Volcker’s Minsky Moment

By Kerry Pechter *Wed, Apr 21, 2010*

“The banks shouldn’t be running casinos on the side,” said former Fed chairman Paul Volcker at the Hyman P. Minsky Conference in New York last week.

At 6’7″ tall, Paul Volcker dwarfed the lectern on the podium at the Ford Foundation in New York last week. He was one of the headliners at this year’s Hyman P. Minsky Conference, and the audience of economists and officials fell silent as he spoke.

“There is something the matter in Washington…,” the 82-year-old former Federal Reserve chairman began.

What followed was not a critique of government, however, but rather a call for better federal regulation of financial institutions in the future. Washington’s problem, he said, was that 16 months after the financial crisis, two key senior positions at the Treasury Department were still vacant.

By the time Volcker finished speaking, in fact, he sounded in sync with the current administration. He asserted that the Fed should keep on regulating the banks, that the financial sector has grown at the expense of the rest of America over the past several decades, and that the “banks shouldn’t be running casinos on the side.”

His sentiments were not out of line with those of most of the people who gathered for the three-day conference, which has been sponsored by the Levy Economics Institute of Bard College for the last 19 years in honor of the late Hyman P. Minsky, who taught economics at Bard prior to his death in 1996.

Minsky developed a cautionary theory that periods of prosperity tend to breed complacency in financial markets, making them vulnerable to crises. Some people thought Minsky’s theory predicted the 2008 financial crisis, which in some circles was dubbed a “Minsky moment.”

The title of this year’s Minsky conference was “After the Crisis: Planning a New Financial Structure.” Given the ongoing efforts in Washington to pass a financial regulatory reform bill—and the debate over whether the Federal Reserve deserves blame for not preventing the crisis or credit for subduing it—the topic was especially timely.

The atmosphere was charged, even heated at times. A buzz was created by the presence of speakers like former New York governor (and “Sheriff of Wall Street”) Eliot Spitzer, Nobel Prize winning economist and journalist Paul Krugman, and the legendary cigar-chomping Volcker.

Volcker had been in the news for over a year, having been appointed by President Obama in early 2009 to chair the newly created Economic Recovery Advisory Board. His so-called “Volcker rule,” a proposal that the largest banks be prohibited from speculative trading on their own accounts or investing in hedge funds, is favored by the Obama administration. Diluted versions of it have also been proposed.

At the conference, where proposals to present the next financial crisis ranged from passing rigid new laws to passing flexible regulations to allowing banks to insure each other or write "living wills" for use during bankruptcies or reorganizations, Volcker expressed skepticism that anything less than laws could effectively rein in bankers from speculative excess.

"You cannot manage the system by relying on regulations," he said, suggesting that regulations can often be fudged and regulators captured. "How long would an aggressive regulator last? I know he won't be the object of great affection in the financial community." Instead, we need a "structural solution," with laws instead of regulations, so that a regulator can say, "I'm sorry but the law won't permit it."

Regarding the wisdom of controversial 1999 repeal of the Glass-Steagall Act of 1933, the Depression-era law that barred commercial banks from underwriting securities and to which the Volcker rule has been compared, he said that "the problem is that we didn't replace Glass-Steagall with anything good."

Volcker said he was against giving hedge funds the protection of a government safety net, in favor of establishing a clearinghouse or exchange for trading derivatives, and for bringing money market funds under the Fed's regulatory umbrella. Money market funds were rescued with public money when they "broke the buck" during the financial crisis.

"If [the money market funds] want to walk and talk like a bank, they need reserves and capital requirements like banks," he said. "They're the same as banks without the oversight and without the regulation. They've taking trillions of dollars out of the banking system and out of supervision. It creates a classic case of regulatory arbitrage. I'd love to see that taken care of."

One of the most contentious issues at the conference was whether the Federal Reserve should have its supervisory powers over the U.S. banking system expanded, be restricted to regulating only the largest, systemically-important financial institutions, or even give way to a more politically accountable, consumer-driven regulatory regime.

Like several other current and former Fed officials who spoke at the conference, Volcker took the side of the institution he once led. "The Fed is in the best position to regulate," he said. "Somebody should have been paying more attention to the development of the subprime mortgage market. But the Fed is in the best position [to regulate the banks] and it would be a big mistake to shut them out of supervision and regulation. The danger of regulatory capture is inherent in the system, and no agency is immune to it. The Fed is in a good position to resist regulatory capture because it also does monetary policy. It isn't just a regulator."

As for how well the government intervention worked in 2008 and 2009, he noted that fears that the government might nationalize the banks were a media exaggeration rather than ever a real possibility. "As it turned out, the idea of a stress test and the complicated process of getting rid of toxic assets worked reasonably well," he said.

Commenting on the repeal of Glass-Steagall and the subsequent merger of commercial banking and investment banking cultures, Volcker regretted that commercial bankers had become infected by the desire for the "higher multiples" of pay that investment bankers enjoyed. He called that a "destructive cultural fact."