



INTERNATIONAL PAPERS IN POLITICAL ECONOMY

Economic Policies for a Post-Neoliberal World

Edited by

PHILIP ARESTIS
MALCOLM SAWYER

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International Papers in Political Economy

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This series consists of an annual volume with a single theme. The objective of the IPPE is the publication of papers dealing with important topics within the broad framework of Political Economy.

The original series of *International Papers in Political Economy* started in 1993, until the new series began in 2005, and was published in the form of three issues a year with each issue containing a single extensive paper. Information on the old series and back copies can be obtained from the editors: Philip Arestis (pa267@cam.ac.uk) and Malcolm Sawyer (e-mail: mcs@lubs.leeds.ac.uk).

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Editors

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Preface

This is the seventeenth volume of the series of *International Papers in Political Economy (IPPE)*. This series consists of an annual volume with eight papers on a single theme. The objective of the *IPPE* is the publication of papers dealing with important topics within the broad framework of Political Economy.

The original series of *International Papers in Political Economy* started in 1993 until the new series began in 2005 and was published in the form of three issues a year with each issue containing a single extensive paper. Information on the old series and back copies can be obtained from the editors: Philip Arestis (e-mail: pa267@cam.ac.uk) and Malcolm Sawyer (e-mail: m.c.sawyer@lubs.leeds.ac.uk).

The theme of this seventeenth volume of eight papers is Economic Policies for a Post Neo-Liberal World. The papers in this volume were scheduled to be presented in late March 2020 at a one-day conference in Cambridge, UK (Downing College), organised by the Department of Land Economy, University of Cambridge, under the aegis of the Cambridge Trust for New Thinking in Economics. The papers were intended to be presented subsequently at the annual conference, entitled *Developments in Economic Theory and Policy*, held at the University of the Basque Country, Bilbao, Spain in June 2020. These conferences had to be cancelled as a consequence on restrictions on meetings and travel in response to the COVID-19 pandemic. We are grateful to the organisers

of the Cambridge Trust for New Thinking in Economics and to the organisers of the *Developments in Economic Theory and Policy* conference series, for funding and help in the organisation of annual conferences over a number of years, which have enabled presentation of the relevant papers, and subsequently published in the *International Papers in Political Economy* series.

Cambridge, UK
Leeds, UK

Philip Arestis
Malcolm Sawyer

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1

Financial Stability: Still Unsettled for the Future

Philip Arestis

1 Introduction

Following the Global Financial Crisis (GFC), a number of proposals emerged which support financial-stability policies. This is expected in view of 24 countries around the world that experienced banking crises. Weaknesses in regulatory architecture, a lack of proper control of the financial sector and undertaking of excessive risks, which were key causes of the GFC, are still evident. An important policy implication is that the focus on monetary policy to meet the single objective of inflation target, thereby macroeconomic and financial stability emerge, is insufficient (Arestis & González Martínez, 2015; Arestis, 2019b; also, IMF, 2009). Appropriate policies are needed. Especially so, as Cunliffe (2019b) argues, “the most important lesson we learned from the crisis is that financial

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stability is a necessary condition for macro-economic and monetary stability” (p. 14). Carney (2020) agrees, “Price stability clearly is not a guarantee for financial stability” (p. 2), and that coordination of monetary and financial stability is important. Indeed such coordination “is codified in the UK institutional set-up with independent monetary and financial policy committees that are required by remit to have regard of the actions of each other” (p. 22). The Bank of International Settlements (BIS, 2011) also confirms that price stability as a single target is not enough. What is needed is “a stability framework in which monetary, fiscal and prudential policy work together to build a robust and stable macroeconomic and financial system that will make the next crisis both less likely and less severe” (p. 3).

Fiscal policy is vital in both the short and the long run, and so is coordination with monetary and financial-stability policies, along with discretion in applying them. Especially so, and as Cunliffe (2019b) suggests, “financial stability depends in part on effective demand management” (p. 14). Financial stability should be the top priority of central banks’ policies; the GFC events, and the coronavirus syndrome, testify to this important requirement. Financial stability, therefore, requires further investigation, the focus of this contribution.

Proposals and policies that aim at securing financial stability and avoid a similar crisis to GFC are in place, but still not fully implemented. Further complexities have emerged, which could produce serious problems. We proceed in Sect. 2 to discuss financial stability and the proposals following the GFC to account for it. Section 3 discusses further problems with financial stability. Section 4 focuses on required policies, and for the post-neoliberal era. Finally, Section 5 summarises and concludes.

2 Financial Stability and Post-GFC Proposals

Financial stability comprises of two regulation frameworks: microprudential (focusing on individual financial entities) and macroprudential (focusing on the entire financial system).¹ Our approach focuses on macroprudential financial stability.

The focus of financial stability should be on proper control of the financial sector so that it becomes socially and economically useful to the economy and to the productive sectors in particular. A well-functioning financial system should channel funds from surplus sectors to those with fund shortages. Banks, and other financial institutions, should serve the needs of their customers rather than targeting huge profits and excessive gains for shareholders. Proper monitoring and assessment of systemic risks, so that financial systems are robust, is an important part of financial stability. According to the Bank of England (2019; BoE hereafter), “Financial stability might sound confusing but it’s just a way of describing the financial system when it’s fulfilling its basic roles. With a stable financial system, the wheels of the economy keep turning, even when the conditions get difficult”. Would macroprudential regulation have prevented the GFC? Aikman, Bridges, Kashyap, and Siegert (2019) suggest that “a macroprudential regime with a suitably strong mandate, coupled with powers to adjust financial system leverage and maturity/liquidity transformation and to limit household sector indebtedness, could have significantly ameliorated the macroeconomic fall-out from the collapse of the real estate bubble” (p. 127). Forbes (2019) suggests, “Macroprudential policy should improve the economy’s ability to withstand shocks and allow the financial system to function effectively under adverse conditions” (p. 471)—see, also, BoE (2009) and IMF (2011).

We discuss next relevant proposals for macroprudential financial stability. We begin with the US Dodd-Frank Act.

¹ ‘Macroprudential’ was mentioned for the first time at the meeting of the Cooke Committee (28–29 June 1979), the forerunner to the Basel Committee (Clement, 2010, p. 59); never implemented prior to the GFC. Microprudential regulation has been around since 1979.

2.1 US Dodd-Frank Act

Dodd-Frank Act was law-signed on 21 July 2010. Relevant proposals include. Volcker Rule: eliminate proprietary investments to prohibit banks to use insured deposits to run own trading operations, and ownership of hedge funds.² Banks can hold 3% proprietary investments of their core capital. Size matters: no financial firm should become ‘too big to fail’. The Act grants government the power to wind down failing financial institutions if they threaten the financial system. A new ‘orderly liquidation’ authority has the power to seize a failing ‘systemically important’ institution. An Office of Credit Ratings to be established to supervise credit rating agencies; ‘shadow banking’ and non-bank financial entities should also be regulated. However, and according to Tarullo (2019), “less attention has been paid to the risks of financial stability that may arise in the ‘shadow banking’ area”. The shadow banking is still “outside the perimeter of prudentially regulated firms” (p. 70).

This Act is the most wide-ranging overhaul of US financial regulations since the 1930s. However, whether it would have prevented the GFC is an interesting question. Our response is in the negative in view of the non-separation of commercial and investment entities. Another problem relates to the ‘Volcker Rule’. This rule is one of the key provisions of the Act. Its aim is to prohibit banks from indulging in speculation. However, it could be that bank trading may shift to ‘shadow banking’, and thereby financial risks increase.

Criticisms of the Act emerged. The Financial Services Forum, which represents 18 top US banks, has argued that the proposed elimination of proprietary investments is too complicated and too costly to achieve. An additional argument is that such proposals put jobs at risk, damage the United States’ competitiveness and threaten its growth. Also, tackling the ‘too-big-to-fail’ institutions should be through effective supervision, not as in the Act. Most frequent argument is that the Act is too complicated. Surely though, it is not as complicated as the collateralised debt obligations (CDOs), one of the main causes of GFC (Arestis, 2016).

² Hedge funds, lightly regulated, pool capital and invest it in a variety of assets.

The US President's criticisms focus on the repeal of Dodd-Frank Act. This is because the Act has prevented banks to provide sufficient credit. The President ordered a review of the Act in early February 2017, with a relevant report produced in June 2017 (see below). The House of Representatives voted, in early June 2017, to replace the Act with their own Financial Choice Act, whose focus is to repeal the Volcker Rule. The Senate proposed easing bank regulations, based on the argument that the economy is better without strict controls, and a split of banks would impair their ability to invest. Clearly, these criticisms aim at dismantling many of Dodd-Frank Act rules on the argument that freeing banks boosts growth.

The US Treasury released its report, 12 June 2017, on financial-regulations reform (Mnuchin & Phillips, 2017), which suggests that the current system of excessive financial regulations undermines the ability of banks to provide credit, thereby constraining economic growth. Since 2009, lending only rose by 25%, far less than in other recent recoveries. The report also claimed, "Dodd-Frank has increased the burden of regulatory compliance without adequate cost-benefit analysis and that Dodd-Frank has prolonged the moral hazard arising from regulations that could lead to taxpayer-funded bailouts" (p. 34). Although it did not reject the Act, it recommended its application with less rigour and greater consultation. In terms of the Volcker Rule, it proposed that it should only apply to very big banks engaged in large-scale operations.

The US Congress passed a bill, 22 May 2018, which exempts medium-sized banks from the stringent rules. Only banks with at least \$250bn in assets are subject to strict Fed oversight, up from \$50bn previously. It marks the biggest change of financial laws since the Dodd-Frank Act. The US Federal Reserve Board voted, 30 May 2018, to relax the limit of banks' ability to engage in proprietary trading, with the greatest relief for smaller banks. In effect, this proposal allows the combined commercial and investment banks to undertake riskier activities with insured bank deposits. If the Fed Board proposal went through, it would take it all back where it was initially. More recently, easing of the Volcker Rule has been undertaken for the financial services industry, which had been complaining that the Volcker Rule took too much of their time and money in

view of it being complicated. Clearly, then, the Act is to be repealed. The US regulators ignore history, especially the causes of the GFC.

2.2 UK Vickers Report

The UK government appointed the Independent Commission on Banking in the summer of 2010 to consider whether a version of the US Dodd-Frank Act would be appropriate for the United Kingdom, and whether banks should be split into commercial and investment entities. The Commission (chaired by John Vickers) produced its final report in September 2011 (Independent Banking Commission, 2011), the Vickers Report. It recommends ‘ring-fencing’ banks’ retail operations from their riskier investment activities. Each part of the ring-fenced bank is a separate legal entity with its own board. The ring-fencing applies to the largest UK banks that have more than £25bn deposits. The UK Prudential Regulation Authority (PRA)³ has the regulator role in relation to the ring-fenced banks. The Vickers Report thereby aims to protect retail-banking activities from losses incurred in investment-banking operations and to prevent taxpayer bailouts of ‘too-big-to-fail’ banks. The reform came into force on 1 January 2019.

Proudman (2018) suggested that had ring-fencing been in place prior to GFC, it would have reduced the likelihood of government support. However, there are problems with the Vickers Report. The main problem of ring-fencing is that banks may be encouraged to take greater risk within the ring-fencing activities, such as mortgages, corporate and other type of assets. This is so since such activities would be more likely to be bailed out. No wonder the UK Parliamentary Banking Commission

³ There are three UK financial regulation committees. The Prudential Regulation Authority (PRA), which is part of the Bank of England (BoE) and is responsible for the supervision and regulation of banks, building societies, credit unions, insurers and major investment firms, at the level of individual institutions. There is also the Financial Conduct Authority (FCA), which regulates the financial services industry. It is accountable directly to Treasury and Parliament. The Financial Policy Committee (FPC) is an official committee of the BoE, with its focus on macroeconomic financial issues, and is responsible for managing the financial sector, with its primary objective to deliver financial stability. It cooperates and coordinates with the PRA and FCA. The PRA and FPC are co-located with the Monetary Policy Committee, at the BoE. They enjoy overlapping membership, and the Governor of the BoE chairs these committees.

proposed a review of this rule so that a full separation of the whole industry is undertaken if the ring-fence is not followed properly. Another problem is Vickers' (2016) argument that the BoE did not adopt the recommendation that banks should ring-fence extra capital equivalent to 3% of their risk-weighted assets (RWA). The BoE suggested that 1.0% should be sufficient. There are problems with the UK Vickers Report and doubts whether it has been implemented properly.

2.3 The European Commission's Liikanen Report

The European Union (EU)-Commission committee, headed by Erkki Liikanen, the Finnish Central Bank Governor, made a ring-fence proposal in 2012. The committee suggested ring-fencing banks' trading business from their retail activities, opposite to the Vickers Report. The report's objective is to contain "banking group's incentives and ability to take excessive risks with insured deposits" and to "prevent the coverage of losses incurred in the trading entity by the funds of the deposit bank, and hence limit the liability of taxpayer and the deposit insurance system" (Liikanen Report, 2012). The Liikanen Report has been criticised in that governments in a crisis may still bail out banks, even ring-fenced ones. Companies may turn away from bank loans to capital markets, thereby disrupting the flow of corporate bank funding. Ring-fencing trading assets would limit the liquidity of corporate bond trading, making this form of financing more expensive. In October 2017 the European Commission withdrew its proposal. The main reason was lack of progress, and in view of the objectives of the proposal, which had already been accounted by other regulations. It is not clear though, how other regulations had accounted for the relevant objectives.

2.4 The IMF Proposal

This proposal (Claessens, Keen, & Pazarbasioglu, 2010) includes high capital and liquid-asset requirements, along with legal regimes that provide orderly resolution of failing institutions. An important complement