The Global Financial Crisis: Preventing a Great Depression and Stopping the Destructive Cycle

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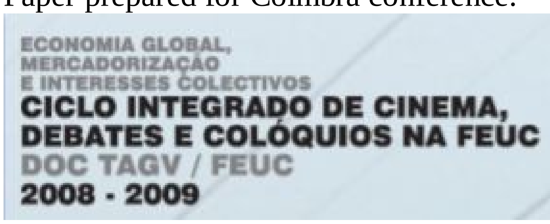


This paper draws liberally on co-authored work with James Crotty and also benefits from discussions at a recent conference on the financial crisis held at the New School for Social Research in New York, organized by PERI and the Schwartz Center for Economic Policy Analysis. Nonetheless, all errors are mine alone.

I. Introduction

The United States, and indeed the entire world, face the prospect of an economic disaster unseen in generations with enormous attendant social and political risks. An interlocking set of downward pressures emanating first from the financial and real estate markets and now dragging down the real economy has started to lead to an unraveling of macroeconomic stabilizers and institutions. Swift and coordinated action by the governments of the industrialized economies, and especially those of Europe, the United States, and China, and support from international financial institutions, can stave off this gathering crises. But this action will work only if it is massive and boldly directed toward serving the needs of people and communities, rather than on protecting the failed institutions and practices of the past that helped create the crisis in the first place and that have now become ineffective or even counter-productive.

So far, the Bush administration in the United States, and a number governments in Europe have invested several trillions of dollars to bail-out the financial markets and institutions hoping that these funds would trickle down to the rest of the economy.[1] While partly designed to prevent a financial collapse, and from that perspective, a necessary effort, it has been, at the same time, an apparent attempt to hit the re-start button and restore the economic trajectory these economies were on before the crisis hit. But this policy has failed, as major financial institutions have hoarded much of the cash, or used the funds to continue their decades long policies of taking over other banks, while paying lavish salaries to enrich financial elites with close ties to government. Governments in the U.S., UK and elsewhere-- trying to protect the prerogatives, wealth and power of financiers -- have been unwilling to direct the banks to lend money to badly affected households, businesses and communities. Meanwhile, real economy businesses, households, state and local governments and others continue to be starved for cash, pushing them and the world economy further and further downward, leading to a worldwide spreading of deflationary pressures.

In the United States, the Obama administration has signaled a desire to take swift action, and to do "whatever it takes" to restore economic health. President-elect Obama has also recognized that to work the policy must serve the needs of "main street" and not just "Wall Street". By contrast, however, in Germany, the Merkel government is reluctant to undertake a major fiscal expansion -while in the European Union, there is an unwillingness to even temporarily suspend the "Growth and Stability Pact" which greatly restricts the ability of governments or the union as a whole from running an massively expansionary fiscal policy. But unless there is a coordinated and large fiscal expansion in Europe as well as in the U.S., prospects for world economic recovery are dim.

The Bush administration's policy, and Europe's reluctance to undertake the necessary financial and fiscal policies reflect an abiding commitment to the neo-liberal project which has placed finance in the driver's seat of the global economy, and has now on the way to driving the global economy over a cliff.

[1] Sarah Andersen, et. al. of the Institute for Policy Studies estimates that the U.S. and European governments have committed $4.1 trillion in bail-out money to banks and other financial institutions so far (IPS, 2008).

The Obama administration has been willing to talk much more expansively than have governments in Europe, but early economic appointments by Obama indicate that the new U.S. administration might also have a strong allegiance to the failed policies and structures of the past. To succeed the Obama administration and governments in Europe need a fundamental reversal of direction, one that places the real economy in the drivers seat, and restructures the broken financial system to serve the needs of the real economy rather than the other way around.

In the U.S., the incoming administration must adopt policies that are directed first and foremost to addressing the real needs of people and communities since, only if jobs, housing, health care, education and social services are protected, will the downward spiral be broken. It must eschew the failed policies of the recent past have been solely oriented to "restoring the confidence" of the financial markets. Instead, what is need is to restore the confidence and health of workers, households, communities, and businesses. Only then, can real incomes and spending trickle up to restore solvency to families, communities, state and local governments and yes, the financial system, itself. As for the future financial landscape, in light of the fact that U.S. financial system has been largely refigured in the last several months by the crisis and government responses, we cannot try to restore a financial system to resemble the one that just collapsed. Instead, the financial system must be re-oriented by government regulation and direction to serve the needs of individuals, families, businesses and communities.

Some have argued that dealing with the immediate economic crisis requires governments to put on hold policies to make a green transition, and raise social protections. While there are often important trade-offs in economic affairs, it is very import in this case to embed these longer term goals into policies for short-term economic recovery which will not only make it more likely that the longer run goals will succeed, but will also greatly enhance the effectiveness of efforts for short term recovery themselves.

Many examples illustrate this point. Raising the minimum wage allows more households to spend on goods without going into more debt; many green investments have been shown to have greater employment impacts than other types of macroeconomic policy, such as tax cuts; dramatically reducing health care costs will go a substantial way to helping to make U.S. car companies and other American businesses more competitive and allow them to both weather the current storms and achieve competitiveness over the longer term.

In Europe, the European Union must suspend the growth and stability pact and undertake jointly, or allow individual governments to undertake large programs of fiscal expansion that, like the program outlined above for the U.S., will serve both the short term needs of helping Europe avoid a catastrophic depression, but will also help to serve the long term needs of the economy, such as helping Europe make the transition to a greener economy. The European Union and individual governments, should also, as we describe below for the U.S., insist on a more active management of the financial institutions that are receiving government support to make sure that they are contributing to economic recover and transformation.

A program for *economic recovery and financial reconstruction* in the U.S., Europe and elsewhere, should be based on well established economic principles forged by John Maynard Keynes in the crucible of the Great Depression of the 1930's, principles which themselves built on what Keynes called an "underground" of economic ideas circulating for decades before, including the work of Karl Marx, Sismondi, Gissell and others. This work has been further developed by Post-Keynesian, Heterodox, and Marxist economists working in the U.S., Europe, Latin America and Asia, but which, over the last thirty years or so, has become increasingly marginalized in the economics profession. But these principles are a far more reliable guide to solutions for the current crisis than the "neo-liberal" policies followed by governments in the U.S., parts of Europe and in many other places in recent decades, policies that contributed to the economic crisis we now face. And, indeed, as governments and economists are struggling with solving this economic crisis, they are rediscovering or re-inventing these Keynesian/post-Keynesian/heterodox principles, with little recognition that, to a considerable degree, the roots of the crises are due to the fact that these governments and economists threw these principles into the garbage heap twenty five or thirty years ago. Instead, the United States, European Union, the IMF and other governmental institutions adopted neo-liberalism as their world views.

Neo - liberalism promoted financial de-regulation based on the premise that financial markets priced risk accurately, bore risk efficiently, and through the "invisible hand" allocated credit in the best interests of society. We now know these premises are false.

Neo-liberalism promoted flexible labor markets leading to wage stagnation and cost cutting as a mechanisms for economic growth, instead of understanding that wages are a source of demand as well as of costs, and that a dramatically unequal income distribution drives households into unsustainable debt and families into economic insecurity and now, distress.

Neo-liberalism saw government acting in the service of workers and the middle class as inefficient, whereas government acting in the support of financial elites as a mechanism for promoting competiveness and growth. The result has been the undermining of the health, educational opportunities and infrastructure of our families and communities.

The "neo-liberal" economic theory and program has ended in disaster and it is now time to return to a more reliable set of economic and social principles:

Free market capitalism, left to its own devices, is unstable and needs proper regulation and automatic stabilizers to avoid major destructive economic episodes. Markets, including financial markets - must be properly embedded in and managed by governments and other social institutions. for them to work efficiently and serve the needs of society. Government is needed to provide leadership in economic areas that have major spillover effects and where markets are therefore likely to fail, such as health care, managing global warming, and public investment in basic infrastructure. Families need financial support to help them provide their crucial services in care giving. Workers need a legal infrastructure that allows them to fight for and win their basic rights, rights that will promote better political governance and a healthier economy over-all as workers will be better able to achieve healthy living standards that will trickle up through the economy .

Adopting these problems will not, of course, solve all the problems of capitalism nor will they, by themselves, lead to solutions to profound challenges faced by humanity, social as global warming, dwindling supplies of clean water, unacceptably high levels of social inequality and exclusion.

But they can help to avoid the worst excesses of capitalism, including its tendencies toward financial kleptomania and instability, which have now – once again -- lead us to this horrible juncture.

In the next section I briefly outline the causes of the current financial crisis with a focus on the U.S., where the crisis originated. I then briefly discuss the attempts in U.S. and Europe so far to deal with the crisis. Then I outline briefly a possible program to pull out of the recession/depression and a set of principles for global regulation of the financial markets that can help resolve this problem and help to prevent a re-occurrence.

II. The Financial Origins of the Crisis and the Failed Policy Response

Financial Origins of the Crisis

My colleague James Crotty, Professor of Economics at the University of Massachusetts, Amherst, has written presciently and insightfully about the financial origins of the current crisis. Long before most economists, he predicted it, and since that time, he has written a number of insightful papers helping us to understand it. In this section, I draw heavily from his work, and especially his paper: "Structural Causes of the Global Financial Crisis: A Critical Assessment of the New Financial Architecture" (http://www.peri.umass.edu/236/hash/123e4328b2/publication/320/).

According to Crotty, the regulatory regime put in place in the U.S. in the aftermath of the Great Depression was designed to prevent repetition of both the speculative excesses of the late 1920s and the failure of thousands of banks in the early 1930s. Regulators tightly monitored and controlled commercial bank activity, while the Securities and Exchange Commission (SEC) forced investment banks to provide more complete and dependable information about securities to the public. Commercial banks originated and held consumer and commercial loans and provided liquidity to other financial institutions in times of market stress. Their ability to provide liquidity was protected by government restrictions on the risk they could take. Banks thus acted as lender of next-to-last resort to other financial institutions, while the Fed was lender of last resort to banks in serious crises.

In European countries, the financial systems were also highly regulated, though each country had its own system of structured financial regulation. These systems worked quite well into the mid 1970s. In the U.S. it then was buffeted by rising inflation, deregulation and the Third World debt and Savings and Loan crises. Two decades of radical de-regulation started to take place, first in the U.S. and then in many European countries.

In the U.S., for example, the elimination in 1999 of the 1930s Glass-Steagall legislation that segregated commercial and investment banking was the culmination of two decades of radical deregulation that created what is often called the **'New Financial Architecture' (NFA)**. The NFA is founded on the belief that capital markets are 'efficient' – the sine qua non of modern financial market theory - and, therefore, need minimal monitoring, regulation or lender of last resort bailouts by government regulators.

As Crotty argues, belief in the narrative about the efficiency of financial markets permeated global financial markets during the past 15 years. Individual and institutional investors, financial institutions of all kinds, and government regulators were guided by it, and the business press filtered almost all discussions about financial markets through its lens. The conventional wisdom embedded in the narrative made individual and institutional investors willing to take on what would previously been thought to be excessive risk in the stock market boom of the second half of the 1990s, and in the financial bubble from 2003 – mid 2007. The latter years were a 'perfect calm' in financial markets. Interest rates, risk spreads, volatility and default rates were exceptionally low, and levels of liquidity - even for complex derivative products such as mortgage backed securities and collateralized debt obligations not traded in markets - were high, as were corporate profits. These conditions, assumed to be permanent in the narrative, led almost everyone to believe that no investment was excessively risky, which encouraged risk taking.

However, the outbreak of the crisis clearly demonstrates that almost every tenet of the narrative was wrong. The contours of the crisis that began in mid-summer 2007 and continues to this day are well known. A housing market bubble in the U.S. began in the late 1990s and accelerated in the early-mid 2000s. Banks and mortgage brokers earned fees in proportion to the volume of mortgages they wrote, and banks earned large fees securitizing mortgages, selling them to capital markets in the form of mortgage backed securities and collateralized debt obligations (CDOs) and servicing them. Investors demanded these complex, risky derivative products because they were given high – often AAA - ratings by credit ratings agencies. They had higher returns than equivalently rated corporate bonds and other safe products whose yield was held down by the low interest rates of the era. (Different returns on product with identical ratings should have signaled that something was wrong with market pricing.) Demand for high yield products was so great that banks and brokers began to sell mortgages to those who could not afford them under terms that were bound to trigger large defaults when the housing price bubble evaporated and/or interest rates rose. Home sales in the U.S. peaked in late 2005 and home construction spending peaked in early 2006. When the subprime mortgage crisis erupted in mid 2007, the entire edifice began to collapse. The crisis began in the US, but since shaky mortgage-based products had been dispersed around the world, we soon had a global financial crisis.

Government Response to Financial Crisis: Too little, too late, too neo-liberal

Government responses in the U.S. and Europe have been late and initially much too small and misdirected. In the last several months, these efforts have been massive and unprecedented by the standards of the last 60 years, but so far they have been focused almost entirely on the financial sector, while the real economy is collapsing underneath it.

Governments responses to the crisis were first to ignore it. (See Figure 1 for a partial chronology). Then, as financial markets began to seize up, or particular institutions such as

Northern Rock bank in the UK started to go bankrupt, central banks, like the Bank of England first denied they needed to do anything – just let the market work – and finally were forced by events to intervene to prevent a major bankruptcy. Little by little, the seriousness of the crisis began to impress central bankers, but by then, the financial crisis had already begun to seriously affect the real economy, and then very serious negative feedback loops between the financial economy and the real economy got more and more intense. During this period, fiscal policy was almost entirely missing, except for a rather small tax rebate scheme in the U.S. in the spring of 2008. This was no accident. The neo-liberal commitment to small government, except in the direct interests of military spending and special favors for politically connected businesses, prevented a major fiscal initiative to restore economic health. Hence, the job of saving the economy fell to central banks, sometimes in cooperation with Treasuries and Ministries of Finance.

One striking aspect of the central banks' responses is how late they were in initiating substantial actions. Despite early signs of serious problems in the sub-prime markets in June and early July the ECB and BE were still *raising* interest rates. It was not until August 13, 2008, that the ECB injected a significant amount of new liquidity into the financial markets, followed a few days later by the Fed lowering the discount rate (August 17) and encouraged large banks to borrow more from the discount window in an attempt to get the banks to use already existing facilities to help provide liquidity. This policy was soon seen as insufficient as the crisis spread and deepened.

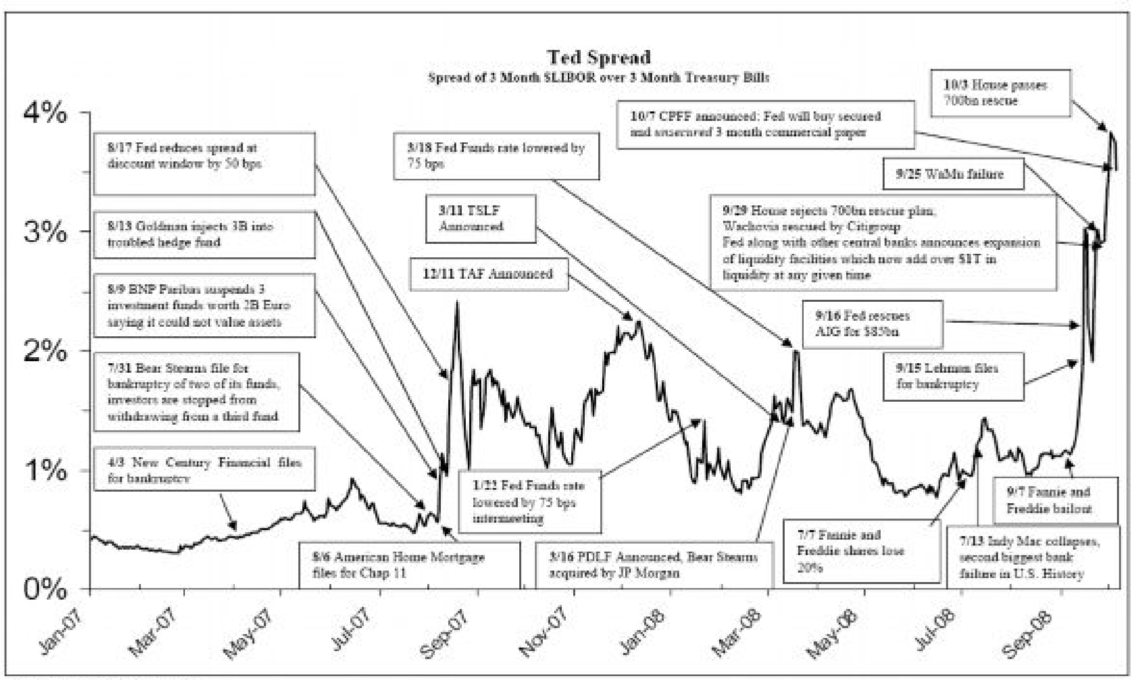
This desultory response was probably due to at least three factors: first, the highly complex and non-transparent nature of the risks associated with the securities whose origination and distribution had been made possible be earlier rounds of de-regulation made it extremely difficult for the Federal Reserve and other authorities to properly anticipate the true severity of the crisis, even as it was unfolding. Second, like central banks and financial authorities for centuries before them, the Fed wanted to avoid the moral hazard and concomitant political problems associated with lender of last resort actions if it possibly could. And third, the inflation-obsessed approach to central banking - accompanied by rational expectations based monetary theory – makes the central banker's prestige synonymous with establishing his anti-inflation credibility. This helps to explain the oddly pro-cyclical behavior of the ECB and BE that were raising interest rates just as the financial markets were about to melt down, and also the tepid initial response of rookie Ben Bernanke who was quite reluctant to undermine his hard earned, initial stock of anti-inflation credibility.

Part of the problem stemmed from the increases in food and commodity prices in late spring and early summer of 2009. The authorities became pre-occupied with inflation, as a result of oil and food price increases. The Fed and ECB were focused on the need to raise interest rates to stem inflation, rather than continuing to deal sufficiently with the underlying cracks in the foundation of the financial system.

But the problem was much deeper than this. The real problem was the true commitment and faith the neo-liberal project which tied the hands of fiscal policy; focused all attention on monetary policy; and even then, retained the belief that the fundamentals of the economy were sound in the sense that there is a stable floor on economic decline, and that eventually, strong pressures for economic recovery will be created in the market place itself. A commitment to low budget deficits and a focus on keeping inflation very low were two manifestations of this broader neo-liberal commitment. Perhaps most importantly, the government authorities were committed to restoring the prominent role of the financial sector and those who acquired vast wealth by working in those sectors, and to avoid at all costs the strong interference of government into the operations of private finance. Slowly, all these commitments and beliefs are being called into question, but governments are still extremely reluctant to fully let them go. Hence, we have seen a halting and ultimately unsuccessful response that has been focused on saving and restoring finance, with a minimum of interference in their operations.

The true test of neo-liberal faith started happening in September, 2008. At that time, the foundation began to truly collapse. Unprecedented financial strains emerged in September, followed by truly extraordinary attempts by the Federal Reserve, the U.S. treasury and European governments to act as lenders of last resort and shore up the system. By the end of September the face of the U.S. financial system had profoundly changed with massive investment banks either going bankrupt or being made into commercial banks, and with huge nationalizations of financial institutions by the U.S. and European governments.

Figure 1



TAF: Term Auction Facility
TSLF: Term Securities Lending Facility
PDLF: Primary Dealers Lending Facility
CPFF: Commercial Paper Funding Facility
Sources: Wall Street Journal, New York Times, Financial Times, Economagic

Thanks to Tom Bernardin for preparing this chart, which is taken from Crotty and Epstein, 2008b.

After early fall, 2008, the Federal Reserve, U.S. treasury and governments in Europe invested billions of dollars to bail-out failing financial institutions, while cutting interest rates dramatically, and supporting credit markets by guaranteeing borrowing. These extraordinary events and actions represented a major move from monetary and central bank policy to a belated shift to fiscal policy as the major tool of lender of last resort activities. Still, by focusing the efforts on the banking industry, the treasuries turned government spending that could have been used to put people back to work directly, and instead turned it into monetary policy, investing it in banks, hoping that it would trickle down to the real economy.

Since November, 2008, many central banks and governments around the world have taken extraordinary actions to bail out financial institutions, nationalize banks, unveil programs of fiscal stimulus, and other emergency economic programs. Yet, these programs are still unlikely to be sufficient.

This continuing failure to rise to the level required by this emergency has resulted from an unwillingness to recognize that the system of neo-liberal economics and the new financial architecture had irrevocably collapsed, and that the old remedies would no longer work. Now, citizens and governments must understand that both in the short run and in the longer run, the point will not be to save the old system, but to implement policies to reconstruct a new system that will serve the needs of the people and not primarily the financial institutions. Meanwhile, the global recession has taken hold. The real economy was very negatively affected by the financial crisis, and now the real economy recession is making the financial crisis itself much worse. Hence we have a very serious negative feedback loop.

Only massive and coordinated fiscal policy actions by governments around the world can prevent a major depression and a likely social catastrophe. These fiscal actions must also be accompanied by a major re-regulation and reconstruction of the financial sector, so that the financial institutions and markets will contribute to rather than hinder the economic recovery, and so that they will not eventually lead to a replay of these enormously destructive events through their irresponsible and, in some cases, corrupt practices.

III. Short-Term and Longer-term Solutions to the Current Economic Crisis and Proposals for Financial Reform

Here we focus on a set of inter-related and critical components of a recovery and reconstruction program, some of which dealing with the immediate crisis, and some dealing with medium term and longer term measures for reform. While the focus of some of this is on the United States, there are also points relevant for Europe.

Immediate Responses to Help Revive the Economy

- *Economic Stimulus Package:* An immediate economic stimulus and recovery program is needed that will move quickly and massively to break the downward economic spiral we are in. It must be large, targeted and serve the real needs of people in the short run and longer run. It should be effective in the short run and set the foundation for longer term economic transformations we need, such as dealing with the major problems of global warming and a broken health care system. This program has to be primarily a fiscal stimulus, and must work primarily through spending initiatives and financial guarantees.

The package should be designed to work quickly; save and create the maximum number of jobs in the most efficient way; provide incomes and aid to those who are most vulnerable and who will therefore spend; maintain important services for families and communities; facilitate longer term goals making the transition to a greener economy, providing health care for all, and repairing nations' infrastructure. One of the principles of a spending package is that it must be structured so that it starts with a large number, and then has automatic or semi-automatic mechanisms to increase it as needed. Thus, **increasing automatic stabilizers** must be a significant part of the package in order to defeat this economic crisis.

International Coordination

The recession has become a global one and therefore the economic stimulus has to be global as well. While some of the key countries, notably the United States and the People's Republic of China, appear to be committed to implementing significant fiscal stimulus packages in order to restore growth, in Europe, where the growth and stability pact and reluctance of some governments to engage in fiscal significant stimulus are hindering bold moves, needed to generate economic recovery. Likewise, in developing countries, aid from the IMF and World Bank must contribute to economic recovery, and not be saddled by austerity conditionality that will undermine the expansionary purpose of the aid itself.

To promote these global reflationary policies, the European Union must suspend the *Growth and Stability Pact* which restricts the government deficits that member states can run. Instead, the European Union must encourage its individual countries to undertake substantial fiscal stimulus. The European Union should consider borrowing on a Union wide basis to fund at least part of this expenditure program, so that the increased debt does not unnecessarily harm the weakest members of the community. For its part, the Obama administration should in the very short term conduct aggressive economic diplomacy to advocate a global reflationary policy lead by fiscal actions.

IMF and Regional Reserve Bank Conditionality: The IMF should be instructed to greatly loosen its conditionality requirements, at least temporarily, so that countries are able to use emergency funds to maintain jobs and livelihoods. By the contrast, the IMF often requires that developing countries cut social spending and credit from the central bank when it receives loans from the IMF. This is often counter-productive, and in this crisis environment, would almost certainly be counterproductive.

Increase Foreign Aid: A recent report by the Institute for Policy Studies reports that while, as we have seen rich country central banks have committed over $4 Trillion in funds to rich country financial institutions, they have committed only 91 billion to development aid and 15 billion to climate change funding in the developing world. Hence, they have committed 40 times more in financial bail-outs than in aid to developing countries or to protect the earth from climate change. Yet, the poorest and most vulnerable are likely to suffer the most. A substantial increase in foreign aid, without neo-liberal conditionality, will be required to keep the poorest from suffering the most. It will also be another break on the deflationary forces engulfing the globe.

Reform the Bail-outs: Financial Sector Protection and Re-Direction

Central banks and governments in a number of regions and countries, including the Federal Reserve, the U.S. Treasury Department and a number of European governments, have spent, promised or guaranteed more than 4 trillion dollars of spending (IPS, 2008) up to several trillions of dollars to financial companies or markets, trying to prevent financial institutions from failing, depositors from losing their funds, and to restore the flow of credit to households, businesses, non-profits and governments to promote economic recovery. While deposits have been protected the financial system has not restored the flow of credit to the economy where it is most needed.

While committing or giving away billions of dollars in taxpayers money, most governments have exerted little control over the financial institutions to force them to undertake actions in the public interest such as reducing interest rates and increasing lending to key areas; eliminate excessive pay packages and dividends; engage in unproductive stock buy-backs, or to increase the flow of lending to households, communities, and governments, while closing the avenues for high risk, exotic investments.

Government authorities must dramatically change direction: they should use their leverage through its various normal regulatory tools, which have now been dramatically enhanced by the massive introduction of public money into bank balance sheets, to gain more public control over these institutions and direct them undertake lending and investments to promote economic recovery. Unless the government starts exerting its authority and control, the public legitimacy of the bail-outs – already thin – will most likely collapse and as a result, one of the major tools that the authorities for economy recovery will be eliminated.

Governments must exert this authority through its regulatory oversight, and/or by demanding seats on boards of companies in which it has made major loans or investments. For example, the government should establish a short-term code of conduct and behavior for these institutions and they should be monitored closely. These must include restrictions on dividend payments, executive compensation. There must be more public control and oversight over these financial institutions to enhance transparency and ensure that these institutions are contributing to the creation of jobs, home ownership, education and other goods that people want and need.

These policies can be employed on the national level in the U.S., the European wide level, and, in the longer run, such policies and practices may need to be developed at the international level.

Ultimately, if the banks and other financial institutions do not serve the public interest, then governments and regional authorities that have invested billions of Euro's to bail-out and recapitalize these financial institutions, may need to nationalize some or many of them so that they can they can be deployed to act in the interests of the majority of people.

Medium and Longer-term Solutions

Though most economists and policy makers recognize that we are in an emergency situation and therefore emergency measures are required, many are also calling for as quick a return to "normalcy" as possible: a return to financial institutions to private ownership and standard market practices, a return to the labor market and tax practices of the past, only marginal changes in health care policies, and so forth. Yet, it was these practices and institutions that have created this crisis, and to return to them would be to set in motion activity that will lead us down the same path again. Moreover, many aspects of the financial system have been irrevocably changed. Concerted attempts to return to the past can only fail. In the 1920's and 1930's, governments in Europe and elsewhere made many destructive attempts to restore the economic conditions existing prior to the first world war, including the gold standard, in a disastrous attempt to hold on to the old order. We must not make the same mistake again.

We must use this moment and the levers of regulation and control that governments are accumulating at high social costs to restructure finance so that it serves the needs of society and the real economy. Policies of financial regulation and reconstruction must be designed for this purpose, and presumptions of privatization for their own sake or on ideological grounds must not be the default option. Retaining major government stakes and exerting more government control in financial corporations may well be the best option for insuring that financial firms operate in the best interests of the society.

At the minimum, governments must use this moment to re-regulate the financial markets and institutions so that this cannot happen again. Until now, financial crises have led to large scale government bail-outs, further de-regulation, a major increase in the size, power and wealth of financial sectors and financiers, and then a crash. This then leads to the cycle starting all over but at a higher level of complexity, size and danger. This cycle of bail-out, de-regulation and crisis must be broken. Here are some ideas for re-regulating the financial sector, drawn from my joint work with James Crotty (Crotty and Epstein, 2008a).

A Nine Point Program for Financial Regulation

The lightly regulated financial system in most of the rich countries were the proximate cause of this major economic crisis. Crotty and Epstein (2008a) show that there were four major source of problems: 1) asymmetric and perverse incentives that lead financial actors to take on excessive risk 2) a regulatory framework that was lax at best, and virtually non-existent in the case of the "shadow banking system" 3) financial innovations and structures that were murky and opaque 4) A system that was at root pro-cyclical in its underlying dynamics. Our nine point regulatory program is thus designed to correct and is presented according to these four basic flaws. As will be obvious, proposals are complementary, but inevitably have some over-lap and will likely be relevant to more than one problem. But this is not a weakness. Regulatory back-up and over-lap is in fact desirable in a system where attempts to evade regulations will be endemic and where fundamental uncertainty is pervasive.

A Nine Point Program for Regulatory Reform

I. Reduce Asymmetric Incentive Structures and Moral Hazard

1. Transform financial firm incentive structures that induce excessive risk-taking.
Perverse incentives for top decision makers in important financial firms is a major cause of the current crisis. This asymmetric pay structure has greatly exacerbated the inherent pro-cyclical behavior of financial markets. Without solving this key problem, it might not be possible to create an effective regulatory regime. One mechanism to make the pay-off structure more symmetrical, and thus reduce incentives for risk-seeking, would be to implement "clawbacks" through which excessive salaries and bonuses paid during the upturn would have to be repaid in the downturn.[2] Such clawbacks could be required in compensation contracts or could be implemented via the tax system, through a series of escrow funds and limitations on deductions from losses.

2. Implement lender-of-last-resort actions with a sting.
Institutions might be too big to fail, but no CEO should be. The CEOs of the seven largest investment banks received a total of $3.6 billion from 2004-07, yet the market capitalization of their firms declined by $364 billion from their peak values, an average fall of 49 percent. As long as there is financial capitalism, there will be a need for the some lender of last resort bailouts, even if all of these proposed policies are implemented. But a key distinction must be made between the financial institution itself and the agents who made the decisions to take risks and benefited from these decisions – top management, key traders and other richly rewarded operators. These rainmakers must be made to pay significantly when their firms are bailed out.

II. Broaden and Strengthen Regulatory Reach

3. Extend regulatory over-sight to the "shadow banking system."
The 'shadow banking system' of hedge and private equity funds and bank-created SIVs had become increasingly powerful. Though humbled by the current crisis, it is nonetheless still very much alive, waiting in the wings to revive if and when the crisis is over. This 'shadow banking system' played a key role in creating the conditions that led to the global crisis. These institutions must be brought under adequate regulatory control.

4. Restrict or eliminate off-balance sheet vehicles.
Move all risky investments back on bank balance sheets and require adequate capital to support them. Capital requirements should be sufficient to protect bank solvency even during the liquidity crises that occur from time to time.

5. Implement a financial pre-cautionary principle.
Once the financial regulatory structure is extended to all important financial institutions, as we propose in point 3, it would be possible to implement a regulatory precautionary principle with respect to new products and processes created by financial innovation similar in principle to the

[2] The $700 billion bail-out program does not contain such provisions. It has only weak language suggesting that new "golden parachutes" for executives leaving the firm might be in jeopardy. Existing golden parachutes would remain in place.

one used by the US Food and Drug Administration to determine whether new drugs should be allowed on the market.

III. Increase Transparency

6. Prohibit the sale of financial securities that are too complex to be sold on exchanges. Eighty percent of all derivative products and one hundred percent of the complex CDOs, credit default swaps and other exotic financial instruments implicated in the current crisis are traded off markets or over-the-counter. If regulators insisted that all derivative securities must be exchange traded, those OTC securities that could be simplified and commodified would shift to exchanges where they would be transparent, involve less counter-party risk, and be cheaper sources of finance. Of course, investment banks and hedge fund traders would not meekly accept such a proposal since writing and trading complex derivatives OTC is a source of huge profits

7. Require due diligence by creators of complex structured financial products. Require the investment banks that create mortgage backed securities, CDOs and other opaque mortgage backed financial assets to perform "due diligence" on the individual securities embodied in these products. "Due diligence" would obligate the issuer to evaluate the risks of each underlying mortgage, then use this information to evaluate the risk of the asset-backed security under varying conditions that might affect the value of the underlying mortgages.

IV. Reduce Pro-Cyclicality

8. Restrict the growth of financial assets through counter-cyclical capital requirements. A number of the previous suggestions might help restrict the excessive growth of financial assets in the boom. But they may not, by themselves, eliminate the excessive growth of financial assets. As a number of observers have noted, asset creation is extremely pro-cyclical. As asset prices rise, bank capital rises as well, so banks can increase loans until they hit regulatory capital constraints. This lending leads to a rising demand for securities and thus higher security prices, which allows the process to continue. To assure control of the rate of expansion of financial assets, regulators should impose *counter-cyclical* capital-asset ratios

9. Create a bailout fund financed by Financial Firms. When the Federal Deposit Insurance Corporation in the U.S. rescues failing commercial and savings banks, it uses insurance funds paid for by the banks themselves, not by the taxpayer. A similar insurance scheme should be created to finance bailouts for other kinds of financial institutions. The government should impose a small transactions tax on all security sales. The fund would typically accumulate hundreds of billion of dollars in normal and boom times prior to the outbreak of a financial downturn. If effective regulations are put in place that prevent a truly dangerous risk buildup in the expansion phase of the financial cycle, the fund should have more than enough money to rescue those institutions that fail in the downturn.

IV. Conclusion

Implementing policies and programs to avoiding a global depression and transforming our economies to be more fair, more stable and more sustainable must be done simultaneously. And the rich countries, which caused this economic crisis to begin with, must take the lead in solving it. Most governments, however, and the business groups that support them, are still committed to the neo-liberal project, if not during the emergency, at least in the medium to long run. And they will push very hard to use this emergency moment to re-establish and solidify their hold on power and the levers of policy when we emerge from this moment.

As a result, most governments will not implement the actions and structural changes that are necessary to prevent the global crisis from getting much worse. So workers, teachers, students, and others must cooperate and take take non-violent, legitimate political activity to push their governments to resolve this crisis while implementing more egalitarian, sustainable and democratic reforms. Unless we push them, they will lapse back into their old, destructive ways.

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