

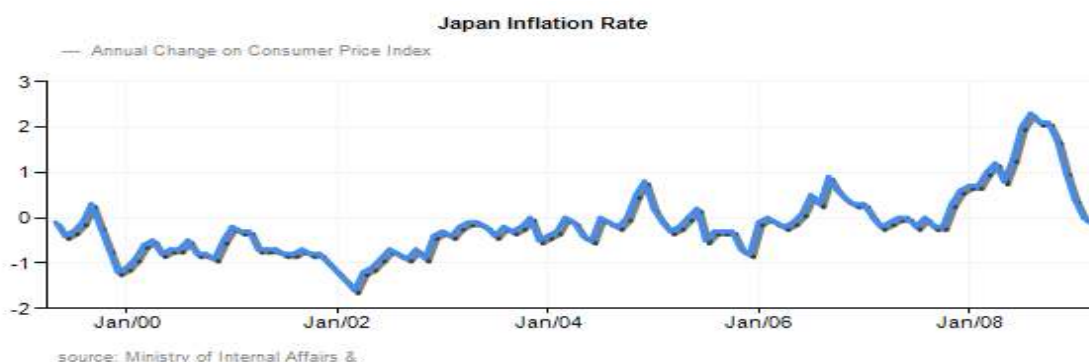
Financial FAQs

A Failure of Capitalism—Part II?

We spoke recently of the possibility of returning to some form of the New Deal economics of Roosevelt and the Great Depression to help us out of this Great Recession. Those were very different times, of course. What made it the Great Depression was the lack of any social safety net at all. It was New Deal legislation that created Social Security, federal deposit insurance, unemployment insurance, and modern bank regulation which gave savers and the unemployed some sense of security. We didn't get Medicare until the 1960s, and even today there is much resistance to universal health coverage.

Part of the problem is highlighted by Professor Robert Shiller in a recent Sunday New York Times Op-ed piece. He said that major recessions in particular mean a wholesale loss of confidence in institutions. And such losses came from too much emphasis on individual self interest as the prime mover of economic activity (rather than on institutions), hence the massive deregulation that was rationalized by an ideology that markets can best regulate themselves.

A more recent example of the effects of such confidence loss is the Japanese deflationary spiral that has now lasted almost twenty years, resulting in a massive devaluation of both income and assets. It was originally caused by real estate and stock market bubbles bursting in the early 1990s. This led to a massive rise in private saving by Japanese citizens, who were afraid to invest their monies in anything other than low yielding, (and more liquid) government securities.

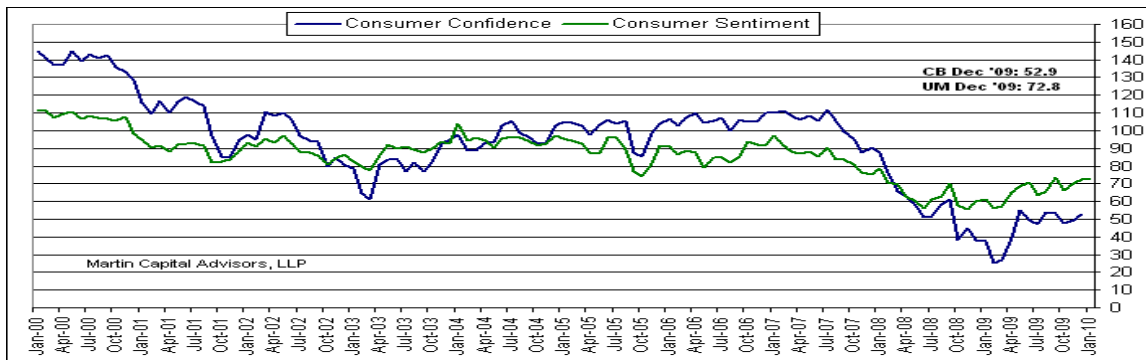


Sound familiar? We highlighted the warning of Nomura Securities' Richard Yoo that such could happen to the U.S. in a recent Barron's article. That is, if government didn't use some of those unused savings to invest in economic activity, then our economic growth could also remain stagnant.

So how to restore faith in institutions outside of ourselves when so many have lost their jobs and savings in this recession, “the most serious crisis in 75 years”, according to former Fed Chairman and Presidential advisor Paul Volcker? It may be a rational choice to save more and pay down one’s debts in such an environment, but an economy can’t grow unless some of those savings are re-invested, as we said. The first step should be restoring faith in the regulatory agencies that allowed the excesses of our financial sector, so that markets remain transparent and the wealthy few aren’t favored.

Paul Volcker himself has been the strongest advocate for again separating commercial from investment banks, similar to the depression-era Glass-Steagall act that was partially repealed in 1999. The core issue is that citizens’ depository savings are federally insured in commercial banks, so commercial banks (as opposed to investment banks, hedge funds, and the like) should be restrained from too risky investments that might endanger those savings. When Glass-Steagall was repealed, banks were able to invest for their own profit, which encouraged more risk taking.

Yet, “Apart from the risks inherent in these activities, they also present virtually insoluble conflicts of interest with customer relationships, conflicts that simply cannot be escaped by an elaboration of so-called Chinese walls between different divisions of an institution”, said Dr. Volcker.



Severe recessions are characterized by a loss of confidence in both government and private institutions. It was the private financial sector that almost failed this time around, after all. And memories of past disasters tend to dim over time.

“I’ve been there—as regulator, as central banker, as commercial bank official and director—for almost 60 years,” said Volcker. “I have observed how memories dim. Individuals change. Institutional and political pressures to “lay off” tough regulation will remain—most notably in the fair weather that inevitably precedes the storm.”

Effective financial reform has a better chance to succeed this time, in part because so many of our private institutions failed—or were proved inadequate to withstand the massive loss of credit, such as mortgage guarantors Freddie Mac and Fannie Mae. This recession has once again shown that we cannot rely solely in individual effort. Strengthening the institutions that support us--whether locally, or nationally, are just as important to maintaining financial health.