Minsky Moments and Financial Regulatory Reform

Remarks before the 19th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Recent examinations of the leaders of Wall Street and big banks by the Congress and the Financial Crisis Inquiry Commission bring to mind a quip reputedly made by Napoleon Bonaparte: "Never ascribe to malice that which is adequately explained by incompetence."

As a prominent investor from Omaha once remarked, it is indeed amazing what is revealed when the financial tide goes out: Many who were presumably cloaked with unique insight and thought to be worthy of enormous fees and compensation packages were revealed as having nothing on. This is not because they were bad people but because they were unawares. They either failed to read history or believed they were exceptional and could avoid repeating it. Little did they know they were, in fact, *un*exceptional. They were simply swimming with the flow of history—unwittingly leading the financial system and the economy onto the shoals, only to be revealed as "incompetent" when the storm subsided, the tide withdrew and Congress and journalists and analysts began to sift through the wreckage.

Charles Mackay documented much of what we have just experienced in his classic 1841 tome, *Memoirs of Extraordinary Popular Delusions*.[1] Washington Irving wrote of it in *The Crayon Papers* of 1890, describing the Mississippi Bubble of 1719.[2] If you wish to read the CliffsNotes version of these historical antecedents, find yourself a copy of John Kenneth Galbraith's *A Short History of Financial Euphoria*, written in 1990, and mark these words:

"The circumstances that induce the recurrent lapses into financial dementia have not changed in any truly operative fashion since the Tulipomania of [1636]. Individuals and institutions are captured by the wondrous satisfaction from accruing wealth. The associated illusion of insight is protected, in turn, by the oft-noted public impression that intelligence … marches in close step with the possession of money. Out of that belief … comes action, the bidding up of values, whether in land, securities, or … art. The upward movement confirms the commitment to personal and group wisdom. And so on to the moment of mass disillusion and the crash. This last [development] … never comes gently. It is always accompanied by a desperate and largely unsuccessful effort to get out."[3]

The fact is that in the world of financial panics, nothing is new under the sun. Financial dementia is a recurring theme throughout history, and excessive leverage is always its causal agent. Levered asset prices always overshoot during booms and overcorrect during busts. Those hailed as financial mavens during speculative bubbles are transmogrified into hapless mortals when those bubbles pop. As financial commentator John Cassidy recently observed as the first lesson from the demise of Bear Stearns, "Leverage kills."[4]

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[1] *Memoirs of Extraordinary Popular Delusions*, by Charles Mackay, London: Richard Bentley, 1841.
[2] "A Time of Unexampled Prosperity," by Washington Irving, in *The Crayon Papers*, 1890.
[3] *A Short History of Financial Euphoria*, by John Kenneth Galbraith, New York: Penguin Group, 1990, p. 106.
[4] "Lessons from the Collapse of Bear Sterns," by John Cassidy, *Financial Times*, March 14, 2010.

At some time between Mackay and Irving—and well before Galbraith—John Stuart Mill pointed out the obvious: "Panics," he wrote, "do not destroy capital. They merely reveal the extent to which it has previously been destroyed by its betrayal into hopelessly unproductive works."[5]

The patron saint of this assemblage, Hyman Minsky, understood the cycle of financial "revelation" documented by Mackay and Irving and Mill and countless other predecessors of Galbraith and, more recently, Michael Lewis.[6] Minsky assigned it a taxonomy: His classifications for leverage encompassed "hedge borrowers," "speculative borrowers" and "Ponzi borrowers."

Minsky understood the progression toward the Ponzi side of the equation that ensues as the game continues and the market accommodates the "betrayal" of capital into "hopelessly unproductive works." The Ponzi borrower works under the assumption that price appreciation will hide cash flows that cannot cover credit obligations (less erudite observers refer to this as the bigger-fool theory). Minsky warned of the denouement of this complex evolution of levered speculation: The domino effect goes into reverse, infecting even the most sound of investments and leading to a financial crisis and economic contraction.

During the Russian financial crisis of 1998, Paul McCulley of PIMCO coined the term Minsky Moment—which he used to describe the moment of epiphany when the light bulb goes on and the market recognizes the jig is up for Ponzi borrowers. I call it a Wodehouse Moment. For it was P. G. Wodehouse—by no means an economist and someone who wouldn't have known a PIMCO from a Pimm's Cup—who effectively summed it all up when he observed: "… just when a [fellow] is feeling particularly … braced with things in general … Fate sneaks up behind him with a bit of lead piping."[7]

Today, as we meet to address the theme of this conference—planning a new financial structure after the crisis—I would like to address some matters you might consider to mitigate the destruction that the lead pipe of Fate inevitably metes out in financial cycles.[8]

Even as we accept that markets and market operators are given to volatility and panic, we also know from repeated experience that market failures that roil the financial system can have disastrous repercussions—setting off an adverse feedback loop of contracting credit flows, declining economic activity, and sustained, high unemployment. This reminds us of the vital role money and well-deployed credit play in maintaining a healthy economy. I liken it to the cardiovascular system. In an economy, the central bank is the heart, money is the lifeblood, and financial markets are the arteries and capillaries that provide critical sustenance to the muscles that are the makers of goods and services and the creators of employment. A properly

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[5] "Panic on Wall Street: A History of America's Financial Disasters," by Robert Sobel, Washington, D.C.: Beard Books, 1999, p. 6.

[6] Lewis' latest works include: *The Big Short: Inside the Doomsday Machine* and *Panic: The Story of Modern Financial Insanity*, a particularly good read.

[7] "Jeeves and the Unbidden Guest," by P. G. Wodehouse, *Saturday Evening* Post, 1916.

[8] For a more detailed treatment of these themes, please refer to the following: the essay by President Richard W. Fisher in the Federal Reserve Bank of Dallas' 2009 annual report, and "Regulatory and Monetary Policies Meet 'Too Big to Fail,'" by Harvey Rosenblum, Jessica Renier and Richard Alm, Federal Reserve Bank of Dallas *Economic Letter* (both forthcoming).

functioning cardiovascular system fosters healthy growth; if that system fails, the body breaks down and the muscles atrophy.

That is what happened in the most recent crisis. Elaborate statistical models and complex securitization products created the illusion of control over credit and liquidity risk in the banking and credit system. They proved to be shills for Minsky's Ponzi borrowers. Misperceptions of risk and misplaced incentives led to misguided actions. As market participants uncovered the truth and the Minsky/Wodehouse Moment came—as it always does, however late—confidence quickly gave way to fear and doubt. With uncertainty in full fever, cash was hoarded; counterparties, already complicit in financing or insuring "unproductive works," viewed each other with suspicion; no business, productive or otherwise, appeared worthy of financing. Galbraith's "moment of mass disillusion" struck. A full-blown seizure occurred. The economy, starved of the lifeblood of capital, shut down.

By now, I suspect many share my conviction regarding the need for improved financial regulation, including those who only a few years ago proclaimed the transcendent efficiency of financial markets—what I refer to as "the elaborate conceit of efficient market theory"—where today's prices are always right, markets are self-correcting and regulation is best kept to a bare minimum.

In theory, the Fed's monetary policy and regulatory functions are separate. In practice, they are anything but—rather, it is a symbiotic relationship. The past two years have highlighted the interconnections of monetary and regulatory policy: Monetary policy depends upon regulation that ensures the soundness of financial institutions.

Changes in the federal funds rate and other methods employed to implement monetary policy get transmitted to the economy through the arteries of the financial sector, affecting the rate at which businesses produce and grow employment, the exchange rate of the dollar and, by extension, international trade and capital flows. The process works most efficiently when those arteries are open and healthy and strong. Sick banks cannot lend and properly act as intermediators. When they cannot lend or are otherwise hampered, monetary policy actions lose their capacity to influence the economy with accustomed efficiency.

Here is the message for those who would peel away regulatory policy from the Fed: We depend on our regulatory arm to provide in-depth, hands-on assessments to guide us as we perform our duty as the lender of last resort. We can't properly operate a discount window or perform the functions of lender of last resort if we don't have firsthand knowledge of our borrowers' financial health. We cannot implement monetary policy effectively without staying abreast of developments in the banking and financial system through the eyes and ears and constant contact of the 12 Banks in our System that observe up close and personal the activities of banks of all sizes—from the roughly $1.7 trillion in assets of the 844 state member banks we regulate to the roughly $16.8 trillion in assets of the nearly 5,000 bank holding companies we regulate (which include but are not exclusively large financial institutions, or LFIs).[9]

[9] Most recently available figures, per Call Reports (state member banks) and financial statements (bank holding companies).

During a crisis, you need the ability to make the proper decisions quickly. It is simply impossible to properly evaluate the health of a potentially troubled borrower with information generated by another agency. This was one of the harsh lessons learned from examining the entrails of Washington Mutual and Lehman and AIG, over whom we had no regulatory oversight at the time they went into cardiac arrest.

Current proposals being discussed in Congress would shrink the Fed's regulatory and supervisory responsibilities by placing all state-chartered banks under the Federal Deposit Insurance Corp. and all nationally chartered banks and their holding companies under some new regulatory agency, leaving us either with no regulatory oversight or solely with regulatory oversight of LFIs. In my view, these proposals are misguided. In keeping with my cardiovascular theme, I have argued that removing the Fed from supervision and regulation of banks of all sizes and complexity—from community banks to the most complex LFIs—would be the equivalent of ripping out the patient's heart, noting that it would surely prevent another heart attack but would likely have serious consequences for the patient. Our job is to keep the patient healthy and prevent another attack—something you cannot do without the ability to monitor the patient's health. The best way to do that is to keep the Fed in banking and financial supervision.

I mentioned LFIs. A truly effective restructuring of our regulatory system will have to neutralize what I consider to be the greatest threat to our financial system's stability. You discussed this topic this morning—I refer to institutions that are considered "too big to fail."

In the past two decades, the biggest banks have grown significantly bigger. The average size of U.S. banks relative to gross domestic product has risen threefold. The share of industry assets for the 10 largest banks climbed from almost 25 percent in 1990 to almost 60 percent in 2009.

Existing rules and oversight are not up to the acute regulatory challenge imposed by the biggest banks. First, these large institutions are sprawling and complex—so vast that their own management teams may not fully understand their own risk exposures, providing fertile ground for unintended "incompetence" to take root and grow. It would be futile to expect that their regulators and creditors could untangle all the threads, especially under rapidly changing market conditions. Second, big banks may believe they can act recklessly without fear of paying the ultimate penalty. They and many of their creditors assume the Fed and other government agencies will cushion the fall and assume some of the damages, even if their troubles stem from negligence or trickery. They have only to look to recent experience to take some comfort in that assumption.

Some argue that bigness is not bad, per se. Many ask how the U.S. can keep its competitive edge on the global stage if we cede LFI territory to other nations—an argument I consider hollow given the experience of the Japanese and others who came to regret seeking the distinction of having the world's biggest financial institutions. I know this much: Big banks interact with the economy and financial markets in a multitude of ways, creating connections that transcend the limits of industry and geography. Because of their deep and wide connections to other banks and financial institutions, a few really big banks can send tidal waves of trouble through the financial system if they falter, leading to a downward spiral of bad loans and contracting credit that destroys many jobs and many businesses, creating enormous social costs. This collateral damage is all the more regrettable because it is avoidable.

These costs are rarely delineated by analysts. To get one sense of their dimension, I commend to you a thought-provoking paper recently written by Andrew Haldane, executive director for financial stability at the Bank of England.[10]

Haldane pulls no punches. He considers systemic risk to be "a noxious by-product" or a "pollutant" of an overconcentrated banking industry that "risks endangering innocent bystanders within the wider economy." He points out that the fiscal transfers made in rescuing or bailing out too-big-to-fail (TBTF) institutions—whether they are repaid at a profit or not—are insufficient metrics for costing out both the damage of their mismanagement and their subsequent rescues. Like me, he puts things in the perspective of the entire cardiovascular system and the body of the economy. He concludes: "… these direct fiscal costs are almost certainly an underestimate of the damage to the wider economy which has resulted from the crisis."

Haldane points to the shrinkage in global output compared with what output would have been in the absence of the crisis that metastasized within the TBTF institutions, arguing that "evidence from past crises suggests that crisis-induced output losses are permanent, or at least persistent, in their impact on the level of output." He calculates that, in money terms, the persistent world economic output lost relative to what would have obtained in the absence of the recent crisis might be $60 trillion or more. That's $60 trillion with a "T"—more than four years worth of American economic output.

To be fair, the author acknowledges that computed output losses may significantly overstate the real social costs of TBTF—that it may not be fair to take a kitchen-sink approach to the costs incurred by letting these institutions lumber on and then be rescued. Regardless, the message is clear: The existence of institutions considered TBTF exacerbated a crisis that has cost the world a substantial amount of potential output and a whole lot of employment.

Haldane also looks at other social costs—among them the funding advantage associated with TBTF institutions, which has widened during the crisis and, according to one reputable study he cites, amounts to $34 billion a year for the 18 largest U.S. banks.[11]

I will let you read Haldane's study and form your own conclusions. For me, it simply adds grist to the mill of my conviction, based on my experience at the Fed, that the marginal costs of TBTF financial institutions easily dwarf their purported social and macroeconomic benefits. The risk posed by coddling TBTF banks is simply too great.

To be sure, having a clearly articulated "resolution regime" would represent a step forward, though I fear it might provide false comfort: Creditors may view favorably a special-resolution treatment for large firms, continuing the government-sponsored advantage bestowed upon them. Given the danger these institutions pose to spreading debilitating viruses throughout the financial world, my preference is for a more prophylactic approach: an international accord to break up these institutions into ones of more manageable size—more manageable for both the executives of these institutions and their regulatory supervisors.

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[10] "The $100 Billion Question," speech by Andrew G. Haldane, executive director, financial stability, Bank of England, March 30, 2010.

[11] "The Value of the 'Too Big to Fail' Bank Subsidy," by Dean Baker and Travis McArthur, Center for Economic and Policy Research, September 2009.

It would obviously take some work to determine where to draw the line. Haldane's paper suggests that "economies of scale appear to operate among banks with assets less, perhaps much less, than $100 billion," above which "there is evidence … of *dis*economies of scale."[12] And if you subscribe to the emerging wisdom that "too big to fail" is synonymous with "too complex to manage," you might agree with me that another term should be added to the banking lexicon—*diseconomies of dysfunctionality*.

The point is there are limits to size and to scope beyond which global authorities should muster the courage to draw a very bright, red line. I align myself closer to former Fed chairman Paul Volcker in this argument and would say that if we have to do this unilaterally, we should. I know that will hardly endear me to an audience in New York, but that's how I see it. Winston Churchill said that "in finance, everything that is agreeable is unsound and everything that is sound is disagreeable." I think the disagreeable but sound thing to do regarding institutions that are TBTF is to dismantle them over time into institutions that can be prudently managed and regulated across borders. And this should be done before the next financial crisis, because we now know it surely cannot be done in the middle of a crisis.

While my views on TBTF may be slightly radical (if eminently sensible), my perspective on the importance of central bank independence is, I believe, very much mainstream. So I will conclude these musings on that more pleasant subject.

Central banks must take a long-term view of the economy and craft appropriate policy responses. We must have the leeway to raise interest rates when others want cheap credit and rein in risky financial practices when others want easy profits. A Fed committed to wringing out the economy's excesses and keeping banks on the straight and narrow is not going to win popularity contests. Some of those displeased by Fed decisions will seek to satisfy their desires by resorting to political pressure.

Independent does not mean unaccountable. We have always been subject to oversight, but since Ben Bernanke took the chair, we have ramped up our efforts to be as transparent as is prudent in the conduct of monetary policy. For example, the Fed is the only business in America that I know of that provides a public accounting of its balance sheet every week—it is called the H.4.1 release, and it is available on the Internet. We now release more fulsome economic projections and minutes of our meetings. At the twice-yearly reporting and testimony before Congress required under the Humphrey–Hawkins legislation, the chairman responds directly and distinctly to questions from members of the key oversight committees. And we have responded to those suggestions we feel further our mission. For example, in the recent Humphrey–Hawkins sessions, the chairman made clear that we are willing to go the extra mile of letting the Government Accountability Office (GAO) peek behind the curtain of the special credit and liquidity facilities we created—even unto identifying the firms that participated in them "after an appropriate delay" so as to allow those firms to conform to their own reporting obligations.

I think it safe to say we have significantly improved transparency. There are limits, however. Some advocate making the monetary policy deliberations held by my colleagues and me at the

[12] See note 10. Per Haldane (p. 19): "In 2008, 145 banks globally had assets above $100 billion, most of them universal banks combining multiple business activities."

Federal Open Market Committee (FOMC) subject to GAO audits, for example. Were this to come to pass, I believe it would lead to the politicization of the FOMC process, injecting Congress at whim into monetary policy and, if so, eventually putting us on the on-ramp to a road that could lead the United States directly to the fate suffered by once-great economies that allowed monetary policy to become the handmaiden of fiscal policy.

A politicized central bank is a crippled central bank. Only a Fed insulated from short-term, political impulses can focus on crafting the right mix of policies for the economy in the long term. It needs enough space to make the tough calls—most notably, when interest rates have to be pushed upward to slow the economy. Fed independence does not just matter for monetary policy. A central bank insulated from politics and the accompanying lobbying can also be a tougher regulator, insisting on strict adherence to capital and leverage requirements as well as prudent management and lending practices.

We see in the current debacle in Greece a significant example of one of the great virtues of an independent central bank. Historically, profligate fiscal leaders in that country have turned to the monetary authority to print their way out of the corner they painted themselves into, debasing their debts through inflation and currency depreciation. That is no longer possible in Europe. The burden of correcting for fiscal malfeasance now rests squarely on the shoulders of fiscal authorities. As was reported just this week, governments across the euro zone have cobbled together a potential €30 billion in aid at below-current market rates, should Greece's debt woes compound and donor countries agree to activate the credit line. It matters not, as was intimated in yesterday's *Wall Street Journal*, whether the European Central Bank played a role in crafting that package.[13] The good news and bottom line is this: The monetary authority is off-limits as an escape hatch. And that is the way it should be—be that authority European or American.

I started out by noting that booms propelled by greed, and busts born of fear, are as old as time itself. This quirk of human nature will always ignite the euphoria that fuels the ups and exacerbates the downs. Nonetheless, we need a monetary policy that leans against that propensity. We need regulatory and supervisory powers that lead to policy that ensures a sound financial system given less to the "betrayal" of capital into "hopelessly unproductive works" and more toward efficiently channeling monetary policy actions to the real economy. We need to keep monetary and regulatory authority united so we can work together in the interest of the entire financial system—not just in the interests of the largest institutions and those too big to fail where there is a greater tendency for the preconditions for Minsky/Wodehouse Moments to metastasize. And we need to ensure that this authority is free from and uncompromised by political pressures, leaving fiscal authorities to fulfill their obligations to the American people—just as we at the Fed must fulfill ours.

[13] "Trichet's Voice Is Drowned Out in Rescue Effort," by Brian Blackstone, *Wall Street Journal*, April 13, 2010, p. A9.