April 30, 2012

Economists, Liquidity Mongers and the Banker Assault on Financial Reform

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This has been a bad stretch for advocates of financial reform – and therefore for the economy as a whole. One after the other, new financial regulations contained in the Dodd-Frank law are being gutted or delayed by regulators and Congress, while the bankers – escorted by a phalanx of paid economists, lawyers and lobbyists – are squealing “wee, wee, wee” all the way home.

Bankers and their lobbyists and economists help grease the skids not just with money – but with terms of “econ-speak” such as “cost-benefit analysis”, and most commonly, “liquidity”. Used and manipulated by the wrong hands, such boring and innocuous sounding concepts can turn dangerous, even fatal in the banker battle against safer financial regulation.

The list of delays, loopholes and obstacles is too long to fully recount, but here are a few of the most important.

First, the Federal Reserve Board decided to delay by two years the implementation of the so-called Volcker Rule which was one of the stronger measures in the Dodd-Frank financial reform legislation that was signed into Law in July, 2010. While the regulators had been given the option for such a delay in the original Dodd-Frank legislation, the deed was done by the relentless lobbying by bankers that first filled the original Volcker rule with massive amounts of wiggle room and devilish complications, and then, over the next year made the rule more and more complex by filling it with even more loopholes and obscure language. Then – like the Republicans who cut taxes to bloat the deficit and then say the budget needs to be cut because the deficit is too large – the bankers demanded to “delay” the Volcker rule on the grounds that it is too complex.

A second set of potentially powerful Dodd-Frank rules – to bring unregulated derivatives, including credit default swaps (CDS) that were at the root of the financial meltdown as well as those that are used to speculate on commodities such as oil and food under oversight and regulation - are now being massively watered down. The Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC) are raising the “limbo” bar of regulation to a whopping $8 billion average worth of derivatives each year, a figure so high that massive energy and financial speculators can easily slither underneath without being subject to serious regulation. The original maximum exception level proposed by regulators in 2010 was $100 million. Only an estimated 30% of traders would have
made it under that bar; with the $8 billion threshold, an estimated 85% of the traders will go unregulated, at least for the next five years.

Third, many of these exemptions and loopholes are dramatically extended in a bill before the House of representatives this week: HR 3336 entitled “The Small Business Credit Availability Act” which has nothing to do with credit to small business, but everything to do with exempting major energy companies like Koch Trading from oversight under the derivatives rules, virtually destroying any chance of derivatives regulation in the already weakened Dodd-Frank Law.

When the banks have not been able to kill or delay bills by stuffing them full of loopholes, as with the Volcker Rule and the rules governing regulations of derivatives, they have gone to court to block the implementation of the legislation. Perhaps most egregiously, the Securities Industry and Financial Markets Association (SIFMA) and the International swaps and Derivatives Association (ISDA) brought a lawsuit to block the implementation of “position limits” mandated by the Dodd-Frank Act to limit speculation in commodities such as food and oil.

The bankers and traders claim that the CFTC must do an extremely costly and time-consuming “cost-benefit” analysis to prove that the regulations will not do more harm than good. Lawmakers such as Carl Levin and analysts argue that in writing the law, Congress already determined that the benefits to society of limiting this destructive speculation outweighs the costs in terms of forgone profits by traders and speculators. The idea of subjecting each regulation to a “cost-benefit” analysis is being used as a tool to stymie the implementation of regulations of the egregious practices of corporations.

It presumes, of course, that the default option should be the unregulated market. Instead, with many presumably dangerous practices –such as the marketing of dangerous financial products – a more sensible default option may be strict controls unless the financial instruments can be shown to be safe and useful: a financial precautionary principle.

But perhaps the most over-used economics term, and most pervasive economic scare tactic, used to fight financial reform is the term “liquidity”. Bankers doing battle against Dodd-Frank routinely get economists – some of them quite prestigious such as Stanford’s Darrell Duffie – to write papers claiming that regulations such as the Volcker Rule prohibitions on proprietary trading will reduce the ability of banks to act as “market makers”, thereby reducing “liquidity” in financial markets. This, Duffie and other economists such as those at the ubiquitous consulting firm Oliver Wyman say, will harm pension funds, corporate borrowers, and governments who will find their costs of borrowing increasing.

Duffie and Wyman economists admit that the Volcker Rule, in fact, has a massive exception to its ban on proprietary trading allowing for banks to hold plentiful inventories of securities that will allow them to “make markets” and provide plenty of liquidity. They simply claim that banks will be afraid that the regulators will penalize them if they cross the line into proprietary trading. Oh yes: bankers are known as shrinking violets who quiver at the thought of straying over a line where a regulator might slap their wrists. This banker timidity will surely cause liquidity to dry up.

To prove their point about the dangers of dry liquidity, Duffie and Wyman almost laughably cite data from the great financial crisis of 2008 – 2009 where liquidity did dry up and yes: this was very costly. But
they fail to mention that a major reason the illiquidity crisis occurred was that the banks engaged in
massively dangerous proprietary trading that crashed the system in the first place, and at the first sign of
trouble, instead of providing liquidity to their customers, the banks massively withdrew liquidity from the
system and dumped assets just as fast as they could.

And we can be certain that if the banks’ proprietary trading is not controlled by a robust Volcker Rule of
some type, the next time around, these banks will again generate massive cycles by providing excessive
liquidity to the system so they can speculate and trade on complex and opaque bets during the up-
swing. Then, when these crash the system, they will destroy the liquidity before their customers can get
their hands on it by dumping securities into the market just as fast as they can. Do these economists
really not understand this?

Some economists do. Find them at Americans for Financial Reform, Better Markets, SAFER, and
Finance Watch among other places.