The Constitutional Law of Money

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Fall, 2017

Discussion Questions Class 17

Market Funding and Financialization

Readings:

Perry Mehrling, "Re-theorizing Liquidity" (draft, June 2016).

John D. Martin, "A Primer on the Role of Securitization in the Credit Market Crisis of 2007" (Feb. 17, 2009) at URL

Krippner, Greta. *Capitalizing on Crisis: The Political Origins of the Rise of Finance* 86-87, 92-97, 102-105 (Cambridge, MA: Harvard University Press, 2011).

Background:

We meet a pair of crucially important modern trends in today's reading. The first is a phenomenon with deep roots in American banking: the ability of financial entities to fund their activity by selling assets in the capital markets, rather borrowing against future income. The connection between the capital markets and American banking was reset after World War II. As Perry Mehrling tells it, the Federal Reserve itself prompted the revision. It cultivated a relationship with a group of large securities dealers so that those entities would facilitate open market operations in government debt. If the "primary dealers" committed to a willingness to buy and sell Treasury bills, the government could intervene to affect the money and credit supply through open market operations without choppy price changes. Mehrling's article in our reading abstracts and generalizes the function of those securities dealers to "make markets" in securities.

The second trend we discuss today concerns the supply of securities. One of the legacies of New Deal banking legislation (the Banking Act of 1933 and "Regulation Q")) was a ceiling on the interest that banks and thrifts could pay on many kinds of deposits. The ceiling acted to divert money from lending institutions at times when the economy was waxing strong: when interest rates rose, stocks and bonds offered better returns and money flowed towards them. As it drained out of the institutions that made mortgages, money flowed out of the construction and housing industries, slowing down economic activity until interest rates dropped and money flowed back into banks. The design arguably produced a kind of balancing effect. But in the 1960s, lawmakers deemed the arrangement counterproductive: they wanted to promote home-owning in urban areas where discontent with problems of inequality was swelling. At the same time, the FHA's method of supporting mortgages through resales was weakening. Pension funds had become the biggest vehicle for personal savings, and those funds preferred investing in the stocks and bonds than doing the work to evaluate and carry mortgages.

Mortgage-backed securities were born in response. The idea was that “a new security-type mortgage instrument” would permit the mortgage industry to draw funds otherwise invested in the securities markets. Hyman 225. The Housing Act of 1968 privatized the Federal National Mortgage Association (Fannie Mae) and liberalized its lending practices. Working with new entities, the Government National Mortgage Association (Ginnie Mae, for subsidized mortgages) and the Federal Home Loan Mortgage Corporation (Freddie Mac, for conventional mortgages), the FNMA pioneered securities that gave investors a claim on a large, diversified portfolio of mortgages.

In today’s reading, the technique of securitization meets the strategy of market funding. Securitization, as we know too well after the financial crisis, would go viral. As it did, it fueled the “market liquidity” made by the primary dealers and other large financial entities. We consider the changes to the monetary landscape that resulted.

Discussion Questions:

1. What is “market liquidity” in Mehrling’s view?

2. The Federal Reserve invited the primary dealers, large investment banks, to “make a market,” or provide a market funding mechanism, for government securities in order to facilitate open-market operations. Why would the primary dealers expand their technique to create market liquidity in private securities?

3. Mehrling argues that “private credit money” becomes dominant as a source of liquidity during peacetime, as if the ascendance of private money creation happens naturally.
    a. Why would a move to private credit money occur?
    b. What legal changes create the conditions within which the market funding pattern that Mehrling observes occurs?

4. Who would be interested in lending to dealers, rather than to banks?

5. What is “securitization”?
    a. What is its goal at an economic level?
    b. At an operational level, why would banks move towards securitizing their mortgages?

6. How does securitization change the role of banks as lenders? Would their new role comport with the ideal for such lending posited by Amar Bhide?

7. How might the expansion of market liquidity affect the ability of the Federal Reserve to control the money supply?

8. What, according to Krippner, created the great upsurge in private and public debt circulating through the financial markets – or “financialization” – in the 1980s, 90s, and 2000s?

9. Where, if anywhere, is judicial oversight of the fundamental design developments in this process? Are there other modes according to which the developments here, developments that transformed the way wealth moves through American society, accountable to oversight? What barriers to accountability exist?