The Failure of Global Finance is Systemic

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Lynn Fries (LF): Hello and welcome to this GPEnewsdocs conversation with guest, Jane D'Arista. We'll be discussing the US and international financial and monetary system. More specifically, we will be revisiting an argument D'Arista made in 2018 with the publication of her book, *All Fall Down*. An argument informed by the 2007-08 great financial crisis and that holds into the present. Notably, that the regulatory and monetary frameworks in place today have intensified rather than defused the threat of another crisis. In the preface to the book, PERI's Robert Pollin says: *'All Fall Down' deserves to be read, reread, and pondered over by anyone who cares about creating a more just, equitable, and sustainable economy.* Jane D'Arista's most recent book, *Memoire: One Among So Many* tells the story of a tireless engagement in the world of finance, government and economic policy committed to social justice informed by objective economic analysis.

Jane D'Arista is a Research Associate at the Political Economy Research Institute at the University of Massachusetts, Amherst. Of special relevance to today's conversation, in 2009 to coordinate an effective response to the then US financial reform efforts, UMass PERI's Gerald Epstein and Jane D'Arista founded SAFER, a Committee of Economists for Stable, Accountable, Fair and Efficient Financial Reform. D'Arista's work in finance, government and economic policy has deep roots. From 1966 to 1986, she served as staff economist for the US Congress. This for the Banking and Commerce Committees of the US House of Representatives and as principal analyst in the international division of the Congressional Budget Office respectively. Among her numerous other distinctions, she was Director of Programs for the Financial Markets Center. The author of a two-volume history of US monetary policy and financial regulation. Her body of published work includes studies of international and domestic monetary systems, financial restructuring, the US international investment position and capital flows to emerging economies. D'Arista has lectured in graduate programs at Boston University School of Law, the University of Massachusetts at Amherst, the University of Utah and the New School University. Welcome, Jane.

Jane D'Arista (JDA): Thank you. Very nice to be with you.

LF: In today's conversation, I will be drawing heavily from your book, All Fall Down. I'll start with a question the title. Why did you choose, *All Fall Down?*

JDA: *All Fall Down* is because the global economy and finance are so interwoven now that the crises in the past, which began, of course, with Mexico, then Latin America and Asia and Russia, et cetera, are increasingly global. And that is because of the word you used earlier which is evolution of the system. It has evolved over time to become what I am actually focusing on in this book. I am trying in this book to make clear how the evolution of the system emerged so that what we have is a very much embedded. free market ideology which has produced two very wrong paradigms for the system. One is the procyclicality of it and the [other] much related, the export led growth model that pervades the system now. So, the issue is that it is a system that produces useless debt. Debt that has built up and is now building up once again, as it did at the beginning of the 2000s to precipitate yet another crisis.

LF: *All Fall Down* traces the shift in the US and international financial and monetary system from a national-bank based system to a global market-based system. The context for this transformation and its subsequent procyclical effects being the neglect or abandonment of existing regulatory frameworks without attention to the implications on systemic soundness. You stated in the introduction to AFD: „This book attempts to provide an assessment of how the monetary and financial frameworks for the US and global economies unraveled over the last 50 years. It offers proposals to reform the broken system now in place and calls for continued attention to the need for reform despite – or because of the hostile political environment. The first section is a brief summary of the developments and proposals described in greater detail in subsequent chapters. The author hopes this summary will help the reader follow the progression of seemingly disparate issues that like pieces of a puzzle are indispensable parts of a narrative that describes how the current vulnerabilities in the system emerged and how they continue to threaten the US and global market". Give us a brief overview of that progression.

JDA: And so, it really was an evolution. It began with a series of things that seemingly were not related, but that work together to create these unfortunate aspects to the global regime. It began perhaps with the Marshall Plan, a very well-intended project, and then also at that time, as the US had all the gold in the world. And the expectation was that giving dollars to countries to rebuild, allies as well as enemies, we would be doing a good thing. And indeed, it was generous and well-intended, et cetera. But then there was also the issue of Russia and the monies that had been given to Russia during the period when we were allied fighting the Nazis. The Russians had those balances and did not want to give them in to US banks. They wanted very much to hold on to them, but also to take the profits. That was the origin of the so-called eurocurrency market, the external market. That banks in London were willing to accept these deposits in dollars from the Russians and invest them and make profits for the Russians in themselves. So, the beginning of that euro currency market, which is really in the middle 1950s is the origin of the paradigm that we have now.

Then a lot of different things occurred along the way that reinforced the structure of the model that we end up with including seemingly unrelated. ERISA, the Employee Retirement Income Security Act which said that companies that had offered pensions to their employees during the war, and many had in order to justify keeping them, et cetera, would need to back them with assets. The bankruptcy of several countries, companies, and the fact that those employees who were not going to get pensions riled the Congress into a good act of saying: put down the money before. Don't just tell them they're going to get it and then go bankrupt so they don't. Give them the money. Well, this would then the beginning of the fact that the household sector would become in the end reliant completely on market forces; that over time, it would be pensions and securitized savings that would be the savings of the household sector. They would not be putting their deposits in banks any longer, and they would not be borrowing from banks anymore. The growth in the mortgage-backed securities market meant that households were really borrowing against the mortgages that they had.

Now, this was not a small thing, and over time, the importance of it not only in the U. S but in other advanced economies, meant that asset backed securities became the dominant assets in the market. And that you had a market that was in effect dominated by something called repurchase agreements. And that led to the fact that the banks losing their share of banking activity, which had been at, in the 1950s, about 65 percent of the market and had fallen to less than 25 percent of the market that is deposit-taking and lending by banks, other activities, shadow banking was off and running. And so banks as they reduced their activities to that and became speculators in the market with off balance sheet positions, increasing constantly were transforming the market. And then you come up into the end of the 1970s, or the beginning of the 1970s; I should say first, when-the US dollar could no longer be backed by gold; and the dollar went down in terms of gold; and then off the gold standard altogether. And there again we have a very important event that contributes to how this evolution is beginning to march on. And so then at the end of the 70s famously, the dollar fell in value. Credit controls were put on. Which were very interesting, I mean, in the sense of all the things they did. It was credit not just by banks and financial institutions but credit issued by the oil companies to buy your gasoline. Everything was being affected at that time. And it was putting the dollar back in place.

The dollar came back in place, indeed. And began to become the hegemonic currency for the global economy. And so, we're moving on then into the position where it was additionally featured because of the decision to allow the commercial banks to take on the recycling of the OPEC funds in the middle of the 70s. The idea was quite misplaced. They thought if they loaned them to the emerging markets, the emerging markets would buy more goods from the advanced economies.It didn't work out that way. So, the beginning of the necessity for emerging markets who had borrowed those dollars to obtain more dollars in order to repay and to monitor the situation for themselves began to create this export led growth situation. I mean, the beginning of the debt. And I want to stress that debt is such an important issue in this whole story of what is happening to our markets and how vulnerable they are and how threatening they are.

The first crisis was Mexico in 82. But crises began to proliferate. And what you had was more Latin American countries involved; the Asian crises beginning with Thailand and going into South Korea and Russia itself. And those were preliminary crises which did not seem of great concern to the advanced economies because they were not affecting, seemingly were not affecting the advanced economies. In point of fact, they already were. Again, creating markets that were so large, opaque and with no information to the people participating in those markets. Namely the foreign exchange market and the MBS, the market for mortgage-backed securities. So, in the end, what we had by the 1990s was a situation in which credit, outstanding credit in the United States had gone from what was $5 trillion in 1982 and that was all the time since the formation of the Republic to $10 trillion: doubled in eight years to 1990 was incredible. So, you had a sort of taking away of guardrails. The regulations began to fall. It's very complicated and I do a lot with it in the book, but no point in putting it here. The point is simply that you began to have a global system which was totally unmonitored. The attempt to monitor it by the BIS [Bank of International Settlements] was very good. They were handling the capital flows part of the issue. But nobody was paying attention to the things that were really happening. For example, what did happen in the early 1990s, we have a situation in which the household sector's net worth relative to disposable income had fallen for the first time since the 1930s. And there was no protection. They were not being insured as their deposits, their savings, were not in the banks. They were in their houses and in the mortgage-backed securities market.

So, the impact on the household sector was really huge, and no one really discussed it. No one noted it. And on we went. Then as the periphery markets began to falter, we had the advent of the Washington Consensus. Which said: Oh**,** let's double down on liberalization and all the things that will allow the market to do the deciding rather than governments. And so the Washington Consensus was reinforced by removal of all capital controls and that meant not only the advanced economies but also the emerging economies. And that was like putting them in total jeopardy. At that point, you would say the export led growth model was fully in force. They were up to their ears in debt with dollars and other strong currencies. And they had to export in order to earn the funds that they needed to service their debt and to buy imports needed to keep up the export possibilities for their economy**.**

The economies got starved domestically. Especially Mexico when it hit its crisis in 1994, the economy almost stopped and everything that was going on was export led. And all the credit was dollar credit which meant it had to be export led. So, we were thoroughly, completely immersed in this situation then by the middle of the 90s. And then at the turn of the millennium, we had the situation in the early 2000 period where we got into what I would say was just what actually happened. At the time of the dollar going off the gold standard, Nicholas Kaldor had made this remarkable statement in a series of artic les they published in the London Times in the fall of 71, in which he said: this will mean that a nation of entrepreneurs and innovators will become a nation of consumers looking at consumption that is meaningless and nonproductive and it will be very much like the bread and circuses during the Roman regime many centuries ago.

By 2003, you would have to say, Kaldor's warning had come to pass. And what you had was what I have called, at that period of time, *The Sorcerer's Apprentice* behavior of the global system. What you had was so much money coming into the United States; into U. S. assets. Money that the U. S. didn't need to finance its current account deficit; more than it needed. Therefore, the US banks and other financial institutions that had this money, sent it back out into the global market. What was famously going on at that time was the yen dollar carry trade. And that meant that the major institutions, not only banks, but others as well, were borrowing short term in yen at a very low interest rate. The Japanese government wanted, as a matter of its decisions about its own economy, to keep interest rates low.

And so, you borrowed in yen short term, and you invested in U. S. bonds long term at a higher interest rate. The positions were getting huge. On the part of the emerging markets which were, of course, very active in the markets at that point, what they were doing was trying to sterilize the dollar inflows coming into their markets. They were finding the procyclical effects of the global system impossible to deal with. If they tried to contract the economy by raising interest rates, they got more inflows. They then became alternatives to the dollar bonds for a higher interest rate. If they tried to lower the interest rates to stimulate the lack of activity in domestic goods markets then the money would flow out and they would be faced with a crisis or the threat of a crisis. So, they were frozen and unable to act and unable to do anything except continue what they were doing.

And they were trying to sterilize the situation by buying all the dollars that came into their markets and putting them in their reserve account, not cashing them in for local currency. And that, of course, seemed like a good solution at the time, but it wasn't. So, in the end, what was going on was this money would go out again to be invested somewhere in a dollar asset. And that would then end up with more dollars going back into dollar assets either domestically in the US or in the Euro markets. And the debt buildup in that period of time, in the early 2000s with a minor crisis in the US over the tech stock situation set the stage for the financial crisis that came.

LF: That gives us a lot of context on how vulnerabilities in the system emerged and progressed to transform the US and international financial and monetary system. And how this shift to a global procyclical market-based system intensified rather defused the debt buildup that as you say set the stage for the 2007-08 US financial crisis. The way you see it, as we speak this system is setting the stage for crisis – again. So, talk now about what you think will be required to defuse that threat to the US and global economy.

JDA: I would start with just reiterating that we have not gotten rid of the free market ideology. But that is still there with us. So, we still have a pro cyclical system, et cetera. But the solutions that have been offered, SDRs [Special Drawings Rights], there are many solutions, of course, but they are not systemic. What we have learned from Keynes was you have to be systemic. You can't do part of it. And then you learn also from Hyman Minsky, is that if you do not stop the evolution, it will repeat and that the story will be a dead story.

So, my concern is that there has been so little attention to the issue of debt and how it affects both emerging and advanced economies and the buildup of debt. At this point, I would also have to say, it was not just that we lost the ability to back the dollar with gold, have we now lost the ability to back the dollar, period.

The dollar is a fiat currency. It depends on confidence and on the belief in the fact that the U. S. economy is going to continue to grow and produce the goods and services and keep its economy in good shape. But the issue is we now have a buildup of foreign holdings of U. S. dollar assets just in the US itself, let alone in the euro currency market where it's so much higher. That has jumped over a period of time until it arrived at the end of 2003 before this last crisis was building at 106 percent of GDP. In other words, we owe more to the rest of the world than an annual production of our national goods and services can cover. That's a possible loss of confidence there. And a possible series of crises, if people begin to withdraw dollars as they did at the end of the 70s and we're in a situation where the dollar falls in value.

If we are in that situation, we will have a global crisis immediately because of the reserves of all the other central banks that hold dollars as reserves on their books will implode and their economies will contract as well. It's a very threatening situation and it's never discussed. It just is there. We talk about other things, interest rates, etc. And so, there's almost nothing the U. S. can do about this at this point. And the fact that it will not be considered in a systemic way is part of the problem that's going on. So, my proposal is, first of all, that in the U. S. market, the Federal Reserve has got to be in control of the entire financial sector, not just banks, which have now so small a share of the market. It can do this by making the reserve requirement once again, the central macro prudential tool for countercyclical policy. And it can do this by putting it on the liability side of financial institutions balance sheet. That would mean that you don't have to have, in the case of banks, an asset that would create a deposit.

In other words, treat everybody the same. On the liability side, along with capital and deposits or whatever, mutual fund shares, et cetera, you would have reserve accounts with the central bank. And those reserve accounts then would be able to increase when a crisis occurred and they would stabilize in value because they would not be falling, pushed down by market forces. They would take a market force position but not the volatility of the market. And so, the central bank could then fill in and add to the liability side of a financial institution's balance sheet and stem a crisis.

And then if things were getting out of hand, that famous punchbowl that was getting pretty rowdy, as McChesney Martin said many, many decades ago: then the Fed would take away those reserve balances by selling their repo(s) [repurchase agreement(s)] back to the institutions. They would be on the Fed's balance sheet as well as repo(s). And that would be the way that it would contract the market by extinguishing reserve balances.

So that is the proposal that is systemic and needs to be put in so that the Federal Reserve will have control of countercyclical operations. It means, of course, that we have to accept the fact that the market has failed. It cannot stabilize**.** Governments must, and you can, as we did have in the 1950s you can create a system whereby~~,~~ stability is built into the system itself.

You may, as with our Republic itself, continue to have to fight, address the issues that will threaten that system, but be aware that it has to be maintained for stability and in order to keep the economy growing. Now, on the international side, it's very complicated. We tried it at Bretton Woods. We did not make it. We did not create a system at Bretton Woods that has worked for us. The fact that there is hegemony of a national currency is our problem.

The fact that a country cannot use its own currency to transact in the international market to buy what it needs, etc. pay its debts and so on is a flaw that has to be corrected. So, my proposal is to create a system that will allow all currencies to be used in the international market. This builds on my reading of John Maynard Keynes and what he was proposing in a clearing union and that was a very important part. He was actually saying: no, no, don't use a national currency, but do something that is, that is public and that is away from governments, et cetera.

That proposal, of course, we know was not adopted. Nor was Harry White's proposal to use open market operations at an international level in order to create counter cyclical operations in the international arena. So, I build on those 2 ideas and propose to create a system where a central agency will be in charge of all the reserves. At the very beginning of the creation of this agency, based on trade and size of economy, *et cetera*, each country will be given an exchange rate and asked to contribute a series of government securities to the clearing agency that will allow it to then create a reserve account that country.

On a daily basis, millions of transactions around the globe are happening. And country A is buying from [country] B and therefore there's going to be a change in its reserve balances at the end of a given period. And so, it will then go into its reserve account and that reserve account will be moved, the funds will be moved to the country that is owed and it will get a larger reserve account. If this goes on for 90 days, say, and exceeds 5%, then the countries need to change their exchange rate and get back to normal.

If it just in the process of doing this, of those daily changes and the automatic change in the exchange rate, you have not added or subtracted liquidity from the system. You have just adjusted reserve balances among the countries to reflect what is going on in the market. Fine. But, suppose you have a situation then that a country is really in trouble. Turkey has had yet another devastating earthquake. There is a need to buy blankets, to get equipment, et cetera. So. you would like to help that country. You can do so by going and buying more of its government securities and adding to its reserve account. So that it can continue to buy in its own currency from the rest of the world what it needs to get through this crisis.

So that does change liquidity a bit in the global system. And then if you wanted to actually pull out the stops, either to expand the global economy or to contract it, you would do it by, again, using the ability of the agency, the clearing agency to buy the government securities of in a number of countries that you want to target and increasing their supply of reserves.

Or conversely, diminishing the supply of reserves by selling government securities back to the countries themselves and reducing their reserve accounts. This is a system that would be as in the currency market, millions of transactions every day, many millions: How would you structure such a system?

Well, you would have agencies in all the major markets. You would certainly have one, you know, in Brazil. You'd have it in the major centers of the world. And the agency itself would be a public agency that would be made up of a board very much like the IMF is made up of a board. But the requirement would be that that board always reflect, 50 percent of it would need to reflect countries with at least half of the global GDP and the other 50 percent would reflect countries with half the global population. So that you would get this mixture, which is both market and, you know, the ability for development to actually proceed.

And so then, some of the decisions that will be made to increase or decrease global liquidity would end up requiring a super majority vote. And this would not be a central bank in the sense of being able to make the decision itself. It would be a public institution but one that was reflecting global governance as we tried to do in the IMF at Bretton Woods.

So, there would be an automatic countercyclical series of actions that could be taken in this situation. And because no country would need to export to earn those reserves, it would not be under pressure to strangle the global economy. As Mexico has done repeatedly in order to be able to survive under NAFTA, say, or in the global economy.

LF: So in short, the first proposal for reform of the US Federal Reserve addresses the loss of countercyclical tools by national central banks in the process of deregulation which has left the global system without the means to moderate excessive growth in credit and which led to an unsustainable explosion of debt in the US and global economies.

The second proposal concerns the critical problem created by the continued reliance on the US dollar as the dominant instrument for global trade and investment. This proposal addresses the need to replace the debt-fueled, export-led growth model embedded in the global transactional framework. This as it is the key currency-based international monetary system that inexorably reinforces the export-led, debt-fueled growth models that drive the US and global economies into crisis.

JDA: I have focused on how it is driving it to crisis but I would also like to emphasize that as we have seen in many cases it also short-changes the development of a country. It pushes all activity into the export sector. That all credit is denominated in external currencies in the dollar or other strong currencies-because of the strength now of some of the other banks that are in these economies. So, you know, a situation in which, they began to import in Mexico, American wheat. Why? Or corn, the famous case is Kansas and corn. Because they can't get credit out to the farmers to grow their own corn.

And one of the great losses to the world has been that in the nooks and crannies in the mountains of Mexico, there are different kinds of corn. There was a whole remarkable diversity of this kind of commodity. And because these farmers then lost and were unable to continue to work, the imports of corn which were pretty much undiversified from the American side has changed the menu of agricultural products of the world. And so, the importance of development, on these little side issues which are not unimportant which are critical for the future especially as we're facing climate change, these are things that we don't talk about. We don't see it as an issue that is affecting us now and needs to be addressed. And that you have to address it through the finance system among other ways.

The finance system has been under-discussed, which is my point. But it's also, deliberately ignored by the media. You don't want to get into all that. I mean, you read my book. My book has all these numbers in it. And you know, it's a little tough to get through it but it's important. And if we discussed it more, and if people were more aware of what was going on. I tried so hard at a given point to make the point about what was happening to small business.

Back in the beginning of the 2000s, I was making the point that if you looked on the page of the flow of funds for the Federal Reserve, you saw that small businesses were not borrowing for loans from banks. They were instead revving up their liabilities for mortgages. So, what the banks had done in that process was say: Oh well, you know, we really don't want to lend you money for more trucks or computers or dry-cleaning machines, etc. You have a house and we'll be able to loan you against your house. That way, we'll securitize it and it'll be off in the market and we won't have to hold the loan. So that will be less capital we have to attract. So that went on for several years. And then, of course, when the crisis came, the small business sector was absolutely flattened. Not only had the value of those houses fallen but that was their channel for lending and they couldn't lend. They were underwater. They could not borrow. They were underwater.

The fact that we did not have the usual resurgence of the small business sector in that crisis prolonged the crisis. And, you know, it was, it was very hard to get people to be interested in that, but it was so critical. It was, it seemed to be minuscule. It was huge. We have in the Federal Reserve, the largest employer of economists in the world. And do they think outside of the box? No. Do they address any of these issues? It's always the same old thing. And again, we are still looking at interest rates and that procyclical system that they are addressing. So I mean, it's true that in the 2000s, the early 2000s, Chairman Greenspan got concerned about what he called a conundrum: Why is it that the [long term] interest rate is not behaving in the way I expect it to? But that was the procyclical nature of the whole situation.

And it has not still been addressed. As we go into more speculation now in the markets. And more carry trade activity as banks are looking for income and profits and there are no guardrails and no regulatory discussions. God forbid you should suggest such a thing as a liquidity requirement for banks. But why would you bother? Because the banks are not that important. I mean, you have got to get it for the hedge funds as well, the mutual funds, etc.

So, if you do it for this one sector, it's not going to work. There is my concern about the systemic nature of reform. That it has to look at the whole and not the part.

LF: Can you talk more about the kind of systemic approach to reform that you are calling for?

JDA: Yes, what we really need to do is to understand all of this that I'm trying to say: what is actually happening? What is our economy now? Our financial system now? And describe it accurately and talk about its deficits, etc. And then we have to say: yeah, we're not going back to the 1930s. We're not going to reinvent the role of banks. This is what we've got. How do we use what we have to reinstate a countercyclical regime?

If it's a market-based economy, how do we fix things, for example, for the household sector? And another paper I wrote many years ago proposing to do financial insurance for individuals, not institutions. And so that you give them the $250, 000 wherever they have their money. Is it a hedge fund or is it where? Whatever. As long as it's a licensed and regulated institution, then they can have coverage. Just as they would have coverage now in a bank. And so that would be something that would be very important to address the issue of the fact that household savings are now at the mercy of the market. And what we have seen in the collapse of net worth was very much again like I'm discussing with the business sector, the household sector took so long to revive.

And the warning that I remember coming from Bill Spriggs, the late Bill Spriggs, wonderful economist, was that the gains of the black community would be absolutely lost in this financial crisis, the one we had before in the 2008-09. And he was so right. And that, you know the comment is, if this is what it is to have wealth now, and if net wealth is important in terms of your position in life, what can you do with your life if you do not have this kind of household wealth? Then you better address that. That has to be a part of the discussion about race, etc.

So, that is what I've tried to say. This is going to take a lot of work. And it's not going to come easily. But it is important to fight to get the ideas out. And to have people talking about ideas. I don't know that mine are the best. I would say, I would love to have lots of ideas out there to rummage through and think about. So, I'm hoping that others will come along. And as I say part of my problem is that the Federal Reserve brings in people in the early part of their careers, academics, others, etc., gives them a little time, it's great on the resume, and then, you know, they indoctrinate them. And the indoctrination is just stay within the box. Don't think outside. And I think that has been a major problem also.

LF: You and others fought very hard to get the reinstatement of reserve requirements across the whole financial system implemented in the overhaul of the US financial system regulatory system after the 2007-08 financial crisis. A key criticism you have of the outcome of post-crisis US financial reform – the Dodd Frank Act of 2010 – was its failure to do so.

In other words, its failure to adopt the kind of systemic approach of looking at the whole not just the parts that you have been talking about.

JDA: Well, we almost got there, at least in one part, during Dodd Frank. A staff member of Senator Dodd's staff, proposed that we extend the definition of loan made by a bank to all the things that they actually do: like a repo, like a derivative, like a securities repurchase agreement of another kind, et cetera. And they got through. And we were all sitting on the telephone that night, seeing what did get through until 3am. And we couldn't believe it happened. That that actually was passed. The value of it was that it was already in the law, a 1865 law that banks had to have a diversification based on the limits on a single loan relative to their capital. Couldn't lend, say more than 10 percent of capital to any one borrower. But that had not been, deliberately had not been placed upon banks borrowing from other financial institutions. Because that's how they were making their money with the carry trade.

I mean, they were borrowing, it was the incestuous borrowing within the financial system itself that ended up having not the lines around the block of depositors but the financial system raiding the financial system. And that was where the collapse came. So, what I'm saying here is that you pay attention to those kinds of things. Well, what happened there was that just got ignored. It was not implemented. And the Fed was listening to them saying: But you know, I mean, you're going to eliminate all of our profits. We can't do that. If I can't go out and do the repos with this bank, that bank and the other bank, I can't build my positions.

Of course, that was the objective of those of us concerned about the system. It was not something the system wanted to have happen and it did not happen. In the end, they won, as they always do. And so, if you aren't going to have a big conference, if you're not going to expose this and talk about all of the things that fall out and cause anguish and harm and undermine the economy, then there's no point. It will continue as it is.

LF: The Dodd-Frank reforms largely affirmed the role of higher levels of capital reserves for banks as the primary safeguard for the financial system. There is whole chapter in *All Fall Down* on the inability of capital requirements to prevent or moderate financial crises. You argue the use of capital requirements as the central macroprudential tool for regulating the US financial system is at the root of the failure of crisis management strategies that have been tried. That the effects of the use of capital requirements as the primary tool for safeguarding the financial system have been a major conduit to collapse rather than a cushion for the financial system in times of crisis.

Can you give us a short wrap on that?

JDA: Yes, the procyclical markets that we have created now which are intractable. There is no way to prevent their being procyclical if you rely on capital for banks only as the cushion to prevent failure and over extension and over lending and borrowing, etc. Capital will not be there in a period of asset decline. It will evaporate, implode, or whatever terrible word you might want to use. And not just that you won't be able to go in the market and say: Ah, I am in a mark to market system where my government securities just went down in price by this amount and now I've got to charge that against my existing capital. So, then you have taken as a result of a price decline, you have diminished the capital you hold and you can't go out in the market easily and buy more, get more capital, because everybody else is in the same situation you are.

And then you have the ongoing erosion of your own holdings of capital and inability to replace them. That's the pro cyclical system that leads to disaster. Conversely, of course, in the expansion side, that's the pro cyclical way that you get all this buildup and debt.

LF: Are you then saying that the ability of reserve requirements to prevent or moderate financial crises in our procyclical market-based system is because reserve requirements are held on the books at book value, face value, par value. And that explains why reserve requirements can be used by central banks as an effective countercyclical tool.

JDA: Right, so reserve requirements that are created by a central bank are accounts that the central bank has control of. It does not have to mark them to market. So that if you have a reserve account, its value will hold. That means, critically you can transfer that amount of money to another financial institution. And that is systemic. It is a systemic support, not just for the individual institution but for the system itself.

Which is what you need and it's not there for capital. Capital is for an individual bank. It's very nice. You can say to the bank: you've got to have so much capital and that's what we do. Every time there is a little quirk in the market, we say: Oh, more capital. Oh my God. Yes. Of course, it doesn't work.

LF: So, among other things, the proposed system-wide reserve regime would overcome the procyclical pressures in a market-based system by allowing institutions to buy and sell reserves at face value in the system. The procyclical pressure of market forces being forced sales of assets at prices that are falling that result in "haircuts" to the capital base a time when as you say capital is desperately needed.

It is not so hard to understand then the big difference between reserve requirements and capital requirements. And why as a macroprudential tool, one has the ability to prevent or moderate financial crises and the other does not.

To cite *All Fall Down* you write: The shift in financial structure from a bank-based to a market-based system has obscured the fact that in the US before the 1980s, bank reserves created by – and held with – the Fed served as a systemic control on money and credit as well as a publicly created liquidity cushion for the financial sector as a whole.

JDA: After all, it was the Federal Reserve itself back in the 1920s that invented counter cyclical operations. Benjamin Strong at the New York Fed Bank, a very brilliant thinker, pragmatic, a banker. Not necessarily doing it for social justice reasons but for economic reasons-because of what was happening in the New York markets or whatever. So, if you don't get back to the counter cyclical, the procyclical and the demand for capital – plentiful in good times, absolutely not available at all in bad times – will keep us in this track toward crisis. And people have tried to figure out ways to make capital requirements countercyclical. And they have failed and they say they have failed. And unless we can get past the neoliberal ideas and the ideology of free markets, we will not make this progress.

In the 1950s, the U. S. had a system which was absolutely wonderful. And the intrusion on that system with the euro currency market was where we began to unravel and where the Thatcher and other ideas came in – the neoliberals. So, privatization, you know, was also an issue which they claimed was a boon for development and it was not. I mean you have to tell the truth. You have to say this is what was going on. Because you are not acknowledging the harm that had gone on in emerging markets at that time. Privatization meant that what was actually happening was that foreigners were making the inroads to replace governments in structures of various economies.

I mean, anathema was any development bank in any emerging market that was directing funds to things like, you know, roads and electrical systems and what have you. Those things did not come through necessarily when they were privatized and in the hands of foreign countries' investors. It was a draining. And we see very clearly the wealth of the advanced countries increasing up to a point before the crisis. I mean, how wonderful the US economy has been. How we have praised ourselves lately. I mean, the best economy in the world, right? We're growing. Well, you know, if you get all that money rolling into your economy, because people have dollars to invest, well, you're going to get growth. You're going to get things going. Well, *et cetera*, up to a point. And I think I'm trying to make the fact that we are at that point.

We don't know, there's no way to predict what will be the tipping point that will cause a crisis. I'm trying to suggest that this round robin issue that is going on, excessive inflows to the US. The US has become an entrepot [intermediary or "pass though" function for global markets]. It is a market that takes the money in and then throws it back out. And so increasingly again like a sorcerer's apprentice.

LF: You discussed in more detail earlier how this scenario is an outcome of the current debt-fueled, export led growth model that generates the kind of cross-border capital flows and worldwide debt that has caused crisis after crisis 1982 through 2008 and as you say is continuing towards another tipping point. Comment further on this other point you just made about the drain from developing to advanced country economies.

JDA: I mean, it is the loss of their own economies because they have to support their debt. And they have to have the foreign currency, the hegemonic system of reserves on their own books, to survive. And this is redirecting the wealth of the world to the advanced economies and draining it away from the emerging economies in many ways. The importance of replacing the export led growth model is the damage it does to the countries themselves. Not just to the emerging markets and development, the ideas of development, but to the advanced countries. The impact it has on, say, the United State in terms of the concentrations and its economy; the failure of diversification and the US. Economy; the inability to moderate expansions that get out of control, etc.

If we don't get rid of that model, if we don't understand that the need to get rid of that model, all of this will continue. And getting rid of that model will require a systemic approach to the global payment system.

LF: As a further comment on development issues, comment on your proposal to channel portfolio investments towards development goals rather than solely towards short-term profits of investors. In *All Fall Down* you present this as an idea for restructuring flows of private international investment to emerging and developing countries. It seems to me that that this kind of restructuring of flows of private international investment could also provide the kind of patient capital all countries of the world need in order to meet climate goals.

JDA: It could indeed. And the idea there is to build again on the World Bank framework but to have the ability to use a closed end fund. The closed end fund means that in the market if you have to sell the shares that you have bought into this fund, you will take the market price. But it means that the issuer does not have to sell the asset. Whatever goes on in the market, that's okay. But having made a loan for infrastructure in country B, that loan will not be disturbed. No sale will have to happen. That's why it's important. It's also important because it is a place, an additional place, for the reserves of countries, not only necessarily emerging countries, to be put where they are not subject to political issues or things of this sort.

The other very important, issue there is that they are a place for emerging markets to acquire assets that can be used as reserves of their balance sheets in order to expand or contract their own economies. And so that would be a very important fact as well. And I think one of the issues that needs to be addressed, and the UN did address it some years ago is: what's going to happen with all the pension funds that are being generated in emerging economies?

And they are substantial, because very much like our own state and local governments, that is something that is being done by governments in emerging markets and some private sectors but mostly at this point governments. And so, how do you invest them so that you get a return, you get the development you want from them? And you've got to create a situation in which they become a stable investment somewhere, non-national, et cetera, and so.

Then you could actually make use of the monies that are created in a given economy to reinforce its development strategies. And in advanced countries as well, because **a**s you say, climate change is going to be a major issue in terms of the need for stable investment.

LF: And a closing thought?

JDA: I do not see the political will at the moment to initiate the kind of discussions that I would like to see happening. If they do happen, it will be as a result of yet another crisis. And as I have said repeatedly, I believe another crisis is coming. The buildup is very similar to the one that we saw at the beginning of the millennium. On the other hand, I also know that we have made some progress. After that last crisis, we see at least in the American situation, so many groups now that are concerned about economic issues. And they were not there before. I mean, hopefully, the, hopefully, the internet has made this possible as well, by giving people the ability to do the research and also to publish the material that they write.

And so that is a different world from the one that we were in before, at the beginning of the millennium. And that is very hopeful. That is where I am hoping that things will begin to work out.

LF: Jane D'Arista, thank you.

JDA: Thank you.

LF: And thank you for joining us.

END
