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Is Deregulation to Blame?

By Josh Eboch
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Deregulation is a convenient scapegoat in the current economic trouble. But what role did it really play?

While casting about for causes of the U.S. financial crisis during the heat of the presidential election, many in the media and Congress hit upon a theme of rampant deregulation. But is deregulation really to blame?

The American Enterprise Institute hosted a conference in late January of financial experts from across the ideological spectrum headlined by former Senator Phil Gramm (R-Texas), to address not only what caused the current crisis, but also how to prevent the next one. As Gramm said, "He who writes history determines the future. . . . What is perceived by the general public to be the cause of this crisis will have a profound impact on the response of Congress."

Gramm explained his role in crafting two pieces of legislation frequently blamed for the financial crisis: the Gramm-Leach-Bliley Act of 1999 (GLBA) and the Commodity Futures Modernization Act of 2000 (CFMA). According to Gramm, GLBA "doesn't deregulate anything." In fact, the bill "does not have a deregulatory section in it." Instead, it repealed provisions of the Glass-Steagall Act of 1933 that prevented affiliation between commercial and investment banks. Considering the prominent failures and rescues of banks, insurance companies, and securities firms in 2008, GLBA offered a convenient target. Unfortunately for that theory, Gramm said, the regulations in Glass-Steagall were already more like "Swiss cheese" by 1999, and even without GLBA, not one of the investment banks that failed or had to be rescued by the federal government in 2008 would have been in violation of Glass-Steagall anyway.

In 2000, Congress debated CFMA, which was intended to give "legal certainty" to credit default swaps for regulatory purposes. But "nobody had ever heard of credit default swaps," Gramm said. Ultimately, Congress determined that "swaps are not futures," even though it had been suggested by at least one commodities regulator that they were. According to Gramm, credit default swaps were still regulated based on the laws already in place regarding the swaps' "underlying assets," often some derivation of subprime mortgage loans.

Contrary to the media narrative, CFMA enjoyed bipartisan support at the time it was passed and, like GLBA, was signed by President Bill Clinton.

Rather than blame deregulation for the present crisis, Gramm, who retired from public office in 2002 and is a vice chairman of UBS Investment Bank, argued that a major factor was the "politicization of the housing market," for which he himself admitted some responsibility. Gramm said the laws were not faulty, but rather it was the regulators themselves, who "lacked the will to act" to rein in risky lending practices "because they thought the process was safe."

Several of Gramm's claims were supported by members of the panel. Adam S. Posen, deputy director of the Peterson Institute for International Economics, argued that, contrary to popular belief, "there hasn't been that much deregulation in the last few decades." Posen believed the crisis has exposed the flaws of ratings agencies, and he suggested doing away with them altogether (in place of relying on credit rating agencies, he advocates a policy of buyer beware). Posen went on to criticize Fannie Mae and Freddie Mac, saying the collapse of the government-sponsored entities should have been no surprise. "If something is half public and half private, it will cheat and it will fail."

Eswar S. Prasad of Cornell University and the Brookings Institution agreed that much of the current crisis could have been avoided if regulators had simply applied "the rules that are on the books." The rest of the world, according to Prasad, believed in the American financial system and its regulations, and consequently gave the United States "enough [financial] rope to hang itself" when those regulations were flouted for the sake of political and financial expediency.

AEI's Allan H. Meltzer and Peter J. Wallison offered several suggestions going forward and sounded a few notes of caution. Meltzer pointed out the importance of allowing prices to find a floor. "When the housing market stops declining," Meltzer said, "we'll sort the system out."

He cautioned against excessive fiscal stimulus. Meltzer recalled a meeting with President Jimmy Carter during the 1976 recession in which Meltzer predicted Carter's stimulus policies would give the economy a "temporary high," leaving Carter to "run for reelection with a lot of inflation"—which is exactly what happened.

In Meltzer's formulation, "capitalism without failure is like religion without sin." You can't have one without the other, and the benefits of capitalism far outweigh the costs.

Wallison was even more pointed in his criticism of the current reactionary sentiment manifested in public calls for increased regulation. He said it would be a mistake to extend to other sectors of the economy "regulation that has so clearly failed when it has been applied to the banking industry." Specifically, Wallison pointed to the "pernicious idea" introduced in a recent report issued by the Group of 30 (an international economic and monetary policy consulting group), that the federal government should increase regulation and federal protection for "systemically significant" companies. "Once you identify a company as systemically significant," Wallison warned, "you are essentially saying it's too big to fail. And what do you get when a company is too big to fail? We already have two; they're called Fannie Mae and Freddie Mac."

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For video, audio, and event information, visit www.aei.org/event1862. Peter J. Wallison addresses the financial crisis and financial regulation in several recent issues of his Financial Services Outlook series. His latest is "Everything You Wanted to Know About Credit Default Swaps – But Were Never Told." Much more on the financial crisis can be found at www.aei.org/financialcrisis.