Foreword

For decades now, Jane D'Arista has been among the tiny handful of people in the United States and globally who truly understand how financial markets and institutions both function and malfunction. A lot of complex razzle-dazzle does certainly take place in contemporary financial systems. And among the Wall Street operators, academic finance professors, and government policymakers and regulators, there is no shortage of people claiming expertise on every possible topic in the realm of finance. Most of them are compensated handsomely for proffering their views. D'Arista stands apart from all such people, for the simple reason that she has always deployed her formidable talents on behalf of the general good. She has never sought the approval of either mainstream economists or Wall Street titans. This has enabled her to examine reality undistracted, with a powerful combination of depth, breadth, and clarity.

All Fall Down builds from D'Arista's long list of distinguished previous contributions. These earlier works include her classic 1994 two-volume monograph *The Evolution of US Finance*, and a wide range of research papers and policy studies she has published subsequently.

Many of these previous publications came out of her 20 years of work, from 1966 to 1986, as a staff member with, respectively, the US House of Representatives Banking Committee, the Congressional Budget Office, and the Energy and Commerce Committee. She continued to publish steadily as Director of Programs for the Financial Markets Center and while teaching Ph.D. courses at the University of Massachusetts Amherst, the New School for Social Research, and the University of Utah from 1999 to 2006. Most recently, in the aftermath of the financial crisis, many of D'Arista's writings grew from her involvement with SAFER—A Committee of Economists for Stable, Accountable, Fair and Efficient Financial Reform, a project that she co-directed with Gerald Epstein.

With *All Fall Down*, D'Arista is able to synthesize and significantly extend this earlier work to deliver original perspectives on two fundamental questions: first, what caused the 2007–2009 global financial crisis; and second, what needs to be done to prevent another such calamity?

The army of finance experts have, of course, provided a plethora of answers to these two questions. But these people were mostly oblivious to the worsening fragility that had been spreading throughout the financial system for decades. Given their track record, it is reasonable to ask why their views should carry credibility now.

In stark contrast, D'Arista's earlier work identified deep problems with the US and global financial regulatory system that were growing over time. In *All Fall Down*, she traces how these developments encouraged excessive financial speculation, which led to the formation of a global financial market bubble. This in turn brought us to the 2007–2009 crisis.

The significance of this overall point—that D'Arista had long recognized the deepening fragility of the US financial system while virtually all mainstream observers were asleep at the switch—cannot be overstated. The reason is simple. The 2007–2009 financial crisis was the most severe since the 1929 Wall Street crash and Great Depression 70 years earlier. Eight million US workers lost their jobs between 2007 and 2009, 9 million US families lost their homes between 2006 and 2014, and $17 trillion in US household wealth—i.e. 24 percent of all household wealth—was wiped out between 2006 and 2008. The patterns were comparable in Western Europe. Moreover, the crisis would have been far more severe still had not the US and Western European governments engaged in massive countercyclical stimulus programs and bailout operations to prop up the collapsing financial system. This was socialism for big banks on the grandest possible scale.

More still, this crisis was by no means an historical aberration. The classic 1978 book *Manias, Panics and Crashes* by Charles Kindleberger makes clear that, throughout the history of capitalism, unregulated financial markets have persistently produced instability and crises. The 1929 Wall Street crash and subsequent Great Depression was only the most severe instance of an overwrought financial market leading to an overall economic calamity.

Amid the 1930s Depression, Franklin Delano Roosevelt's New Deal government put in place an extensive system of financial regulations in the United States. The single most important initiative was the Glass-Steagall Act of 1933, which divided up the banking industry into two distinct segments: "commercial" and "investment" banking. Commercial banks were limited to the relatively humdrum tasks of accepting deposits, managing checking accounts, and making business loans. Commercial banks would also be monitored by the newly formed Federal Deposit Insurance Corporation. This provided government-sponsored deposit insurance for the banks in exchange for the banks accepting close scrutiny of their activities. Investment banks, by contrast, were free to invest their clients' money on Wall Street and other high-risk activities, but had to steer clear of the commercial banks. Similar regulations were imposed on savings and loans and other depository institutions.

For the most part, the Glass-Steagall system did its job. For the first 30 years after the end of the First World War, US and global financial markets had become dramatically more stable than in any previous historical period. This was while GDP grew at a healthy rate and unemployment remained low in the US and other advanced capitalist economies. But even during the New Deal years themselves, financial market titans were already fighting vehemently to eliminate or at least defang the regulations. Starting in the 1970s and continuing through to the 2007 crisis, they almost always got their way. As a result, the increasingly unregulated financial markets were able to operate again according to their own self-destructive logic.

As D'Arista explains in *All Fall Down*, one of the critical developments that contributed to the weakening of the Glass-Steagall regulatory system was the emergence of the Eurodollar market, beginning in the late 1960s. Through the Eurodollar market, non-US banks, and even US banks operating offshore, could create dollar-denominated accounts for their customers. This enabled these offshore institutions to perform virtually all the functions of banks located within the US, but without having to abide by the Glass-Steagall regulations.

A related development was the emergence of what D'Arista (and her co-author Tom Schlesinger) initially called the "Parallel Banking System" in a prescient 1993 paper.[1] D'Arista and Schlesinger described the development of entities such as the General Motors Acceptance Corporation and General Electric Capital, GE Capital, which were able to operate like banks within the US without facing the US regulatory laws that applied to banks. These entities initially grew out of the operations of their parent non-financial corporations, such as GM and GE.

But this parallel banking system burgeoned over time into what is now more broadly termed the "shadow banking system." The shadow banking system includes mutual funds, holding companies, and finance companies among other non-bank intermediaries. As with the Eurodollar institutions, the shadow banks became capable of performing most of the lending and other functions of traditional banks, but without facing the same regulatory requirements. As one indicator of how the shadow banks grew in importance, as of the decade 1970–79, traditional banks and

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1 Jane W. D'Arista and Tom Schlesinger (1993), "The Parallel Banking System," in Gary Dymski, Gerald Epstein, and Robert Pollin, eds, *Transforming the US Financial System: Equity and Efficiency for the 21st Century*, Armonk, NY: M. E. Sharpe, ch. 7.

other regulated depository institutions accounted for 47 percent of all lending in the US economy while the shadow banks accounted for 5 percent. For the years immediately prior to the 2007 crisis, the traditional banks' share of lending had fallen to 20 percent while the shadow banks' share had risen to 28 percent.[2]

Of course, all the experts extolling the virtues of unregulated financial markets were forced to retreat in the aftermath of the 2007–2009 crisis. This is the context in which the new financial regulatory system—the Dodd-Frank system—became law in the United States as of 2010. Dodd-Frank was a massive, 2300-page tome of legalese. Nevertheless, it provided only a broad framework for implementing a new regulatory system, leaving large numbers of critical details to be hashed out at the various regulatory agencies. This was because the big-time Wall Street players calculated that they could dominate the rule-writing process once their lawyers and lobbyists could caucus quietly with the day-to-day regulators after the public's attention had drifted elsewhere.

D'Arista's own assessment of Dodd-Frank in *All Fall Down* is typically unvarnished. She writes that the measure "seemed to go through the motions of a major reform effort, giving nominal recognition to problem areas without confronting the underlying structural issues that contributed to the collapse." But even with these weaknesses, as of this writing (March 2018), President Donald Trump and the Republican-controlled Congress have been maneuvering to repeal or at least roll back Dodd-Frank. D'Arista's perspective here is that "those who favor repeal give little weight to the belief that the role of regulation is to protect the public whose money is at risk. Their proposals seem to argue that the role in making policy is to support a profitable financial system."

By contrast, the concluding chapters of *All Fall Down* develop a clear regulatory structure that would be capable of "protecting the public whose money is at risk." One centerpiece of D'Arista's proposal is a new system of reserve requirements, i.e. requirements that financial institutions maintain a cash reserve to fortify themselves during periods of market downturns, when the value of income-generating assets experience sharp declines. Financial institutions would generally choose to minimize their cash reserve holdings so that they can use these funds to earn profits from making loans or investments. Under the old regulatory system, banks were required to hold cash reserves but non-bank intermediaries—i.e. shadow banks—were not. This created a serious

2 Robert Pollin and James Heintz, *Study of the US Financial System*, FESSUD, 2012, p. 126, http://fessud.eu/wp-content/uploads/2012/08/USA-Financial-Systems-Studies10.pdf.

regulatory disparity favorable to shadow banks, which in turn undermined the entire regulatory system.

As D'Arista explains, one of the strengths of her proposed system of uniform reserve requirements is that it will strengthen the ability of the Federal Reserve to counteract speculative bubbles. As speculative bubbles begin to form, the Federal Reserve would have the capacity to increase the cash requirements for financial institutions, which would, in turn, slow down the flow of credit channeled into speculation. Indeed, during the late 1990s speculative "dot.com" stock market bubble, then Federal Reserve chair Alan Greenspan himself acknowledged that this type of regulatory intervention would work effectively, observing at one point that "I guarantee that if you want to get rid of the bubble … this will do it."[3] But Greenspan, like so many other regulators and policymakers before and since, was simply unwilling to confront Wall Street at that time or any other time. Hundreds of millions of ordinary people worldwide paid the price of such behavior with the 2007–2009 financial crisis reckoning.

Jane D'Arista makes abundantly clear in *All Fall Down* that we cannot allow Wall Street to continue setting the rules that govern our financial system. She makes equally clear how we can transform our financial regulatory system so that, first and foremost, it serves the interests of ordinary people, in the US and throughout the world. *All Fall Down*, in short, deserves to be read, reread, and pondered over by anyone who cares about creating a more just, equitable, and sustainable economy.

Robert Pollin

3 See William Grieder, "Il Maestro's Failed Magic," *Nation*, March 27, 2002, p. 6, https://www.thenation.com/article/il-maestros-failed-magic/.