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Borrowing Alone
The Theory and Policy Implications of the Commodification of Finance

by

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Can a reduction in the number of games of golf adversely affect the economy? Firms and homebuyers are relying less on commercial banks than they did in the past, and while many authors have examined this trend, few have noted its social aspects.

Most economists would acknowledge that some sort of change is under way in the way consumers and firms borrow money. Bonds now account for two-thirds of nonfinancial business debt outstanding, compared to one-half as recently as 1985 (Federal Reserve Board of Governors 2003; Bassett and Zakrajšek 2003). The number of new commercial and industrial bank loans has been falling monthly (Economagic 2003; Bassett and Zakrajšek 2003). A large portion of the loan market is now accounted for by syndicated loans, which are held mostly by banks with no ongoing relationship to the borrower and are traded in secondary markets (Bassett and Zakrajšek 2003, 487–490). This trend parallels the increasing dominance of Freddie Mac and Fannie Mae in the mortgage markets. These "government-sponsored enterprises," which package mortgages into bonds for sale to the public, now guarantee or own roughly half of the mortgages outstanding in the United States (Economist 2003).

These trends can be seen as part of a commodification, or marketization, of the credit markets. Certainly, traditional bank loans are in many ways commodities. But consider some characteristics of bonds. Publicly issued securities are traded on anonymous public markets by firms and securities owners do not have any intimate knowledge of the issuer. Investors are indifferent between two bonds with the same risk-return profile. Some securities, especially mortgaged-backed securities, are traded as members of a broad, generic category, rather than as the obligations of particular persons or firms. Generally, members of a class of bond trade at similar values, as would two different bushels of wheat of the same quality. The owner of a bond typically has little personal contact with the firm or bank that originally issued the security and may hold the bond for a very short period of time. Often a bond is held as part of a very diverse portfolio, so that the owner has only a small stake in the profitability of the issuing firm.

There is significant evidence, summarized below, that commercial bank loans do not share most of these qualities and are in that sense not commodities (Uzzi 1999). One important difference is that bank borrowers are offered an interest rate that is set by the bank—not the market—and that may be lower for "good customers." Firms with an ongoing relationship to a bank may receive favorable treatment in many respects. In return, they may pass along information to their banks to which an "arm's length" lender might not have access. Ties between borrower and lender partly take the form of personal relationships and social

interaction, and not simply business letters and contracts. They may be governed by norms of reciprocation, rather than specific quid-pro-quos. To the degree that bank finance is, to use a sociological term, “embedded” in ongoing personal relationships, it is not a commodity (Anderson 1993; Mirowski 1990).

Whether bank loans are market goods discussed below. Assuming there has been a shift to less personal forms of finance, what might be some of the implications of the shift for policymaking? If bankers are discriminatory in forming relationships, a reduction in the personal aspects of obtaining loans might be desirable in many respects. An example would be an improvement in the fairness of the lending process. But not all goods are best treated in an impersonal way. Concerns surrounding the rise of bond finance can fall within several broad areas.

First, there are macroeconomic implications. Some economists have argued that with banks accounting for a shrinking portion of business loans, monetary policy has lost its effectiveness (D’Arista 2002; Estrella 2002; Palley 2003). Some scholars believe that in the past, when banks were the primary lenders to business, the Federal Reserve Bank could influence the amount of lending by constraining or easing the availability of reserves to the banking system. Since those who hold bonds are not required to keep reserves on hand, such actions have little effect on debt securities sales.

Another area of policy concern is governance. Commercial banks often monitor firms’ activities and can exert some control, ensuring that their funds are not misused. Owners of bonds, having a more distant relationship with borrowers, do not have the information and leverage needed to discipline them in this way.

Finally, the changing form of finance may have implications for equality of access to credit. Since investment increasingly takes the form of securities purchases, it matters whether women and minority group members are excluded from debt markets.

The paper finds that neither commercial bank loans nor securities sales are generally preferable from the point of view of efficiency, governance, equality of access, or the potency of monetary policy. The well-known attributes of bank and financial market lending, respectively, are less economically functional than many observers believe. The main duty of a lender to assess risk, and neither type of lender can surmount the biases and irrational aspects of estimating risk. Risk is always gauged within a framework of convention and is subject to racial and other biases. Nevertheless the fairness and efficiency of the lending process is potentially

subject to improvement. Several existing institutions point the way toward such improvement, but to simply reverse course and return to traditional commercial banking would be a retrograde step. Making the financial sector truly rational will require policymakers to think seriously about race, gender, and class and about the distribution of power.

WHAT DO BANKS DO?

The recent changes in finance fit the general pattern of commodification identified by Anderson and other experts on the differences between economic and noneconomic goods. We would like to know what is at stake, from a policy perspective, in this commodification. What has been lost with the move toward securities finance will depend upon what banks actually do when they make loans, and how they go about it. Two groups of economists who have studied this issue are the imperfect information school and the social economists. I examine their views in the next two sections, and then suggest some extensions in the next section.

Economists and sociologists generally agree that the role played by commercial banks has something to do with their ability to counter dishonest borrower behavior and deal with risk (Bernanke 1983; Stiglitz and Weiss 1981; Bernanke, Gertler, and Gilchrist 1999). In a seminal paper on the role of banks in the Great Depression, Bernanke argued that banks are unique in their ability to lend to small "idiosyncratic" borrowers, who did not have access to the bond market (1983). Banks are able to intermediate between their depositors and small borrowers because they are specialists in making certain money is lent to "good" borrowers. Their techniques include:

> "developing expertise at evaluating potential borrowers; establishing long-term relationships with customers; and offering loan conditions that encourage potential borrowers to self-select in a favorable way" (263).

The costs of this sort of activity ("costs of credit intermediation" or CCI), including application and monitoring costs and losses on bad loans, rise when the normal operations of the commercial banking system are disrupted, as they were during the period 1930 to 1933.

Subsequent elaborations of the imperfect information theory of banking have built on the same concepts as Bernanke's article. Stiglitz and Weiss (1981) devised a model in which projects

varied in their riskiness. In Stiglitz and Weiss's model, banks were unable to determine the riskiness of a project without some sort of "screening" device, such as credit rationing. When interest rates were relatively high, borrowers with relatively low-risk, low return projects would withdraw from the loan market, leaving only high-risk borrowers. It was in the interests of banks, then, to keep interest rates below the so-called "market-clearing" level, a strategy that left some borrowers unable to obtain funds at any interest rate.

One feature of Stiglitz and Weiss's model is that banks may screen companies based not only on the interest rate they are willing to pay, but also on observable characteristics that may be correlated with risk. So, entire groups may be redlined, or unable to borrow at any interest rate.

Rationing credit is not the only means available to banks to deal with imperfect information about potential borrowers. They may establish long-term contracts that punish failure to repay a loan in some future period (Townsend 1982). For example, a loan contract could require any unpaid loan amount to be rescheduled over future dates. This would reduce the incentive to borrow for non-legitimate purposes or to misuse money, once it has been borrowed.

Thus, Neo-Keynesians have thus been discussing the unique role of commercial banks for some time. In their view, commercial banks are experts in reducing the costs associated with various forms of risk that arise in an environment of asymmetric information. The purpose of banks is to deal with unobservable characteristics of the borrower and his or her endeavors. Ordinary investors are shielded from some crucial information. Banks solve this problem by setting up a contractual link with the borrower. The contract may "solve" the informational problem by requiring collateral, setting a below-market-clearing interest rate, or establishing a long-term relationship (Stiglitz and Weiss 1981; Townsend 1982).

To their credit, the imperfect-information Keynesians recognize the importance of bank credit, vis-à-vis other forms of lending. They argue that the relationship between the bank and its client is important and that such relationships, not just the interest rate, are crucial to the functioning of the credit market.

So, this group of Keynesians offers one possible answer to the question, what might be lost with the decline of commercial and industrial lending by banks? Their answer is that problems of asymmetric information will re-emerge unless they are solved in some other way.

Bondholders cannot be assured of the probity of the borrower in the same manner that commercial bankers can. We will see that this will generate policy problems distinct from those raised so far by observers of the credit-to-securities trend. But the New-Keynesians have not adequately theorized about the social aspects of lending.

SOCIAL ECONOMISTS' INSIGHTS INTO BANKING

An alternative view of what is at stake in the waning of commercial bank business loans is suggested by a different group of researchers altogether. Recently, social economists have begun to investigate the properties of bank credit, particularly its social aspects (Keister 2002). A number of findings have emerged. First, borrowers who have long-term relationships with a certain bank tend to be able to borrow at lower interest rates than those who do not purchase multiple services from one bank or do not have long-term ongoing relationships with a bank (Uzzi 1999, 487). Second, particular bankers are often friends of a sort with their customers and customers' families, and they feel they can trust those customers more than others (488).

Third, borrowers of high social station or with connections to powerful individuals often enjoy unusually good access to credit (Guseva and Rona-Tas 2001, 640). Fourth, race and gender matter (Uzzi 1999). Fifth, the availability of credit to a firm is partly influenced by the presence of bankers on the firm's board of directors, and by the school from which the CEO graduated (Keister 2002, 44). Sixth, bankers often make use of third parties—with whom they are tied by religion, ethnicity, or nationality—to verify the honesty of a borrower (Ferrary 2003; Guseva and Rona-Tas 2001). Seventh, when credit is tight, banks are more likely to restrict the supply of funds to new customers than to established ones (Wolfson 1994, 177).

Most or all of these findings conflict with the characteristics of a market good described by philospher Elizabeth Anderson, since they indicate that access to credit depends upon personal characteristics and relationships. I quote her at length.

> "The norms governing market relations are impersonal, suitable for regulating the interactions of strangers. Each party to a market transaction views his relation to the other as merely a means to the satisfaction of ends defined independent of the relationship and of the other party's ends. The parties have no pre-contractual obligations to provide each other with the goods they exchange. They deal with each other on an explicit, quid pro quo basis that serves to guarantee mobility. Because market transactions can be completed so as to leave no unpaid debts on

> either side, they leave the parties free to switch trading partners at any time. The impersonality of market relations thus defines a sphere of freedom from personal ties and obligations. Impersonal freedom also implies that one need not exhibit specific personal characteristics or invoke special relationships to gain access to the goods traded on the market. Money income, not one's social status, characteristics, or relationships, determines one's access to commodities. The impersonality of the market has been evolving for centuries, and, in some cases, notably regarding discrimination on the basis of race, ethnicity, gender, and sexual orientation, it still has a long way to go." (Anderson 1993, p. 145).

In Anderson's terms, commercial banks do not act as purveyors of a commodity. When those with a longstanding relationship to a banker—personal or businesslike—are able to obtain loans at special interest rates, Anderson's condition that "Impersonal freedom also implies that one need not exhibit specific personal characteristics or invoke special relationships to gain access to the goods traded on the market" fails to hold. Consider Guseva and Rona-Tas's finding that "Reliance on existing networks of trust allows Russian banks to issue cards to families and friends of top bank executives…Another solution is to stretch direct, personal ties. Trust is transitive. Friends and relatives of banks' top executives and long-term customers often recommend potential cardholders, both formally and informally"(639).

Anderson's criterion of the irrelevance of relationships is also violated when "good customers" can obtain relatively inexpensive loans and maintain the flow of credit in bad times. Finally, it is not only relationships between the bank and the borrower that matter, but also ties between a borrower and a third party who has a social or business connection with the bank.

Second, consider Anderson's statement that "the norms governing market relations are impersonal, suitable for regulating the interactions of strangers." Banks and their customers do not interact as strangers; they often know both their clients and their families quite well. One bank relationships manager related that "On the golf course, at a ball game, or the theatre, they [borrowers] will let their guard down more often. We exchange information—not like a marriage—more like dating" (Uzzi 1999, 488)

Third, it is not true that "Money income, not one's social status . . . " determines access to credit. Guseva and Rona-Tas point out in the context of the Russian credit card market that banks "target people of a high social profile, for example, individuals holding positions of economic or political power or those who are famous. They are deemed trustworthy both because they tend to be affluent and because they are securely anchored at the top of the national social hierarchy." (Guseva and Rona-Tas 2001, 640).

Fourth, banks see their relationships with customers as more than instruments to achieve their private ends; the relationships themselves have value to both partners: “the optimization is not a strict economic one because it integrates both a psychological and a social dimension. When a client declares bankruptcy, the banker does not only see the failure of a client but also the failure of a friend . . . The nature of these exchanges is not purely economic. They are symbolic and social, too” (Ferrary 2003, 689). Uzzi argues that his data indicate that “even in a business culture that uses the yardstick of money to gauge value, banks and clients develop expressive bonds that affect their economic decisions” (1999, 501).

Fifth, “The embedding of commercial transactions in social attachments promotes the benefits discussed above by enacting expectations of trust and reciprocal obligation that actors espouse as the right and proper protocols for governing exchange with persons they come to know well” (Uzzi 1999, pp. 483–484). This conflicts with Anderson’s point that when goods are treated as commodities, “The parties have no pre-contractual obligations to provide each other with the goods they exchange. They deal with each other on an explicit, quid pro quo basis that serves to guarantee mobility.” The conflict here is not that benefits are not exchanged between a bank and a borrower. To take an example of reciprocal obligation from everyday life, friends may exchange favors with one another but not expect that any particular favor will be reciprocated immediately and at equal value. They feel obligated to behave in certain ways because of a long history of exchanges, both metaphorical and literal.

What is the role of all these social influences on access to credit? Some clearly serve no ends other than the prejudices of the lender. Do some of the social aspects of credit ensure honesty or serve any other economic function, or do they merely amount to nepotism, elitism, and racism?

According to evidence gathered by social economists and sociologists, bankers believe that the types of social strategies enumerated here help them make sure loans are paid back—the problem cited by the imperfect-information Keynesians. (Of course, as these scholars acknowledge, new problems are created by the exclusion of borrowers based on these social criteria.)

Close relationships ease the flow of information. According to one “relationship manager”:

> “A relationship on a social basis tends to break a lot of ice and develop a relationship that’s more than cold facts, interest rates, and products. It’s an

> emotion-based bond.. that's so important to have.. [because] the customer will let us know about problems early, so we can correct them" (Uzzi 1999, 488).

Also, in many cases, honesty is enforced by the threat of ostracism (Ferrary 2003, 688). A business person who does not act in good faith may find it difficult to do business anywhere in the community.

Sociologists emphasize the economic function even of partnerships that take on a fraternal guise. "Transactors anticipate that others will not voluntarily engage in opportunistic behavior. Instead, exchange partners share the belief that these motives, coupled with access to private information, can enlarge the pool of potentially beneficial transactions that are not available through market means" (Uzzi 1999, 484).

Thus, relationships between bankers and businesspeople may draw upon motives that are normally not considered economic, but some believe the end result is economically beneficial to all parties involved. In one author's words, socially embedded ties both "create unique value" and "motivate exchange partners to *share* the value" (Uzzi 1999, 483 [emphasis in original]).

The sociological studies of banking cited here indicate an aspect not emphasized by imperfect-information Keynesians or most other economists: personal and social relationships of trust, and not just business relationships, are involved. They help solve informational problems without formal contracts, collateral, credit rationing, and so on. These relationships are not only "dyads" of two firms, but groups of people with multiple ties. These social relationships permit the free flow of information, and they also help ensure honesty by putting "social capital" at stake. But the friendships involved often take on a logic and purpose all their own, reorienting business activity partly toward social ends (the desire and compulsion to reciprocate the favors of a friend), rather than profit maximization.

The important things to note about the social view of banking are: (1) that social economists and sociologists agree that the main function of banks is to help ensure the selection of "good" borrowers and their repayment of loans; (2) that sociologists emphasize the role of non-economic relationships, such as friendships, in which business partnerships are embedded; and (3) social economists cite the importance of other aspects of relationships than the flow of information, such as social pressures that help ensure honest behavior.

IMPERFECT-INFORMATION AND SOCIO-ECONOMIC THEORIES OF BANKING: SOME QUALIFICATIONS

Existing theories of banking set forth by imperfect-information Keynesians and social economists clearly show that commercial banking is not merely the sale of certain services on a market. Banking involves ongoing interactions between banks and their best customers. But both groups leave some issues unexamined.

First, good friendships are characterized by honesty. But often, intimate relationships drive people to keep some bad news unspoken, if revealing them might bring shame. For example, many people are more likely to give personal information to their psychologists, with whom they have a strictly professional relationship, than to close friends. There are conceivably things that one might confide to a member of the clergy but be unable to broach even with one's mate.

Second, by the time banker and client become friends, it may be too late to stop a project. It seems unlikely that client and banker would immediately scrap a project once they became friends and discovered that the project was risky or fraudulent. If a pair of individuals has a great deal invested in a particular project (including their emotions), it may be in their interests to keep problems to themselves. Another reason honesty is less likely to prevail than one might think is the fact that businessperson and banker are often drawn to one another by commonalities or relationships that predate whatever loans are granted and that tend to transcend business matters. Both parties are privy to much information even before a transaction is formally considered, and the banker is as likely to be a coconspirator as a whistle-blower. A system of kickbacks, for example, is most likely to be successful when there is trust among the businessmen involved in the scheme (Granovetter 1985, 491–492).

Third, when business relationships are governed by the norms of personal relationships, the relationship might come to take precedence over the business venture itself. If the banker and his or her client are enjoying one another's company too much, they may not be productive when they meet. Close personal relations to a client might easily have the effect of blinding the banker to the flaws of the project. Granovetter notes that business relationships are not simply altruistic but rather involve the rational pursuit of "sociability, approval, status, and power" (1985, 506).

Fourth, while commodification of a good such as sex may rob it of its essence, some goods actually are commodities and are best seen in that light (Anderson 1993, 180–181). This can particularly be the case if one party to a relationship uses a pretext of genuine care to strengthen his or her economic position vis-à-vis the other party. One thinks of certain corporations that use a paternalistic stance toward their employees to extract more effort or gain consent to exploitative conditions. Also, many salespeople encourage their customers to think of them as friends, so that they become reluctant to slam the door or refuse an offer. If "personal" banking fits into the same category as these situations, it may not improve efficiency over all but rather enable banker or client to gain the upper hand and appropriate value rather than creating it. Large corporations are unlikely to be taken advantage of in this way, as they typically have access to money markets and can achieve a great deal of bargaining power by searching for the best deal among a number of banks. Smaller firms, on the other hand, are less sophisticated than large corporations and exercise less choice among lenders, so they may be vulnerable to manipulation in a social context (Uzzi 1999, 485).

Fifth, the rhetoric of "value-creation" may be misleading, in that oftentimes relationships come about because products are "tied" together in such a manner as to share rents that would otherwise be reaped by stockholders or consumers. Banks often provide needed loans as a compensation for other (more profitable) business: a recent survey of top financial officers of large corporations found that 56 percent "believed that a commercial bank had refused to lend funds or changed the terms on which it was willing to lend because the company did not agree to do other business with the bank" (Atlas 2003). This form of marketing is illegal, and at best it is a form of anti-competitive behavior; at worst it amounts to a form of bribery. Recently, courts have found that certain investment-banking firms have provided executives with opportunities to buy securities from initial public offerings, which can be very lucrative, as a way of soliciting other forms of business (Thomas 2003). Clearly, there is a difference between sharing the benefits of honest behavior and this sort of mutual back-scratching.

Sixth, it may be that socializing between banker and borrower is merely a cultural expectation or a form of conspicuous consumption, in no way necessary for whatever business is transacted. Even in this case, an individual who declines to socialize may risk losing a loan, but the loss would merely reflect the fact that norms of conduct had been violated. If I fail to shake hands with a colleague, I might find it difficult to conduct business with him or her. But the practice of shaking hands does not itself serve any economic function independent of its

cultural acceptance and symbolic import. There may be many occasions in which people shake hands without conducting any business whatsoever. Similarly, playing golf, enjoying a drink at happy hour, or attending a baseball game may simply serve a social function or mark the participants as members of an elite.

All of these observations suggest that, while relationships between bankers and their business customers are an important factor in lending activities, they are not always economically functional. In fact, they may represent an inefficiency or a waste of resources. Business may be thoroughly mixed with pleasure, but no clear causal relationship may exist between the two.

From a policy perspective, this section, then, demonstrates that some of the rituals of banking may be less useful than some people believe; the world might not suffer too much if they were eliminated in favor of more anonymous forms of lending. However, the anecdotal evidence gathered by Ferrary (2003) and Uzzi (1999) that socializing acts as an enforcement mechanism should be taken seriously. The view propounded here is that form does not merely follow function.

ANOTHER WAY OF THINKING ABOUT BANKERS' RELATIONSHIPS

An alternative way of viewing the "relationship" aspect of banking, and one that may encompass some of the other ideas expressed by imperfect-information and social economists, is to see the attribution or perception of risk as social to the core (Douglas 1992; Dymski 1998). First, perceptions of risk tend to be shared by social groups or by an entire culture. Groups of people tend to regard other groups as bearing risk, with individual characteristics being a secondary consideration. One thinks of caste societies, in which members of some groups are believed to contaminate others merely by touching them. Often these sorts of beliefs are fostered by a kind of mass hysteria, as, for example, in the case of the AIDS epidemic.

The same risk may be regarded as more or less threatening, depending upon its social context. In particular, risk among socially connected individuals may be underestimated or regarded as acceptable. In many cultures, people use other family members' plates without washing them, but would never do the same with strangers' or even friends' dinnerware. And in traditional caste societies, dirtiness and contamination are associated with particular groups.

Certain neighborhoods in the United States are dangerous and susceptible to public health problems; this phenomenon is certainly in part a self-fulfilling prophecy.

One observer points out that "Cultural values and social location have always provided the materials for self-serving constructions of epidemiological risk. The poor, the alien, the sinner have all served as convenient objects for such stigmatizing speculations" (Rosenberg, quoted in Douglas 1992, p. 36).

Second, socially shared notions of risk are not inculcated in a process separate from, and prior to, doing business. The acquisition of knowledge about risk is accomplished during golf games and other meetings. Douglas's diagnosis of modern theories of risk perception is as follows: "Public perception of risk is treated as if it were the aggregated response of millions of private individuals. Among other well-known fallacies of aggregated choice, it fails to take account of persons' interaction with one another, their advice to one another, and their persuasions and intersubjective mobilizations of belief" (1992, 40). Or, "Embeddedness [of business relations in social ones] changes actors' motives rather than treats them as immutable. While RMs [relationship managers] may build networks to gain access to private information, enacting a relationship also attenuates the narrow aims that may have motivated it originally" (Uzzi 1999, 500–501). One way of thinking about this is to say that tranactors not only *acquire* information from one another but also *create* something new: a relationship of trust. Trust is developed between particular individuals in an ongoing process as business takes place (Granovetter 1985, 486).

Extending these observations to policy questions, commercial banking, in drawing business people into intimate relationships, may create as many problems as it solves. If banking draws its strengths from social relationships and commonalities, by nature it will exclude certain individuals who do not enjoy the needed social connections. If attributions of risk are culturally relative, it may be better to allocate credit on a more anonymous basis through an institution such as the bond market.

Also, the institutional features of banking, to the extent they contribute to certain forms of bias in the assessment of risk and the allocation of credit, may be subject to debate or criticism. If banking relationships are used for risk reduction as much as risk perception, then relationships may create creditworthiness, rather than the converse. The proper institutional framework might encourage the formation of needed relationships that would not otherwise exist. Banks that hired loan officers from more diverse socio-economic, racial, ethnic

backrounds might find that the potential for profitable business existed in some hitherto neglected places. Not all useful business relationships are to be found at golf courses.

Consider some examples in which risk is perceived and handled in an unconventional institutional context. The Grameen bank of Bangladesh has demonstrated that extremely poor borrowers who lack credit in almost all societies can be reliable, at least given the right kind of institutional support. Compartamos, a similar Mexico City financial institution lending to very poor women, has a default rate of just over two percent (Weiner 2003). It is interesting to note that this organization uses some of the same social techniques as more traditional banks. When the bank opens for business in a new town, officers seek out the most highly respected women to obtain advice on establishing lending institution (para. 23). Who is qualified for credit depends upon whom one asks. This phenomenon can also be observed in industrialized economies: studies indicate that small business loans granted under the Community Reinvestment Act are just as profitable on average as regular loans (Thomas 2002, 22).

These examples of the social theory at work show that commercial banks are not very effective or evenhanded in discerning risk. They are biased toward groups from which their customer base has traditionally been drawn. They accept certain cultural givens, such as the notion that the elite are more likely to pay money back to the bank. Having done all this, they fail to recognize their own biases, insisting that their risk control techniques are objective and scientific. As a result, they fail to offer disadvantaged borrowers the same sort of embedded relationships that allow more conventional businesses to flourish. Appropriate government policies, along with idealistic and ambitious individuals, might alleviate this problem.

POLICY IMPLICATIONS OF COMMODIFICATION

What are the policy implications of the marketization of finance, in light of the skeptical interpretation of banks' role offered above? Is marketization a development to be encouraged? Clearly, some of the most important implications of the sea change in banking are related to governance. Securities owners may be too far removed from the activities of a corporation to prevent insiders from engaging in fraud or managing poorly. The danger of lax governance has been illustrated recently by a string of corporate scandals.

Some would argue just the reverse: they say that investor capitalism, more than banker-dominated capitalism, can potentially support the dynamism and efficiency of firms. These observers assert that this role for investors could be ensured if firms' activities were made visible to outsiders, perhaps by assiduous accountants and regulators. Increased transparency would also help insure that securities were priced correctly, helping to improve efficiency. Well-informed traders could impose discipline on corporate managers by selling shares of poorly performing companies (Rajan and Zingales 2003). It is therefore in the interests of good governance, in this view, to eliminate cozy banker-borrower relationships, which often allow inefficient activities to go unchecked (remember Mazda-Sumitomo).

This argument about governance depends upon the risk assessment abilities and other knowledge of securities holders. But Keynes, in chapter 12 of the *General Theory*, showed that securities pricing is not rational. Investors never operate with full knowledge of the prospects of a company or how it should be managed. Empirical evidence of this fact is provided by the wide swings in stock values that take place in very short periods of time. If one could somehow calculate the "correct" value of a stock, it would not be as volatile as market prices. The technology stock boom of the 1990s is just one example. If investors lack the information to price stocks rationally, it is hard to see how they can ensure proper management, even with adequate accounting standards. In comparison, bankers have a wealth of information at their disposal and are not as skittish as securities holders, partly because their investments are illiquid.

The social theory of risk provides support for the Keynesian argument. Douglas believed that scientific measures of risk are often as unreliable as those of traditional societies and might have been skeptical of the ability of a particular new form of finance to solve the problem once and for all. Both Keynes and Douglas argued that the perception of risk was based largely upon convention and mass psychology, as well as the bias of the perceiver. The degree of risk of a future project is in principle unknowable. Whether through a securities market or a commercial banking system, risk is always dealt with through social means. No particular forms of finance, in the abstract, can claim any special ability to solve the problem of risk, or of governance.

This casts doubt on a second purported benefit of securities finance: the notion that competitive securities markets somehow democratize the allocation of capital. Proponents of this view often cite cases such as the Grameen bank (Rajan and Zingales 2003, 4), but as we

have seen, institutions of that type rely on many of the strategies used by relationship bankers, rather than the arm's-length relationships touted by these proponents.

Some authors have argued that individual investors are more willing to take risks on innovative ideas and upstart entrepreneurs than are traditional banks. Banks often make decisions by consensus and have a great stake in maintaining their reputations; therefore, according to some, they are biased toward established, conventional projects. But it is interesting to note that the supporters of securities-based finance use examples such as that of a Stanford Business School graduate wanting to start a new business (Rajan and Zingales, 2003, 5). It is only in a highly idealized, and probably unattainable, financial system that ordinary individuals could issue bonds. (The only possible exception is the venture capital market, which has recently shown its limitations. It does not operate on principles of perfect competition.)

One rather radical solution to the governance and access problems associated with marketized lending would be to enhance the relationship of firms with their workers as a replacement for their dealings with bankers, by allowing workers to carry a dual role as investors. This approach would offer the same kind of checks and balances, long-term perspective, and intimate relationship and would introduce the views of individuals from working-class backgrounds. Workers may be the only group to know more about a firm than its bankers. As owners, they have a vested interest in a firm's success and would have an interest in preventing wasteful or greedy behavior by managers. (Of course, ownership must be accompanied by control; if workers are mere passive investors, they will have no impact on governance.) Workers, like traditional banks, would not dump their investment based upon their animal spirits. They might be willing and able to help see a firm through hard times because they are rooted in their companies and share a stake in their long-run success. An ongoing process of worker involvement, much like bank involvement, could go beyond the provision of finance to an improvement in governance.

Finding ways to give workers equity interests in firms would provide more financial stability. Greider (2003) has described some successful company turnarounds executed with the help of capital from union and other pension funds. In a similar vein, the reach and financial footing of community development banks could be enlarged; such institutions tend to take a long view of investment decisions. This approach would aid effective governance without simply moving backward to a world in which traditional bankers, with their hidebound traditions, held enormous economic power.

What worker ownership and bank capitalism have in common is the use of "voice" rather than "exit" as a means of control (Hirschman 1970). Securities holders who believe that a firm is poorly managed can exit (or threaten to exit) by selling their positions. But insiders such as workers, who cannot readily exit, can provide input through the use of "voice" in decision-making. Much as in a marriage, many problems can be solved short of the threat of separation. This is in fact one of the chief benefits of marriage. A marriage partner may be good or bad *ex ante*, but he or she may become a better partner if conditions within the relationship are favorable to constructive and honest discussion. The quality of a partner is endogenous to the relationship.

Another implication of securitization involves Community Reinvestment Act regulations, which require that all banks set aside some of their loans and investments for underserved groups and areas (Thomas 2002). Potentially, these rules go beyond governance to allow people from diverse backgrounds to start their own firms. Studies show that these laws have been somewhat successful, but they are subject to certain types of bank evasion.

One such form of circumvention is to meet the letter of the law by investing in securities, CDs, and mutual fund shares backed by certain forms of loans to disadvantaged firms and consumers, rather than by directly lending. Often these instruments are bought and sold several times in order to gain multiple credits for the same underlying investment (Thomas 2002, 14). Unfortunately, this type of investment deprives the borrower of the type of ongoing relationship with a major lending bank that is such a key to obtaining additional services, as bankers lose interest in minority firms once they have met their legal requirements. Moreover, some of the investments recently acquired by major banks fall on the borderline between "subprime" and "predatory" loans. The latter involve unfair terms and are sometimes granted with the anticipation that the borrower will default. The lender has no stake in the success of the borrower, since failure is anticipated from the beginning. Surely, no lender and borrower who enjoyed a good personal relationship would enter into such loan contracts. The law should probably changed at the next opportunity to encourage more conventional loans that may create the kind of social connections needed by minority- and women-owned businesses. This argument illustrates that the type of relationship that exists between a banker and its customer may reflect economic power. Disempowered people may find it difficult to form beneficial relationships. Good policy should be aimed at compensating for inequalities of power.

A final area of policy concern is the effect of marketization on macroeconomic policy. Some economists believe that central banks' control of the supply of bank reserves is less potent as a policy instrument than it was when bank borrowing was a more dominant form of finance. Banks are required to hold reserves in proportion to certain types of liabilities, such as checking accounts, which they need in order to fund their lending activities. Thus, the theory goes, the central bank can constrain the volume of bank lending by trading government bonds for reserves.

But, the argument goes, no reserves are needed when a firm finances itself by selling a bond to some type of investor other than a bank. Nonbank investors, such as insurance companies and mutual funds, can purchase as many bonds as they would like without holding any reserves. So, the central bank may lack any tool with which to control an economy that is growing too rapidly on the foundation of borrowed money, or to cool an overheated market for some form of asset.

This line of reasoning has led many observers to call for "asset-based reserve requirements" that would apply to any institution holding bonds (Palley 2003; D'Arista 2002). But the problem these measures would purportedly address is not new, and the proffered remedies might not be strong enough to solve the problem.

First of all, it is now recognized by many economists of different stripes that central banks have little discretion in supplying reserves to the banking system (Le Bourva 1992 [1958]; Moore 1988; Wray 1990, 1998). Banks purchase only enough reserves to satisfy regulations and to meet unexpected needs. If the Fed attempts to increase the amount of reserves in existence, it will merely drive the federal funds rate downward very rapidly. It does not do this, because it usually operates with a nonzero interest rate target.

So, even in the old days, when commercial banking was much more important than it is today, control of the monetary stock was beyond the reach of central banks. In that respect, the newer emerging forms of finance will not present any new problems. What offers more of a policy challenge is that ties between lender and borrower are weaker now than in the past. Davidson (2002, 10, 181) points out that securities markets, being "liquid," have both advantages and disadvantages over other forms of finance. A person is more willing to lend his or her savings at a low price if he or she can potentially get the money back in short order. But liquid markets are unstable for exactly the same reason: the ability to buy and sell securities rapidly opens the door to destabilizing speculation.

This analysis of the distinctive virtues of liquid markets does not fully apply to banks (Bossone 2002). They are able to "transform" illiquid assets (loan contracts) into liquid instruments, such as transactions accounts. The bank itself is certainly committed to holding its more illiquid assets for an extended period of time, but depositors can withdraw their funds at any time. Thus, commercial banks do not seem to suffer a disadvantage compared to bondholders, at least as far as providing lenders with liquidity is concerned.

Some observers have proposed that central banks reduce the liquidity of financial markets by imposing small ad valorem taxes on sales of securities. Davidson (2002, 200–212) has argued that such "transactions taxes" would be ineffective, because they would not be large enough to outweigh the perceived gains from speculation. Another area of concern would be that even if day-to-day volatility were reduced by such a tax, longer-term changes in returns would continue. As long as such fluctuations take place, investors will attempt to profit from the movements of interest rates, amplifying those movements in the process.

A bolder policy action might reduce the problems associated with speculation in liquid assets. The Federal Reserve could actually engage in purchases and sales of a wider variety of assets than it does currently, including long-term government bonds and conceivably even private securities. It would then be able to peg the values of some classes of assets, rather than merely discouraging short-term speculation. In this way, the economy would enjoy the benefits of securitization while maintaining some stability (preventing crashes) in the financial sector. Perhaps more firms would have access to capital, and the potential for financial crisis would be lessened.

CONCLUSION

A sea change has taken place in how firms and homebuyers obtain finance. Some have argued that the old system, in which people knew the bankers intimately, was functional because it allowed lenders to have a peak at inside information as to the viability and legitimacy of a project. Others argue that it is the new system that achieves the greatest efficiency and should therefore be promoted by policy. The thrust of this paper is that both forms of finance can be either functional or dysfunctional (especially in their handling of risk) and the means exist to make them more functional. In the current system or in any conceivable reformed system, social relations will form the basis for both types of finance. Rather than attempting to dismantle

“relationship finance” in the name of some utopian system free of social influences, efforts should be made to make both forms of finance more stable and democratic.

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