

March 24, 2009

The Honorable Gordon Brown  
Prime Minister of the United Kingdom  
of Great Britain and Northern Ireland

Dear Prime Minister:

On February 20<sup>th</sup>, the Center on Capitalism and Society at Columbia University which I direct had its 6<sup>th</sup> Annual Conference on “Emerging from the Financial Crisis” in New York City. The conference brought together a great many distinguished policymakers, bankers, regulators, journalists, and scholars. Members and Foreign Members of the Center took key roles in the discussion, as did several members of its Advisory Board and its chairman, Peter Jungen. Paul Volcker, currently chairman of President Obama’s Economic Recovery Advisory Board, was the luncheon speaker. The dinner speaker was the financier and philanthropist George Soros. Dr. Josef Ackerman, Chairman of Deutsche Bank, gave concluding remarks. Three Nobel laureates – Robert Mundell, Joseph Stiglitz and I – each spoke in a panel and so did Madame Christine Lagarde, France’s Minister of the Economy.

The conference faced several questions: why the end of the recent boom has been so destructive, why there is a widespread sense that early return to a normal degree of prosperity and economic inclusion is not in prospect, and what could be done to improve the prospects. A premise widely shared at the conference was that, particularly in the United States, there had been a decline in dynamism starting early in the decade, with an attendant decline of inclusion – signs of which attracted little notice during the housing boom. This decline is all the more challenging now that most households and many companies are striving to correct their over-indebtedness. Another widely shared premise was that a durable return to high prosperity and to broad inclusion – to careers permitting ordinary people across the range of society to flourish and to high employment rates across society – will not take place without a revival of dynamism in the U.S. economy. And there will be little prospect of that until the financial sector is reoriented to serve first and foremost the business sector.

Since financial reform is high up in the G-20 agenda for the April 2<sup>nd</sup> meeting in London, I would like to share with you some of the finance-based interpretations of what led to the crisis as well as some of the more distinctive policy proposals for financial reform coming out of the Center’s conference.<sup>1</sup> The reform proposals fall broadly into four areas. The first includes proposals for better structuring of institutions, taking as unchanged their scope. The second area includes the creation of a new class of banks with the aim

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of reorienting the financial sector so as to serve the business sector – to finance long-term investment and innovative projects by business firms. The third includes a conceptual framework to use in dealing with excessive asset price changes, an urgent issue as long as markets do not establish a bottom in asset prices. The last area addresses the need for international cooperation in establishing a coordinated regulatory framework and in supporting emerging markets through the international financial institutions.

Why, with imaginably limitless possibilities of reform and structural change, one set of proposals rather than another? A brief discussion of the causes and causal mechanisms behind the financial crisis, as the conferees saw them, may help to illuminate the focus on the proposals discussed below. It is clear that the emergence early in the 2000s of extraordinarily low real interest rates in the global economy played a role in setting off the boom in several asset markets, the housing market notable among them. Throughout the decade, there were non-monetary forces throughout the decade driving much of the decline of rates: the huge surpluses of national saving over domestic investment in China, Germany and the oil-rich nations which came to be labeled imbalances.<sup>2</sup> Central banks would not have been able to keep policy rates of interest high in the face of this surge in world saving, though it can (and has) been argued that monetary policy cut policy rates too far and kept them so very low too long.

Several speakers at the conference held that these “imbalances” – together with U.S. legislation in 1998 and 1999 encouraging home ownership – were sufficient to have caused the crisis.<sup>3</sup> There was some consensus, however, that it was the banking industry that turned a classic asset-price correction and concomitant downturn (to a normal or mildly subnormal level of economic activity) into a full-blown financial crisis in industrial countries. This crisis became severe in the United States and United Kingdom, and somewhat less so in Germany. (In the U.S. some responsibility can also be attributed to real estate speculators able to obtain mortgage loans that were one-way bets.) According to one view, by the present decade the banks in the U.S. had lost two of their accustomed markets: venture capital and private equity firms had taken away some of the banks’ loan market at the low end and the development of the commercial paper market had taken away much of the market at the high end. The questionable response of the banks to their reduced profitability was to take on more risk, not less, by borrowing more in order to lend more where they could, expecting that the added leverage of their capital would restore the rate of return on their capital to the industry target levels.<sup>4</sup> Yet, as all banks added to the stock of mortgages and other loans on the books, diminishing returns must have set in: high house prices and fewer credit-worthy borrowers. This leverage made banks vulnerable.

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In the consensus view at the conference, it was the large, diversified conglomerate structure of the financial services industry and the mismanagement that its poor governance structures allowed that produced the extreme speculative excesses of the final years. In the U.S., the former structure became riddled with conflicts of interest between retail and investment banking after repeal of the Glass-Steagall legislation in 1999. Since then, the trading activities of investment banks have been collateralized by the insured deposits of the retail banks. It is now the taxpayer who is painfully bearing the cost of this ultimately costly subsidy to so-called investment banking, which is a perversion of the classical investment banking of the late 1880s. At the same time, there were conflicts of interest among the different activities performed by investment banks, most notably between the buy side and sell side of investment banking. This had to do with the fact that the interests of customers in different areas were often in conflict with each other. Chinese walls among these activities clearly were unable to mitigate these conflicts of interest. As a result, had they wanted to, many a big bank CEO would not have had the executive power to command the management to stop its lending and move to retrench.

In addition, poor governance structures allowed and encouraged regulatory and accounting arbitrage and other deceptive practices. The financial sector failed in several of its functions: mitigating risks and allocating investible resources. (It was an indication of the dysfunctional size to which the banking industry had grown, one conference speaker suggested, that, at least on paper, the financial sector accounted for 30 to 35 per cent of total corporate profits.) The huge bonus arrangements positively encouraged CEOs each year to “roll the dice” another time on the calculation that they would not be in their job once market forces turned around.<sup>5</sup>

## **I. Regulatory reform of existing financial institutions**

As is widely understood, the need for regulation arises whenever there are externalities that have a deleterious impact on the effective allocation of resources or the stability of markets. Participants pointed to failures in banks that had externalities well beyond themselves and that became a burden on taxpayers. Two externalities mentioned by several speakers were the asymmetries in information and the inability of the financial markets to “pricing in” the level of overall financial systemic risk. First, a new regulatory framework is clearly necessary to redress the asymmetries in information, mainly as a result of the informational gap between sophisticated institutional market players and retail customers. The latter do not often understand the complexity of the instruments (insurance policies, derivatives, structured products, mortgages) and could thus hardly understand the risk that they entailed. Second, there is a need for “pricing in” systemic risk. In a weakly regulated and competitive system, systemic risks were not reflected in market prices and financial risk managers did not take them into account in managing their own balance sheets. Thus, as aggregate leverage increased in the upswing of the credit cycle in 2002-2006, financial institutions failed to increase their capital cushions and strengthen their liquidity as asset prices boomed.

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<sup>5</sup> Much of the critique in this paragraph was offered by Joseph Stiglitz, a member of the Center, both at the conference and earlier at the Lindau Conference of Nobel Prize Winners in August 2008.

### *A small corrective tax on short-term indebtedness*

A attractive proposal in this regard was the proposal of one of the speakers for a small tax on short-term borrowings by financial companies – from big banks to tiny hedge funds. The tax might apply to terms up to 3 years in length. This regulation would cause financial companies to avoid borrowing at short term in favor of medium-term and long-term debt. Of course this move would have the private benefit that the company would have a longer time to make adjustments following a bad turn of events than it would have had it availed itself of short-term credit; though borrowing at longer term might still cost more. The key point, however, is that the entire economy would enjoy the “external” benefit from the greater breathing room of the financial sector. The sector would not have to call in business loans in order to meet the repayment demands of nervous creditors.<sup>6</sup>

### *Steps toward greater ‘economic inclusion’ in financial markets*

It was pointed out at the conference that the crisis appears to provide an opportunity to develop financial markets so as to offer more *inclusion* – what is referred to as “democratization of finance.” Proponents speak of a need to expand the information infrastructure, perhaps by subsidizing financial advice for the common man, expanding risk management through futures markets, home equity insurance and continuous workout mortgages.<sup>7</sup>

### *Addressing conflicts of interest in the ratings industry*

The need to eliminate the oligopolistic nature of the ratings agencies is clear. (A recommendation was made to use part of the resources of stimulus programs in the United States and other parts of the world to create a few new rating agencies with the critical mass to compete with the three established ones.) Opinions were more diverse with respect to how to eliminate these agencies’ conflicts of interests. There was agreement that rating agencies must be “single-product firms” providing no services other than ratings. To avoid making the issuers of bonds the buyers of the services of the agencies, a way must be found to create an *Investor Reports*, analogous to the magazine *Consumer Reports*, the subscription revenues from which would pay the agencies.

Although the need for regulation in general is clear in these and perhaps other cases, a great concern at the Center on Capitalism and Society is how to design regulation without discouraging funding for investment in innovation in the non-financial business sector, which has been the main source of dynamism in the U.S. economy. In the regulators’ understandable desire to keep price fluctuations within tighter limits, there is the danger that policymakers – often pushed by the public – will now adopt regulations dampening incentives and competition to the point where they start to weaken or narrow some of the sources of dynamism in the economy. It is important that venture capital and angel investors, an important source of financing for non-financial innovation, not be discouraged by new regulations. We need to encourage entrepreneurship and ensure that young people have the opportunity to start new businesses. If finance were available, depressed economic conditions would lower the cost of new start-ups by lowering wages

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<sup>6</sup> Where a proposal has unique authorship I would like where practical to give credit. The proponent of the above proposal is Richard Robb, a member of the Advisory Board of the Center.

<sup>7</sup> Several ideas of this kind have been discussed for some time by Robert Shiller, a member of the Center.

and rents and by making qualified people available. This in turn could provide new dynamism to the economy.

## **II. Reshaping financial institutions**

### *A return to “narrow banking”*

Since the costs of the financial conglomerates were significantly large in relation to the benefit of reaping the informational advantages of conglomeration, there was serious talk during the conference about the need for a return to “narrow banking.” Although the idea is not new, narrow banking would be a way to protect the payments system and to insure a reactivation of credit. In this scheme, commercial banks would use their deposits to make loans to consumers and small and medium sized businesses rather than investing solely in low-risk securities, as other proposals for narrow banking contemplate. Investment banks might not be allowed to accept deposits from households and possibly from non-bank businesses.

The return to narrow banking, even if this was not the prime purpose, would promote a return to the interpersonal relationships between bankers and their clients, which will facilitate the management of risk. It had been the shift from personal to technical relationships, together with the creative minds of accounting and mathematical experts that had created complex derivatives that had made risk management so difficult.

Measures to re-establish narrow banking will necessarily involve the divestiture or closure of the investment banking activities of retail banks. Such restrictions will provide an opportunity to reintroduce measures of structural separation between fundamentally incompatible wholesale financial activities. At the same time, the government might have to take over ownership of the failed banks at least for a while.

The other option discussed was to move forward using government funding to create a new bank or banks (rather than saving failed ones). If the government had used the \$700 billion of the bank rescue package, it could have capitalized a bank with assets leveraged up to \$7 trillion, which could have created employment to offset that lost in the failed banks.<sup>8</sup>

By focusing regulation on the deposit-taking banks, all other financial institutions could bear the risk and pay the cost of bad decisions, without much regulation and without a potential cost to taxpayers. There would have to be, however, supervision to avoid systemic risk. Narrow banks could restart effective intermediation and ensure that consumers and employment-creating small and medium-enterprises are adequately financed and can contribute to the reactivation of the economy.<sup>9</sup>

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<sup>8</sup> It may be that such a decision would cause added bank failures and thus cost the government added costs to the Federal Deposit Insurance Corporation.

<sup>9</sup> The proposal at the conference for a return to narrow banking was made by John Kay and Amar Bhide, Foreign Member of the Center and Member of the Center, respectively.

In my view, avoiding excessive regulation of hedge funds, private equity funds, and other sources of risk capital is essential to ensure that innovative and high-risk ideas in the non-financial business sector are adequately financed and that the U.S. economy can regain its dynamism. Without it, the global economy will suffer.

*Recreating classic investment banks for selecting and financing innovative projects*

The restoration of prosperity in the U.S. requires restoration of aggregate investment activity. That restoration will in turn require restoration of aggregate bank lending. But the existing banks appear unlikely to be able to raise the necessary increase of capital in view of their past performance.

Further, in view of the patent unprofitability of investing in U.S. housing (at the boom levels of recent years, at any rate), any restoration of aggregate bank lending will require a strong renaissance of lending for business investment. But the existing banks lack the expertise to serve the business sector of the economy.

It has to be concluded that the “strong renaissance” will require a *new class* of banks – banks dedicated to serving the business sector and banks whose fixed orientation to business will encourage bank staff to acquire the appropriate expertise in lending to businesses. (The mix between loan finance and equity finance, and whether they should be under the same roof, are matters best left for future discussion.)

A parallel point is that regaining the “feel” of prosperity – the mental stimulation, intellectual challenge, exploration and the consequent sense of personal growth that people hope and expect to gain from engagement in business enterprises – will require the financial sector to foster *innovation* in the business sector. Innovation coming only from elite government institutes, industrial labs, and hi-tech companies cannot deliver at the level of ordinary people working in ordinary businesses this experience of flourishing. Furthermore, the quest for innovations in such a top-down manner is far less likely to deliver commercial successful innovation – under given conditions – than the restless experimentation in search of better methods and better products carried on by companies having the invaluable experience and intuition to make progress. Growth of productivity and real wages – and ultimately even high employment – requires commercial innovation to keep up the rate of return in the face of the volume of investment needed for high employment.

Would these new industrial banks be able to earn a normal rate of return? A very dark cloud here is that the dynamism of the business sector in the U.S., and perhaps the U.K. as well, has been in decline for many years. In the 1990s the number of initial public offerings (IPOs) by young companies – typically raised to adulthood by venture capital firms – ran at the rate of 350 per year. In the present decade, the number of IPOs has been only 50 per year. It is likely therefore that the rate of new firm formation has likewise declined. Venture capital firms in Silicon Valley are shrinking. Thus, it appears that the new class of banks – banks that have acquired the expertise to judge well (about as well as one can) the long-term investments and innovative projects to finance – will require government support. This help by the

government might take the form of a subsidy to reduce the new banks' cost of capital. Or it might take the form of an initial endowment contributed to each bank by the government.<sup>10</sup>

Of course, there is abundant precedent for subsidized finance in western and eastern nations alike. In the U.S. there are the massive subsidies and tax breaks to encourage dwellers to own their own homes and own more; and there are subsidies to the banks in the Farm Credit System. The recent one-time bailouts aside, only business – the “chief business of America” – is asked to go without subsidies and, indeed, to pay stiff corporate taxes as well (on top of the personal taxes paid). Thus the proposed subsidy would be a step *toward* fiscal neutrality, not another step *from* it.

It seems clear, then, that with the prospects of profitable lending to the housing sector diminished by the swollen housing stock and the profitability of business lending in doubt, regaining an authentic prosperity will necessitate a pro-business initiative to revive business investment and business innovation.

*Creating a development bank to finance infrastructure and other “project finance”*  
A proposal was also made at the conference for the creation of a development bank specializing in project finance to focus on infrastructure development, investment in new technologies, investing in the working poor, the environment, and other capital projects.<sup>11</sup>

At a time when reform of the financial system is discussed, a critical consideration is whether those reforms could address the still insufficient levels of economic inclusion without stifling dynamism. Countries – ranging from France and the Netherlands to Singapore and Chile – have adopted or are in the process of adopting subsidies to companies for their ongoing employment of low-wage workers. A development bank could be the institution to channel and monitor this type of subsidy, which I began advocating since the mid-1990s, both as a mechanism for inclusion and also for reactivating lagging economic activity.<sup>12</sup> In fact, as a candidate in 2008, President Obama hinted at subsidies to widen “rewarding work,” although no provision in this direction has been made of the envisaged magnitude – such as 2 per cent of the GDP.

### **III. A framework to deal with excessive asset price swings**

There was wide recognition at the conference that, although it is now endemic among financial practitioners, the Rational Expectations postulate, in assuming that markets possess complete knowledge as well as information – so that they tend always to equilibrium, deviations from which are results of exogenous factors – is untenable. No model of rational individual choice in a capitalist setting of genuine innovation and consequent “Knightian uncertainty” has ever been produced that gave theoretical support

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<sup>10</sup> This proposal of mine I put forward in my paper “The Justice of a Well-Functioning Capitalism and the Reforms that Will Realize It” for the conference <New World, New Capitalism>, chaired by President Nicolas Sarkozy and former Prime Minister Tony Blair, Paris, 8-9 January 2009.

<sup>11</sup> Such a proposal was put forward by Jeffrey Sachs.

<sup>12</sup> Phelps, *Rewarding Work* Cambridge, Mass., Harvard University Press, 1997. Reprnt. Edn. 2007.

to that assumption. And the empirical record strongly suggests that history does not endlessly repeat itself, so that forecasts that were on the mark in one era have in other eras been far off the mark for long stretches of time. For many, this crisis was more evidence that market fundamentalism, that is, the belief that markets are self-correcting, and hence should be left to their own devices, was a misconception.<sup>13</sup>

Moreover, the sharp downswings in housing and equity prices, which followed long upswings that moved excessively far above historical benchmark levels, helped to trigger and continue to fuel the financial crisis. As the downswings continue, there is a real danger that they may also become excessive and drag the economy and the financial system into an even deeper crisis. A new conceptual framework – Imperfect Knowledge Economics (IKE) framework – was proposed so that officials have measures in place to help dampen such excessive movements if they come to pass.<sup>14</sup>

Standard economic theory explains such swings as “bubbles,” unrelated to fundamentals, arising only because market participants fall prey to irrationalities, herding instincts, or reliance on technical rules. The policy prescription of the standard theory is to either leave markets unimpeded (other than ensuring transparency, and eliminating other market failures) or extinguish asset-price swings as soon as they arise, even if this requires massive government intervention.

Although psychological elements and technical trading may play a role, markets undergo swings even if everyone bases their trading decisions solely on fundamental factors. Thus, eliminating price swings as soon as they appear makes little sense. At the same time, markets are not perfect and participants must cope with imperfect knowledge about how to interpret fundamental factors in forecasting future returns.

The IKE framework provides the rationale, because of excessive price swings, for policy intervention in asset markets. It also has important implications for how regulators should measure and manage systemic risk in the financial system. This framework acknowledges that, within a reasonable range, the market would do a far superior job, though not perfect, in setting prices, recognizing at the same time that price swings can become excessive and that this excess is socially costly.

To apply this IKE framework, officials need to ascertain a “guidance range” of non-excessive prices, that is, a range where prices are not too high or too low from levels that are consistent with longer-term prospects. In addition to regularly announcing policy ranges, officials could vary margin and capital requirements or rely on other tools if the downswings do become excessive. To dampen them, policy should encourage the trading behavior of bulls, which are helping to bid prices up, and discourage the behavior of bears, who are betting on a continuation of the downswing.

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<sup>13</sup> A survey, with references to the work of Roman Frydman, a Center member and others, is my “Revolutionary Times, Then and Now,” in *Capitalism and Society*, vol. 3, no. 3.

<sup>14</sup> The rationale and details of this proposal are in Roman Frydman and Michael Goldberg, “Financial Markets and the State: Price Swings, Risk, and the Scope of Regulation,” Working Paper No. 29, available at the Center’s website. It is also forthcoming in the Center’s electronic journal *Capitalism and Society*.

Although this proposal requires further work in establishing adequate guidance ranges in various markets, the policy would be easy to implement and be transparent. The idea has been overlooked in policy discussions, perhaps because the vast majority of economic models account for asset price fluctuations with just one set of views, that of the so-called “representative agent.” Such models are unable to target policies differently to bulls and bears.

The important policy conclusion from this framework is that restrictions on short-selling, such as the uptick rule, and other such measures that do not differentiate between bulls and bears and do not distinguish whether the long swing is excessive from above or below, could actually lead to greater instability. In fact, improving the financial markets’ ability to self-correct to sustainable values is the entire point of prudent measures. Depending on the situation, the uptick rule, a total ban on short selling, and other measures which pay no regard to whether an asset is over or undervalued may be beneficial in some circumstances and counterproductive in others. The prevailing view that policymakers should be bound by fixed rules will not do.

#### **IV. International cooperation**

Many of the participants pointed out to the need and urgency of countries to work together to design and institute a new financial regulatory framework that is internationally consistent. Some conferees pointed to areas such as capital adequacy, liquidity management, and financial reporting standards for all financial and non-financial corporations in which the need for internationally-consistent regulation and supervision may be imperative.

As discussed earlier, there was support for regulating the rating agencies and regulating the “non-cooperating centers” on a global and consistent basis. There was much less support for regulating hedge funds, particularly if narrow banking was adopted.

There was also concern for the strong contagion that had taken place from the financial crisis in advanced countries to many emerging markets and support for increasing the resources of the international financial institutions to provide financing to emerging and low-income countries.

Let me take this opportunity to send good wishes for the G-20 meeting in April.

Sincerely,

A handwritten signature in black ink, appearing to read "Edmund S. Phelps", with a long, sweeping flourish extending to the right.

Edmund S. Phelps  
Director

March 24, 2009

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Dear Prime Minister:

On February 20<sup>th</sup>, the Center on Capitalism and Society at Columbia University which I direct had its 6<sup>th</sup> Annual Conference on “Emerging from the Financial Crisis” in New York City. The conference brought together a great many distinguished policymakers, bankers, regulators, journalists, and scholars. Members and Foreign Members of the Center took key roles in the discussion, as did several members of its Advisory Board and its chairman, Peter Jungen. Paul Volcker, currently chairman of President Obama’s Economic Recovery Advisory Board, was the luncheon speaker. The dinner speaker was the financier and philanthropist George Soros. Dr. Josef Ackerman, Chairman of Deutsche Bank, gave concluding remarks. Three Nobel laureates – Robert Mundell, Joseph Stiglitz and I – each spoke in a panel and so did Madame Christine Lagarde, France’s Minister of the Economy.

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Why, with imaginably limitless possibilities of reform and structural change, one set of proposals rather than another? A brief discussion of the causes and causal mechanisms behind the financial crisis, as the conferees saw them, may help to illuminate the focus on the proposals discussed below. It is clear that the emergence early in the 2000s of extraordinarily low real interest rates in the global economy played a role in setting off the boom in several asset markets, the housing market notable among them. Throughout the decade, there were non-monetary forces throughout the decade driving much of the decline of rates: the huge surpluses of national saving over domestic investment in China, Germany and the oil-rich nations which came to be labeled imbalances.<sup>2</sup> Central banks would not have been able to keep policy rates of interest high in the face of this surge in world saving, though it can (and has) been argued that monetary policy cut policy rates too far and kept them so very low too long.

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### *A small corrective tax on short-term indebtedness*

A attractive proposal in this regard was the proposal of one of the speakers for a small tax on short-term borrowings by financial companies – from big banks to tiny hedge funds. The tax might apply to terms up to 3 years in length. This regulation would cause financial companies to avoid borrowing at short term in favor of medium-term and long-term debt. Of course this move would have the private benefit that the company would have a longer time to make adjustments following a bad turn of events than it would have had it availed itself of short-term credit; though borrowing at longer term might still cost more. The key point, however, is that the entire economy would enjoy the “external” benefit from the greater breathing room of the financial sector. The sector would not have to call in business loans in order to meet the repayment demands of nervous creditors.<sup>6</sup>

### *Steps toward greater ‘economic inclusion’ in financial markets*

It was pointed out at the conference that the crisis appears to provide an opportunity to develop financial markets so as to offer more *inclusion* – what is referred to as “democratization of finance.” Proponents speak of a need to expand the information infrastructure, perhaps by subsidizing financial advice for the common man, expanding risk management through futures markets, home equity insurance and continuous workout mortgages.<sup>7</sup>

### *Addressing conflicts of interest in the ratings industry*

The need to eliminate the oligopolistic nature of the ratings agencies is clear. (A recommendation was made to use part of the resources of stimulus programs in the United States and other parts of the world to create a few new rating agencies with the critical mass to compete with the three established ones.) Opinions were more diverse with respect to how to eliminate these agencies’ conflicts of interests. There was agreement that rating agencies must be “single-product firms” providing no services other than ratings. To avoid making the issuers of bonds the buyers of the services of the agencies, a way must be found to create an *Investor Reports*, analogous to the magazine *Consumer Reports*, the subscription revenues from which would pay the agencies.

Although the need for regulation in general is clear in these and perhaps other cases, a great concern at the Center on Capitalism and Society is how to design regulation without discouraging funding for investment in innovation in the non-financial business sector, which has been the main source of dynamism in the U.S. economy. In the regulators’ understandable desire to keep price fluctuations within tighter limits, there is the danger that policymakers – often pushed by the public – will now adopt regulations dampening incentives and competition to the point where they start to weaken or narrow some of the sources of dynamism in the economy. It is important that venture capital and angel investors, an important source of financing for non-financial innovation, not be discouraged by new regulations. We need to encourage entrepreneurship and ensure that young people have the opportunity to start new businesses. If finance were available, depressed economic conditions would lower the cost of new start-ups by lowering wages

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<sup>6</sup> Where a proposal has unique authorship I would like where practical to give credit. The proponent of the above proposal is Richard Robb, a member of the Advisory Board of the Center.

<sup>7</sup> Several ideas of this kind have been discussed for some time by Robert Shiller, a member of the Center.

and rents and by making qualified people available. This in turn could provide new dynamism to the economy.

## **II. Reshaping financial institutions**

### *A return to “narrow banking”*

Since the costs of the financial conglomerates were significantly large in relation to the benefit of reaping the informational advantages of conglomeration, there was serious talk during the conference about the need for a return to “narrow banking.” Although the idea is not new, narrow banking would be a way to protect the payments system and to insure a reactivation of credit. In this scheme, commercial banks would use their deposits to make loans to consumers and small and medium sized businesses rather than investing solely in low-risk securities, as other proposals for narrow banking contemplate. Investment banks might not be allowed to accept deposits from households and possibly from non-bank businesses.

The return to narrow banking, even if this was not the prime purpose, would promote a return to the interpersonal relationships between bankers and their clients, which will facilitate the management of risk. It had been the shift from personal to technical relationships, together with the creative minds of accounting and mathematical experts that had created complex derivatives that had made risk management so difficult.

Measures to re-establish narrow banking will necessarily involve the divestiture or closure of the investment banking activities of retail banks. Such restrictions will provide an opportunity to reintroduce measures of structural separation between fundamentally incompatible wholesale financial activities. At the same time, the government might have to take over ownership of the failed banks at least for a while.

The other option discussed was to move forward using government funding to create a new bank or banks (rather than saving failed ones). If the government had used the \$700 billion of the bank rescue package, it could have capitalized a bank with assets leveraged up to \$7 trillion, which could have created employment to offset that lost in the failed banks.<sup>8</sup>

By focusing regulation on the deposit-taking banks, all other financial institutions could bear the risk and pay the cost of bad decisions, without much regulation and without a potential cost to taxpayers. There would have to be, however, supervision to avoid systemic risk. Narrow banks could restart effective intermediation and ensure that consumers and employment-creating small and medium-enterprises are adequately financed and can contribute to the reactivation of the economy.<sup>9</sup>

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<sup>8</sup> It may be that such a decision would cause added bank failures and thus cost the government added costs to the Federal Deposit Insurance Corporation.

<sup>9</sup> The proposal at the conference for a return to narrow banking was made by John Kay and Amar Bhide, Foreign Member of the Center and Member of the Center, respectively.

In my view, avoiding excessive regulation of hedge funds, private equity funds, and other sources of risk capital is essential to ensure that innovative and high-risk ideas in the non-financial business sector are adequately financed and that the U.S. economy can regain its dynamism. Without it, the global economy will suffer.

*Recreating classic investment banks for selecting and financing innovative projects*

The restoration of prosperity in the U.S. requires restoration of aggregate investment activity. That restoration will in turn require restoration of aggregate bank lending. But the existing banks appear unlikely to be able to raise the necessary increase of capital in view of their past performance.

Further, in view of the patent unprofitability of investing in U.S. housing (at the boom levels of recent years, at any rate), any restoration of aggregate bank lending will require a strong renaissance of lending for business investment. But the existing banks lack the expertise to serve the business sector of the economy.

It has to be concluded that the “strong renaissance” will require a *new class* of banks – banks dedicated to serving the business sector and banks whose fixed orientation to business will encourage bank staff to acquire the appropriate expertise in lending to businesses. (The mix between loan finance and equity finance, and whether they should be under the same roof, are matters best left for future discussion.)

A parallel point is that regaining the “feel” of prosperity – the mental stimulation, intellectual challenge, exploration and the consequent sense of personal growth that people hope and expect to gain from engagement in business enterprises – will require the financial sector to foster *innovation* in the business sector. Innovation coming only from elite government institutes, industrial labs, and hi-tech companies cannot deliver at the level of ordinary people working in ordinary businesses this experience of flourishing. Furthermore, the quest for innovations in such a top-down manner is far less likely to deliver commercial successful innovation – under given conditions – than the restless experimentation in search of better methods and better products carried on by companies having the invaluable experience and intuition to make progress. Growth of productivity and real wages – and ultimately even high employment – requires commercial innovation to keep up the rate of return in the face of the volume of investment needed for high employment.

Would these new industrial banks be able to earn a normal rate of return? A very dark cloud here is that the dynamism of the business sector in the U.S., and perhaps the U.K. as well, has been in decline for many years. In the 1990s the number of initial public offerings (IPOs) by young companies – typically raised to adulthood by venture capital firms – ran at the rate of 350 per year. In the present decade, the number of IPOs has been only 50 per year. It is likely therefore that the rate of new firm formation has likewise declined. Venture capital firms in Silicon Valley are shrinking. Thus, it appears that the new class of banks – banks that have acquired the expertise to judge well (about as well as one can) the long-term investments and innovative projects to finance – will require government support. This help by the

government might take the form of a subsidy to reduce the new banks' cost of capital. Or it might take the form of an initial endowment contributed to each bank by the government.<sup>10</sup>

Of course, there is abundant precedent for subsidized finance in western and eastern nations alike. In the U.S. there are the massive subsidies and tax breaks to encourage dwellers to own their own homes and own more; and there are subsidies to the banks in the Farm Credit System. The recent one-time bailouts aside, only business – the “chief business of America” – is asked to go without subsidies and, indeed, to pay stiff corporate taxes as well (on top of the personal taxes paid). Thus the proposed subsidy would be a step *toward* fiscal neutrality, not another step *from* it.

It seems clear, then, that with the prospects of profitable lending to the housing sector diminished by the swollen housing stock and the profitability of business lending in doubt, regaining an authentic prosperity will necessitate a pro-business initiative to revive business investment and business innovation.

*Creating a development bank to finance infrastructure and other “project finance”*  
A proposal was also made at the conference for the creation of a development bank specializing in project finance to focus on infrastructure development, investment in new technologies, investing in the working poor, the environment, and other capital projects.<sup>11</sup>

At a time when reform of the financial system is discussed, a critical consideration is whether those reforms could address the still insufficient levels of economic inclusion without stifling dynamism. Countries – ranging from France and the Netherlands to Singapore and Chile – have adopted or are in the process of adopting subsidies to companies for their ongoing employment of low-wage workers. A development bank could be the institution to channel and monitor this type of subsidy, which I began advocating since the mid-1990s, both as a mechanism for inclusion and also for reactivating lagging economic activity.<sup>12</sup> In fact, as a candidate in 2008, President Obama hinted at subsidies to widen “rewarding work,” although no provision in this direction has been made of the envisaged magnitude – such as 2 per cent of the GDP.

### **III. A framework to deal with excessive asset price swings**

There was wide recognition at the conference that, although it is now endemic among financial practitioners, the Rational Expectations postulate, in assuming that markets possess complete knowledge as well as information – so that they tend always to equilibrium, deviations from which are results of exogenous factors – is untenable. No model of rational individual choice in a capitalist setting of genuine innovation and consequent “Knightian uncertainty” has ever been produced that gave theoretical support

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<sup>10</sup> This proposal of mine I put forward in my paper “The Justice of a Well-Functioning Capitalism and the Reforms that Will Realize It” for the conference <New World, New Capitalism>, chaired by President Nicolas Sarkozy and former Prime Minister Tony Blair, Paris, 8-9 January 2009.

<sup>11</sup> Such a proposal was put forward by Jeffrey Sachs.

<sup>12</sup> Phelps, *Rewarding Work* Cambridge, Mass., Harvard University Press, 1997. Reprnt. Edn. 2007.

to that assumption. And the empirical record strongly suggests that history does not endlessly repeat itself, so that forecasts that were on the mark in one era have in other eras been far off the mark for long stretches of time. For many, this crisis was more evidence that market fundamentalism, that is, the belief that markets are self-correcting, and hence should be left to their own devices, was a misconception.<sup>13</sup>

Moreover, the sharp downswings in housing and equity prices, which followed long upswings that moved excessively far above historical benchmark levels, helped to trigger and continue to fuel the financial crisis. As the downswings continue, there is a real danger that they may also become excessive and drag the economy and the financial system into an even deeper crisis. A new conceptual framework – Imperfect Knowledge Economics (IKE) framework – was proposed so that officials have measures in place to help dampen such excessive movements if they come to pass.<sup>14</sup>

Standard economic theory explains such swings as “bubbles,” unrelated to fundamentals, arising only because market participants fall prey to irrationalities, herding instincts, or reliance on technical rules. The policy prescription of the standard theory is to either leave markets unimpeded (other than ensuring transparency, and eliminating other market failures) or extinguish asset-price swings as soon as they arise, even if this requires massive government intervention.

Although psychological elements and technical trading may play a role, markets undergo swings even if everyone bases their trading decisions solely on fundamental factors. Thus, eliminating price swings as soon as they appear makes little sense. At the same time, markets are not perfect and participants must cope with imperfect knowledge about how to interpret fundamental factors in forecasting future returns.

The IKE framework provides the rationale, because of excessive price swings, for policy intervention in asset markets. It also has important implications for how regulators should measure and manage systemic risk in the financial system. This framework acknowledges that, within a reasonable range, the market would do a far superior job, though not perfect, in setting prices, recognizing at the same time that price swings can become excessive and that this excess is socially costly.

To apply this IKE framework, officials need to ascertain a “guidance range” of non-excessive prices, that is, a range where prices are not too high or too low from levels that are consistent with longer-term prospects. In addition to regularly announcing policy ranges, officials could vary margin and capital requirements or rely on other tools if the downswings do become excessive. To dampen them, policy should encourage the trading behavior of bulls, which are helping to bid prices up, and discourage the behavior of bears, who are betting on a continuation of the downswing.

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<sup>13</sup> A survey, with references to the work of Roman Frydman, a Center member and others, is my “Revolutionary Times, Then and Now,” in *Capitalism and Society*, vol. 3, no. 3.

<sup>14</sup> The rationale and details of this proposal are in Roman Frydman and Michael Goldberg, “Financial Markets and the State: Price Swings, Risk, and the Scope of Regulation,” Working Paper No. 29, available at the Center’s website. It is also forthcoming in the Center’s electronic journal *Capitalism and Society*.

Although this proposal requires further work in establishing adequate guidance ranges in various markets, the policy would be easy to implement and be transparent. The idea has been overlooked in policy discussions, perhaps because the vast majority of economic models account for asset price fluctuations with just one set of views, that of the so-called “representative agent.” Such models are unable to target policies differently to bulls and bears.

The important policy conclusion from this framework is that restrictions on short-selling, such as the uptick rule, and other such measures that do not differentiate between bulls and bears and do not distinguish whether the long swing is excessive from above or below, could actually lead to greater instability. In fact, improving the financial markets’ ability to self-correct to sustainable values is the entire point of prudent measures. Depending on the situation, the uptick rule, a total ban on short selling, and other measures which pay no regard to whether an asset is over or undervalued may be beneficial in some circumstances and counterproductive in others. The prevailing view that policymakers should be bound by fixed rules will not do.

#### **IV. International cooperation**

Many of the participants pointed out to the need and urgency of countries to work together to design and institute a new financial regulatory framework that is internationally consistent. Some conferees pointed to areas such as capital adequacy, liquidity management, and financial reporting standards for all financial and non-financial corporations in which the need for internationally-consistent regulation and supervision may be imperative.

As discussed earlier, there was support for regulating the rating agencies and regulating the “non-cooperating centers” on a global and consistent basis. There was much less support for regulating hedge funds, particularly if narrow banking was adopted.

There was also concern for the strong contagion that had taken place from the financial crisis in advanced countries to many emerging markets and support for increasing the resources of the international financial institutions to provide financing to emerging and low-income countries.

Let me take this opportunity to send good wishes for the G-20 meeting in April.

Sincerely,

A handwritten signature in black ink, appearing to read "Edmund S. Phelps". The signature is fluid and cursive, with a long, sweeping horizontal stroke at the end.

Edmund S. Phelps  
Director