that decreasing uncertainty about future monetary policy should stimulate investment – and even if it does not, it cannot hurt. Or could it? Well, it might.

If the Fed promise is believed by the markets, the term structure of interest for instruments with maturities from overnight up to two years will go completely flat at a near zero interest rate. There will then be zero profit to be gained by borrowing short and lending long within this two-year maturity interval. So a lot of large positions in this

---

<sup>6</sup> And American law allows the homeowner to walk away from a mortgage debt scotfree.

part of the market will be liquidated.<sup>7</sup> The earnings that up 'til now accrued to the institutions holding these positions will disappear.<sup>8</sup>

Until this recent Fed announcement, its policy was largely aimed at creating enough bank profits to allow the banks to recapitalize at a merry clip. We will have to see whether the disappearance of this income will cause financial institutions to resume deleveraging. If they do, the much discussed “double dip” may prove hard to avoid.

### **The Shell Game<sup>9</sup> and Central Bank Independence**

Consider the distributive effects of present monetary policy. Banks can acquire funds from the Fed at close to zero percent interest. Not much bank lending to business has resulted from this. Instead, the banks buy U.S. Treasuries. Until quite recently, these yielded close to 4%. Eurozone troubles have now caused enough of a flight into dollar assets to reduce the 10-year bond yield to below 2%. Two percent is still not a bad deal if you can lever it up sufficiently.

In this operation, the central bank is handing the banks “free” money with which to buy bonds which are liabilities of the tax payer. Part of the profit from this deal the banks use to repay the bailout support they received from the government during the crisis. This enables the government to claim that the bailouts have been fully “repaid.” Actually, they have been transformed into liabilities of taxpayers.

The profits from buying Treasuries with money borrowed at a zero interest rate are of course very substantial. So Wall Street executives are once again able to claim large

---

<sup>7</sup> See column by Ben Gross. “Helicopter Ben’ Risks Destroying Credit Creation,” **Financial Times**, September 7, 2011.

<sup>8</sup> Note that “the rot” may not stop in the maturities below two years. Institutions who have issued liabilities shorter than two years previously may find it impossible to finance their holdings of longer maturities. Etc.

<sup>9</sup> Cf. my “Shell Game,” VoxEU January 2011.

bonuses. Meanwhile, millions of retired Americans (for example) have lost a substantial part of the interest earnings on their savings that they had counted on.

This “shell game” of reshuffling incomes and liabilities is not all that complicated. It ought to be a scandal, I think. But it is on the whole going on “under the radar” of public opinion.

The point I want to make here, however, is different. If monetary policy has large and complex distributive effects – as I believe, I have shown – it ought not to be conducted by central banks that enjoy “political independence.” *In a democratic country, the central bank should be responsible to the elected legislature.*

### **Regulation**

To stop the threatening collapse into another Great Depression, the United States and a number of other countries went into deficits large enough to create doubts about their future solvency. At the same time, the Federal Reserve System, the ECB, and the Bank of England engaged in what is charitably characterized as “unconventional” operations that greatly lengthened their balance sheets.

Two obvious conclusions follow: First, *we cannot afford to risk another financial crisis because we do not have the resources to stop it.* Secondly, therefore, the regulatory system needs to be reconstructed and made “fail-safe”. While it may be important to have a financial system that is efficient in various respects, it is now *absolutely vital* that it be made as safe as humanly possible – even at the cost of some efficiency losses.

There are broadly speaking three approaches to financial regulation. The first seeks to determine the structure of the financial sector. The second regulates what financial institutions are required to do, allowed to do and not allowed to do. These two approaches will overlap to some extent. The third approach works on the incentives of

decision-makers in the financial sector so as to change what they want to do and not want to do. Let me take these three in turn.

### *Regulating structure*

In yesterday's lecture, I explained how the Glass-Steagall Act divided the U.S. financial system into a number of "watertight compartments". It regulated *the structure* of the financial system. Each financial industry was defined by the assets firms were allowed to acquire and the liabilities they were allowed to issue. Institutions in one compartment could not branch into another. The point of the story was that it pretty much made the system as a whole into an "unsinkable ship."

Some thirty years ago, the United States went through the crisis of its savings and loan industry. Like the present crisis, it began as a crisis in home financing. But it also *ended* where it had begun. The losses incurred in the liquidation of the S&L industry were of roughly the same magnitude as the ones stemming from mortgages in the present crisis. But they did not propel the entire American financial sector into crisis and caused no problems beyond the borders of the United States. One watertight compartment flooded, but the ship did not sink.

The financial system which we have allowed to evolve in recent years is not compartmentalized in any significant way. When a small offshore (London) office of a giant insurance company (AIG) can threaten the survival of the entire banking system, we must realize that we are in a different world – a world of "conglomerate finance."

The *Volcker Rule* is an attempt to draw a line between depository commercial banking and investment banking. The "ringfencing" recommended by the just released Vickers Report in the U.K. has the same objective. Both are rather modest moves towards reintroducing some compartmentalization of financial activities so as to protect

traditional depository banking from the riskier activities of investment banks. Banks in both countries immediately began lobbying to water these proposals down.

### *Regulating behavior*

This is not an easy matter. There are a fair number of behaviors to consider. So the Dodd-Frank bill runs to over 2600 pages! Providing a comprehensive system of oversight of 2600 pages of rules and regulations does not seem a trivial task.

But what is far more difficult *under the conditions we have now allowed to develop* is to provide a system that could *keep one step ahead* of proliferating financial innovations aimed to circumvent existing regulations. This second requirement is well nigh impossible to meet when the private sector pays the innovators large multiples of what the government pays the regulators. Only societies with exceedingly strong traditions of public service would have a chance of preventing all the clever talent from flowing into the private financial sector.

International negotiations on bank regulation have focused on finding an improved version of the Basel capital requirements. The banks found ways around the old Basel requirements, for example, by creating 'special investment vehicles' or 'conduits' offshore. Citycorp had a half a dozen of these vehicles in the Cayman Islands that eventually came close to bankrupting the bank. It remains to be seen whether capital requirements can be written, that the banks will not find a way to evade.

The general problem with capital requirements is that they are inherently pro-cyclical. They automatically loosen in the upswing and tighten in the downturn. This is one reason to prefer reserve requirements on the short liabilities of financial institutions.

### *Incentives of Bankers*

The alternative to constraining bankers with thousands of pages of regulations that prohibit them from doing various things is to change the incentives that make them do those things. Bankers used to have the reputation of being stolid, cautious, conservative, dull people. Today's bankers are jet-setting high rollers. This is not an instance of spontaneous, inexplicable social change. The system of incentives within which bankers operate has changed.

Back in the beginnings of fractional reserve banking, bank owners were subject to unlimited liability<sup>10</sup>. Later, American bankers were subject to double liability. California at one time had triple liability. Investment banks had full liability as long as they remained partnerships.<sup>11</sup> And investment bankers back then were on the whole conservative. The transformation of the investment banks into limited liability corporations – which is really quite recent – turned them into perils to society.

So my suggestion is to require bank executives to be remunerated largely with shares that carry double liability.<sup>12</sup> If the bank fails, the executives would not only lose their equity in the firm; they would have to ante up an equal amount of their own money. I will not get into the details of how to make this work. Obviously, there would have to be rules about the length of time for which a bank executive would have to retain these shares and he or she would have to be bonded for the liability, etc. The point is, of course, that double liability should make decision-makers less willing to take large risks. In addition, these liabilities of executives would be added to the required reserves of a bank to provide a buffer-stock giving a measure of protection to the taxpayer before the government digs into his pocket for another bail-out.

---

<sup>10</sup> I learned about unlimited liability in banking 30 years ago from Lawrence White whose 1984 Book, **Free Banking in Britain** (2<sup>nd</sup> edn, London: Institute of Economic Affairs, 1995) had been his UCLA dissertation.

<sup>11</sup> Goldman-Sachs was the last of the big American investment banks to change from partnership into corporate form in the 1990s.

<sup>12</sup> Cf., my "A Modest Proposal," VoxEU, January 2010.

There is one more aspect of this proposal worth mentioning, namely, its effect on the “too-big-to-fail” problem. Executives in one department of a conglomerate bank would have reason to take a lively interest in the risks assumed in other parts of the bank. This introduces a diseconomy of scale that would operate even in periods when the bank is not experiencing internal dissension or conflicts about policy. Since the economies of scale in banking are thought by most financial economists to be weak or non-existent, double liability might be sufficient to cause the giant banks to spin off some of their activities as separate firms.

### **Escaping ideological simplicities**

Keynesian economics taught that the macroeconomy was unstable, that a big public sector contributes to stability and that the market economy needs extensive regulation to work properly. Friedmanian economics presumed the stability of market systems and argued for a smaller public sector and for less regulation of private sector activities.

The economic-political debate remains to a distressing extent stuck in simplistic ideological versions of these two worldviews. One can see no end to the high decibel blame game which in the United States features, in one corner, free marketeers blaming Fannie May and Freddie Mac for the debacle and, in the other, critics intent on savaging Wall Street. These ingrained attitudes on both sides are proving a great obstacle to a sane diagnosis of our problems and to devising reasonable solutions.

What started out as a crisis in American housing financing has now metastatized into a financial crisis of the eurozone that will not at all fit into the simplistic categories of ideologues. The Iceland and Ireland disasters were due to their banks, the troubles of Greece to its government. The current problems of Portugal, Spain and Italy show no common clear-cut pattern of public profligacy versus private virtue or *vice versa*.

A return to sanity might start with a general recognition that we are living with the legacy of great and costly mistakes made in both the private and the public sector. Politicians, regulators, bankers, businessmen, households and, not to forget, *economists* have all been participants in a tremendously costly collective illusion.

### **Social and Political Consequences of Economic Instability**

Underneath our problem with ideology-spouting public intellectuals lies a deeper and more serious difficulty. It is one for which there is no easy solution but, even if we have no solution, it is a problem we had better be aware of.

Societies that systematically exploit large numbers of their members in ways that are seen to be unjust breed radicals on the left. Their demands are to overturn the system. Societies that turn unpredictably, inexplicably unfair create radicals on the right. Their demands are to reimpose order -- and preferably an order based on traditional values. Both processes can be seen at work in the United States today.

As long as a system of free markets stays stable the distributional outcome generated by the “forces of supply and demand” are understandable and tend to be widely accepted. The financially unstable economy is another matter. The incidence of gains and losses over a long boom and sudden crash makes no sense to ordinary people.

A dramatic financial crash and its macroeconomic consequences will have immediate effects on how people perceive the economic system of which they are part. The relationship between personal effort and personal reward is no longer seen as predictable and reliable. Also individuals or families relatively untouched by events see unfair misfortunes all around them – and learn of unfair good fortunes mostly in socially distant places. The sense of distributional justice is lost. People feel disoriented and respond with anger. The political expressions that this anger and mistrust take are often not aligned with economic interest. In the United States, large segments of the income



classes that have been losers in the changes in income distribution have gravitated to the right and notably to the Tea Party.

Popular reaction to the systematic shift in the distribution of income which has occurred over recent decades has crystallized far more slowly. The view that the gains and losses are often undeserved and therefore unfair has spread only gradually. The recent, rapid spread of the Occupy Wall Street movement has begun to form a counterweight to the Tea Party on the left. The conservatism of the Tea Party means that its members know what they are *for*. The Occupy Wall Street movement is less coherent. The participants in its demonstrations may have some idea of what they are *against* but no positive program as yet. Neither movement gives evidence of much understanding of economics.

The gathering strengths on both right and left – while the center “lacks all conviction” -- is making it increasingly difficult to form a political consensus around economically sensible policies.

Europe has struggled for sixty years to realize the dream of effective economic unity. All of a sudden, it seems that there may be no way to save the enterprise that will be in accord with conceptions of fairness and justice held by majorities in all the countries involved. If the European dream ends in a shipwreck, it will be one more great tragedy to add to the record of economic instability.