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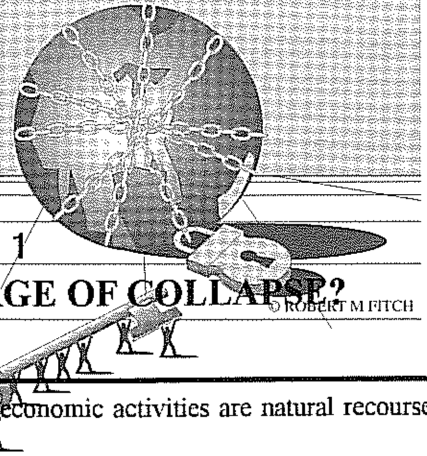

IS THE WORLD'S FINANCIAL SYSTEM ON THE VERGE OF COLLAPSE?

A Critical Review of 'The Stiglitz Report'

(The following write-up by GroundSwell editor Nadine Stoner is from a panel presented at the Aug. 5, 2012, Council of Georgist Organizations conference held in Bloomington, MN. Moderator Edward Dodson is a retired financial analyst for Fannie Mae, and also the Director of the School of Cooperative Individualism. Dr. Mary (Polly) Cleveland is adjunct professor at Columbia University School of International and Public Affairs, and also Executive Director of the Association for Georgist Studies. Dr. Nicolaus Tideman is a Professor of Economics at Virginia Polytechnic Institute [NT1], and author of numerous articles. Fred Harrison is an author (most recent book *The Predator Culture,* and also *Boom Bust)* and journalist. Not present for the panel but who submitted papers about the Stiglitz Report were Dr. Fred Foldvary and Adele Wick, whose papers are posted on the website of the School of Cooperative Individualism, www.cooperativeindividualism.org/.

(The Stiglitz Report is posted on the web at www.stiglitz-sen-fitoussi.fr/documents/report_anglais.pdf. Titled "Report by the Commission on the Measurement of Economic Performance and Social Progress," the Commission was instigated in 2008 by French President Nicholas Sarkozy, who asked Joseph Stiglitz, Economics Professor at Columbia University (president of the Commission), Jean Paul Fitoussi (coordinator) and Amartya Sen (advisor) to create the international commission of distinguished professors, economists, and financial specialists. The Report is addressed to political leaders, policy makers, the academic community and statisticians, and also to civil society organizations.

Moderator Ed Dodson opened the panel discussion with the comments that there is almost no consensus in the Georgist community about what ought to be done about reforming the global monetary system. We argue about the definition of money, about the role of banks, whether banks should be owned by the government and the money supply created by government or privatized. At the same time of our global crisis, the Stiglitz Report was published in 2010 analyzing the causes of the global meltdown and providing recommendations of what ought to be done.

Major conclusions reached by the Stiglitz Commissions were as follows.

* The financial and economic crisis was caused by a combination of private sector activities and flawed public policies.

* Changes in law and policy were driven by an ideological bias that markets are self correcting.

* Movement to market-oriented economics systems benefited many in some countries but worsened life for many in others where the primary economic activities are natural recourse exploitation.

* In many developing countries environmental degradation has been a serious consequence of the global financial structure.

* Globalization has been accompanied by high levels of instability, particularly in developing countries.

* Massive rescue packages have so far staved off global depression, to a certain degree positively by stimulating spending to address long-term environmental problems.

* Global discussions have been taken over by the G-20 nations, but too many nations remain excluded from such discussions.

* The need for financial reform is broadly recognized, but there is yet no consensus over needed changes in laws and regulation affecting corporate governance, competition and bankruptcy.

* There remains significant concerns over protectionist steps adopted by some governments.

* Reforms must reflect a broad view of social justice, poverty reduction and protection of the environment.

* Current institutional arrangements must be greatly strengthened, reformed and made independent of political considerations to be effective.

* The need for a new global reserve system is critical to resolve problems of shrinking aggregate demand.

For the CGO conference Ed had recruited the panel to review the Report and posed a number of questions for discussion.

Question 1. Is the Stiglitz team correct that financial markets are not self-correcting?

Nic Tideman: Sometimes.

Fred Harrison: It is self-evident they are not self-correcting at the point where some fundamental problem arises where people of their own volition are unable to overcome the obstacles that prevented the market from functioning. Is that the fault of markets or because of some other consideration is the question Stiglitz didn't address. Economists like the term market failure because it gets them off them off a lot of hooks. They tend to blame the market if something goes wrong and they don't know why it went wrong or don't know what to do about it. So it is a market failure and it apparently it does self correct at times. They actually should be recognizing that what we have is a failure of governance, and if we want the market to continue functioning in the way it would if there were no prior risks then we need to (continued on page 2)

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attend to the problems of governance. The problems of governance are almost totally ignored except as addressed in a fundamental way by Stiglitz.

Polly Cleveland: Financial markets are not self correcting in any kind of market where there is a long time on the horizon and where there is uncertainty. They are not self correcting, and it requires some kind of regulatory involvement to insure against fraud and to make sure there is good information. That is the financial, insurance, and real estate markets. None of these are self correcting because of long time expanse involved.

Q 2. There is no mention of a need to return to a distinct separation between commercial banks and investment hanks. Is this a serious oversight by the Stiglitz Team?

Polly C: Yes. On the other hand they may be realizing we have got the shadow banking sector which is very hard to control anyway. There are the investment banks and commercial banks but there is also the shady side that is very hard to regulate, like derivatives.

Fred H: It is called oversight. In the report we see both the Stiglitz team and rest of the world and media talk about banks that are now too big to fail, because they merge a variety of functions into single institutions that put us over a barrel. We need to start breaking up those financial institutions, but that then enters into dangerous territorial waters for economists and policy makers because they don't like the idea of too big to fail, or they don't want the risks of the political cost of discussing breaking up banks. It wasn't about oversight. Intuitively they couldn't actually enter into that discussion. I don't believe bankers actually embarked on activities leading to the credit crunch thinking if we take too much risk, it doesn't matter because the taxpayers will bail us out. It is just the way it worked out. Politicians are not actually willing to address these issues of financial institutions – the structure, the density of the financial institutions - because of what they perceive to be political risk.

Nic T: I would fault the Stiglitz Commission for a slightly different thing.

The fundamental problem is fractional reserve banking, which we should get rid of entirely. There is a recent book by a professor of economics at Boston University, Laurence Kotlikoff, with the unusual title, *Jimmy Stewart is Dead*, referring to the film, *It's a Wonderful Life*, which tells a story of a crisis at a savings and loan association. There is something fundamentally fraudulent about taking people's money, promising they can have it back whenever they want, and then investing it. Kotlikoff's suggestion is to tell people: Either you put your money in a bank, it stays in a vault and you pay a small storage fee. Or you invest it in a mutual fund. But don't have institutions that take people's money for investments and then create systemic risk by telling them they can have it back whenever they want it.

Fred H: The Stiglitz Commission was asked to examine the present institutions and what to do about them. If there is going to be a move into alternative models they first of all have to deconstruct the current financial system to explain why it is not functioning properly and therefore the need to do something about it. Economists and politicians complain about the world financiers taking risks. They can afford to do so because the taxpayers will bail them out. The politicians and economists complain about others failing in their moral duty to address reform in a way that would allow voters to decide if we want to take action to break up banks that are too big to fail. There was a serious lapse of responsibility in my view by this commission that didn't push issues in a way they should have. I do think they ought to have examined the issue of the structure of banks. Was it an oversight or was that a deliberate sidestepping of their duties.

Nic T: I think there is a tendency of people with responsibility for international financial affairs to limit their purview to commonly considered possibilities. The Stiglitz Commission was a bit adventuresome in the range of reforms considered. I wouldn't have expected them to take into account something like fractional reserve banking because it is too far off the beaten path to be expected of them. I think such ideas have to come from farther afield

Polly C: The separation between commercial and investment banks is a U.S. policy but not a worldwide policy and this was a worldwide Commission of experts in finance.

Q 3. The Stiglitz Team has nothing to say about the responsibility of the bond rating agencies for the proliferation of private placement mortgage-backed securities collateralized by "no doc" subprime mortgage loans. What should be done about the rating agencies?

Nic T: I don't know enough about rating agencies to know the answer. It was a terrible way for the rating agencies to behave, but I am not aware of any reform that we could implement that would do anything about it. The rating agencies clearly did a terrible job. The market will bring about some reforms and the rating agencies, at least for a year or two, will have to be more careful about how they make ratings.

Fred H: Those of you who saw the documentary Inside Job understand it was all a game, a charade, and the credit rating agencies were part of that game to milk the system as best they can by pretending they are behaving responsibly and even behaving responsibly at times. But when temptations get great that is when they get into their devious tricks. The rating agencies participated in this scam by according ratings that suggested the risks were low but it got out of hand. They were in this cozy circle of institutions and individuals who were drawing fat fees out of their activities involving the subprime mortgages. It is impossible for us to expect individuals or institutions exposed to temptations to behave any other way than they did. Rating agencies underestimated risk when they should have been warning people. There were clear incentives to mislead people. Their clients were requiring ratings of the kind that enabled them to earn the fees they were receiving. There is not much we can do about the rating agencies at the present time under the existing value system and institutional arrangements. The only way to address problems with any one element in the whole framework is to change the whole system itself fundamentally. Otherwise, you can't expect the rating agencies to behave like angels (continued on page 13)

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when the people they are relating to are behaving like devils. They are all in the same game. We can't expect rating agencies to behave anything other than according to what they are allowed to do which is determined by the incentive built into system. We can't do anything about it and that is why Stiglitz said nothing. Fundamentally they don't address what is driving the system.

Polly C: There are three rating agencies: Moodys, S&P, and Fitch. What's wrong with them is they have a monopoly. Legally for government agencies or corporations or that kind of thing you have to get ratings from one of them. They have a legal monopoly because there is no competition. They are paid by the people whose bonds they are rating. They are not paid by people who are consumers of the ratings. How that might be arranged for ratings to be paid for by consumer, I don't know. Two things are wrong with the rating agencies: monopoly and they are paid by the providers.

Ed Dodson commented. I spent 20 years at Fannie Mae. We were the nation's largest issuer of mortgage backed securities. The reason the subprime market exploded on Wall Street was that our credit risk people refused to accept those loans as collateral for mortgage backed securities. When our credit risk management people ran them through credit risk models, the charge that would have had to be made to lenders, called a guarantee fee, was 50 times greater than basis fees charged on a conventional mortgage loan. Our Fannie Mae credit people knew this was toxic and doomed for failure, and Fannie Mae didn't participate. As a result, bond rating agencies took over the responsibility which they were not prepared to do. To the extent they had any people in their operation who had the technical ability to underwrite mortgage risks they ignored them. The outcome was inevitable. I think most of people I knew in the industry knew what was going to happen.

Fred H: Polly rightly points out there are only three rating agencies. But they don't have a monopoly on the rating risk. This was a collective failure. If the rating agencies who were saying this is low risk, where were the market analysts saying they are wrong. Where was the media saying risks are rising way above what originally was suggested? What was stock market doing? There was a collective engagement in same attitude and the rating agencies participated in that psychology. It is too easy for the rest of us to get off hook for us by blaming them.

Q 4. Is there anything in the report that would seriously restrict the ability of the United States government to continue accumulate debt?

Nic T: There is a warning in the report, but the report also points out that the debt of the U.S. operates to provide reserves for other countries, and other countries want reserves. So we have a conundrum: The system is likely to be ineffective somewhere. If other countries get all the reserves they want, then the U.S. is likely to have accumulated too much debt. The report suggests that we need a system of international reserves that doesn't depend on the U.S. running a deficit. But once we install this improved reserve system, people will not have as much interest in holding American debt, so there might be a collapse in the market for American debt once we get the international reserve system.

Polly C: I agree with Nic. There was at least a hint that they could get an international system running and then people would leave American treasuries to go to this international reserve system. I don't think an international system is likely to work or get off the ground.

Fred H: Debt is to our kind of economy what heroin is to the addict. There is no way in which the U.S. government could be allowed to yield up its right to create debt because the system would cease functioning. Whatever Stiglitz might have suggested, the pressures from other countries and pressures for domestic needs of the people in the U.S., etc. are such that given current awareness of acceptance of the economic system as we have it there is no way of getting around this problem of continually increasing indebtedness of the U.S. government.

Q 5. Do you concur with the Stiglitz team's conclusion that the subprime mortgage crisis was an outgrowth of a dramatic increase in the supply of credit generated by the "global capital markets," a widespread failure of central banks to "dampen the speculative increases in housing and other asset prices," and "lax financial regulation" in the United States and several other countries?

Polly C: I agree. The only thing missing from statement is that there was outright criminal activity which is not getting prosecuted. The Attorney General of New York, Eric Schneiderman, is trying to stop a sweetheart settlement between the Bank of America and the Bank of New York. There has been massive criminal activity.

Fred H: Why was this happening? What was driving it? Were governments in hock to financiers so they felt they had to lighten up the regulatory system, because they did. Even if we had a tough regulatory system would it have made any difference ultimately? The sheer force driving activities that led to such subprime problems was such that I don't believe a tougher regulatory system would have prevented what actually happened. Global markets would have continued to swirl around dumping money where the biggest wind fall profit could be made. No one was interested in dampening the speculative increases in the housing market anyway. Something fundamental was missing in this analysis. Policy makers today are supposed to be looking for solutions, and they weren't finding any in the regulatory system as defined now. I am talking about central bankers having to control credit. They were not willing to get to the heart of the problem.

Nic T: The problem was greed, stupidity, and fraud. There were some people who understood that these mortgages were garbage but the issuers were always able to find buyers because the mortgage-backed securities were guaranteed by large financial corporations. For a long time the main culprit was AIG who didn't know what they were doing at the time. The new head of corporation didn't understand the financial market and was more of a marketing person. The people running the mortgages were more mathematicians than economists. They didn't think it could (continued on pg.14)

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possibly happen that housing prices all around the U.S. would fall at the same time. They thought that by mixing mortgages from different places they were adequately insured. They were not properly trained for what they were doing. AIG finally did figure it out. But by that time they were too deeply involved to get out. There were other people at Wall Street banks who were envious of all money AIG making, and they replaced AIG after AIG refused to guarantee any more mortgage-backed securities. There was a lot of stupid copy-cat behavior and that's how Wall Street got into it as well. By the time the banks figured it out, they were in so deep that they couldn't get out.

Polly C: Something not mentioned here was the growing inequality of wealth and income. The greater the inequity the more you have a small elite controlling a great deal of the wealth of the economy, and the small elite were looking for a higher return on investments. So part of the scramble to create collateralized debt obligations and then insure them with the credit watchdogs was to continually provide supposedly AAA safe investments for this wealthy elite. The growing inequality played a big role in this bubble and why this bubble was so much worse than the one 18 years ago and the one 18 years before that.

Fred H: Nic described the situation, the states and AIG's role. We can't put the burden on one institution. AIG didn't operate in Ireland or the UK or Spain where we have the same events. Our guys were reasonably honest in the UK. It is a mistake to look at what happened in terms of collective stupidly. I think they knew what they were doing and were required to do it that way. If we don't like it, there is no good in blaming the individual or institution for a systemic process that nurtures that kind of activity. When the Stiglitz Commission turns the focus on individuals, it is great for the system because the good guy shoots the bad guy and the system goes on repeating the same mistakes. Don't let the system off the hook by allowing politicians and worthy commissions to focus too sharply on a few crooks. Some of them were crooks but most of them weren't. We, like most homeowners, didn't complain about what we were pocketing so why complain about what they were pocketing. It is the system that needs to be attended to.

Ed Dodson: I have a follow up observation. The argument for deregulating banks in the Reagan era was that the global economy was growing fast and required financial institutions to be able to respond to global financial needs. Deregulation allowed them to do business not only across states in the U.S. but to engage in acquisitions and mergers internationally that would diversify business loans geographically. Therefore, they would be immune to regional economic downturns. Is this systemic or is this simply a logical outgrowth of a series of mistaken policies based on inappropriate assessment of where the global economy was?

Fred H: Economics operates in two hemispheres - two parallel universes. The authorized discourse of the free markets, and Reagan was expressing wisdom as far as the market is concerned, as practiced in capitalistic economy was rational. The culmination was the sub prime mortgage. The other reality in a parallel universe was what Reagan was saying, while it ought to be sensible, would be if the system was operating efficiently as he was told by economists it was. If all the assumptions were true, what he was prescribing would have made sense. The underlying realities of the economy contradict that wisdom but nobody was around to suggest that to Reagan and Thatcher at the time, and they are not doing it now despite all the study by commissions such as Stiglitz.

Polly C: AIG was operating internationally. The little shop within AIG that caused all the damage - the one that created and sold credit to foreign shops all over the world - was located in the UK. This was a sort of a rogue shop. They didn't know what they were doing. Goldman Sachs took advantage of them and Goldman Sachs took advantage of the Fed to force AIG to cough up the entire value of the credit default shops that had been bought. The Feds paid by bailing out AIG. Talk about mega corrupt maneuvers. The book by Dani Rodrick, The Globalization Paradox, points out that within a country you can have a certain amount of regulatory control over your institutions but internationally there is no global institution that can control an internationally operating corporation. In the same way you can't claim multinationals are engaged in free trade because they are engaged in trade free of the restraints that they would be operating under in a sovereign nation in the same way you can control corporations within your own country.

Nic T: I don't have much faith in regulation. It seems to me ineffective to focus on the problem of regulatory capture. I would focus instead on the problem of being too big to fail. There is something tragic about having organizations that are too big to fail and then heaping the cost of rescuing them onto taxpayers. If they are too big to fail, that seems to me to be reason to break them up. If we have to rescue institutions because they are too big to fail, then it is important to rescue them in ways that are as painful as possible to the equity holders and bond holders that got us there.

Ed Dodson: when I started at Fannie Mae in 1984 , we got 80% of our business from about 150 lenders. When I retired in 2005, 80% of business was from 10 lenders.

Fred H: It is too easy to blame the crooks. We had a collective failure of paradigm. An example is in 2005 when Boom Bust was published. Merrill Lynch in London said come in and talk to some of our most favored clients. They invited me to their board room and gave me the freedom to address their clients. I described what would happen in 2-3 years. Merrill Lynch in London couldn't actually respond in a way that would have protected that institution's investors and their money because they were operating under the influence of their headquarters in New York. They didn't have the wisdom to go to the people within Merrill Lunch, the decision makers in New York, to ask is Harrison correct. They didn't make any constructive responses. They went down like everybody else. It wasn't because they were crooks and it wasn't because they were conspiring to make super profits by duping their clients. It was a lack of imagination or understanding. They were behaving rationally. I had to be deviant one. They couldn't fit what I was saying into the consciousness of that institution (continued on page 15)

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or how the market works.

We need a commission to examine the system itself it as opposed to individual failures. Until then, we won't make progress in reaching that collective unconsciousness that protects the system - commissions like Stiglitz with their paradigm conclusions that don't actually challenge the fundamental powers.

Q 6. Is there any merit in the Stiglitz team's called for "a new bank or banks operating without the bad debts of the failed institutions" but without a "competitive advantage over existing banks"?

Nic T: A distressed bank is sometimes divided into a "good bank" and a "bad bank." The bad loans are put into the bad bank, which gets bailed out, while the rest of the institution is restructured in such a way that it can operate without being dragged down by its past mistakes. This is socialism for the rich, facilitated by high barriers to entry into banking. I think it would be more effective when banks get in trouble to kick out the bankers, let investors to lose their stakes, and bring in someone else. The difficulty of starting new banks makes people reluctant to endure a transition period before new banks emerge, so they come up with rescue plans. I don't know if that is the best available option.

Polly C: This refers to proposals in the process but not tied down that we need to charter brand new banks but not so gigantic they are too big to fail that could engage in commercial lending because they would have a clean balance sheet. The problem with the too big to fail banks that are sitting on bad assets is they don't want to write them down because they would be insolvent. They get 0% interest money from the Fed and play in the derivatives market and that way they are rebuilding their real balance sheets. Meanwhile, nobody is doing any productive lending for real investment. There is a severe credit rationing going on. The idea banks aren't lending because businesses are not borrowing, because everybody is waiting to see what happens, is not so for small businesses.

Fred H: I find it pathetic that commissions with people like Stiglitz should be concerned about not giving a competitive advantage to any new institution. Ireland has attempted to rescue some part of the system by hiving off all bad debts onto taxpayers with a new institution holding them, trying to clean up operations of the remaining banks. Why should we be concerned about competitiveness when people being rendered uncompetitive are people who are ultimately having to carry the cost for this kind of behavior, which is the people of Ireland who have been made unemployed, who will be losing entitlements they need to receive because of the need for government to cut spending programs. It is a competitive advantage. When did the system worry about competition right up to point where we are today? We want competition but in the end they will reconstitute the system so that people will be making super profits and politicians will derive benefits from that process.

Polly C: The way I understand what they mean by competitive advantage is that these banks would not have special government guarantees or favors because too big to fail banks can get money cheaper and get better investors because they have this government guarantee. I think it means not having a competitive advantage without government guarantee that would give them an advantage over ordinary banks without guarantee.

Q 7. The Stiglitz team writes that environmental resources must be appropriately priced in order to lessen global warming. The report is silent on specifics. Is charging market rents the right policy choice, or the only effective policy choice?

Polly C: If you charge market rents, if you charge for emissions of carbon dioxide, for the public you certainly are charging for use of the atmosphere as a dump. If we assume air belongs to everybody we ought to be charging polluters for their emission of pollutants into commonly owned air and water. Peter Barnes' thesis, capanddividend.org, is a good proposal for how to charge. If that's what is meant, they are on the right track but they are too vague about it.

Nic T: The use of the word "rent" here is atypical, but reasonable. Pollution taxes are like rent in that they represent a charge for use of common resources. Charging such rent isn't the only available policy. One could only determine the appropriate number of permits and auction them off. The cap-and-auction system requires that you know what the right quantity is. If it happens instead there is some social cost that prevails over a considerable range of quantities, then it makes sense to set the price rather than the quantity. I think it is better not to set either the price or the quantity but rather to seek to identify the price-quantity combination that represents the intersection of supply and demand. Any efficient way of managing the problem requires people to pay for the harm they do.

Fred H: Now we are beginning to touch on Stiglitz's personal problem. He understands Henry George economics and will say so publicly and did as recently as last December in a speech in Washington. He said what we have got to do is to return to George's idea of charging rent for natural opportunities. Yet when he gets the opportunity to expound on and document what we are discussing, there is no reference to this at all. He has the problem that he can't say it because he is chairing a group of people who would not have shared his view, so he couldn't intrude on the outcome of this report. Two years ago I spent an hour interviewing Stiglitz in a filmed interview. I put questions in such a way that he could have commented about land and Henry George and he didn't.
In the end, I had to ask leading questions on the land component of housing and the subprime issue. After the interview I gave him a copy of Boom Bust and Ricardo's Law. He flipped through it and said, now I know why you asked me about land. He could not voluntarily up come up with what he already knows to be correct, that it is the incentives generated in land market that led to people behaving like they do in mortgage markets.

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