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Reform Options for Financial Systems

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The neoliberal globalisation project gained momentum in the late 1970s through free market policies in the United Kingdom and the United States. Domestic and international financial systems have been increasingly liberalised and deregulated with the following important results:

a) Integration of financial systems

The deeper integration of international financial markets resulting from the deregulation of capital flows, together with the switch to flexible exchange rates after the breakdown of the Bretton Woods System, created a new source of shocks and uncertainty, as well as a new field of speculation.

b) The increasing role of non-bank financial institutions

Non-bank financial institutions such as investment banks, hedge funds, and private equity funds, became important players. These institutions usually have a speculative orientation, look for high short-term returns and work partly with extreme leverages. Non-bank financial institutions did not only use their own huge funds for their speculative activities; they also tapped the commercial banking system to mobilise additional funds for diverse investments in and outside the financial markets. Thus, commercial banks became more exposed to extreme kinds of risk. In addition, - segments of the financial market which had once been sheltered, like the real estate sector, became fully integrated.

c) Development of a shadow financial system

A shadow financial system with a low level of regulation (or none whatsoever) flourished and became important. Scarcely regulated offshore centres became international financial centres facilitating tax evasion, money laundering and other internationally organised criminal services.

d) Securitisation, financial innovation and derivatives

Securitisation exploded after the 1970s: firms and financial institutions preferred to hold short-term marketable papers instead of bank deposits; economic units of all types issued a growing variety of debt securities to get funds; banks sold their rearranged credit portfolios to non-bank financial institutions whereas rating agencies without any legally binding mandate gave these papers high ratings. Any government supervision was put in a ridiculous dual position: first they were consulting how to design those credit derivatives, then had to evaluate their quality.

Derivatives are initially designed to reduce price-related risks of financial instruments, e.g. changing asset prices, the price of foreign currencies or changing interest rates. The pricing of those derivatives is relatively transparent and the derivatives are marketable. Default and other qualitative risks (climate, temperature, natural disasters) are evidently hard to price, thus less tradable. Nevertheless, those products – hard to standardise or even to value – were developed and actively traded on less-regulated Over the Counter (OTC) markets.

The fundamental problem with risk markets is that risks are not eliminated through trade - they are simply reallocated. As in many cases, both contract partners are speculators, the market is transformed into a big casino where governments and tax-payers become unwitting guarantors.

e) Powerless central banks and supervisors

Central banks became onlookers in the new financial system. In fact, the interest rate remained their only tool to control price level changes, asset price bubbles, exchange rate movements and GDP growth. Central banks do not have instruments to guide funds resulting from expansionary monetary policies towards productive investment. Due to unstable international capital flows, monetary policy in many historical episodes had to follow the primacy of external stabilisation.

As a consequence, price bubbles in all asset markets have become more frequent, with negative economic consequences. At the same time, exchange rate volatility and increasing current account imbalances added to the instability of financial markets.

Frequently, price bubbles went along with credit expansion, in many cases not financing real activities. The big picture is that indebtedness increased. For example, private household debt in percent of GDP in the US increased from below 50% in the 1970s to over 100% in the late 2000s; enterprise debt increased in the same period from around 75% to over 125%[1]. Government debt to GDP in many countries also increased sharply over recent decades.

The deregulation of financial systems which began in the 1970s produced an unsustainable credit expansion for almost all sectors in many countries and a general layering of debts. Bubbles, unsustainable credit expansions, international exchange rate turbulences and growing current account imbalances indicate a more and more fragile financial system. Even the current crisis could be overcome - without fundamental changes a new bubble with probably even more disastrous consequences will necessarily develop.

As a fundamental reform option, we favour a financial system in the tradition of the Glass-Steagall Act and the original Volker Plan. These plans were much more radical than the watered-down legislation which was passed in the US in July 2010.

What could the blueprint of a stable financial system which serves economic development look like?

The financial system should be divided into banks and non-bank financial institutions. Such a regulation implies a distinctive wall between banks, being the major source of finance for firms, and more risk-oriented and even speculative non-bank financial institutions. Commercial banks are then forbidden to engage in proprietary trading, e.g. speculating with their own or borrowed funds; they are not allowed to own investment banks, hedge funds or private equity funds nor to give credit to those institutions and other non-banks. If the latter want to get funds for their businesses, they are forced to attract money held by households. These funds will create sufficient venture capital for start-ups and risky innovations which are not financed by commercial banks. Financial or any other business relations to institutions outside the regulated financial systems (e.g. offshore) are strictly banned.

The allocation of loans originated by banks should be regulated by the central banks. Loans to the real estate sector can be quantitatively restricted as consumption credit. Equity holdings for such credit could be discretionarily changed by monetary authorities. This would allow counter-cyclical equity holding in contrast to Basel II, which leads to unwanted pro-cyclical effects.

Real estate financing and large parts of the private equity industry with their specific social and financial dimensions could be considered a special case and permitted only to specialised and state-licensed institutions. The real estate market can be made a special segment with regulated credit relationships to the rest of the financial system.

Banks in a liberalised environment are triggered to follow aggressive and risky business strategies to defend or increase their market share. To reduce destructive competition between banks, in a regulated financial system, competition among commercial banks could be limited by fixing, for example, real deposit rates of commercial banks. Also, ceilings for interest rates could be given by central banks. In a very highly regulated system, the central bank could even fix interest rates and the quantity of credits the banks are allowed to give. The advantage of such a regulated credit rationing system is that restrictive monetary policy can be implemented without increasing interest rates.

Derivatives should be sold and bought only in regulated and controlled markets. Strictly controlled position limits shall exclude speculative attacks. Only certain standardised products which have been checked by a supervision agency should be allowed, and only certain agents with licences should take part in the market. Securitisation of credits should be possible to a certain extent. If the originator of a loan is forced to keep a substantial part of the loan in its books and derivatives are standardised, securitisation is harmless.

Last but not least, such a system needs international capital controls to give central banks instruments to control unstable international capital flows. Current account imbalances should be kept small. The debates during the Bretton Woods negotiations in the 1940s could be a starting point for the development of such a system.

A financial system outlined above is not imaginary. It existed in the US and most other industrialised countries after World War II. Even comprehensively regulated systems existed and partially still exist in different versions in all East Asian miracle countries after World War II. The Chinese financial system after 1978 also fits such a system. Financial systems in these countries offered sufficient and cheap credit for the enterprise sector and thus stimulated growth and employment without financial market instability.

For many, the above blueprint of a reformed financial system does not seem politically enforceable. However, the fragility of the financial system will continue. History may create a window of opportunity for a change. If such an opportunity comes, we should know what to do.

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Further Reading:

S. Dullien, H. Herr, EU Financial Market Reform. International Policy Analysis 2010, Friedrich Ebert Foundation, http://library.fes.de/pdf-files/id/ipa/07242.pdf

[1] Fed, Flow of Funds Accounts Database 2010