FINANCE WITHOUT FINANCIERS

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ABSTRACT:

In response to the financial crisis of 2007 – 2009, governments in the United States, Europe and elsewhere have invested billions of dollars in financial institutions to prevent them from going bankrupt and from further disrupting the global economy. Despite these massive public bail-outs, a government and "elite" consensus has emerged that these nationalized or quasi-nationalized financial institutions should be privatized as soon as possible, and that, apart from modest changes in financial regulation, our economies should return to the status quo ante financial structure as soon as possible. In short, despite a massively disruptive economic crisis caused by financiers, our best option as a society is to return to a financial system run by these financiers. We disagree. As the crisis reveals, financier dominated finance has a number of crucial flaws: it creates major externalities that contribute to financial and real economic instability; it promotes short-term investment strategies; it contributes to inequality; and it undermines economic efficiency and the achievement of social goals in the real economy. We argue that a better strategy for achieving economic recovery, restructuring and widely shared, sustainable prosperity is to use public investments in the financial sector to build on the successful Post-World War II experiences of publicly oriented financial institutions in Europe and the US to create a stronger presence of

"finance without financiers". We provide case studies of the positive and negative experiences with publicly owned and controlled financial institutions in the United States, France, Germany and Italy, and draw lessons for successfully creating more publicly oriented financial institutions moving forward. We emphasize local differences, policy space and "social management" of these financial institutions to ensure that publicly owned financial institutions is, at the same time, genuinely publicly oriented institutions that fit local conditions.

KEYWORDS: financial crisis, financial regulation, social management, financial institutions, nationalization.

JEL: G01, G18, G28, H82.

INTRODUCTION.

The economic crisis of 2007 – 2010 has forced the governments of rich countries to invest more public money and play a bigger role in organizing financial institutions and markets than at any time since the middle of the 20th century. This marks a major defeat for the policy consensus, forged in the 1980's and implemented first by Ronald Reagan in the United Sates and Margaret Thatcher in the UK, and then emulated and propagated by governments in Europe, by the European Union, the IMF and other institutions. This consensus was committed to private ownership of financial institutions and "light touch" financial regulation.

While this debacle represents a massive failure in financial regulation the problems with the financial sector go deeper than that. For even when things seemed to be going smoothly, these financial markets were highly inefficient. They often failed to contribute to an efficient allocation of credit, a true reduction of risk in the system, or an efficient inter-temporal transfer of wealth (see Epstein, "What Does Finance Do?"). Instead, they concentrated wealth and income, led to speculative booms and busts, and facilitated massive global financial imbalances, while generating huge incomes for those operating in the financial markets (Crotty, 2009b.).

Fearing a repeat of the credit market panic that followed the failure of Lehman Brothers Inc., governments in Europe and the United States have invested massive amounts of public funds in private financial institutions. At the time of writing, it is unclear how much more will need to be invested to stabilize the financial systems of the world's major economies. The U.S. government has undertaken so-called "stress tests" to gain a sense of how stable its major financial institutions are after the initial round of public interventions. The government has publicly revealed the results of these stress tests, suggesting that future investments of public funds are likely to be limited. Even though these tests have been widely criticized as being created to be too easy to pass, they still imply widespread public ownership and massive subsidies for a number of large banks, including Citibank and Bank of America. In Europe, the extent of required continued public investment is equally unclear since the European authorities refuse to undertake public stress tests. The possibility of continued, large-scale public involvement in Europe's major financial institutions is thus hard to know but is likely to remain significant.

Yet, despite the massive failures of the past hands-off public policy approach to financial sectors and the subsequent need for public subsidies of struggling financial institutions, most governments in the Europe and the United States have chosen to return, for the most part, to the status quo ante. This consensus appears to be forming among the G-20 governments along the following lines. First, governments should exert relatively little formal control over the financial institutions that they have heavily invested in. Second, governments should develop an "exit strategy", which effectively means they should clean up the balance sheets of these banks and then re-privatize them as quickly as possible. Third, financial regulation should be strengthened somewhat, so that privately owned financial institutions do not expose the world's

largest economies to the risk of major financial crises. At the same time, though, these regulations should not be so strong that they create inefficiencies or stifle "financial innovation".

The main reason for the consensus is that the political power of finance, bent but not broken by the crisis, is successfully lobbying for its resuscitation and salvation. But, an additional important reason for it is a lack of appreciation on the part of policy makers and economists of the important role that publicly owned, publicly managed, and/or publicly directed financial institutions have played, not just in the distant past or in developing countries, but in the rich countries themselves and in the recent past. The current mantra is that "governments do not know how to run banks" but the fact of the matter is, governments and other stakeholder-driven entities have managed many banks for many periods and have often done so very well. These institutions of "finance without financiers" have delivered many public benefits in a range of countries over a long period of time.

In this paper, we argue that what we need now is a much stronger role once again for "finance without financiers". That is, we need *publicly oriented financial owners and managers* to operate a larger share of the financial system in rich countries. We do not need governments to automatically develop "exit strategies" or to entirely re-privatize their financial systems. Instead, governments should develop programs to utilize the ownership stakes they have in financial institutions and to develop publicly oriented banks to better serve the needs of the real economy. These *publicly oriented financial institutions* can take many forms: fully nationalized large banks that engage in the full range of banking activities; nationalized banks that serve specific purposes, such as making green investments or supporting cooperatively owned business or credit for small business owners; or public support for smaller local banks or a network of smaller local banks. These new financial models will have to be appropriate to the current state of globalization and technology, but the impact of these phenomena on the likely success of publicly oriented finance is likely to be less serious than commonly believed. As we will discuss in this paper, these changes will actually make "finance without financiers" easier and more effective.

Critics will argue, on both theoretical and empirical grounds, that financial institutions "without financiers" will not be able to behave any differently than all the other, "less publicly oriented" financial institutions. The theoretical argument is that market competition will force banks and bankers to conform to its dictates, leading publicly oriented banks to engage in the same types of behaviors as the others. For empirical evidence, critics will point to the multiple recent examples of public financial institutions in the UK, Austria, Italy, France, and elsewhere that ended up making many of the same risky investments made by privately owned institutions and, in this and previous crises, have been subject to many of the same problems as privately operated financial institutions experienced.

As an empirical matter, in the recent crisis, not all financial institutions engaged in the same speculative behavior or were equally harmed by the financial crisis. And there

have been a number of examples of publicly oriented financial institutions that have succeeded in operating differently from private banks.[1] Thus, financial institutions do not have to behave in a risk seeking way. Still, it is important to recognize that financial competition, as well as fads and norms do place enormous pressures on even initially publicly oriented institutions to join the herd. It is thus crucial for public policy to create structures and incentives to guard against this dynamic and limit the exposure of major economies to the kind of financial risks that we are experiencing.

Thus it will be crucial to develop *social governance structures* to prevent "finance without financiers" from becoming "finance FOR financiers". These social governance structures will need to have several components, including democratic governance by those effected by the financial institutions' actions, strong financial regulation over-all to prevent massive gaps in practices between publicly oriented financial firms and the market, and compensation and/or tax schemes which reduce the benefits in the system for destructive financial practices. Where possible, these *social governance structures* should build on existing local practices and institutional structures, where possible, rather than being invented whole cloth or imported wholesale from abroad.

Unfortunately, there are significant political obstacles to building on these local structures and practices, especially in Europe. The extremely neo-liberal European Union Financial Market Directive has placed great pressure on countries trying to dismantle publicly oriented financial institutions, arguing that these lead to unfair competition, or amount to "financial protectionism". Individual countries can and do resist these pressures, but still, for 'finance without financiers" to succeed in the European context, more "policy space" has to be created to allow countries to develop these institutions.

In what follows we attempt to address these issues primarily by using a "case study" approach. We will present examples drawn primarily from European and U.S. experiences that show how publicly oriented financial institutions have succeeded and failed. We draw lessons from these historical experiences for ways to use the public's investments in financial institutions to promote better financial performance.

The rest of the paper is structured as follows. The next section briefly sets out what the functions that financial markets should perform, contrasting this list with the role actually played by current financial practice. Section III presents case studies of "finance without financiers" first by giving a broad overview of European, U.S. and Japanese experience following the Second World War and then presenting more detailed studies of the United States, France, Germany and Italy. Building on these case studies, section IV suggests some models for transforming current public investments in financial firms into publicly oriented financial institutions. The final section (V) concludes.

[1] Gilian Tett, for example, describes in detail some of the safeguards that JP Morgan took relative to many other banks during the bubble, despite enormous pressure on it do to otherwise (Tett, 2009).

1. WHAT SHOULD FINANCE DO?

Standard mainstream analysis posits that financial markets serve a number of essential functions in capitalist economies; they: 1) intermediate between savers and borrowers 2) mobilize savings 3) allocate credit to their most profitable and productive uses 4) engage in maturity transformation 5) provide liquidity 6) facilitate inter-temporal allocation of consumption and wealth 7) reduce risk. (Mishkin, 2008)

The recent financial crisis, as well as the poor social performance of liberalized financial markets over the last several decades, has shown that liberalized financial markets do not conform to mainstream financial theory. The poor performance of mainstream financial theory and neo-liberal financial practices compel a search for more adequate theoretical foundations for understanding what finance should do. Schumpeterian analyses emphasize the role of finance in mobilizing savings for productivity enhancing investment, including for the *creative destruction* that accompanies economic growth. Other economists have emphasized, instead, the *destructive* aspects of finance, raising questions about how socially creative wild-cat finance really is. Marx described the financial fraud and deceit that reached dizzying heights during speculative booms and busts; Keynes brilliantly showed how finance often enrich the rentier's at the expense of productive investment and can undermine the overall stability of the financial system itself; Minsky, Crotty and Kindleberger detailed domestic and international endogenous cycles of boom and bust that only strong government controls could tame. (Crotty, 2008; Patnory, 2003; Tett, 2009). These raise questions about *negative externalities* created when financial institutions and regulators fail to take into account the negative impacts their decisions can have on other financial institutions and the real economy. Behavioral financial theorists question the 'rationality' of financial actors. And critics of many stripes have derided the *short-term orientation* that financial markets impose on the economy, through imposition of *shareholder value* imperatives, and short term trading strategies in derivatives markets, for example.

Another prominent stream of economic thought has emphasized the key role of the state in managing finance to increase the creative and reduce its destructive aspects. This literature emphasizes the public role in underwriting, guiding and utilizing finance for private and public purposes. Gerschenkron showed the importance of the state in mobilizing finance, especially in "Late Developers". Zysman, Amsden, and Eichengreen, emphasized specifically the role of the state in helping to structure and mobilize finance for development and economic restructuring, when economic restructuring was a state goal, for example, after the Second World War in Europe, Japan and the United States.

Drawing inspiration from this strong historical and theoretical literature, we argue in the case studies below, that systems with appropriate structures of "finance without financiers" are more likely to promote social goals such as widely shared prosperity, Gerschenkronian development, Schumpeterian dynamism and Minskying stability, than are financial systems based primarily on neo-liberal principles, dominated by financiers.

2. EUROPEAN AND AMERICAN EXPERIENCES WITH "FINANCE WITHOUT FINANCIERS".

2.1 Introduction[2].

It is well known that after the disasters of the Great Depression and the second World War, governments in the UK, Europe, Japan and even the United States asserted much greater control over central banks and the financial industries than they had had in the previous period. (Capie, et. al., 1999). Ministries of planning and finance, as well as central banks were extensively involved in credit allocation mechanisms for economic restructuring and economic growth. Central banks utilized a variety of credit allocation techniques to accomplish these goals, and in most cases, these techniques were supported by capital and exchange controls on international capital movements. Ministries of Finance and Treasury Departments played major roles, along with central banks, in directing credit and organizing financial institutions to serve public purposes. In addition, many financial institutions were nationalized in whole or in part, and their managers were directed by governments to address social needs. Hence, through strict regulations, credit allocation techniques and/or through public ownership and control, "finance without financiers" became widespread in the "advanced" countries, following the great depression and the Second World War.

Analysis by Lester Thurow and the U.S. House Banking Committee in the early 1970's identified three main techniques for protecting or promoting priority sectors commonly used during this period: (1) asset based reserve requirements (2) government borrowing in the capital market and re-lending to preferred sectors and (3) competition by government financial institutions for primary saving flows and lending captured flows to preferred sectors (for example, through the government postal savings system). In the case of Sweden, asset based reserve requirements were used to aid the housing market. (ibid.) In Japan, government savings institutions were used to capture personal savings flows and these were channeled by the finance ministry (of which the Bank of Japan is a part) to industries that were perceived to most preserve economic growth. (ibid., p. 13; see also Zysman, 1983; Pollin, 1995 and Grabel 2000, U.S. Senate, 1981.).

The U.S. government created a myriad of public and quasi-public financial institutions, moreover, that supported national goals, notably housing. (Dymski, 1993; Wolfson, 1993). In Europe and England, central banks that had been independent before the war found themselves subject to state ownership and control after 1945 (Capie, et. al., p 72). During the War, monetary policy was often implemented through direct controls while interest rates were held low and constant. Direct controls continued in the aftermath of the war with various credit allocation techniques. (Capie, et. al., 1999, p. 25.)

Prominently used during this period were credit controls. These are measures by which the authorities seek to modify the pattern and incidence of cost and availability of credit from what markets would generate on their own (Hodgman, 1972, p. 137). Credit

[2] This section draws on Epstein (2006).

controls seek to influence credit allocation and interest rate structures. (ibid.). In Europe credit controls served a number of purposes: (1) to finance government debt at lower interest rates (2) to reduce the flow of credit to the private sector without raising domestic interest rates (3) to influence the allocation of real resources to priority uses and (4) to block channels of financial intermediation and thus to assist restrictive general monetary policy and (5) to strengthen popular acceptance of wage-price controls by holding down interest income. (Hodgman, ibid.).

European experiences with credit controls varied from country to country. In Germany, controls were used only briefly after the Second World War. In the Netherlands and the United Kingdom, extensive use was made of them, but they were always seen as temporary and short-run expedients. In the Netherlands, credit controls were used to support macroeconomic policy, rather than credit allocation. In the United Kingdom, the principle aim of controls was to facilitate low cost government debt. The government was concerned about the impacts of high interest rates on the bond market, on income distribution and on the balance of payments. A more limited aim of the quantitative ceilings was to guarantee a flow of short term credit at favorable interest rates to high priority activities such as ship building and the finance of exports and productive investment in manufacturing. Credit ceilings were put into place, and exemptions were sometimes made for priority sectors (Hodgman, 1972, p. 144). Moreover, the Bank of England identified sectors for which credit should be limited, such as consumption and the financing of imports. Some empirical work indicated that the controls were effective (ibid; p. 145). In England, as elsewhere, these credit controls were accompanied by exchange and capital controls. On the other hand, France, Italy and Belgium were a different story. There, the principle of controlling credit flows and interest rates to serve national interests was widely accepted. Italy and Belgium also used similar policies. In the case of Italy, a major goal was to help develop the Southern part of the country. (U.S. House of Representatives, 1972, p. 11, and the discussion below). The general consensus of analyses of these experiences is that they are most successful when the controls apply to a broad swath of the financial sector, to avoid arbitrage and avoidance, when they are accompanied by capital and exchange controls, to avoid capital flight, and when they are part of a coherent plan of economic promotion and development (Zysman, 1983; Hodgman, 1972; U.S. Senate, 1972; U.S. House of Representatives, 1981).

In addition to using credit controls, here there was also increasing and extensive state regulation, ownership and control over financial institutions (see Zysman, 1983 and the discussion below). In addition, there is a great deal of historical precedent for the positive roles of public banks to achieve public goals. Alice Amsden (2001) details the key role of public development banks in helping successful developing countries such as South Korea, Taiwan, Brazil and others achieve rapid economic growth in the second half of the 20th century.

2.1.1 Individual Case Studies.

To delve more deeply into experiences with "finance without financiers" we present four country case studies of post-World War II experiences: The United States, France,

Germany and Italy. In each of these case studies, we try to address some of the following questions:

1. What did these "publicly" owned, controlled, or coordinated financial institutions do?
2. What were their goals.
3. How were they governed: for example, what were their incentive structures, management structures, over-sight by government, governing principles, etc.?
4. Why did they break down or change – internal problems? State failure? Corruption? Change in external environment that they could not/did not adapt to? Change in external governance regime (i.e., the rise of neo-liberalism and privatization, or what?
5. Are these (or aspects of these) models for us now?
6. How would they have to be modified to work in the contemporary environment?

2.2 The USA: The Successes and Failures of Fannie Mae.

2.2.1 Introduction.

During the 1930's, the US government implemented major innovations in government involvement in finance. President Hoover and then Roosevelt created a number of institutions, including the Reconstruction Finance Corporation, which was initially used to re-capitalize banks and other firms, and then to finance war procurement during the Second World War, and housing finance institutions, to prevent foreclosures and provide liquidity to housing finance markets. (Knodell, 1994; Todd, 1992; Butkiewicz, 2002).

The RFC, which was closed down in 1953, largely because of political opposition of Republicans who opposed government financial interference in the markets and opposition by private financial institutions who feared competition from the RFC. Though ultimately tainted by scandals, the RFC is widely thought to have played important roles in rescuing private financial institutions, and helping allocate credit to achieve important social goals, particularly during World War II. As we see below, though the housing finance institutions also started off in promising fashion, and initially achieved important social goals, they were pushed into becoming hybrid institutions – partially private and partially public – which led to their perversion and ultimate collapse.

2.2.2 Housing Finance in the 1930s: Introduction.

During the 1930's, as now, home foreclosures were a major causality of the financial and economic crisis. In 1931, only 254,000 non-farm housing units were built, compared with an annual average of over 700,000 during the 1920's, while between 1926 and 1931, the percentage of non-farm mortgages in foreclosure had almost tripled (Moss and Bolton, 2009, p. 2). In 1932 President Hoover recommended the creation of the Federal Home Loan Bank System, a network of 12 regional banks to lend up to $2 billion to private banks and "thrifts" specializing in home lending. Although the bill eventually passed and helped reduce bank failures it was never effectively implemented to stabilize homeownership. When Franklin Delano Roosevelt took office, one of his first

initiatives was to establish a government agency that could refinance individual mortgages, rather than supporting the home ownership indirectly through the private banks. He established the Homeowners' Loan Corporation (HOLC) which was capitalized by the Reconstruction Finance Corporation (RFC), another depression era government institution charged with "financing agriculture, commerce and industry". (Moss and Bolton, 2009, p. 3). HOLC was authorized to finance its activities by issuing government guaranteed bonds that were exempt from taxation at all levels of government and was given a 3 year term to refinance the mortgages of "borrowers who were faced with the loss of their homes through foreclosure or tax sales". Typically, the HOLC would buy the mortgages from private banks at a discount, and pay for the mortgages with the tax-free bonds it issued. Then HOLC would retire the mortgage, consolidate the homeowner's related debts into a new 15 year mortgage at a lower interest rate. Hence, participating homeowners, "not only saw their mortgage-related debts wiped clean and reorganized into a single low interest amortized loan, but also benefited from the appraisal process that reduced the principal they owed." (ibid, pp. 3 – 4). Local communities also benefited because through HOLC, delinquent property taxes were paid and allowed homeowners to make necessary improvements on their homes. "In so doing, the HOLC helped to ensure local government solvency and the maintenance of neighborhood property values." (Ibid., p. 4).

In addition, the Federal Government provided seed money to start a network of privately run "thrift" institutions in areas not served by such institutions. The U.S. Treasury, in fact, became the single largest shareholder in many of these banks. Some of these were located in metropolitan areas as well, which made local privately owned banks angry with the government competition.

In 1934, the government passed the National Housing Act. Among other things, this act established the Federal Housing Administration (FHA). "The FHA would play a leading role in the modernization and standardization of mortgages, thus helping to revolutionize the American housing industry." (ibid., p. 5). The FHA significantly strengthened the secondary market for mortgages across the country by guaranteeing the mortgage but also by holding all of the parties to a minimum set of standards. Still, more was needed to restore the housing industry. In 1938, the Federal National Mortgage Association (FNMA) which came to be known as Fannie Mae, was created. It started with an initial capital of $10 million from the RFC, its supervising agency. Its mission was to buy FHA mortgages from loan originators. For the next 16 years, the U.S. Treasury, via Congressional authorization, financed Fannie Mae's operations. (ibid, p. 6). It was not authorized to make direct mortgages, but by making "advances or precommitments on mortgages" it came very close. Its work was expanded with the GI Bill in 1944, which created Veteran Administration loans (VA loans) for soldiers returning from World War II. The VA insured a portion of the loans, and by 1949, Fannie Mae began purchasing these mortgages as well.

A housing boom followed the War and by the 1950's, as inflation and interest rates rose, more and more banks wanted to sell loans to Fannie Mae so that they could get reserves to sell higher interest rate mortgages. Fannie Mae had to get larger and larger

allocations from the Treasury to finance this activity. The government and congress got concerned that this government financed role was becoming unsustainable. (ibid., p. 7). This lead to a big debate on what to do with Fannie Mae: banks and thrift institutions wanted it to be privatized; consumer groups, and construction companies wanted it to stay as is.

In a fateful decision, Congress reached a compromise, passing the Federal National Mortgage Association Charter Act in 1954. Fannie Mae was established as a "public-private hybrid whose secondary mortgage market operations were set up to become decreasingly dependent on federal funding." (ibid., p. 7). A goal was established of eventually completely privatizing the institution. "In addition to charging fees for its services, Fannie Mae was also authorized by the Charter Act to issue bonds and notes…these debt securities had to be approved by the Treasury" and limits were placed on the amount of debt it could issue. Moreover, Fannie Mae was "granted stand-by authority to borrow from the Treasury". (ibid., p. 8)

Beyond funding issues, Fannie Mae was directed under the Charter Act of 1954 to focus on three areas: Its secondary mortgage market activities through which it bought FHA and VA loans; provide loans to "segments of the national population" that were unable to obtain such loans on their own" and third to manage their portfolio of previously granted loans.

This new status created a number of problems. One of the most important was how was Fannie Mae going to reconcile its public and private objectives: on the one hand "to support the government's efforts in the housing field" with its private incentives to operate "on a profit making, self-sustaining basis"...(ibid, p. 8). These problems were about to become worse, as plans for privatization were greatly accelerated by President Lyndon Johnson and the Democrats in the late 1960s. Johnson, greatly concerned about the budget deficits associated with fighting the Vietnam War and to a much lesser extent, the so-called "Great Society Programs", was facing pressure to put "on budget" the operations of Fannie Mae in the secondary housing markets. (ibid., p. 8). Rather than risk jeopardizing these other priorities, he chose to formally privatize Fannie Mae. The government decided to spin off the other two functions of Fannie Mae into a new organization the Government National Mortgage Association (GNMA) that came to be known as "Ginnie Mae" and placed it in the government in the "Housing for Urban Development", HUD. HUD retained relatively broad supervisory authority over Fannie Mae. According to the law, the HUD could still require Fannie Mae to take secondary mortgage actions to further 'the national goal of providing adequate housing for low and moderate income families", though, as the legislation made clear, HUD would also recognize the need for Fannie Mae to pursue a "reasonable economic return". (ibid., p. 9). Additionally, Fannie Mae could not issue any securities without HUD authorization and HUD could limit the dividends that Fannie Mae paid to stockholders. HUD could also examine Fannie Mae's books and could force it to file reports to HUD. Finally, the President of the United was authorized to nominate – and the Senate to confirm – five of Fannie Mae's board members. In addition, the President was granted the additional authority to remove any of the fifteen board members for "good cause". (ibid., p. 9).

Fannie Mae retained its ability to borrow from the Treasury up to 2.25 billion and, moreover, was authorized to issue debt securities without having to register them with the Securities and Exchange Commission. And in 1970, Fannie Mae was authorized to purchase conventional home mortgages, in addition to FHA and VA mortgages.

Importantly, the 1968 legislation also authorized Ginnie Mae to insure mortgage backed securities (MBS) constructed on the basis of portfolio of FHA and VA mortgages. Technically, Ginnie Mae did not issue any securities, it just insured them. Because these securities were guaranteed by Ginnie Mae, which was an entirely government-controlled agency, their "full and timely" payment was explicitly guaranteed by the Federal Government. These securities were known as "pass-throughs" because they simply passed through the principal and interest payments made by a pool of Ginnie Mae mortgage holders – prepayments included – through to Ginnie Mae security holders." (ibid., p. 10). Starting in 1974, Ginnie Mae was allowed to purchase conventional mortgages, but it could still only insure pass throughs backed by FHA, VA or Farmers Home Administration mortgages.

The 1970 legislation also established the Federal Home Loan Mortgage Corporation (Freddie Mac) to "foster a national "secondary market for conventional residential mortgages". (ibid., p. 11), a program that Savings and Loan associations had lobbied for many years. Freddie Mac was set up as mixed public-private corporation and so did not have to pay any taxes aside from those on its real estate holdings. Freddie Mac issued its first pass-throughs in 1971. Freddie Mac guaranteed the "full and timely payment of interest and the ultimate payment of principle" on these securities. However, because the FHLMC, like the FNMA was only a government-sponsored enterprise (GSE) and not a full-fledged government agency, the promise did NOT carry the explicit backing of the federal government. (ibid., p. 11).

Fannie Mae and Freddie Mac issued more and more "pass-through' securities. They became very popular with investors. The timely payment of interest and principle was guaranteed by Fannie Mae and Freddie Mac, even though they, in turn, DID NOT carry the explicit backing from the Federal Government (ibid., p. 12).

These mortgage backed securities enjoyed tremendous growth during the 1970s and 1980s. Pension funds and mutual funds were particularly interested in them. Despite the absence of explicit government guarantee, there was a general belief among market participants which – in the 1980's and 2008 turned out to be true – that these securities enjoyed an implicit government guarantee. Consequently, these GSE pass-throughs, like GSE bonds, were generally priced by the market "as if they were triple A rated securities or government agency issues". (ibid., p. 12).

2.2.3 Regulation of the GSE's.

As the government sponsored agencies multiplied and their public-private hybrid natures became more complex, their regulatory structure became more complex and fragmented. The United States Government Accountability Office (GAO) among others

repeatedly raised concerns about its regulatory structure. (GAO, 2008). "The current housing GSE regulatory structure is fragmented and not well equipped to oversee their financial soundness or hosing mission achievement. The Office of Federal Housing Enterprise Oversight (OFHEO) is responsible for safe and soundness oversight of Fannie Mae and Freddie Mac while the Federal Housing Finance Board (FHFB) is responsible for safety and soundness and mission oversight of the FHLBank System. Both regulators lack key statutory authorities to fulfill their safety and soundness responsibilities as compared to the authorities available to federal bank regulators. For example, OFHEO and FHFB are not authorized to limit the asset growth of housing GSEs if capital falls below predetermined levels. Moreover, the Department of Housing and Urban Development (HUD) which has housing mission oversight responsibility for Fannie Mae and Feddie Mac…may not have sufficient resources and technical expertise to review sophisticated financial products and issues." (GAO, executive summary). The GAO and others have concluded that, "Creating a single housing GSE regulator could better ensure consistency of regulation amount the GSEs." But this was not done until the GSE's became insolvent and had to be put in receivership by the US government in September, 2008, at the cost of billions of dollars to U.S. taxpayers.

2.2.4 The Impact of the GSE's: From Promoting Housing to Socializing Risks and Privatizing Benefits.

In its initial stages, the GSE's and related public housing finance institutions successfully promoted the development of housing in the United States, and these benefits spread widely at through the middle and working classes of the U.S., if not to the poor. But as more and more of the system was privatized, and as the regulatory structure of the housing GSEs became more fragmented and lax, this hybrid structure of private ownership with government privileges, especially the implicit debt guarantees, and ineffective oversight that appeared to give public approval of its behavior, turned out to be a lethal combination. It not only lead to an ultimate massive failure leading to large losses for the public, but it undermined the public mission of the GSEs to promote sustainable housing options among the underserved. And, thought the GSEs were not primarily responsible for the sub-prime crisis over-all, they did play a role. This is particularly problematic considering that they had been at least partially tasked with promoting a real and sustainable solution to the US's housing problems.

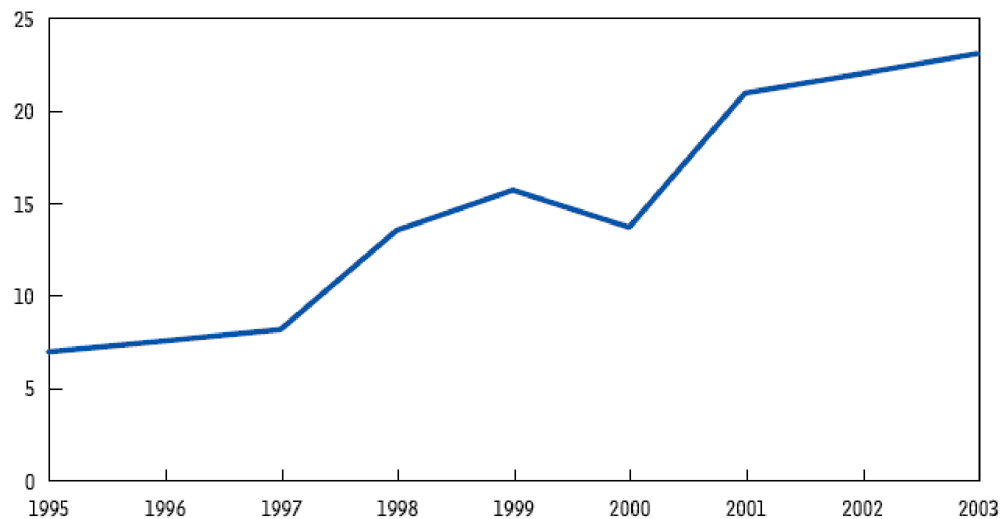
2.2.5 Costs and Benefits of the Housing GSEs.

Most of the literature has studied the implicit government subsidies granted to the housing GSE's, primarily from the implicit government guarantee of the GSE's debts, and, to a less extent, other benefits such as exemptions from some taxes and fees. The most cited studies by the Congressional Budget Office (CBO) and Federal Reserve economist Wayne Passmore suggest these subsidies have been quite substantial. Figures 1 and 2 below show two estimates of annual subsidies. Figure 2 estimates are larger because they assume that the mortgages in the portfolio are renewed in the longer term.

Figure 1.

Total Federal Subsidy to the Housing GSEs, 1995 to 2003

(Billions of dollars)



Source: Congressional Budget Office.

Thus, by 2003, the government subsidy was estimated to be somewhere between 20 and 45 billion dollars per year. (CBO, 2003).

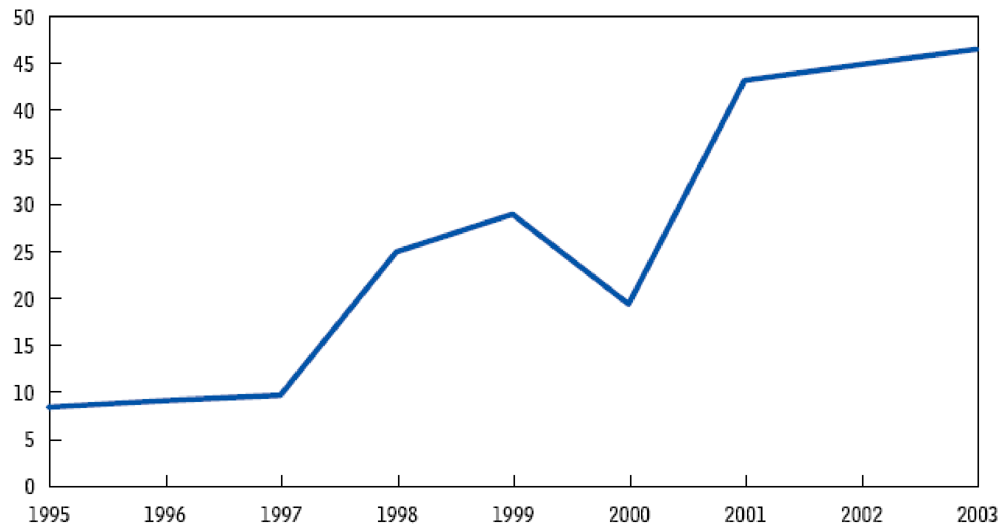
Who benefited from this subsidy? Most evidence suggests that by the 1990's, when the GSEs were under relatively little regulatory scrutiny, the majority of the benefits accrued to the managers and owners of the GSEs themselves, and not to the home buyers or even to the banks that sold the mortgages to the GSEs.

The Congressional Budget Office in 1996 estimated that in 1995 Fannie Mae and Freddie Mac retained more than 42% of the subsidy granted to them by the United States Government, while passing through the remainder to homeowners and banks. In a later study, Passmore estimated that shareholders, including managers of Fannie Mae and Feddie Mac who have significant stock holdings and options, retained 53 percent of the value of the subsidy, which in total he estimated to be 122 billion to 182 billion dollars in added value. This amounts to about $79 billion dollars (Passmore, 2005).

Figure 2.

Total Federal Subsidy to the Housing GSEs Under an Assumption of Sustained Growth, 1995 to 2003

(Billions of dollars)



Source: Congressional Budget Office.

Note: This figure reflects a "perpetual horizon." Under that assumption, this year's growth in the GSEs' outstanding debt and mortgage-backed securities is sustained; that is, this year's new security issues will be reissued when they mature.

Given the substantial benefits that the GSEs received from their relationship with the government, it is understandable that this left lots of room for corruption and political scandals.

2.2.6 Political Role and Corruption.

There have been many corruption scandals at Fannie Mae and Freddie Mac, scandals that stem from its hybrid relationship with the government and with its massive privileges that it wants to protect. As Jack Shafer wrote in Slate, the online journal: The key to Fannie Mae's survival was the patronage system it ran". (Shafer, 2008). "For years, high level jobs at Fannie Mae were lucrative prizes for lawyers, bankers and political operatives waiting for their next U.S. government post". (ibid.). These posts were exploited by some of the top executives. At the top of the list was Franklin D. Raines, chairman and chief executive officer at Fannie Mae from 1998 – 2004. He was forced to leave Fannie Mae in 2004 when regulators discovered it had broken accounting rules "in an effort to conceal fluctuations in profit and hadn't maintained adequate risk controls". The New York Times reported that regulators "have said that of the $90 million paid to Mr. Rains from 1998 – 2003 at least 52 million was tied to bonus targets that were reached by manipulating accounting". (ibid.)

Robert Zoellick, current head of the World Bank was an officer at Fannie Mae twice, the second time, between 1993 and 1997 when, according to the American Banker he "used his close ties to Republicans in Congress, such as Speaker of the House Newt Gingrich, Republican from Georgia, to defend Fannie Mae from new taxes." (Slate, 2008).

There is a very long list of influential Republicans and Democrats who worked to protect Fannie Mae and Freddie Mac from more regulation and who profited handsomely from doing so. These influential lobbyists were sometimes joined by advocates of affordable housing and other advocates of the poor, who believed that Fannie Mae and Freddie Mac were helping their constituents. Sometimes Fannie Mae and Freddie Mac would win their favor by making donations to their organizations, a small amount relatively speaking for them but a very large amount for these groups. As Paul Gigot, a strong critic of Fannie Mae and Freddie Mac put it: "Fannie has been able to purchase political immunity for decades by disguising its vast profit-making machine in the cloak of "affordable housing". (Wall Street Journal, July 23, 2008.) Of course, this was only one component of its strategy: it also spent millions in lobbying and hired vast numbers of influential republicans and democrats to attack anyone who tried to limit its prerogatives.

2.2.7 Role in Sub-Prime Crisis.

After the crisis that followed the failure of Lehman Brothers in October 2008 and during the U.S. presidential campaign in 2008, the Republicans claimed that the main cause of the financial crisis was the role played by Fannie Mae and Freddie Mac in buying and packaging sub-prime mortgages. This, they claimed, stemmed from the well meaning but wrong headed government goal of creating the American dream of housing for all Americans. In essence, they claim, the financial crisis was not an example of market failure, but government failure. This claim is still be repeated by Republicans and right wing economists as they try to write the narrative of the economic crisis.

Is there truth to what they are saying? Well, first of all, if it were true that Fannie Mae and Freddie Mac played a major role, this would still not be a matter of government failure. For as we have seen, these were not government institutions. They were essentially private institutions reaping enormous private benefits, but using certain government privileges, notably the implict government guarantee of their debt and lack of key financial regulation, to make enormously risky bets. In this, they were not terribly different from many of the other financial institutions implicated in the crisis.

Be that as it may, the fact of the matter is that, while Fannie Mae and Freddie Mac were indirectly involved in some of the abuses of the sub-prime crisis, they came into it rather late, and so played a contributing role, not a lead role. (Krugman, 2008; Calculated Risk, 2008; personal communication with Dean Baker, June 11, 2009). Krugman argues that "Fannie and Freddie had nothing to do with the explosion of high-risk lending a few years ago, an explosion that dwarfed the Savings and Loan fiasco. In fact, Fannie and Freddie, after growing rapidly in the 1990's, largely faded from the scene during the

height of the housing bubble". (Krugman, 2008). This was partly because of constraints that the regulators had put on the GSEs after the accounting scandals.

They did come back into the market toward the end of the bubble to try to regain market share. But they could not purchase, insure or underwrite the sub-prime loans because their charter forbid them to do it. Regulators and regulations prevented Fannie Mae and Freddie Mac from engaging in the worst of the abuses. In fact, the very definition of a sub-prime loan is a loan that does not meet Fannie Mae and Freddie Mac standards. As Lewis Ranieri, the legendary promoter of mortgage backed securities (MBS) made famous by Michael Lewis in *Liar's Poker*, put it in a speech before financial regulators at the height of the sub-prime bubble, according to Muolo and Padilla:" at least when Fannie Mae and Freddie Mac dominated the mortgage business 'they played the role of gatekeeper'; the…GSEs had loan underwriting standards – things like minimum down payments…and mortgage insurance that covered potential losses. 'Those standards have been pushed aside". ..now, he said, 'The rating agencies are playing the role of quasi-regulator'. (Muolo and Padilla, 2008, pp. 216-217.

Still, as one analyst put it, "Fannie and Freddie had about as much o do with the "explosion of high-risk lending" as they could get away with. We are all fortunate that they couldn't get with all that much of it." But it is true that they did not like losing market share and chafed under the constraints that had been imposed on them. So they pushed the envelope as far as they could within their charter. They got involved in many "near sub-prime loans." (Calculated Risk, 2008). And in the earlier years, they were very important in supporting the mega-housing lenders that were eventually implicated in the crisis, for example Angelo Mozilo, the owner of Countrywide which was one of the largest sub-prime lenders. As Muollo and Padilla tell the story about the 1990's, "Over the next 15 years Countrywide and Fannie Mae – Mozilo and Johnson and then Mozilo and Franklin Raines, Johnson's successor – would be linked at the hip. Johnson invited Mozilo to attend and speak at retreats for Fannie Mae's top executives and sales team. The Fannie Mae chief, in turn, frequently flew on the Countrywide Corporate jet…As Countrywide's loan originations soared into the stratosphere, so did Fannie Mae's on-balance-sheet assets." (Muolo and Padilla, 2008, p. 113.)

In the, one can agree with those who argue that "we can give Fannie and Freddie their due share of responsibility for the mess we're in, while acknowledging that they were nowhere near the biggest culprits in the recent credit bubble. They may finance most of the home loans in America, but most of the home loans in America aren't the problem."(Calculated Risk, July 14, 2008).

2.2.8 Lessons to Be Learned for Finance without Financiers..

Most observers agree that before the GSEs were partially privatized, they played an important role in providing liquidity to the housing market and helped provide a massive pool of housing for working class and middle class Americans. To the extent that this was a social goal of the United States, it was served reasonably well. They were never

pushed very hard to provide housing for the poorest Americans and they did not facilitate that goal to any great extent.

The problem was when the GSEs were partially privatized. This created enormous, perverse incentives for it to act to maximize private wealth at the public's expense and to utilize its wealth to build a political machine that maintained its position.

There was nothing inevitable about this evolution. The government could have retained the GSEs as proper government agencies, without creating these perverse incentives. But to do so would have required the government to properly account for the costs and risks associated with doing so, and placing these on the Central Budget. This it was unwilling to do. As a result, it took the ultimately risky strategy of maintaining a contingent liability for the debts of the GSEs, without at the same time instituting adequate controls.

What options does the government have moving forward? These have now been fully nationalized, at least temporarily, and placed under a uniform regulator. The government should use this opportunity to develop a structure to clarify the important social roles of the GSEs, keep those roles public, under strong regulations and management, and then privatize the other roles without any government guarantees, explicit or implicit. That means that the institutions cannot become too big to fail. Otherwise, the US tax payer will once again be liable to socialize the costs of very considerable private benefits.

2.3 France.

2.3.1 The French banking system under tight State control (1936-1986).

As was the case in all the "advanced" economies, the 1930s crisis led the French government to strengthen the institutional framework and increasing the State's role in financial and macroeconomic governance. These early post-war reforms were then extended during the period of the Socialist Government in the early 1980's, when the role of the state in financial ownership, control and regulation was expanded considerably. After the mid-1980's, however, the state's role in finance was rapidly reduced with extensive financial de-regulation and privatization.

The Act of June 13 1941 created a centralized governance institution, the Conseil National du Crédit. It also introduced a distinction between deposit banks, investment banks, medium and long-term credit banks, and financial institutions. This compartmentalization of banking activities was based on the time horizon of transactions, which meant that deposit banks were only allowed to engage in short-term operations, as opposed to medium and long term credit banks who could conduct longer term transactions. The purpose of this principle was to control lending and to regulate money creation and the allocation of savings.

After World War II, the nationalization of the Banque de France and the four leading deposit banks (Crédit Lyonnais, Société Générale, Banque Nationale pour le Commerce et l'Industrie, and Comptoir National d'Escompte) gave the government a prominent role in France's banking sector. Later, the Act of February 11 1982 which was instituted by the newly elected left wing government led by François Mitterrand nationalized thirty-six deposit taking banks. At that stage, virtually all banks were owned by the State.

Besides ownership of banks, the French public authorities instituted a financial regulatory framework that placed strict controls over financial activities. Three groups of regulatory instruments are worth mentioning. First, most interest rates were administered according to the major goals of the government's economic policy. Thanks to this policy, bank lending with low (below market level) interest rates was expanded to strategic sectors such as farmers, small business, social housing. Second, banks had to comply with rules aiming at controlling their activity. Ceilings were imposed by the Central bank on bank lending with a view to regulating money creation and to curb inflation. In addition, during the decade following WW II, banks had to comply with floors with respect to their portfolio of public bonds. This measure was used as a way to channel savings towards the financing of public investment. Third, the French authorities imposed until 1989 a strict control on banks' international operations and on their transactions on the forex market.

In general, France had, perhaps, among the most extensive and successful sets of credit allocation controls of all the western countries. These controls, were part of the government's overall approach to industrial policy. When the Bank of France was nationalized in 1945, it was placed under the National Credit Council, the institution in charge of implementing the financial aspects of the government plan. (Hodgman, p. 147; Zysman, 1983). The broad aim of credit policy in France was to contribute to the modernization of the French economy and its ability to compete in international markets. To influence the volume and allocation of credit, the Bank of France used various methods (see Hodgman, 1972, p. 148 and Zysman, 1983, for descriptions). Among the tools of credit allocation were widely used were *asset based reserve requirements*. With these requirements, Banks had to observe minimum reserve requirements with lower rates on privileged assets. "These asset reserve requirements had the dual purpose of adding to bank portfolio demand for the specified assets and of preventing the banks from using these eligible assets for rediscounting at the central bank." (Hodgman, 1972, p. 148.) A second technique – ceilings on credit extension – were also been used. The ceilings were used to reduce credit expansion without raising interest rates, and also to allocate credit because priority sectors were exempted from the ceilings. These included short-term export credits, medium-term loans for construction, and others. These ceilings applied to a large range of financial institutions, and were accompanied, as well, by capital and exchange controls as an important concomitant. (Hodgman, 1972. pp. 148-149; Zysman, 1987). A third tool was the scrutiny of individual credits made by banks. This allowed the Bank of France to approve loans for privileged purposes and restrict loans for other uses. Another approach to affecting the allocation of credit involved the use of rediscounting of bills for priority purposes (ibid., p. 151).

These various measures were intended to affect primarily short-term and medium credit flows. Other tools at the disposal of the Ministry of Finance and other institutions were designed more to affect the medium and long-term flow of credit. (ibid;, p. 149).

Zysman (1987) has emphasized the role of these credit allocation techniques in helping to revive the French economy and help it adjust to structural challenges in the post war period. This role has been facilitated by the existence in France of a bank based financial system, unlike the capital market based systems in the U.S. and U.K., which, according to Zysman, make such credit allocation mechanisms more difficult to implement (see also Pollin, 1995 and Grabel, 2000). Italy and Belgium also used similar policies. In the case of Italy, as we will see below, a major goal was to help develop the Southern part of the country. (U.S. House of Representatives, 1972, p. 11).

2.3.2 The reshaping of the French banking system by liberalization policies.

With the banking Act of 1984, a new framework that was imposed on all “credit institutions”, represented the first stage in the liberalization of the French banking system. This act abolished the legal distinctions among the different types of banks mentioned above with a view towards creating “universal banking”. Following this, successive French governments – both leftwing and rightwing - implemented a major liberalization of French financial markets. All economic institutions were allowed to issue money market instruments after 1985. Most administered interest rates, as well as credit ceilings and the control of international operations, were abolished.

It is important to note that the role of the European Commission, a radical neoliberal institution, has been decisive in this liberalization process in all European countries. The transposition into French law of the European directive of June 24 1988 on the free movement of capital eliminated lending restrictions and currency controls and removed many of the administrative barriers that had compartmentalized credit institutions business in European countries. This directive also broke down many of the institutions of "finance without financiers" in the other European countries discussed later, especially Germany.

These liberalization policies had a major impact on the banking system in France. They gave rise to disintermediation in lending and alignment of bank lending rates with those of the capital and money markets more generally. As a result, differential interest rates could not be used for credit allocation purposes. In addition, capital market-based financing has increased dramatically while bank-based financing is declining. The financial intermediation ratio, which measures the proportion of total lending to non-financial agents from resident financial intermediaries, fell from 71% in 1971 to 41% in 2001 according to the Banque de France.
During this time, the banking sector underwent a spectacular process of concentration. State ownership and family ownership have nearly disappeared. The number of credit institutions shrank by half, from 2001 in 1990 to 974 in 2005. The proportion of bank assets held by the top twenty institutions rose from 65.1% in 1988 to 78.4% in 2002. The top ten banking groups control more than 85% of the total retail banking business in

France. BNP-Paribas has become the sixth largest European bank in terms of market capitalization and the largest bank in the euro area (Commission Bancaire).

2.3.3 Lessons to be learned from the French experience.

The role of the State has been very important in the French economy in the past, and still is today under different forms. This "Colbertist" tradition is criticized by the neoliberal view because State involvement is considered on *a priori* grounds to be an obstacle to economic growth. This view, however, stands in contradiction with existing evidence. Indeed, as discussed earlier, it has been shown that government intervention has played a decisive and positive role in the French economy before the great switch towards financial liberalization in the early 1980s. Government involvement contributed to the so-called post-war miracle, not only in France, but in all major European countries (Eichengreen, 2006). Economists from the French "*Ecole de la régulation*" have shown that banking systems under government control were strategic institutions of the so-called Fordist capitalist regimes during the postwar period and contributed in a decisive manner to the "*Trente glorieuses*" (1945 – 1975), i.e. the three decades of reconstruction and rapid growth in the aftermath of WW II (Boyer, 2004).

In France, the State controlled banking system has been an efficient instrument for the governments in two respects. First, it allowed producers in all sectors to acquire external funds to increase their investment outlays at a low cost beyond the level permitted by sole reliance on internally generated profits. Second, at the macroeconomic level, credit control by the Banque de France has been an efficient tool to restrain monetary creation and inflation. To put it simply, the French banking system was managed to achieve goals corresponding to the interest of the productive sector, taking into account macroeconomic constraints.

But, as in the case of Fannie Mae and Freddie Mac, as well as with other cases discussed below, a central weakness of the Post-War French banking system was its "governance structure". In the case of France, the State control of high level bank managers was not tight enough. The "Crédit Lyonnais" scandal in the mid 1980s illustrates this problem. Chairman Jean-Claude Haberer took excessive risks which caused huge losses (100 billions of francs).

One explanation of this scandal is the connivance of the State bourgeoisie elites in France. In France, the leaders and managers of the state mostly attended the same University, the Ecole Nationale d'Administrative (ENA), an elite training ground, that tends to create a common ideology and connections of loyalty, among its members. In the early post – war period, this was greatly influenced by the anti-Nazi resistance bonds and helped create the ethic of public purpose ethic that promoted "finance without financiers". With the rise of neo-liberalism, however, these same bonds and connections were transformed into a common goals of implementing privatization and neo-liberalism, and facilitating a market framework for individual profit and advancement. This promoted the ethic of "finance FOR THE financiers". This ethic of

loyality and personal gain contributed to the financial corruption that brought down Credit Layonnaise.

Partly as a result of this change in ethic and creed, and as the recent financial crisis shows, the governance structures of privately owned and operated financial firms can be a disastrous failure as well, and can also cost tax payers billions of dollars. Still, if one wants to revive a system of more publicly oriented financial system, it is necessary to ameliorate if not solve these serious governance problems. We further address these issues below.

Indeed, despite of the just mentioned problems with the breakdown of French financial governance, one can easily see that todays' neoliberal banking systems in France, as well as in all advanced capitalist countries, appears to be worst on almost all grounds than the situation which prevailed during the "Fordist era" during the Second World War. Let us take three major criteria – i.e., growth, banking stability and banking governance - to compare these two historical periods. It is well established now that the State controlled banking system contributed to the rapid rate of growth in the "*Trente glorieuses*" decades. Conversely, there is a presumption that commercial banks have become procyclical under the influence of market pressure (including prudential regulation). This means that market-based banking systems do not contribute to steady growth as they used to in the Fordist regime. If we look at the governance of banks, the on going financial crisis provides strong evidence that today's liberalized banking system is a complete failure. Greedy bank managers and traders completely escaped from the control of shareholders and banking authorities, causing huge financial and social damage. The French experience shows clearly that, according to major criteria, the performance of State controlled banks has been much more efficient that the performance of market-based banks run by financiers.

2.4 Italy: State and market in Italian Banking.

In the past century (from the 1930s up to the beginning of the 1990s) the Italian banking industry has been substantially managed by the State or by local public bodies. But after 1990 (thanks to the so called Amato – law), in few years time the whole banking sector was "privatized". The "privatization" took place in parallel with an equally fast process of concentration, inspired if not directly managed by the Central Bank (Banca d' Italia). The target was to promote a system of large private banks in the form of limited companies. In addition, while the activity of the traditional commercial bank was constrained to provide mainly short term commercial credit to firms, in the 1990s Italian banks have been allowed to operate as "universal" as well as "mixed" banks.

Prior to "privatization in 1990, The Italian banking system consisted of a variety of institutions that were dominated (almost 80% of the activity) by the role of the "public" sector.

Supporting the "public nature" of the banks, is the Italian Constitution where Article 47 states that the mission of banking is to preserve and protect national savings. Only in

1980 did the High Court (Corte di Cassazione) concede that banking activity could be considered similar to business activity. Since the early 1930's through the end of the 1970's, public ownership of the banks was also considered as necessary to protect "efficiency standards" and was likewise seen as necessary to guarantee the "neutrality" of the allocation of credit.

The main category of public banks, now completely disappeared, was the *Istituti di Credito di Diritto Pubblico* (ICDP, Public Law Credit Institutes) which included the *Banca Nazionale del Lavoro* (established in 1926 and completely owned by the Ministry of Treasury) and the four most ancient Italian Banks (existing since the end of the XV century); *Banco di Napoli, Banco di Sicilia, Istituto San Paolo di Torino, Monte dei Paschi di Siena*) whose top management was appointed by the Treasury. Although they were not "State Banks" they were managed by the State and by representatives of local institutional bodies.

Banche di Interesse Nazionale (BIN)*: Banca Commerciale Italiana; Credito Italiano; Banco di Roma.* Limited Companies with a "private" origin which had the State as their main shareholder (*banche a partecipazione statale*, for this reason they are considered "public").

While the ICDP were born as non – profit organizations, the BIN were for- profit organizations, saved in the early 1930's by State intervention. They belong to the system of the *Partecipazioni Statali,* an original formula, largely applied in Italy to Banks and to industrial firms, under the control of IRI (the *Institute for the Industrial Reconstruction* that had been active until a few years ago).

Local authorities and institutions (like Universities, Chambers od Commerce, professional associations, etc.) were in charge of the 89 *Casse di Risparmio* (non profit organizations born to help local development, to support small business, and to promote and protect local savings). The *Casse di Risparmio* shared with the system of *Banche Popolari* (BP) and *Banche di Credito Cooperativo* (BCC, cooperative banks) the mutualistic approach to banking. This part of the banking system (and the wise management of currency devaluation) have been the financial "core" behind the most celebrated experience of the Italian Industrial Districts.

While the privatization process has been applied to the ICDP and to the *Casse di Risparmio* (all transformed into limited companies), it has not been able to dissolve the cooperative form and mutualistic principles that still prevails in the BP and BCC system. In 1995 the share of the "public" in total banking assets had been reduced to around 60% and by 1999, to less than 10%.

Now, after almost twenty years of experience, the "privatization" process provides some interesting lessons. From 1993 on, there is an overall decline of the cost and profit efficiency of the Italian banks. The decline affects especially the "new" large banks operating as limited companies, an *agent* that played the main role in the concentration and consolidation process. By contrast, a much less disappointing performance has

been realized by banks that share the so called *mutualistic* nature (BCC and POP). This is true in general and in the regional dimension as well.

Moreover, there are still strong elements of "public banking" even with respect to Italy's "privatized banks". As far as the present financial concerned is concerned, it is clear that the large limited companies sector represents the critical point of the Italian banking system, and it is also quite evident that the essential safe guard for a “stable” governance of these large groups is represented by the very peculiar nature of their main shareholder: the network of the so called Banking Foundations “resuscitated” in 1990 by the Amato law. In its turn, the central role of the Banking Foundations raises the interesting question of how “private and on the market” the main Italian Banking Groups really are.

“Modern” banking began in Tuscany and in the vice-reign of Naples at the end of the Fifteenth Century. The Neapolitan case is particularly interesting because it is the only one where it is possible to follow banking evolution from a documental point of view.
A peculiarity shared by all these banks is the original nature of their founders, specifically philanthropic institutions, whose mission included aid to particularly weak social classes (orphans, abandoned children, prisoners, unmarried mothers), and sanitary assistance (like hospital institutes), while granting particularly accessible forms of credit to the poorest people (the system of loan on pledge of the Monti della Pietà is a typical example).

Through the door of philanthropy, the world of credit was drastically open and reformed. The authorizations granted in the course of time by the Spanish Viceroyalty to the Neapolitan Philanthropic Institutes so that they could extend their activities to fields usually controlled by the “money lenders” quickly made them dominant on the market. In this area the institutes quickly defeated the competition by using a code of conduct that – according to the nature of these activities – would neither allow them to practice usury nor consider customers as a mere object of speculation. This is an important example of how an efficient *not-for-profit* policy can beat the profit logic, typical of the private management of the credit relationship.

The phenomenon of the Neapolitan Public Banks is very interesting because they were established as out-and-out banks, a direct emanation (even if in a different form) of the original philanthropic institutes that became their owners. The philanthropic institutes then became the “shareholders” of the respective banks and benefited from the incomes deriving from the bank activities that were statutorily allotted to the realization of the philanthropic mission of the controlling institutes. Most important, these institutions were able to introduce (with the “Fedi di credito” and “poilizze”) a system of fiduciary circulation well before the “invention” of the Bank of England.

It is now evident that after more than four centuries, in 1990 the Italian lawmakers reviewed the evolution of this model and applied it to the Public Law Credit Institute (ICDP) and to the Savings Banks for reinstating the distinction between the conferring body (Foundations/Philanthropic Institutes) and the underwriting bodies (Commercial

Banks) even though this was not their intent. Forcing the analogy, it could be said that the scheme of the Neapolitan Public Banks, not only was restored in 1990, but it is nowadays a dominate model, as the three important bank groups (Intesa-San Paolo, Unicredito, Monte Paschi) are strictly controlled by a solid network of Banking Foundations. It is important then, to understand that the mission of commercial banks in Italy may be seen to be rooted in social commitment and philanthropy and that this feature represented the main factor of their success on the market.

What can we learn today from this ancient story? Certainly, credit appears now - in terms of instruments and organization - a very different business, but what is quite modern an/or instructive is the "governance" side of that experience. Still, a closer look reveals that the most interesting feature of the modern Banking Foundations, is their manyfold double sided nature that takes them in between the "public" and the "private". In Italy they have been labeled "public" until 1998 and then "private" afterwards by virtue of the concession of the power of producing their own Statutes. They are still supervised by the Ministry of Trasyury, but their Governance comes from the convergent decision of several statutary stakeholders representing the interests of their communities.

2.5 Germany.

Germany has a long standing history of public involvement in its banking sector. Three particular institutions deserve mention here. They are the Sparkassen (savings banks), postal savings institutions, and the German development bank called the Kreditanstalt fuer Wiederaufbau (KfW), or Bank for Reconstruction. These institutions comprise a substantial share of the German financial system and they perform a wide range of financial services with a particular focus on personal wealth building and small business financing.

2.5.1 Sparkassen.

The German banking system rests on three pillars: public banks, private banks, and cooperative banks. Of the public banks, savings banks (Sparkassen) constitute the largest sub-sector. Germany's first Sparkasse was founded in Hamburg in 1778. (DSGV, 2009a) This and other early Sparkassen aimed to educate Germans on savings, build wealth for low-income families, and promote local economic development (DGSV, 2009a).

Even today, Sparkassen remain committed to public welfare and are owned by municipalities. Their services are open to all German citizens regardless of their individual income or assets (DGSV, 2008, p. 28). About 35 million people have one or more accounts with a Sparkasse or one of their umbrella organizations, the so-called Landesbanken.DSGV, 2008, p. 42). Today there are 446 Sparkassen with about 16,000 branches and offices employing approximately 261,000 staff.(DGSV,2009b)

The Deutscher Sparkassen- und Giroverband (German Savings Bank Association, DSGV) serves as the umbrella organization of the Sparkassen-Finanzgruppe and its

438 savings banks, 11 Landesbanken, 11 Landesbausparkassen, 12 public insurance companies and many additional financial service providers. The DSGV is a decision-making body and represents the Sparkassen-Finanzgruppe's interests regarding banking policy, regulatory law, and other banking industry issues on both national and international levels. (DGSV, 2009c) The savings banks provide a full range of services – either directly or through Landesbanken – for personal, corporate, particular small and medium sized enterprises municipal and institutional customers.

Their operations, though, are guided by three principles. First, they are regional, i.e. they only serve clients in their geographic area, typically the boundaries of their municipality. Second, they are owned by municipality (city, town, or county). Third, they are not publicly held. (DSGV, 2009a). The savings banks pursue a business policy described as "Fair. Human. Close at hand." That is, they are profit-oriented but not exclusively profit-maximizing. (DSGV, 2008 p. 23)

The Landesbanken play a crucial role for the operations of Sparkassen since they can offer additional financial services, from which Sparkassen are prohibited. The members of Landesbanken include Sparkassen and their and their owners, municipalities. Independent Sparkassen can be voluntary members. Whereas the Sparkassen are controlled locally, the Landesbanken are controlled by the state governments. Moreover, Landesbanken can engage in a range of banking services, such as regional, national and international loans, as well as certain brokerage services, which Sparkassen cannot offer.

In 2007, the year of the most recent annual report available, the Sparkassen-Finanzgruppe was the market leader in multiple segments. It had a 35.4% market share of business volume in the German banking industry, a 38.1% share of deposits, and 38.6% share of loans, including 36.5% of construction financing (DSGV, 2008).

A March 2009 press release from the DSGV announced that Germany's 438 savings banks experienced a profit of 1 billion euros in 2008. Heinrich Haasis, President of the DSGV, credits the savings banks as being a stabilizing fixture of the German economy, with customers' confidence in savings banks increasing during this financial crisis. Haasis also noted that none of the savings banks' 251,400 has been laid off due to the financial crisis. With that many employees, savings banks represent the largest commercial employer in Germany. (DSGV, 2009d)

According to another March 2009 press release, during the last fiscal year, savings banks enjoyed their highest growth rate since 2001, increasing their balance sheet total by 2.5% to 1.1 billion euros. In 2008, savings banks also saw customer credit increase by 13.9 billion euros (to 631.4 billion euros) and customer deposits increase by 24.8 million euros (to 742.3 billion euros). (DSGV, 2009e)

The role of public institutions, though, has not gone unchallenged. In particular, other EU member countries have challenged the implicit government subsidy for Sparkassen that arises from the public ownership and guarantee of the Sparkassen in Germany. In

2005, based on a compromise negotiated with the EU Commission in 2001 to be compliant with the State aid rules of the EC treaty, the guarantee obligation for the new liabilities of the Sparkassen and Landesbanken was discontinued and the maintenance obligation was replaced. (LBBW, 2002; DSGV, 2009a)

2.5.2 Postal savings institutions

Another part of the German public financial service sector included the postal savings banks. These institutions traditionally offered limited banking services, particularly checking accounts and savings accounts, to their customers. In 1985, though, Germany established a government commission to explore privatization and liberalization of the German Post. The Post was divided into three sectors in 1989: postal service (Deutsche Post), postal banking (Postbank), and telecommunications (Deutsche Telekom). Additional reform in 1995 changed these three parts into public companies. In 1999, Deutsche Post purchased 100% of Postbank's shares from its sole shareholder, the federal government. In June 2004, Postbank went public. Deutsche Post remained the majority shareholder until it sold its shares to Deutsche Bank AG in September 2008. The agreement was modified in January 2009 to grant Deutsche Bank AG an initial 22.9% acquirement of Deutsche Postbank AG during the share exchange (Deutsche Postbank, 2009, p. 15) The current shareholder structure thus is: 39.5% Deutsche Post, 25% + 1 share Deutsche Bank AG, 23.7% institutional investors, and 11.8% retail investors. (ibid., p. 16)

2.5.3 Kreditanstalt fuer Wiederaufbau

The primary German development bank is the Kreditanstalt fuer Wiederaufbau (KfW). Shareholders include the Federal Republic of Germany (80%) and German federal states (20%).DSGV, 2009a; LBBW, 2002) KfW performs domestic economic and social tasks and services on behalf of the government and serves as an advisor to the government.(KfW, 2008, p 3) For instance, KfW launched the "Housing, Environment, Growth" initiative in 2006 and it finances investment and advisory services in less industrialized economies.(ibid., p. 9)

2.5.4 The economic impact of publicly oriented financial institutions

A number of studies have documented the potentially positive impact of publicly oriented financial institutions on economic growth and stability. German public savings banks, for instance, have been a long running positive contributed to economic growth since the 1950s (Grunbacher, 2001; Hakenes, Schmidt, and Xie, 2009). Faster economic growth also tends to result in a stronger, positive response from publicly supported financial institutions and smaller banks than from their counterparts, suggesting a pro-cyclical reinforcing mechanism between publicly oriented financial institutions and economic growth (Schertler, Buch, and von Westernhagen, 2006). These economic growth contributions from publicly oriented financial institutions primarily originate from their focus on lending to small and medium-sized enterprises and on start-up businesses (Harm, 1992; Hakenes, Schmidt, and Xie, 2009; Schertler,

Buch, and von Westernhagen, 2006). In particular, these are areas, where publicly supported financial institutions can improve the efficiency of the economy by eliminating credit market inefficiencies (Buch and Doepke, 2008). Importantly, these effects of publicly supported financial institutions do not seem to depend on the size of the publicly oriented institution (Bloch, 2008).

2.5.5 The Current Crisis

Several of the Landebanks were caught up in the recent financial crisis. Their exposure was partly due to the fact that they were large financial institutions, and partly due to having made some of the same mistakes as other financial institutions: buying toxic ABS, investing in risky real estate to make up previous losses in eastern Germany, or by simply trying to expand too rapidly. The financial problems of these banks have created a strong political backlash and calls for reform. From our point of view, the lesson is that public financial involvement requires stricter regulatory oversight; otherwise there will be a tendency to use public money to privatize gains while socializing losses.

2.5.6 EU Pressures

As described earlier, there is an attempt by the European Commission (EC) to reign in the public financial institutions in Germany. But that the German government still remains committed to the cooperative banks and the savings banks and is waging a battle with the EU to protect these public institutions, while agreeing to make reforms. It is likely that the German government will win in this instance. The publicly supported banks, especially the savings banks are very popular and they enjoy tremendous support. On the other hand, the EC has no clear constituency for its position, other than maybe Citibank, Barclay's and a few other large UK and US banks with a retail emphasis who are fighting for "equal access" to the German retail market.

Another political constituency supporting the local public financial institutions is local governments. Germany is a federal state, unlike France. The savings banks are a source of power, positions, and money for local and state governments. These politicians will defend the savings banks because it is in their interest. That puts local politicians against an increasingly unpopular European bureaucracy. Cooperative banks are, to some extent, the rural counterpart to the savings banks and therefore similar arguments apply. The KfW is crucial for large scale export products and for housing finance. Again, both have strong constituencies in Germany. So, for the time being, the locale constituencies in Germany are winning the battle to retain local policy space for "finance without financiers".

3. FINANCE WITHOUT FINANCIERS IN THE AFTERMATH OF THE GLOBAL ECONOMIC CRISIS.

3.1 Approaches to Finance without Financiers

As is clear from the preceding, there are many possible mechanisms and forms to enhance the social orientation of finance that have been adopted and, have been generally successful. As is also clear, in most developed countries these practices have been significantly scaled back and transformed, but, for the most part, they have NOT been entirely abandoned. Moreover, the emergency actions of many countries have now invested billions of dollars of funds in the financial sectors of these countries and these investments give renewed opportunities for more social guidance and control over financial activity.

In this section we outline several possible forms of finance without financiers. Clearly, the particular form(s) that should be adopted will vary from country to country. We will start from the premise that a large bank has been "nationalized" in whole or in part. The question is: what should be done with it next.

Here we briefly discuss four approaches to longer term social ownership and control: 1) Full public ownership and control of the bank 2) Part public and part private ownership of general purpose bank 3) Separate off one or more special purpose banks from the nationalized bank 4) re-privatizing the bank but run it as a public utility in which its activities are highly restricted, but it, in turn will have a moderate but fairly stable rate of return.

3.1.1 Full Public Ownership and Control of the General Purpose Bank

Some have argued that all of the insolvent or nearly insolvent banks should be fully nationalized and maintained as public banks, (Moseley, 2009). Moseley, for example, argues that these banks should be run "according to public policy objectives (affordable housing, green energy, etc), rather than with the objective of private profit maximization." In addition to providing financing for important social objectives, the permanent nationalization would, according to Moseley, have other advantages as well. In the short run, it could help the economy recover by increasing lending to households and businesses, where as now, banks are just hoarding cash. In addition, it would improve the equity of the financial rescue plans. Says Moseley, unlike the "current bailout policies" it would "not involve a massive transfer of wealth from taxpayers to bondholders" and stockowners.

In the longer run, according to Moseley, nationalized banks would be "freed from the need to maximize short-term profit" and therefore would avoid toxic assets and promoting financial asset bubbles, those actions that have lead to the current crisis. "Instead, the deposits of these megabanks would be invested in decent affordable housing to all. With housing more affordable, mortgages would be more affordable and less risky".

Moseley's claims that bank nationalization would stabilize the over-all economy is based on his assumption that many large banks would be nationalized. But, in fact, that seems very unlikely and so, instead, it seems to make more sense to think of bank nationalization as affecting a few large banks and then relying on macro-prudential regulations and other factors to help stabilize the overall economy.

From that perspective then, the main arguments for longer term bank nationalization are two: 1) their usefulness for helping to achieve important public economic goals and 2) equity (and fairness) concerns: making sure that the taxpayers get benefits from their investments in these banks and these benefits are distributed more equitably than bank incomes and profits.

Here we will focus on the first since the second is more or less well known and even self evident.

3.1.2 Role of Public Banks in Achieving Public Goals

Public banks can play a very important role in this context. They can be large and multi-purpose, they can be smaller and more decentralized, or they can be small and networked to achieve economies of scale in terms of support, insurance, and risk pooling.

3.1.3 Role of a Large Public Bank in the Current Period

In the current context, there are both short term and long-term goals that could be well served by socially oriented banks. In the short term, such banks could provide lending to businesses and provincial (or state and local governments) that are trying to maintain employment and services and expand production. Nationalized bank will be more oriented to provide these kinds of loans rather than sitting on excessive reserves or paying out dividends to stockholders trying to keep the private capital cushion high enough to prevent nationalization, or paying excessive salaries and bonuses to top executives and "rain makers" who will not be needed in the national banks because these kinds of high stake trading activities are very unlikely to occur.

In this longer term, these same priorities would be more central to the operations of the "nationalized bank" than a typical privately owned institution. That is, the nationalized bank would place more evidence on lending to businesses, governments and households engaging in real investment and employment generation, rather than investing in proprietary trading, speculation and mergers and acquisitions.

In the medium to long term, the bank could develop expertise in those areas of great need for the European and US economies. All of these economies have major longer-term structural needs, including making a transition to climate-safe economies.

The nationalized banks can:

1. Specialize in funding for "green initiatives", both small and large. These can include, lending to 1) Business with new technology ideas, serving some of the role of venture capitalists but not requiring such a massively high rate of return and hurdle rate as they do 2) smaller business loans directed at projects such as home and building refurbishing, that can help green the economy (Pollin, et. al, 2009) 3) Underwriting government bonds issued for important social goals such as green technology, education funding, mass transportation. Having a large player in the public bond arena that can compete with and try to keep more "honest" the other players in this market would be of great use to municipal, state and provincial governments 4) In the US (and some European countries?) student loans can be underwritten—as economies must retool for the green future and other future challenges. In the US, for example, playing a role in education loan business to once reduce the corrupt and monopoly practices could help reduce excessive fees and loan costs. 5) Public banks, if they have enough market power, can help enforce standards in the financial market place in those areas where demanders of bank services will prefer these higher quality services. In other words, a large bank that enters the marketplace enforcing higher standards can help promote a dynamic of a "race to the top" in the provision of high quality banking services.

There are activities that the public banks will be prohibited from engaging in. The rampant deal making in toxic assets; proprietary trading and exotic financial engineering unrelated to public purposes.

Where will the bank get the assets to engage in these actions: they will get it from depositors and other capital providers. The public bank will be seen as extremely safe, with a government guaranty provided to depositors and other providers of long term credit, but the rates of return paid will not be as high as possibly available in other financial markets and institutions. This can be sustainable, however, only if there is strong monitoring of the investment portfolio of the bank to make sure that they investments are relatively low risk or achieve important social goals for which there are high social rates or return. In the latter case, the direct subsidy cost of the government on the activity has to be accounted for and appropriated by congress and the fiscal authorities. This way, the bank may be able to take some significant risks to achieve social objectives, but these have to be transparent and paid for transparently by the congress and fiscal authority. Budgets for such activities must be appropriately considered through the normal appropriations process.

Thus, these public banks can advertise to depositors that by investing in these banks, they are truly investing in America and that their investments are safe. Combined with the broad deposit network this should provide a large amount of credit funds available to invest in the real economy.

3.1.4 Selling off the Irrelevant Parts of the Banks

Presumably, a significant part of the nationalized bank will not be relevant to the new public entity. These are sections which have engaged in the kinds of financial

engineering, trading, and speculative activities that the new public bank will not be engaging in. These parts of the bank should be sold off and the profits should be used to defer the costs to the public of the takeover.

3.1.5 Model 2: Smaller more Specialized Public Banks

A second approach would be to carve out a smaller bank with one or more specialized goals. For example, the government could create the "Green Bank of America" or that would specialize in lending to private businesses and governments for green activities. Other examples would be the "European Education Bank", and/or "The European Infrastructure Bank" which would focus on underwriting (possibly in public private partnerships) the creation of more infrastructure, particularly those meeting social goals such as green transportation. In this case, the government would then divide the "good bank" into two or more parts and retain those that would specialize in these actions and sell off those that would be privatized .The public bank would want to retain the depositor base in order to fund these more specialized, activities.

Another example would be the "Co-op Bank of Europe", where the bank would fund worker's, or farmer's or community cooperatives or other cooperative businesses, including co-operative banks. To be sure, a larger bank could have these different specializations as separate departments *within* them.

3.1.6 Model 3. Public Utility Model

Another model is to turn the nationalized banks into a public utilities, perhaps with joint public/private ownership. This is an approach similar to that that was common in the United States in the early Post-World War II period. This would be a return to what Paul Krugman has called "boring banking". Banks would fund basic investments as they did in the 1950's -1980's in the areas of basic corporate loans, housing, business, state and local governments. They would have to hold a high level of capital and have a significant liquidity cushion. In exchange, they would have strong government guarantees on deposits and other long term borrowing which would enable them to attract deposits and credit at competitive rates. Thus, public utility banks would have relatively stable earnings and modest rates of returns. They could attract capital from pension funds and other investors wanting this risk and return profile.

The major differences between the public utility model and the nationalized model is that:

1. The bank would not be subject to close day to day management of their operations in which they were expected to satisfy specialized public goals. Of course, the broad restrictions imposed on these banks would force to act broadly in a consistent manner with public goals.
2. Their profits would only accrue to the public as a portion of the government's share of the capital of the bank.

As a model, the public utility model might be more acceptable in the U.S. than a fully nationalized bank would be. And avoiding issues of social versus private rates of return might make this bank somewhat easier to operate, as it would then just have to subject itself to a market test. Its major disadvantage is that it would not be as useful as a tool for achieving specialized social goals as would a public bank as described above.

3.1.7 Governance, Financial Regulation and Policy Space

Social Governance: Oversight, Incentives and Management

One lesson we can draw from our case studies is that there is crucial need for strong "social governance" if publicly owned financial institutions are to remain effective agents of the public. In other words, just because institutions are publicly owned, does not mean they will be publicly oriented.

We define “social governance” as the institutional arrangements which structure the management of public banks under social control. The key to effective social governance is to have democratic management systems that effectuate not just transparency, but accountability to a broad array of stakeholders. This is in contrast to the "shareholder value" notion that requires the firm to be accountable to shareholders only. Social governance requires that the firm be accountable to stakeholders including workers connected with the firm, community members that are affected by the firm's actions, and where relevant, other institutions, like state and local governments, which may be strongly impacted by the firm's actions. Of course, if the bank is publicly owned, then the public owners must also be appropriately represented.

Social governance may take various forms in different countries since the past history and the institutional framework is different from one country to the other (path dependency). But the most effective approaches are likely to involve "checks and balances" to ensure that a wide range of important stakeholders have voice.

To implement such social governance, it not only makes sense to pay careful attention to local institutions and customs, but it may be sensible to build on currently existing institutions. For instance, in Germany the co-determination system which involves both managers and labor unions in the decision process, could provide a useful point of departure for the building of social governance. In France, the “Comité d’entreprise which brings together managers and unions for decisions on social matters, can be used to become the major institution of social governance.

In the U.S. public banks should have a board of directors which are "hands-on" directors, consisting of government officials from Treasury and other relevant government institutions. for If, for example, the bank's charter is to serve as a "green bank", then, perhaps, the Energy Department as well as stakeholder representatives, such as labor, small business, state and local government, as well as specialists with expertise in green transformation would have management oversight.

3.1.8 Compensation Policies

Pay scales both inside the public financial institution, as well as for other financial firms, will have an important impact on the success of "finance without financiers". The pay of bank staff and executives must be high enough to attract excellent talent, (so cannot be on the normal governmental scale, presumably) but at the same time would be no where as high as has been made by Wall Street rainmakers and CEO's in the roaring 90's and '00's. The goal, presumably, would be to attract excellent, experienced and skilled people who nonetheless have a strong public orientation. There may need to be limits on financial pay in private sector firms –perhaps through taxation policy - in order to prevent the gap between the public employees and private ones from becoming so large that they undermine the public orientation of the managers of public firms.

3.1.9 Creating Policy Space in Europe

As discussed earlier, reviving "finance without financiers" may require extensive differences in local practice, and even a significant amount of local experimentation. In a federal System like the US, such differences and experimentation have a long history and a good deal of space. But in Europe, the EC financial directives to "level the playing field" for financial competition, might significantly limit the opportunities for such differences and experimentation. To create the necessary policy space, the EC members should explicitly carve out finance from competition policies since finance constitutes has special characteristics that could justify such a "carve out". Most importantly, finance constitutes a strategic asset, much like education and health care, and, as we have seen, can cause enormous problems unless it is regulated carefully according to local needs and customs.

3.1.10 The Importance of Strong Financial Regulation

For any of these schemes to work, there has to be strong financial regulation overall. Crotty and Epstein (2009) describe a set of regulations that would make the overall financial system more stable, more efficient and more equitable in the United States. TUAC, 2008, among others, has developed a set of proposals for Europe. These and similar proposals would reduce the massive and perverse compensation schemes that now pervade the financial system, and would make more difficult the more abusive financial practices that have contributed to this crisis. This is important in general, but also for the success of these models of public banking.

First of all, without appropriate financial regulation, our financial systems would inevitably lead to more booms, crashes, and overall instability. All financial institutions – these public ones included – have difficulties operating in such an environment. This boom and bust cycle could place enormous strains on the incomes and even solvency of the public banks.

Second, without strict and successful regulations, the attraction of very high short run rates of return and extremely high salaries and bonuses in the private financial sector

could pervert the public purposes of public banks, by eroding the efficacy of monitoring and regulation, by pulling away expertise and management skill, by making it more difficult to attract capital during financial bubbles and by eroding the confidence of regulators in the necessity and usefulness of the public banks.

Third, strict financial regulations would help the public banks make the transition from insolvent private banks to successful public ones. The public bank would be able to attract good talent because, among other reasons, these bankers would realize that they cannot do enormously better in the private sector; the kinds of investment skills learned in the public bank will also be useful in the private banks and vice versa, making it easier to find skilled bankers who are more willing to adopt to the culture of public banking. Over time and more generally, there would be more likely to be self-reinforcing dynamics between as the divergence between returns and actions of public and private banks would be less than would occur in the absence of strict regulation and the return of "wildcat" finance.

4. CONCLUSIONS.

The current financial system has failed, and in fact, has not been operating well for many decades now. It is time to restructure financial regulation and financial institutions so that they better address the considerable challenges facing our economies. Better financial regulation will be necessary but it will be far from sufficient to accomplish these goals. A variety of ways must be found to make it more likely that financial markets and institutions serve social purposes. As we have argued here, there are a variety of historical and currently existing models of "finance without financiers" that we can draw upon to help us strengthen the social productivity and efficiency of finance. Of course, these will have to be tailored to local, national and even regional norms and goals. Now is the time to broaden and strengthen these institutions where they exist and to create new ones where they do not. The current crisis and significant public investments in private finance focuses the public's attention on these issues now, and delaying measures to address these issues will risk condemning our economies to more decades of unstable, inefficient and inequitable finance.

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