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U.S. APPROACHES TO FINANCIAL REGULATION ARE INCOMPLETE AND INADEQUATE, NEW LEVY ECONOMICS INSTITUTE STUDY SAYS

Until Regulation Reforms Incorporate Hyman Minsky's Theory that Instability Is an Inherent Part of the Financial System, They Will Fail to Head Off Future Crises

ANNANDALE-ON-HUDSON, N.Y.— Analyzing U.S. policy responses to the global financial crisis over the past five years, chiefly the Dodd-Frank Act, a new paper from the Levy Economics Institute of Bard College argues that the approach has been incomplete and inadequate, very much like the "piecemeal" and "patchwork" pattern of reform that Hyman Minsky cautioned against in his 1986 book *Stabilizing an Unstable Economy*.

"As Minsky emphasized, you cannot adequately design regulations that increase the stability of financial markets if you do not have a theory of financial instability," write Senior Scholar Jan Kregel and President Dimitri B. Papadimitriou in their new paper, "Building Effective Regulation Requires a Theory of Financial Instability." "If the 'normal' precludes instability, except as a random ad hoc event, regulation will always be dealing with ad hoc events that are unlikely to occur again. As a result, the regulations will be powerless to prevent future instability."

Despite the well-known phrase "Minsky moment," the authors argue that Minsky's approach had little to do with "moments." "It was about the sustained, cumulative processes in which periods of stability induce an endogenous increase in potential financial fragility," they write. "Fragility provides the fertile ground for financial instability, leading to a process of debt deflation and a full-blown crisis. . . . Regulation of the system cannot be effective if it is simply based on measures produced to remedy and reverse the conditions generated by the current 'moment.' It needs to reformulate the structure of the

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financial system itself. Unfortunately, the current approach to regulation seeks to remedy the present moment by applying to the business models of existing financial institutions a series of mostly cosmetic changes, leaving the basic structure of the system unchanged in some crucial respects."

Extending some of Minsky's ideas, Kregel and Papadimitriou conclude that a blueprint for a more stable financial architecture would include breaking banks down into smaller units and creating a bank holding company structure with numerous types of subsidiaries subjected to strict limitations on the types of activities allowed to them. "Such restrictions on both overall size and subsidiary function could enhance the ability of regulators to understand and supervise the activities of the subsidiaries, and to react to innovations," they write. "While best known for his analysis of financial fragility, Minsky was primarily concerned with providing guidance for proposals to create a financial structure that ensures a stable transaction system and provides for the capital development of the economy. Until we internalize his vision of financial fragility, however, we are unlikely to be able to design a financial architecture that more reliably meets these twin objectives."

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One-Pager No. 30: *Building Effective Regulation Requires a Theory of Financial Instability*

To read the full text of this policy paper or to learn more about the Levy Economics Institute of Bard College, please visit www.levyinstitute.org.

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