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Building Effective Regulation Requires a Theory of Financial Instability

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Stepping back and surveying the last half decade's worth of US policy responses to the global financial crisis, what we see before us looks very much like the "piecemeal" and "patchwork" pattern of reform that Hyman Minsky cautioned against in his 1986 book *Stabilizing an Unstable Economy*. If there ever was any real political space for fundamental reform of the financial system, it has since disappeared, even as the economic wounds left by the crisis continue to fester. The battle to shape the rule-making and implementation process of the 2010 Dodd-Frank Act is ongoing, but Dodd-Frank—indeed, the whole host of policy reactions (and nonreactions) since 2007—is largely undergirded by an approach to financial regulation that is incomplete and inadequate.

In a recent *Bloomberg* column, former director of the Office of Management and Budget Peter Orszag lamented the fact that official forecasters had relied on economic models that, because they did not take financial leverage into account, badly underestimated the severity of the fallout from the subprime mortgage collapse. The ensuing crisis sparked renewed interest in Minsky's work in no small part because he had developed an account of economic stability and instability that took finance and financial leverage seriously. But Minsky also had particular views about how the regulatory system and financial architecture should be reformulated, and one of the many lessons we can learn from his work is that there is an intimate connection between how we think about the prospect of financial market instability and how we approach financial regulation.

As Minsky emphasized, you cannot adequately design regulations that increase the stability of financial markets if you do not have a theory of financial instability. If the "normal" precludes instability, except as a random ad hoc event, regulation will always be dealing with ad hoc events that are unlikely to occur again. As a result, the regulations will be powerless to prevent future instability. What is required is a theory in which financial instability is a normal occurrence in the system.

Despite the well-known phrase, Minsky's approach had little to do with "moments." It was about the sustained, cumulative processes in which periods of stability induce an endogenous increase in potential financial fragility. Fragility provides the fertile ground for financial instability, leading to a process of debt deflation and a full-blown crisis. While the 2007–09 crisis was not, strictly speaking, inevitable, the structural transformation that the economy had undergone rendered the financial system highly vulnerable to a shock. The shock happened to emanate from the subprime mortgage market, but the fact that the subprime crisis was able to spread to the rest of the financial system and set off a full-scale bout of systemic instability and debt deflation can be explained by pointing to a process of sustained and increasing financial fragility in the rest of the financial structure.

Regulation of the system cannot be effective if it is simply based on measures produced to remedy and reverse the conditions generated by the current "moment." It needs to reformulate the structure of the financial system itself. Unfortunately, the current approach to regulation seeks to remedy the present moment by applying to the business models of existing financial institutions a series of mostly cosmetic changes, leaving the basic structure of the system unchanged in some crucial respects.

The framework for reregulation must start with an understanding of the longer-term systemic changes that took place between the New Deal reforms—principally, the Glass-Steagall Act of 1933—and their formal repeal under the Gramm-Leach-Bliley (GLB) Financial Services Modernization Act of 1999. The New Deal reforms were eroded by an internal process in which commercial banks that were given a monopoly position in deposit taking sought to remove those protections because unregulated banks were able to provide more efficient substitute instruments that were unavailable to regulated banks. Regulators and the courts contributed to this process through rulings that progressively allowed commercial banks to reclaim securities market activities that had been precluded in the New Deal legislation. The 1999 Act simply made official the de facto repeal of the 1930s protections.

Difficulties in implementing many Dodd-Frank provisions have led to calls for a return to Glass-Steagall, but Minsky believed that, due to financial innovations, Glass-Steagall was already outmoded when it was introduced. However, close study of his work, and an extension of some of Minsky's ideas into our post-GLB world, reveals a blueprint for a more stable financial architecture that could deliver some of the main benefits of the structure provided by Glass-Steagall. The blueprint includes breaking banks down into smaller units and creating a bank holding company structure with numerous types of subsidiaries subjected to strict limitations on the types of activities allowed to them. Such restrictions on both overall size and subsidiary function could enhance the ability of regulators to understand and supervise the activities of the subsidiaries, and to react to innovations.

While best known for his analysis of financial fragility, Minsky was primarily concerned with providing guidance for proposals to create a financial structure that ensures a stable transaction system and provides for the capital development of the economy. Until we internalize his vision of financial fragility, however, we are unlikely to be able to design a financial architecture that more reliably meets these twin objectives. Whether the next crisis delivers a more convincing lesson remains to be seen—the limitations of the Dodd-Frank approach make it likely that we won't have to wait long to find out.

A more detailed discussion of these topics can be found at www.levyinstitute.org/pubs/eBook_2012.pdf.

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