Gerald Epstein: From Boring Banking to Roaring Banking

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Gerald Epstein is a professor of economics and a founding co-director of the Political Economy Research Institute (PERI) at the University of Massachusetts-Amherst. He has written extensively about U.S. and global finance and recently delivered the Distinguished Faculty Lecture at UMass-Amherst titled "When Big is Too Big: Do the Financial System's Social Benefits Justify Its Size?" In April, he sat down withDollars & Sense co-editor Alejandro Reuss to discuss major themes in his current research—the dramatic growth in the financial sector, the transformation from regulated "boring" banking to deregulated "roaring" banking, the ways the current system has ill-served the economy and society, and the need for regulation of private finance and development of alternative financial institutions.

Dollars & Sense: What should we be looking at as indicators that the financial sector has grown much larger in this most recent era, compared to what it used to be?

Gerald Epstein: There are a number of different indicators and dimensions to this. The size of the financial sector itself is one dimension. If you look at the profit share of banks and other financial institutions, you'll see that in the early post-war period, up until the early 1980s, they took down about 15% of all corporate profits in the United States. Just before the crisis, in 2006, they took down 40% of all profits, which is pretty astonishing.

Another measure of size is total financial assets as a percentage of gross domestic product. If you look at the postwar period, it's pretty constant from 1945 to 1981, with the ratio of financial assets to the size of the economy—of GDP—at about 4 to 1. But starting in 1981, it started climbing. By 2007, total financial assets were ten times the size of GDP. If you look at almost any metric about the overall size of the financial sector—credit-to-GDP ratios, debt-to-GDP ratios, etc.—you see this massive increase starting around 1981, going up to a peak just before the financial crisis, in 2006.

Two more, related, dimensions are the sizes of the biggest financial firms and the concentration of the industry. For example, the share of total securities-industry assets held by the top five investment banks was 65% in 2007. The share of the total deposits held by the top seven commercial banks went from roughly 20% in the early postwar period to over 50%. If you look at derivatives trading, you find that the top five investment banks control about 97% of that. So there's a massive concentration in the financial system, and that hasn't declined—in some ways, it's gotten worse—since the financial crisis.

D&S: Could you describe the qualitative changes in financial institution behavior in this same era, and the origins of these changes? When we hear that year 1981, we immediately think of deregulation. Is it just deregulation, or is there more to it than that?

GE: We can roughly think about two periods of banking and finance in the post-World War II era. Coming out of the Great Depression, when there was a lot of financial regulation, the Glass-Steagall Act separated investment from commercial banking, there were rules governing the issuing of complex and risky securities, rules for different kinds of financial institutions in terms of what kinds of assets they could hold. Savings and loans could mostly focus on housing, commercial banks primarily on business loans, investment banks couldn't take deposits and mostly engaged in underwriting and those kinds of activities. There were interest-rate ceilings, high capital requirements, leverage requirements. During this period, most of the activity of banks, commercial banks particularly, was in terms of taking in deposits and making individual loans—business loans, mortgages, real-estate loans. Many people call this the age of "boring banking." It was also called the age of "3-6-3" banking—bankers paid 3% interest, lent out at 6%, and got to the golf course by 3:00 in the afternoon.

Then starting in the late 1970s and early 1980s, their activities really changed, partly as a result of financial deregulation, partly as a result of increased competition from other kinds of financial institutions. Relatively unregulated banks could pay depositors higher interest rates, could charge higher interest rates on their loans, and could engage in new kinds of financial innovation—such as securitization, which is placing a bunch of loans into a bundle, such as an

asset-backed security or mortgage-backed security, and selling these things off. "Boring banking" could no longer compete, so instead of engaging in one-to-one lending, they started engaging in more activities with the capital markets—bundling up or securitizing loans, selling them off, using derivatives to hedge risks but also to make bets. They kind of became like hedge funds in the sense of doing a lot of trading, buying and selling a lot of derivatives, engaging with the securities and capital markets. But they still had the government guarantees like they were banks.

D&S: How does finance measure up, during this most recent era of deregulated finance, against the key claims that are made about its socially constructive role?

GE: If you look at the textbook description of the positive roles that finance plays, basically it comes down to six things: channel savings to productive investment, provide mechanisms for households to save for retirement, help businesses and households reduce risk, provide stable and flexible liquidity, provide an efficient payments mechanism, and come up with new financial innovations, that will make it cheaper, simpler, and better to do all these other five things. If you go through the way finance operated in the period of "roaring" banking, one can raise questions about the productive role of banking in all of these dimensions.

Taking the first role, channeling finance to productive investment, in the early post-war period, nonfinancial corporations on average got about 15-20% of their funding for productive investment from outside sources, from banks and from the capital markets. For the rest, they used retained earnings. In the latter period, after around 1980 or so, this was cut more or less in half—to 7-10%. So finance didn't really provide a huge percentage of funds for nonfinancial corporate investment in the age of roaring banking. So you have this paradoxical situation where the income going to finance grew significantly while the real contribution to providing funding for investment went down. During the 1960s, finance got about 40 cents for every dollar they gave to nonfinancial corporations for investment. By the 2000s, it was up to 66 cents.

What was finance doing instead? As Juan Montecino, Iren Levina, and I point out in a paper we wrote, they started lending to each other, instead of to the real economy or nonfinancial corporations. So we looked at intra-financial sector lending as a share of total lending from 1950 to 2010 and we found that, from 1950 up to around 1980 or so, they were only doing about 10% of total lending to each other. Just before the crisis in 2008 or so, they were doing almost 30% of all lending to each other. This lending to each other really was a way of providing finance for derivatives trading and other kinds of betting, rather than financing real investment.

The second role is providing mechanisms for households to save for retirement. There are a lot of studies that show that banks didn't do a very good job in the period of roaring banking. Part of the problem is that the savings vehicles that finance provides for households come at a very high cost. If you put your money in a mutual fund, say, with Fidelity or one of these other companies, oftentimes the fees that you have to pay are very high, and the returns that you get

aren't any better—sometimes worse—than if you put your money in a broad portfolio of stocks, like the S&P 500 or something like that. There are a lot of studies that show that the returns that you get from putting your money in these active funds is more than 2% less than if you just put it into a broad stock portfolio. Well, this 2% is going directly to the company, to Fidelity and the people who work for them, so it's a way that finance is overcharging.

The way in which finance has failed in helping households save for retirement is even more stark if you realize that, for most households in the United States, most of the wealth that people have is in their homes. If you think about what the financial sector did to people's savings in their houses in that period, it's a pretty dismal record—especially for African-American and Hispanic and other minority households, much more so than for white households. Already, African Americans' wealth is just a fraction of white wealth, and most of their wealth was in their houses. The financial crisis of 2006-2007 pretty much wiped out a large percentage of African-American wealth during this period. So clearly, roaring banking didn't do much to help households save for retirement.

The third role is to reduce risk. You just need to look at the kinds of financial products that banks were selling under the guise of reducing risk—like credit default swaps, mortgage-backed securities, asset-backed securities, etc. These products lost enormous amounts of value during the financial crisis, and would have lost almost all of their value if the government hadn't bailed them out. The financial sector was a source of enormous risk, rather than a source of reducing risk.

The same can be easily said of the fourth function, providing stable and flexible liquidity. If you look at the housing bubble and the tremendous run-up in asset prices provided by the tremendous increase in liquidity from the financial sector—through asset-backed securities, subprime lending, and so forth—you realize that it was not stable. It was actually what led to the asset bubble and crash. So private banking does not provide stable or flexible liquidity. In the end, in 2008, the Federal Reserve had to come in and provide enormous amounts of liquidity to the system to keep it from melting down entirely.

For the fifth role, to provide an efficient payments mechanism, we see a similar kind of thing. The only thing that kept the payments system operating after the financial crisis was the enormous amounts of liquidity that the Federal Reserve flooded into the financial system.

Moreover, if anyone has ever tried to transfer money from one bank to another, or overseas, you realize that our payments mechanism—even in normal times—is very inefficient. Banks can hold onto your funds for two or three or four days before making them available to you, when you try to transfer from one bank to another, just as a way of extracting more money from households. Both in abnormal times and in normal times, the payments mechanism in the period of roaring banking is very poor.

Finally, that brings us to banking innovations. Paul Volcker famously told a group of bankers in 2009 that the only financial innovation that he could see in the last 20 years that had been at all efficient was the ATM. There's no evidence that financial innovations have led to more economic growth. Jim Crotty and I did a literature survey that showed that at the minimum 30-40% of financial innovations over the last 20 years or so are used at least to some extent, if not largely, to evade regulations or to evade taxes—that is, to shift around pieces of the pie from the public to the banks, rather than to increase the size of the pie.

In short, roaring banking has done a pretty dismal job of providing any of these functions that the textbook case says finance should provide.

D&S: Of course, bubbles burst and exacerbate the severity of downturns. One of the amazing things about the aftermath of the recent crisis has been the apparent imperviousness of the financial sector to serious reform—especially in contrast to the Great Crash of 1929 and the Great Depression. How do you make sense of that?

GE: You have to use a political economy approach to understand the sources of political support for finance. I call these multilayered sources of support the "bankers' club."

The lead group in the bankers' club is the bankers themselves, and the politicians that they're able to buy off with financial contributions and so forth. Their ability to do that, of course, has become much greater with changes in the campaign finance reform laws and Citizens United and so forth, so it makes it much easier for the banks to throw enormous amounts of money at politicians and prevent significant reform. This is true for both parties, for the Republicans and for the Democrats. We know how important finance was to Bill Clinton's political coalition in raising money. That's been true for Democrats for many years, not just Republicans.

The bankers have a lot of other support as well. Historically, the Federal Reserve has been one of the main orchestrators of the bankers' club. You can clearly see that in the role that Timothy Geithner played—when he was at the New York Fed, and then after he became Treasury Secretary under Obama—in fighting tooth-and-nail against any significant reform. He was one of the main figures in the opposition to tough reform through the Dodd-Frank Act. The Federal Reserve, through many mechanisms—the "revolving door" mechanism, the fact that they regulate banks, and so on—is a very strong member of the bankers' club.

A perhaps surprising group in the bankers' club has been many economists, especially academic economists who work on finance. Some of them take quite a bit of money from financial firms as consulting fees or are on the boards of directors of financial firms. Jessica Carrick-Hagenbarth and I studied this, looking at a group of 19 well-known academic economists who were working with two groups, the Pew Charitable Trusts Financial Reform Project and the Squam Lake Working Group on Financial Regulation, on financial reform issues. And they were coming up with financial reforms that, while some of them were OK, a

lot really lacked teeth. We found that many of them, if not most of them, had some kind of association with financial firms, but were not disclosing this when they would write their academic papers speak on the radio or on TV or give testimony.

An important source of power of the bankers' club is that bankers can threaten to fail if we don't bail them out. They can threaten to leave—to move to London, Frankfurt, Hong Kong, or Shanghai—if we don't give them what they want. So this threat is the ultimate "club" that the bankers hold over our heads, and they use that all the time in the fight over financial reform.

On top of that, there's an important member of the bankers' club that in the 1930s wasn't a member—nonfinancial corporations. This time around, if you look at the fight over Dodd-Frank, you find very little opposition to banks from other members of the capitalist class. They were either silent or supported the banks. This is a big contrast to the 1930s when a lot of industrial firms did not support the banks, and in fact joined with FDR on financial regulation. Why is this? Why didn't we see more opposition from other capitalists to what the banks had done? After all, what the banks did led to this massive recession and hurt profits, at least initially, created all sorts of problems for nonfinancial corporations—and yet they supported the banks. Part of the answer may be that nonfinancial corporations have now become financialized themselves. The CEOs of these corporations get a lot of their incomes and wealth through stock options and other kinds of financial activities. Some nonfinancial firms have large financial components themselves. GE, for example, is now spinning off its financial subsidiary, GE Capital. But for many years it was getting quite a lot of income from GE Capital. And it's not just GE but also many other large nonfinancial corporations.

So there was a united front among the capitalists to oppose strong financial reform. Finance had plenty of money to buy off politicians. And while there was strong and valiant effort on the part of Americans for Financial Reform, Better Markets, some academic economists who were opposing what the banks did, and important roles played by Elizabeth Warren and some other senators—it just wasn't enough, given this united front of capitalists, the money machine, and the academic economists who were giving legitimacy to what the banks were doing.

D&S: That brings us to the question of a reform agenda for now. We've heard a lot about the need for re-regulation of finance, with an eye toward the restoration of the boring banking of the 1950s-1970s. The other question is whether the functions of finance require capitalist banks at all, even within a capitalist economy. Could all the functions of finance be done better by public and cooperative financial institutions, rather than private capitalist banks?

GE: The way I've been thinking about it is that we need both—that they're complements to each other. Short of complete overthrow of capitalism, and having a totally socialist economy, which is unlikely to happen in the immediate future, what I think we should argue for is both re-regulation of private finance and a much stronger push for what I call "banks without bankers." We need to have re-regulation of private finance as long as it continues to exist, for two reasons.

First, as we've seen—and as John Maynard Keynes and Hyman Minsky and others argued—private finance can create a lot of problems if it's not regulated. As Keynes put it, when "enterprise is a bubble on a whirlpool of speculation," we're in big trouble. You have to bring private finance under control so that it can't continue to generate these massive bubbles and then crashes, which create enormous problems for workers and for households all over the world.

Second, as long as there's private finance out there and the bankers are making enormous profits and incomes, not only does that generate a worsening of the income distribution—it's an engine for inequality—it also makes it hard to have a stable and productive public financial sector. If you have public or cooperative banks, and you have people running those institutions and they think of themselves as financiers or bankers, and they realize that they could jump ship and work for the private financial sector and make five, ten, fifteen, twenty times what they're making in the public interest, this can be extremely tempting. Or it can get them to reorient the activities that they engage in to make them more profitable and look more like private banks. This is what happened to a number of public financial institutions around the world in the run-in up to the financial crisis. The first financial institution that really got into trouble, or one of the first, was a Landesbank, a regional provincial public bank in Germany that was supposed to be making boring banking investments, but instead was making roaring banking investments, because they wanted to keep up with the private financial institutions.

You can't let there be too big a gap between the activities and the incomes and pay between the public sector and the private sector if the public sector is going to do the job it needs to do. Of course, you can have a gap, and it can be somewhat large, but it can't get as big as it got in the 2000s. So for both of those reasons I do think that we do need to control private finance.

But in order to break up the bankers' club and to provide the real kind of finance that society needs, we do need to promote more cooperative finance and public finance. How do you do that? Well, there are a bunch of different ways. For example, there's the State Bank of North Dakota, and there are a number of organizations that are trying to promote state banks in other states. I know there's been an organization in Massachusetts, for example, that's been trying to do this. There are credit unions all over the country, so building the credit unions by having a national credit union bank to support them. These are all things that should be done.

The government should stop subsidizing the "too big to fail" banks by bailing them out. This lowers the cost of funds for these banks, allows them to grow larger and squeeze out cooperative and other kinds of community banks. So the government should end too big to fail as a way to make more room for these other kinds of public and cooperative banks. The Federal Reserve could serve as a backstop for these types of banks, by agreeing to act as a lender of last resort, to let them use their securities as collateral for borrowing. So there are all different kinds of ways that the government could support the creation or expansion of these sorts of institutions.

I think that's necessary for us to get out of the trap that we're in.

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