



BOOK REVIEW

JIMMY STEWART IS DEAD: ENDING THE WORLD'S ONGOING FINANCIAL PLAGUE WITH LIMITED PURPOSE BANKING

By Laurance J. Kotlikoff, Hoboken, New Jersey: John Wiley & Sons, Inc., 2010, ISBN 978-0-470-58155-1, 241pp.

By now there are many papers, studies, reports, statements and books about the global financial crisis and the so-called 'financial tsunami' that hit the financial world sometime in 2007-2008. Although many causes have been highlighted and many lessons (at least in theory) drawn from the huge shock, we are still trapped with the financial system the way it was functioning prior to the crisis.

Let us suppose that the financial system, that had led us into the current abyss, is nothing more but a box. Then, all of the findings so far are basically the thoughts and ideas that had come from 'within the box.' Logically followed, the so-called solutions to the problems of the current financial system are designed to preserve the basic structure of the system. The people and corporations that had brought about the crisis in the first place are the very same ones who are called back by the government(s) to rescue us. It is hard to believe that they can offer us anything but another miserable end result (p. 190).

In short, the running of a huge fiscal deficit by the US government and many other governments around the world; the establishment of another set of rules and regulations; the introduction of yet another regulator when there are already 115 regulators in the USA; the cutting of the pay slips of the Wall Street executives on one the one hand, while allowing them to cash in huge bonuses on the other are counterproductive measures as they leave the current – inherently unstable – financial system intact.

All of these measures are, according to Laurance J. Kotlikoff, the author of the book, *Jimmy Stewart is Dead*, are wrongly prescribed medicine for a terminally ill financial system. What the U.S. government

had done so far is only throwing money at the problem, and to Kotlikoff, this is not a long-term solution (p. 5). As he rightly pointed out, "Moving toxic assets from private entity A to private entity B is not going to change the fact that these assets exist and that someone is going to end up holding them and pray they pay off." (p. 105). The best proof for this argument is the fact that since the spring of 2007 there are now 325 failed banks in the US, while there were *only* 105 banks that failed up to the time of publication of this book.¹

The first four chapters of the book deal with the crisis itself. In these chapters, Kotlikoff eloquently and bluntly describes how, why and by whom this crisis was allowed to occur and how we can recognize similar features in the future. It is now, more than ever before, clear that the current financial system is not stable and that Adam Smith's *invisible hand* is not doing what the proponents of the market theory proudly claimed it will do (p. 14). First, self-interested, greedy and profit-motivated individuals (investors, bankers and corporate leaders who, in the pursuit of high profits, mostly speculated in the market) were using all means in order to gain extra profit and neglected their obligation for check-and-balance. Their thirst for extra profit had led them to provide credit even to those individuals who were not capable to bear it.

Second, the invisible hand and market economy had failed to adjust and to warn us about the 'tsunami' in the financial market. If the theory of free market were correct, we would not be facing this problem at all.

In his book, Kotlikoff labels the current market system as a system that is "replete with market failure" (p. 164). Furthermore, he elaborates not only the inherently and destructively ill nature of the current global financial system, but also offers a viable, yet simple, alternative that addresses all the issues raised by other authors. While acknowledging the deficiencies of the current financial system and agreeing (to some extent) with other authors on some of the causes of the financial meltdown, Kotlikoff begs to differ to a great extent when it comes to applying an appropriate solution.

He is a scholar who thinks 'outside of the box' and tackles the underlying problems with a holistic approach. Radical times beg for radical changes, and in his view we have come to the point where we have to make a radical change. Hence, there is a dire need for the financial services industry to be fundamentally reformed.

Now, after more than two years from the crisis eruption, the disturbing fact is not how much has changed in the financial world, but

rather how little, as highlighted by Kotlikoff (p. 126). Hence, as bluntly pointed out by Kotlikoff, “we need a financial system that is completely transparent to keep us from falling back into our ‘trust no one’ equilibrium. We also need a system with automatic financial firewalls, which also keeps Uncle Sam from catching fire. Limited Purpose Banking satisfies both these requirements” (p. 30).

Starting with chapter five, Kotlikoff begins to elaborate on his proposal about Limited Purpose Banking (LPB). In short, Kotlikoff’s proposal consists mainly of two things: (a) the creation of a single financial oversight regulatory body; and (b) the conversion of all banks and bank-like institutions into mutual funds. Furthermore, there will be two types of mutual : (i) cash mutual funds that will hold only cash and where 100% reserve requirement will be imposed; and (ii) other mutual funds that will use customers’ (investors’) money to be invested in specified asset classes only. In general, each mutual fund would hold what it says it holds and nothing else. Hence, cash mutual fund would hold cash alone; T-Bill mutual fund would hold six-month Treasury Bills alone and nothing else.

His proposal limits banks to their legitimate purpose which is an intermediation between borrowers and lenders. Banks, as pass-through mutual funds, will be involved in the intermediation alone, hence, there will be no-risk banking since the “intermediation requires no risk-taking whatsoever” (p. 124). As Kotlikoff pointed out, under LPB, “banks would let us gamble, but they would not themselves gamble” (p. 126). While he depicts the negative impacts of leveraging, he is not opposed to leverage per se. Rather he is against banks (or any other bank-like institutions) leveraging our money (as either shareholders in a firm or as taxpayers) without our explicit knowledge and consent. His proposal allows leveraging, but under LPB we, not a bank, will leverage with our own money, consent and transparency. There will be no third party involved and as such it provides natural financial firewall (p. 144).

Apart from establishing a single regulatory body, this proposal would bring an end to what Kotlikoff calls “insider rating” that is “a key cause of our financial debacle” (p. 128). The proposed system would rely on independent ratings by the government and it would require full disclosure and provide maximum transparency. Under this system, the ultimate risk will be borne by people, not companies, and people will be aware of the risks they are exposed to in the first place. Having all these things in place, this system will have built-in firewalls that would protect us from similar crises in the future.

Nevertheless, as Kotlikoff himself pointed out, his idea of LPB is relatively similar to the idea of Narrow Banking advocated by Irving Fisher, Henry Simons, and Frank Knight in the 1930s and endorsed by Milton Friedman and Robert Litan, among others (pp. 132-133). These prominent scholars called for 100% reserve requirement that would provide the government with the control of the M1 money supply.

Currently, the government has only an indirect control of money supply as it largely depends on the money multiplier (pp. 133-134). Similarly, through LPB – Kotlikoff argues – the government will gain the control of the M1 money supply as well. Nevertheless, Kotlikoff ignores the fact that this proposal failed a long time ago due mainly to lack of political will and the power of banking lobby. The main weakness of the book is that, unfortunately, it fails to significantly elaborate the mechanism in converting Kotlikoff's model into reality and how his model can overcome the shortcomings of the present system.

Throughout the book, Kotlikoff has highlighted several figures that played a major role in the global financial fiasco and he openly criticizes their actions. In fact he says: "The point, then, is that these guys and gals—their decisions, their moves, their conversations, their personalities, their knowledge, their competitiveness, and their addictions to gambling, power, drugs, booze, interactive golf, or card games—are themselves a large source of systemic risk. And there is no purpose to this risk. It's not economic risk. It's man-made risk, which we neither need, nor can afford," (pp.111-112). However, the book fails to elaborate further on the importance of moral, ethics, rules-compliance and accountability values that are needed to make an effective and proper use of human capital. Can we be sure that the managers of these mutual funds will not end up doing the same or similar activities that will lead to catastrophic end results?

When it comes to values, according to Milton Friedman, economics is value neutral. However, it is a strange irony that Neoconservatives who are the strongest backers of the current system advocate value-free economic policies but value based politics. This poses a serious challenge to those who advocate the structural reform of the system, because due to the dominance of the American political system by Neoconservatives America's political will for such reforms has been seriously weakened. The fundamental ingredients of a value-free economic model are free markets and deregulation. However, if free markets and deregulation are left to themselves, then, more often than not, they would lead to abuse(s) of the market freedom by market

players leading to huge fluctuations in the market and also serious economic crises – a glimpse of which we saw in the 2008-2009 crisis originating at Wall Street. Once such crises occur, then, there are loud and wide calls for the government to save the economy and the capitalist system from self-destruction. We have seen that in 2008-2009 the US government responded to such calls by huge bailouts of leading financial institutions. All of this was done in the name of public interest. Economic history is a frequent witness to such interventions by governments in such crises in the name of public interest. Hence, the challenge before the advocates of the value-free economics is the following: Can a value-free economic system, founded in free markets, protect the public interest?

In conclusion, although providing an ‘outside of the box’ alternative solution to the financial plague, Kotlikoff’s book lacks a comprehensive blueprint to operationalize his proposal; how it operates; its specific implications for overcoming the ills of the present system; and highlighting the specific advantages. Nevertheless this book is an eye-opener for all those interested in the global financial architecture and those looking for alternative models of financial systems.

ENDNOTE

1. This number is as of December 21, 2010. For more details, see: <http://www.fdic.gov/bank/individual/failed/banklist.html>.

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