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The Profit-Based Approach
Αποτίμηση Κεφαλαιακών Τίτλων από τα Θεμελιώδη Μεγέθη: Η Προσέγγιση των Κερδών

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3j. Policy Implications. Some notes on financial regulation

The failure of the investment bank Bear Sterns in 2007 marked the beginning of the current depression. At first, regulators thought it was an isolated case that could be contained through traditional monetary policy tools. By mid-2008, however, the subprime market failure made clear that the situation required extraordinary measures since most of the U.S. and global banking system had collapsed. The main policy followed aimed to securitize banks through capital injection, troubled asset purchases, and central bank accommodation against low-grade collateral. Governments supported this policy with state budgets and central banks through asset purchase programs that were intensified after the COVID19 pandemic. The state issued bonds to raise central bank capital and support the 'socialization' of financial-sector losses. In the U.S. alone public debt increased from about 8.7 trillion dollars in 2007 to almost 27 trillion dollars at the end of 2020. Public debt in almost every country followed a similar path.

These monies prevented meltdown mainly by enabling banks to revolve or turn corporate debt to equity, maintaining consumer credit as well. Most of the economic activity remained in place instead of collapsing and the world economy entered a period of weak investment and volatile growth. In the context presented by equation 3.56, this means that parameter (a) was reduced to sustainable levels. But this cannot restore the gross profit rate to growth sustainable levels. This is the reason banks sequestered most of the liquidity they received. Actual investment activity and credit expansion will appear again when corporate profitability and consequently the bank depository base are restored.

For contemporary mainstream literature, the persistence of the crisis is unanimously accepted nowadays. Explanations vary, ranging from high debt (mainly public debt) hampering growth (Reinhart & Rogoff 2013) , to blaming austerity policies applied to contain debt (actually to suppress wages). Recent mainstream research talks about conditions of 'secular stagnation' (Summers 2015). The latter approach stresses the limitations of monetary policy summarized in the so-called 'zero interest limit' and promotes fiscal expansion (Krugman 2012). However, the high debt explanation disregards that low returns brought about the debt crisis in the first place, while the second ignores that in depression corporations and banks sequester monies rather than invest them. Therefore, Keynesian 'trickle-down' policies justifying fiscal expansion have limited effect.

The reasoning appearing here suggests alternative policies promoting direct state investments (Shaikh 2011). That is policies restoring economic activity and bank liquidity through increases in employment. As we have shown profit-motivated growth breaks down in a depression. At this stage, it is state investments following social goals that can offer employment to those who need it the most and have a 'rise-up' effect on businesses serving the increased demand.

Nevertheless, official policies support different trends. As public debts pile up and bank liquidity surges speculative financial investments are taking up a substantial part of bank portfolios. Stock exchanges have hit record prices, not supported by corporate fundamentals, whereas sovereign bond yields are negative for some time in major European economies like Germany. All these are raising concerns that a new financial crisis is around the corner. If central banks downsize accommodation policies and governments issue new bank regulation directives financial episodes may reappear from the burst of the current speculative bubble. This situation worries policymakers around the globe. Recently, rumors started circulating that there were discussions about mutual write-offs of sovereign debt between G20countries. Irrespective of the success of such policies, but the fact that such discussions may be held shows that expansionary monetary policy is about to reach its limits.

At the level of bank regulation, the clearest policy outline is the 'Volcker rule' passed on Dec 10th, 2013 by the U.S. legislative bodies. A similar but slower process took place in the E.U. around the so-called 'banking union' with the establishment of the SSM as the central regulatory body.

Sticking to the 'Volcker rule' because of concreteness we note that its main aim is to prevent banks from assuming equity and derivative risk through hedge funds and other vehicles but does not prevent them from running that risk directly in their balance sheet. The only factor discouraging the assimilation of risk is increasing capital requirements. This is a policy relying on the assumption that financial assets carry a particular amount of relatively stable risk. If the risk is stable, banks can securitize depositors by assigning the appropriate amount of additional capital to back the risky assets appropriations. But, as we have shown above, this does not hold especially when growth trends turn unstable, in such times capital requirements may prove insufficient and the taxpayer will lift the burden once again. The 'Volcker rule' is the latest chapter in a long series of regulations going back to the 'Peel act' in mid-19th century England. Marx in Capital Vol. III (Marx 1894) mocked this early policy for being useless when the system was in normal accumulation and was withdrawn in the crisis of the 1850s to avoid bank failures.

The target of bank regulation is to protect the broad public, at least in part. Given uncertainty underlying financial markets, the rules applied must focus on what kind of assets pension funds, banks, and the broad public can hold and to what proportions, to contain possible future damages. Depressions cannot be managed away through appropriate policies because they emerge from the contradictions of profit-motivated growth. These contradictions become manifest in the fact that depressions appear every thirty to forty years the first on record dated as back as 1790. In this regard, financial crises will always be a potential trigger of such events and regulation policies can only mediate losses by directly constraining risk. This means that institutions that take deposits or pension plan installments cannot hold just any kind of risky asset and the assets permitted cannot assume just any proportion of the asset side. This should be the focus of regulatory policies. Unfortunately, recent amendments applied by the FDIC in July 2020 have softened the restrictions for

banks. The latter now can invest in certain categories of venture capitals and SPVs thereby extending their exposure in risky assets rather than placing rules in the structure of their balance sheet. Perhaps such a move has been made in order to sustain the New York Stock Exchange bubble until the November 2020 US presidential election. It may, however, reflect policies of a more permanent nature. Irrespective of the underlying intentions, however, these recent developments are indicative of the limitations of financial regulation in capitalism.

At present, the likelihood of a new major financial crisis depends on how stable the currently prevailing roughly stagnant growth path is and how it may be affected by the pandemic. Stability seems to rely on the extraordinary liquidity measures taken by the Fed, the ECB, and most of the other central banks in the world. These policies are keeping interest rates low and keeps 'enhancing short term speculative financial investments. The capital impairment that would boost the rate of profit leading to gradual recovery seems to move at a slow and uncertain pace. When these policies will eventually stop financial panics and sharp corrections cannot be ruled out. Recent legislation in Greece and other EU countries hampered by the crisis indicates that a period of accelerated capital impairment may take place in the years to come. Such policies will bring sustainable growth at some point, but they will aggravate the consequences of the crisis for the vast majority of the population. In this regard, the policy of direct state investment mentioned above (Shaikh 2011) becomes more relevant for an inclusive recovery.

Recovery from the present depression is proceeding at a very slow pace so far. Looking back to the history of crises, we have to go back to the 1873-1896 depression, the longest capitalist crisis on record, to find something similar.

Conclusion

In this chapter, we have shown that asset pricing is important for crisis theory and financial regulation. The fact that it has been downplayed in the context of the current depression has led to important shortcomings in its explanation and policy suggestions. For the Marxist tradition, this was due to a certain extent to the fact that the relevant section (section V) in The Capital Vol. III is incomplete. As we elaborated the critical factor that held back the efforts for developing an asset pricing theory from a Marxist perspective is whether the various categories of financial capital enter the profit equalization process like commercial capital.

The profit-based approach is based upon the assumption that capital mobility equalizes the returns between the corporate and the financial sector. This is not an interpretation of Marx but more of a reconciliation of his insights with a theory of asset price determination. As we saw this theory can price loans, stocks, and bonds. But when it comes down to derivatives and asset-backed securities systematic mispricing is the rule. Nevertheless, we saw that this category of fictitious capital follows the laws of capital accumulation as well.

This last result is important for bank regulation and to a certain degree, it has been incorporated in the initial version of the Volcker rule in the US. However, the legislation never prevented banks from purchasing and holding derivatives, asset-backed securities, and risky assets in general. It prevented them only from holding these assets through SPVs and this way made the trade more expensive for banks since they needed additional reserves to back their depository base. The rationale behind this is that risk is calculable and for this reason, adequate reserves can secure depositors. We saw that this is not the case because stock, bond, and interest rate returns do not follow the normal distribution. In other words, they do not experience a constant standard deviation. This means that any amount of reserves can prove insufficient. For this reason, I proposed the limitations to be placed on the percentage of risky assets in the bank balance sheet.

The whole discussion on bank regulation acknowledges that capitalist crises cannot be managed away because they are inherent in the system. Their effect on the financial system can only be tempered through regulation. This is known to us since the time of Marx who used to scorn the Peel act for holding in times of normal accumulation and being withdrawn in times of crisis. Therefore, the main issue is the persistence of the present depression and the limitation of monetary policy and fiscal austerity policies in creating an environment of sustainable growth. In this regard, the implementation of policies of direct state investment is more important than any set of bank regulatory rules.