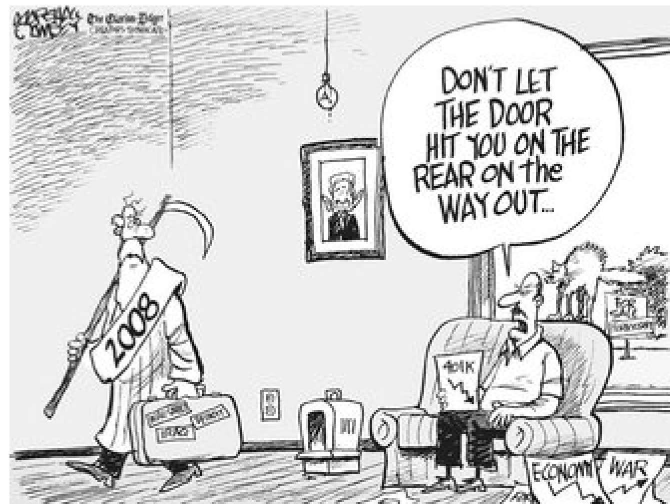
The Washington Times
www.washingtontimes.com

Avoidable Disasters

By Richard W. Rahn
Published December 31, 2008

Many had warned, but few who were in a position to act even tried to avoid the very predictable economic calamities of 2008. This was the year that proved Ronald Reagan's old adage, "The government is not the solution; it is the problem." As we enter the New Year, the question is again, "Will those in charge do what is necessary to avoid the very obvious new economic wrecks coming?"



The U.S. government has now explicitly said there are financial institutions (and other companies - autos, etc.) that are "too big to fail." If that is (arguably) true, then they must be more highly regulated than the smaller institutions, particularly in terms of capital adequacy.

The reason is quite simple. If the government guarantees the debt of big companies, those institutions will have a much lower cost of capital than their smaller competitors, which is not only unfair but will destroy new and smaller companies, thus killing much of the job and productivity creating innovation in the U.S. economy. So far, the Washington governing class has failed to even discuss this disastrous consequence of the bailouts, let alone figure out a solution.

It is now widely understood that the current economic mess was a result of the Federal Reserve (Fed) keeping interest rates too low during the middle of this decade, as even Alan Greenspan now admits. Also, Congress pushed banks into providing mortgages to

people who were insufficiently creditworthy, while at the same time resisting calls to provide more oversight and regulation of the two government-sponsored mortgage giants (Fannie Mae and Freddie Mac).

In addition, the Securities and Exchange Commission chose to take its eye off the ball of rooting out financial fraud and instead imposed very costly, counterproductive and destructive rules on the financial industry, including forcing companies to "expense" stock options and incomprehensible "mark to market" accounting rules.

The economic situation will not appreciably improve without corrective action on the above-mentioned items. In the late 1990s, the Fed implicitly followed the Taylor Rule, a formula developed in 1992 by John Taylor, a former member of the President's Council of Economic Advisers and undersecretary of the U.S. Treasury, that indicated when to increase or decrease interest rates in conducting monetary policy. This resulted in relatively low inflation and strong growth.

The Fed made an exception to the rule in 2000 because of the anticipated Y2K problem, which turned out not to be a problem - but this Fed policy deviation largely caused the 2000-01 recession.

From the Fed's establishment in 1913, its monetary policy has been the primary cause of each recession - and it is now obvious the Fed should be abolished or at least drastically overhauled. In the meantime, the Fed should go back to following the Taylor rule until fundamental monetary reform is implemented, or the United States will almost certainly go back to the boom-bust cycle.

In addition to the Fed's actions, the mortgage meltdown was caused by banks being forced, by regulatory actions and the Community Reinvestment Act (CRA), to make loans to unqualified people; plus irresponsible behavior and undercapitalization at Fannie Mae, Freddie Mac and a number of private financial institutions. For at least a decade, many economists and noted financial experts had warned about the debacle that would occur at Fannie and Freddie. They were ignored by the members of Congress (because all too many of them were on the take - that is, recipients of large political donations from Freddie and Fannie).

The same congressional committee chairmen, Barney Frank in the House and Chris Dodd in the Senate, who failed in their oversight responsibilities, now say they want to "reform" rather than abolish Fannie and Freddie - which will almost certainly result in a repeat of the current disaster. (Nonconflicted experts, such as former Treasury General Council, Peter Wallison, have advocated a phaseout of the two organizations - which is the correct course of action.)

The SEC also needs to be abolished, and the Sarbanes-Oxley bill should be repealed. The SEC has repeatedly failed in its primary mission - investor protection - as has been all too evident in the world record Madoff Ponzi scheme - while at the same time destroying the U.S. Initial Public Offering market, which is the engine of future economic growth.

(Where would the United States be without Intel, Microsoft, Apple, Google, Amazon, etc? Under the new SEC rules, it would have been almost impossible to create these innovative powerhouses.) There are plenty of federal and state laws against financial fraud, which makes the SEC redundant at best.

As for Ponzi schemes - when will Congress address the world's largest Ponzi scheme - Social Security, which it created? Social Security depends on an ever-increasing number of new taxpayers to fund the retirement payments of the ever-growing numbers of the longer-living elderly. The only question is, "In what year will it fail?"

Finally, the new administration and Congress are promising a big increase in federal spending, ignoring the fact that historically when government spending rises as a percentage of gross domestic product, growth falters and vice versa. A major reason growth has been relatively weak during George W. Bush's term is that, unlike Ronald Reagan and Bill Clinton, he allowed (by not using his veto pen) government spending to grow more rapidly than the economy.

Those who want to replicate Herbert Hoover's and Franklin Roosevelt's spending increases will find that if they succeed, they too will replicate a decade without growth.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.

http://www.washingtontimes.com/news/2008/dec/31/avoidable-disasters/

Copyright © 2008 News World Communications, Inc. All rights reserved.