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The Next Step to Financial Recovery: Re-regulation

President Obama got an earful from other world leaders, especially European leaders, during the recent economic summit in London. Those leaders deflected Obama's push for them to spend more stimulating their own and the world economy. Instead these world leaders insisted that the primary problem was private financial institutions, especially American financial institutions, run amok and the need to control and regulate them.

That is hard for Obama to do right now because his policy is to try to develop a public-private partnership with the very companies, like insurance giant AIG, whose shenanigans have brought the world economy to its knees. While seeking Wall Street's cooperation, Obama cannot be too harsh or threatening.

But sometime soon we have to step away from just propping up the "too big to fail" banks, investment firms, and insurance companies whose excesses did us all in and ask what went wrong and what has to change.

The problem is not that investors, in pursuit of higher returns, took on higher and higher risks that finally went bust. Some investors will always be doing that. The wildcat oil companies carrying out the initial exploration of new areas or the gold miners who raise capital to support the search for a new mother lode are historical examples of such risk-taking in the pursuit of high returns. The crazy dot-com investments of the late 1990s were another. But the risks associated with those ventures were clear to all

concerned and the failure of those risky enterprises did not threaten anyone but the principals involved.

The concern with the current financial melt-down is that it has carried the American and world economies with it, threatening businesses and their workers who had nothing to do with the wild risk-taking.

After our last great financial collapse, the Great Depression, we put in place a system of financial regulation that sought to accomplish several things:

First, banks, investment houses, insurance companies and other financial institutions had to maintain sufficient reserves to cover the risks they took on. Either the risks had to be scaled back or the reserves had to be boosted. Private and government auditors regularly scrutinized those financial institutions to evaluate their security and solvency.

Second, the regulations sought to assure full disclosure of the information that was necessary for investors to evaluate the risks associated with various investments. Major efforts went into assuring as much transparency as possible. It became illegal to hide risk, bad news, or developing financial problems.

Third, a variety of controls were put in place to reduce the dangers that the impact of bursting speculative bubbles would spread from one sector to another, bringing the whole financial system down. Investment banks that underwrote corporate investments were separated from retail banks that primarily took in deposits and made loans to local businesses. Retail banks in turn were not allowed to speculate in real estate or the stock market. Similar lines separated insurance companies from other

financial institutions. Limits were also placed on the extent to which stockbrokers could lend money to people to facilitate stock purchases.

None of this sought to prevent people from taking on financial risks on their own. Rather it sought to keep certain types of financial institutions on which we all depend from putting other people's money at risk without their knowledge and keeping the collapse of the inevitable speculative financial bubbles from bringing financial ruin to millions of bystanders.

Beginning in the 1980s and accelerating in the 1990s, as the deregulation craze swept the country, we systematically dismantled the financial regulatory structure that had been in place for half a century, a half-century that, coincidentally or not, was largely free of serious financial panics in the United States.

That push for financial deregulation coincided with a shift in the focus of our financial sector. Our nation was slipping into a post-industrial phase as our manufacturing sectors shrank with American firms shifting their operations overseas while foreign firms built new facilities in the United States. Instead of mobilizing finance to launch new industries, our financial firms turned to buying, selling, and reorganizing existing companies to try to squeeze a higher return or more cash out of them. Financial ingenuity also went into crafting more and more ingenious ways of repackaging existing financial instruments into higher yield securities. The financial sector of the economy exploded in size and wealth, far outstripping the growth in the real economy. The race to find ways of generating higher and higher returns for investors accelerated. Increasing numbers of Americans entered the increasingly accessible financial investment frenzy, also searching for the pot of gold at the end of the rainbow.

Our Presidents and Congress supported that financial boom by removing most limits on the activities in which banks and insurance companies could engage and most controls on the new financial securities that were being created. An unregulated shadow banking industry developed that appeared to offer much higher returns at no higher risk. The mythical something for nothing apparently became real, at least for a short while. We were all going to get rich together.

The naïveté and shared rapacious greed of that frame of mind, in hindsight, is both clear and appalling. The herd mentality that swept up several Congresses and Administrations now is also clear. What is not clear is what we are going to do about it now.