

Economic Prospects

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The collapse at the end of 2007 of the U.S. housing bubble and the speculative market for subprime mortgage loans demonstrates, yet again, the simple point that financial markets should never be allowed to operate without tight regulations. The only thing preventing today's financial markets from experiencing a 1929-style collapse is government bailout operations. These include the Federal Reserve pumping cheap credit into the distressed markets and the federal government expanding the fiscal deficit to inject more spending into the economy.

Yet U.S. politicians—Democrats and Republicans alike—began deregulating the U.S. financial system in the 1970s based on the contention that the regulations devised during the 1930s Depression were not appropriate to contemporary conditions, and that financial markets could operate more effectively in a free-market setting.

The loud chorus of politicians and economists advocating financial deregulation over the past generation have had one point on their side: that the financial system has become infinitely more complex since the 1930s. This is evident from the fact that something that had been as simple as local Savings & Loans making home mortgages in their communities—recall Jimmy Stewart in *It's a Wonderful Life*—has now been converted into a speculative global market. But it doesn't follow that, because the old regulations had become outmoded, financial markets should be free to operate unregulated. What we really need is a new regulatory system that, given current

conditions, is capable of promoting both financial market stability and widespread access to affordable credit.

How Did We Get Here?

There are new aspects of this most recent financial crisis relative to the scores of previous crises that have erupted regularly throughout the history of capitalism. The most prominent new feature resulted from something that was supposed to benefit working families—that is, creating opportunities for families with less than stellar credit records to obtain mortgages and buy their own homes. These opportunities for “subprime” borrowers emerged after Wall Street began bundling together thousands of mortgages and treating the bundles as securities that, like stocks and bonds, could trade freely on global financial markets.

The idea behind bundling mortgages into marketable securities is that the local bank or S&L that lends you money to buy a home does not hold onto your loan once you get your money. Rather, they sell the loan to a big financial institution, like the government-sponsored agencies Fannie Mae or Freddie Mac, who, in turn, bundle thousands of individual mortgages into securities. Fannie or Freddie then sell these mortgage-backed securities to banks, hedge funds, and other market players.

When thousands of mortgages are packaged into one security, the dangers of lending to higher-risk subprime borrowers were supposed to decline. This is because, within a large portfolio of mortgages, the losses that lenders would incur from the small share of borrowers who are delinquent or in default would be offset by the much larger proportion of borrowers who are making payments on time.

But the logic here is deeply flawed. Citigroup and Merrill Lynch were two of the biggest global players in this market, holding huge pools of subprime mortgages. But it never followed that the riskiness of their holdings should diminish as a result. In fact, the opposite turns out to have been the case—that the fortunes of most subprime borrowers rose and fell together with the housing market’s boom and bust cycle. The difficulties that borrowers faced of meeting monthly payments were pervasive, not a matter of isolated individual cases. Citigroup and Merrill both experienced unprecedented losses in 2007 as a result.

Unregulated Capitalism Breeds Financial Crises

Particulars aside, there’s an awful lot about the current financial crisis that is familiar. After all, it was only in 2001 that the U.S. stock market crashed, after having been driven during the late 1990s to unprecedented levels of speculative frenzy by the dot.com boom. A global financial crisis emerged in East Asia in 1997-98, and spread rapidly from there. The sure-thing investment then was securities markets in developing countries. The U.S. hedge fund Long Term Capital Management—guided by 3 economics Nobel Laureates specializing in finance on their board of directors—collapsed in that crisis, requiring a \$4 billion bailout from other Wall Street firms to prevent a market meltdown. More generally, Charles Kindleberger’s classic book, *Manias, Panics and Crashes* documents that, from 1725 onward, financial crises have occurred throughout the Western capitalist economies at an average rate of about one every 8.5 years.

The most severe instance of an overwrought financial market leading to an overall economic calamity was the Roaring Twenties, which produced the 1929 Wall Street

crash. This in turn led to a collapse of the U.S. banking system, with the consequent disappearance between 1929–33 of nearly 40 percent of the nation’s banks.

Roosevelt’s New Deal government put in place an extensive system of financial regulations in the United States in this historical context. 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. FDIC 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 & Loans in 1932, and continued to operate through the 1970s. In particular, under the old regulatory regime, mortgage loans in the U.S. could be issued only by Savings & Loans and related institutions. The government regulated the rates S&Ls could charge on mortgages, and the S&Ls were prohibited from holding highly speculative assets in their portfolios.

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 to the present, they have almost always gotten their way. As a result, our now largely unregulated financial markets operate according to their own self-destructive logic.

Taking our current crisis as a case in point, when market players became convinced that subprime mortgage lending had become a much safer bet through “securitizing” these loans, money rapidly flowed into the market. Housing prices rose as a result, seeming to create new wealth out of thin air for homeowners. Loan officers earned handsome commissions from bringing new customers to their banks. These officers did not have to return their commissions two years later when the loans, now held perhaps by a Swiss hedge fund, went sour. Market bulls grew rich while bears seemed out-of-step. For a time, overoptimistic expectations became self-fulfilling.

Rethinking Financial Regulations Today

A major problem over time with the old Glass-Steagall system was that there were large differences in the degree to which, for example, commercial banks, investment banks, stock brokerages, insurance companies, and mortgage lenders were regulated, thereby inviting clever financial engineers to invent ways to exploit these differences. An effective regulatory system today should therefore be guided by a few basic premises that can be applied flexibly but also universally.

One measure for promoting both stability and fairness across financial market segments is a small sales tax on all financial transactions. This tax would raise the costs of speculative trading and therefore discourage the types of excesses that are occurring regularly in financial markets. At the same time, the tax will not discourage investors who intend to hold onto their assets for a longer time period, since, unlike the speculators, they will be trading infrequently.

Another important initiative would be to implement what are called asset-based reserve requirements. These are regulations that require financial institutions to maintain

a supply of cash as a reserve fund in proportion to the other, riskier assets they hold in their portfolios. Such requirements can serve both to discourage financial market investors from holding an excessive amount of risky assets, and as a cash cushion for the investors to draw upon when market downturns occur.

One example of an asset-based reserve requirement already in place is the margin requirements on stocks purchased with borrowed funds. During the stock market bubble of the late 1990s, former Federal Reserve Chair Alan Greenspan acknowledged that he could have dampened the bubble by raising margin requirements, but he refused to take action. A simple proposal would therefore be for current Fed Chair Ben Bernanke to actually make use of this policy tool that is already available to him.

The same policy instrument can also be used to push financial institutions to channel credit to projects that advance social welfare, for example promoting affordable home-ownership. Policymakers could stipulate that, say, at least five percent of banks' loan portfolios should be channeled to low-cost housing. If the banks fail to reach this five-percent quota of loans for low-cost housing, they would then be required to hold this same amount of their total assets in cash.

Many more details obviously need to be worked out. But the basic approach is clear. If financial markets feel entitled to rely on government life supports whenever they face troubles, why shouldn't we invite public controls over the financial system the rest of the time, when these would so emphatically benefit the well-being of the majority?