The financial crisis has led to a variety of recommendations of how to change monetary policy and how to regulate the financial system in order to avoid similar crises in the future. Yet, as solutions provided stem from economists with diverging theoretical backgrounds, solutions by different authors - even though seemingly convincing at a first glance if judged on their own - may appear incompatible or even contradicting compared to one another. To understand and evaluate the underlying theoretical assumptions and resulting policy recommendations, Sheila Dow's publication "Monetary policy and regulation of financial markets - a Keynesian view", presented at the "Keynes Konferenz 2011" in Vienna (Dow 2012a), provides an extremely valuable basis.

The comment starts with quickly summarizing her main points on the relation between theory and policy advice from a Keynesian point of view, and the interrelation between theory, institutions and policy. It also recapitulates the convincing arguments of the paper against mainstream approaches. After discussing Sheila Dow’s Keynesian recommendations for monetary policy and financial market regulation where she concentrates on “principles and approach rather than details” (ibid.: 2), the comment provides ideas for more detailed recommendations for financial market regulation that could be regarded as being in line with Keynesian principles. The focus is on the role for international banking regulation, even though Sheila Dow is rather sceptical about it and stresses its crisis promoting role.

1. The role of theory for policy advice in Keynesian approaches

Dow (2012a) takes Keynes’ The General Theory as a starting point, yet extends her analysis to Keynesian and Post Keynesian approaches in general, contrasting these views with neoclassical mainstream approaches. As stated in the abstract, the paper’s aim is to “...explore the relationship between theory and policy in a Keynesian framework.” According
to the paper, there is an important difference between Keynesian and mainstream approaches: While the latter tend to separate "positivist" theory from "normative" policy recommendations, "Post Keynesian theory is developed with a view to addressing policy questions, rather than a separable abstraction, within a general exercise in political economy as a moral science." (ibid.: abstract). The possibility of a value-free theory would have been denied by Keynes, as he "... saw economics as a moral science, with values embedded in theory, something of which account needs to be taken when giving policy advice." (ibid.: 58). As a consequence, a Keynesian approach would call for being as conscious as possible about underlying values instead of claiming to provide value-free theories. In addition, a pluralist approach to concepts and methods would be preferable.

2. The role of theories in shaping EMU institutions

Drawing on Karl Niebyl (1946), who analyzed for classical monetary theory how ideas shape reality and vice versa, Dow (2012a) exemplifies the interaction between theory, institutions, and policy options by analyzing monetary policy arrangements in the European Monetary Union (EMU). According to the paper, many of the current problems in the EMU are due to the fact that monetary institutions for the euro have been built based on an inadequate theory. As monetarist theory (the paper explicitly cites Frenkel and Johnson 1976) dominated mainstream thinking at the time of the introduction of the euro, the resulting policy advice was to separate fiscal policy from monetary policy by setting up an independent European Central Bank whose only aim was price stability, while at the same time establishing fiscal deficit and debt criteria for the member countries in the Maastricht Treaty. The idea was that monetary flows would be sufficient to restore equilibrium in case of structural differences between EMU member countries, making inter-country fiscal transfers unnecessary. That this structure, and especially the lack of fiscal transfers, is now heavily constraining the ability of member countries' governments to solve the current crisis in the euro area, as Dow (2012a: 48) argues, can hardly be denied.

Dow (2012a) criticizes that monetarist theory was adequate to describe monetary institutions and production of the eighteens century. As today's money is created endogenously (instead of exogenously as assumed by monetarist theory), policy recommendations based on monetarist theory are misguided and provoke crises. She points to the problem that following Niebyl's framework, the current crisis should have revealed this inadequateness and should have led to a shift in monetary theory.
Yet, up to now, this has not occurred. Instead, mainstream proposals for reforming monetary policy are quite influential in economic debates. Prominent recommendations are a return to traditional banking, which in its extreme would call for 100% reserve backing. One can only support Sheila Dow’s critic on these recommendations (Dow 2012b), as this would impede credit creation of commercial banks, decreasing the supply of credit to an extent that would imply a major credit crunch in the short run and noticeable lower credit levels in the long run, harming economic development.

Even though she leaves the survival of monetarist ideas unexplained, one could argue that the survival of the theory is due to the fact that monetary institutions are functional, even though being based on an inadequate theory. Her statement that the current institutional setting by ignoring the endogeneity of money impedes the central bank to reach the goal of price stability seems to be rather extreme: “If central banks cannot determine the money supply and more generally financial markets exercise power over central banks and governments, then central banks cannot hope to achieve their inflation targets and monetary flows cannot be presumed to be equilibrating, while governments are constrained in their spending and borrowing.” (ibid.: 49). Standard textbook presentations following the endogeneity of money approach like e.g. Miskin (2009) would not go as far as to state that reaching the inflation goal is impossible, just because full control of the money supply is impossible for a central bank. And empirical evidence speaks against Dow (2012a)’s statement. Up to now, the ECB has been extremely successful in reaching the HICP y-o-y target of “below, but close to 2%” since the introduction of the euro.

3. Keynesian recommendations for monetary policy

In contrast to mainstream approaches separating the real from the nominal sphere, Post Keynesian approaches assume greater interconnectedness and therefore recommend an integration of monetary policy, fiscal policy, and financial regulation (Dow 2012a). To clearly separate Keynesian recommendations for monetary policy and financial market regulation is therefore difficult. That is e.g. reflected in her citation of Arestis and Sawyer (2010), who claim that Keynesian monetary policy is directed more towards financial stability than monetary stability.“ (Dow 2012a).

Sheila Dow’s main starting point for policy recommendations regarding monetary policy and financial regulation after the financial crisis is the necessity to re-establish trust. The Keynesian concept of trust is broader than the one in mainstream (game theoretic) approaches where trust
can be calculated as the likely outcome in a game based on rational expectations. In Keynesian approaches, uncertainty impedes precise calculation, leading to a more important role for trust: Without it, society would not function. Yet, once destroyed, trust in the Keynesian sense is much harder to regain as it needs a long time to build up (Dow 2012a).

In order to show the implications for monetary policy, Dow (2012a) cites Keynes’ theory of knowledge under uncertainty. She writes that according to Keynes’, “... interest rate policy should be addressed more at influencing expectations and the state of confidence than the relative cost of credit as such” (ibid.: 51). Following Keynes, what is needed for a good climate for investments is confidence in stable conditions, but at the same time low long-term interest rates.

Based on this, Dow (2012a) provides the following recommendations for monetary policy in the current crisis: First, the central bank should engage in quantitative easing in order to ease the pressures on the bond market (to support fiscal policy) and lower long-term interest rates. According to her, the aim is not only to ease liquidity problems, but also to raise aggregate demand. Second, in the case of state owned bank, the government should engage in easing credit conditions by “...directing increases in bank credit at reasonable rates” (ibid.: 52). She is aware of the limitations of monetary policy in easing credit conditions and of possible dangers and therefore recommends targeting small businesses with impaired credit access (ibid.).

4. Keynesian recommendations for financial market regulation

Similarly to monetary policy, the Keynesian alternative for financial market regulation concentrates on re-establishing trust. Even though mainstream approaches seem to follow a similar agenda, the difference in policy recommendations again stems from the different concept of trust. As mainstream approaches refer to the narrower concept of calculative trust, the main focus is on moral hazard problems and the role of misleading incentives. Accordingly, policy recommendations for financial regulation try to decrease risk taking by banks by limiting credit creation (see the discussion on 100% reserves backed banking above), decrease moral hazard problems in bank management by limiting bank bonuses payments, try to increase the transparency of financial products to allow for correct risk calculation, and - in case of irrational behavior - propose ‘nudging’. Dow (2012) convincingly criticizes the underlying belief that the “true” price can be calculated and that all risk can be measured adequately.
Yet, Keynesian recommendations for establishing trust in financial markets remain vague: "... the exact policies by which broad moral hazard is to be averted and trust restored will also vary with context" (ibid.: 57). Even though this statement can hardly be contradicted, its usefulness for policy advice is limited. Fortunately, Dow (2012b) provides two clearer recommendations for keeping trust and fighting moral hazard issues in a broader sense: First, suggestions for central banks are to monitor undue swings in market sentiment and counter them as a market maker. Second, the article suggests counteracting moral hazard issues by moral suasion in order to promote a change in culture in financial institutions.

The only concrete recommendation for financial market regulation in Dow (2012a) refers to the introduction of a world central bank along the lines of the Keynes Plan for Bretton Woods. Combined with an international financial transaction tax and symmetrical pressure on countries to neither show excessive current account surpluses nor deficits, this would inhibit destabilizing capital flows and imbalances in current account balances. If one assumes current account imbalances as a major driver of the financial crisis, the suggested world central bank would be a convincing solution. Yet, how this would help in re-establishing trust remains unclear.

5. Details for financial market regulation

As Dow (2012a) stresses the importance of a trustable monetary and financial system for real investments, one could expect her to be a supporter of international financial market regulation. She admits that "... global characteristics of the crisis have encouraged the view that regulatory reform should be designed and implemented at a global level." (ibid.: 57). Nevertheless, she disapproves of international banking regulation as a means to fight future crises, regarding it as one element in causing the crisis: "After all it was the introduction of capital adequacy requirements on an international basis by the Bank for International Settlement in the 1980s which, as we have seen, caused the behaviour which led up to the current crisis." (ibid. 57).

Of course she is correct in saying that the financial sector tries to circumvent regulation in creative ways. And unfortunately, international banking regulation of the Bank for International Settlement had indeed an important regulatory loophole regarding capital adequacy requirements: Basel I generally required 8% capital for all risk weighted assets, yet it only applied to banks, not other financial institutions. Even liquidity or credit guarantees of banks to special purpose vehicles (SPVs) did not fall under this rule. But to follow from this that capital adequacy requirements indirectly caused the crisis would be misleading. Instead, the lack of
those requirements for banks' SPVs contributed to the financial crisis. The subsequent Basel II agreement tried to close the loophole, enforcing capital for (short-run banks liquidity guarantees to) SPVs, yet unfortunately too late.

Even if international banking regulation will continue to face the problem that it only applies to banks and not all financial institutions, there is nevertheless an important role for international banking regulation to further the stability of the banking system. Prudent regulation could further trust in the banking system in the Keynesian sense of the word, especially as national regulation alone would not be enough for internationally operating banks in highly interrelated economies. Yet, one has to admit that the current regulation is still suboptimal. That is especially true if the aim was establishing trust and furthering a climate that promotes real investment in a Keynesian sense. If that was the goal, international banking regulation should aim at higher capital ratios in order to promote a stable financial system, reduce incentives for pro-cyclical credit supply and increase incentives for banks to provide credits for real instead of financial investment. It should also increase the incentives for financial institutions to engage in long run safe engagements instead of short run risky projects.

What would have to be changed? Basel II corrected the mentioned loophole in capital adequacy requirements, yet it introduced new problems: Banks were allowed to rely on official ratings for the assessment of credit risk (standardized approach) or to assess the risk on their own (internal ratings). Both options furthered pro-cyclicality, as ratings for financial products tend to improve in an economic upturn, lowering capital requirements, while the opposite is true for a downturn, leading to low capital ratios when capital is needed most. In addition, "big" banks using the internal risk assessment were able to calculate lower risks, showing capital ratios well below the officially required 8% at the onset of the financial crisis.

The new rules under "Basel III" can be seen as a step in the right direction for higher required reserves, even though pro-cyclicality will stay an issue as credit risk calculation still relies on official ratings. But there are also improvements: Basel III enforces higher capital ratios with at the same time higher capital quality (the ratio of the so called "Tier 1" capital was raised). To counter the problem of high pro-cyclicality of capital requirements, banks are supposed to hold countercyclical buffers. In addition, systemically relevant financial institutions, so called SIFIs, are confronted with even higher capital ratios (BIS 2011).

Yet, even though Basel III addresses important problems, there is another problem besides furthering pro-cyclicality: Basel III is definitely
not incentivizing ordinary credit supply of banks to companies: Current regulation makes holdings of structured products more attractive than direct credit supply to companies. A structured product being based on 1000 credits requires less capital than the equal amount of credits supplied to firms. Even though this is justified by portfolio theory showing that - in theory - risk decreases with increasing portfolio diversification, the financial crisis has shown some flaws to this idea: First, in the run up of the financial crisis structured products like asset and mortgage backed securities (ABS and MBS) as well as collateralized debt obligations (CDO) were characterized by high risk concentration - in contrast to the theoretical assumption of risk diversification. Second, even though names like “asset based securities” refer to underlying assets, holders of these structured papers can hardly access those underlying assets once the interest payments stop. Contrary to that, banks engaging in credit supply to companies generally do ask for (and, in case of default, have access to) collateral for “ordinary” credit supply, such that this seemingly riskier business may in the end be less risky compared to holdings of structured products. Insofar it is questionable that Basel III capital requirements for structured products are generally well below those for ordinary credit supply.

Of course, changes in international banking regulation would not be sufficient to increase the attractiveness of ordinary retail banking. Continuing innovations in information technology are constantly decreasing the costs of financial innovations. Coupled with the short term profit orientation of the mark-to-market approach, this benefits the development of new financial products and increases intra-day speculative activities as the more attractive business model for banks as well as non-banks. To counter those developments which are a threat to long run productivity developments for the whole economy, financial market regulation should focus on furthering old-fashioned credit supply for financing real investment instead of short run financial investment.

One way to discourage banks from engaging in the latter is the introduction of a financial transaction tax (also discussed in Sheila Dow 2012a, but there only as a means against excessive capital flows jeopardizing a stable world currency), constructed in a way that increases the costs for short-term financial transactions, as for example the one proposed by the European Commission (EC 2011). In addition, national taxation should be changed in a way to favor real investment over financial investment. This would especially call for increasing capital income taxes again, which had been lowered in many countries in the past.
6. Conclusion

Sheila Dow (2012a) argues convincingly in favor of Keynesian recommendations for monetary policy and financial regulation, criticizing mainstream approaches. According to her, the main focus for Keynesian recommendations lies on re-establishing trust in a broad sense. Yet, while the paper provides valuable recommendations for monetary policy, as well as on the interaction of this policy with fiscal policy and financial market regulation, the guidelines for financial market regulation remain rather general. She rejects international banking regulation, classifying it as a cause of the crisis.

In contrast to this assessment, the comment stresses the role that international banking regulation could play in implementing the Keynesian call for a stable and trustworthy climate for investment. Yet, in order to do so, the new capital requirements in Basel III are only one step in the right direction but far from being sufficient. Besides abolishing incentives for a pro-cyclical credit supply, international banking regulation should stimulate old-fashioned bank credit to companies for real investment as an attractive business model for banks. That would call for higher capital ratios for structured products. Yet, international banking regulation alone would not be sufficient to promote ordinary bank credit for real investment. In addition, regulatory changes should be complemented with the introduction of a Europe wide financial transaction tax and changes in national taxation to stimulate real over financial investment.

References


