Mommy! The Government Made Me Do It! (III)

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Version: 1.0.5
Start Date: February 9, 2009
Home URL: http://www.jmcgowan.com/Mommy3.pdf

Economist John B. Taylor blames the government for the financial crisis in a Wall Street Journal editorial and an upcoming book. Here is why he is wrong.

Introduction

In today's *Wall Street Journal* ("How Government Created the Financial Crisis", *Wall Street Journal*, Monday, February 9, 2009, Page A19) noted economist John B. Taylor blames the government for the current financial crisis. Taylor is currently a professor of economics at Stanford University and a senior fellow at the conservative Hoover Institution. The Hoover Institution will soon publish a book by Taylor (*Getting Off Track*: *How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis* according to Taylor's web site) blaming the government for the financial crisis. In blaming the government, Taylor is merely one of many conservative, libertarian, and business sources blaming the fiasco on the government rather than the senior executives of the banks that are in trouble[1,2,3,4,5,6,7,8].

To many, especially on the Left, such claims seem utterly astounding. After all, the Bush Administration was in power for eight years (2001-2009) with a Republican Congress for six years (2001-2007). The Bush Administration was widely seen as a very pro-business, pro-free market, anti-regulation Administration. The Federal Reserve was headed first by Alan Greenspan, a former devotee of free market advocate Ayn Rand and a Reagan Administration appointee, and then by Ben Bernanke, a monetarist. Over the last thirty years a variety of Depression era regulations of the financial industry such as the Glass-Steagall act have been repealed or weakened either by legislation or by regulators. How then could any sane person blame the government?

Blaming the government is nothing new. Conservative, libertarian, and business writers, publications and think tanks (such as the *Wall Street Journal* editorial page) have a long history of blaming the government for economic and financial fiascoes that followed the adoption of public policies initially billed as "free market", "deregulation" or similar terms. Often these policies turn out on close examination to be selective deregulation or changes in regulations that favor certain firms and individuals. Previous examples include the Great Depression, the savings and loan deregulation fiasco of the 1980's, the failure of conservative author George Gilder's high tech investment advice in the 1990's and the California electricity market deregulation fiasco of 2000. (See Appendix A)

Blaming the government for the housing bubble and associated financial crisis is being used to explicitly or implicitly exonerate the leaders of several very large banks that appear to be in severe trouble: Citigroup, Goldman Sachs, Morgan Stanley, and several other major banks. These banks appear to be surviving on over a trillion dollars in government funds from the Federal Reserve under Chairman Bernanke and the US Treasury through the Troubled Assets Relief Program (TARP). TARP has already spent $350 billion of the $700 billion authorized in 2008. It may perhaps not be a coincidence that many TARP recipients are major advertisers in the *Wall Street Journal* (See Appendix B). The Federal Reserve has already committed at least one trillion dollars to support various banks. The blame the government arguments are being used to argue implicitly that the government, ultimately the taxpayer, *owes* the banks an ever growing amount of bailout funds. Despite or more likely because of this huge subsidy, the US and global economy is in a tailspin.

Professor Taylor trots out a laundry list of government scapegoats for bad decisions by major banks (See Appendix C for a list of government scapegoats from all sources). This is also a common pattern in previous blame the government exercises. The government is quite large with numerous programs, laws, and regulations. Essentially any and all government programs, laws, and regulations that have any relationship to the fiasco, however tenuous, may be blamed. A list of several scapegoats makes a comprehensive rebuttal difficult.

The Government Scapegoats

Professor Taylor starts by blaming the single most prominent and common government scapegoat for the housing fiasco: the Federal Reserve and Alan Greenspan. The article attacks the Fed and Greenspan for keeping interest rates low after the 2001 recession, especially from 2003 to 2005, comparing the interest rates unfavorably to the interest rates suggested by his eponymous Taylor rule assuming a policy of targeting inflation at 0-4%.

In other contexts, some conservatives, libertarians, and business sources have blamed the Great Depression specifically on attempting to maintain the gold standard, which is essentially a policy of targeting 0% inflation. If monetary policy is loose during a fiasco, it was too loose and caused the fiasco. If monetary policy was tight during a fiasco, it was too tight and caused the fiasco. The only constant is that the government caused the fiasco and not businesses and business leaders – the latter hidden behind abstract terms like "the private sector" or "the free market".

Loose monetary policy does not force banks or bankers to make bad loans. Nor does it force people to buy overpriced homes in a speculative housing bubble. In fact, banks have a fiduciary responsibility to their stockholders to make sound loans. Even if the federal funds rate is 0%, the banks have an obligation to make loans that will be paid back. If they cannot find appropriate loans, then they should not borrow money even at 0%.

The Federal Reserve is now pursuing extremely loose monetary policy, even looser than in 2001. Yet, housing prices are in free fall. The housing bubble is largely independent of the monetary policy. Loose monetary policy makes it easier for an asset bubble to form, but it is neither a necessary nor a sufficient condition for a bubble. Notably, banks are now explaining their failure to lend TARP funds to strapped businesses and households by citing their fiduciary responsibility to make sound loans. The Federal Reserve did not force banks to make the unsound loans that created the housing bubble.

If the Federal Reserve is guilty of anything, it is guilty of failing to regulate the banks and stop the unsound loans. The Federal Reserve failed either to prevent the housing bubble or deflate it before it turned into a financial disaster.

Taylor pauses briefly to imply the Federal Reserve somehow caused the credit rating agencies to underestimate the risk of mortgage backed securities.

Adjustable-rate, subprime and other mortgages were packed into mortgage-backed securities of great complexity. Rating agencies underestimated the risk of these securities, either because of a lack of competition, poor accountability, or most likely the inherent difficulty in assessing risk due to the complexity.

Of course, the Federal Reserve didn't force anyone to bundle mortgages into complicated mortgage backed securities. The private sector credit rating agencies should not have even issued credit ratings for securities too complicated for their analysts to understand. Banks like Citigroup, hedge funds, and others should have conducted independent evaluations of the accuracy of the credit ratings, since these were exotic new financial instruments and there was no significant historical data on the accuracy of the credit ratings. They should have been wary since the credit rating agencies were paid by the mortgage backed securities issuers to provide the ratings.

Taylor blames the government sponsored enterprises Fannie Mae (the Federal National Mortgage Association or FNMA) and Freddie Mac (the Federal Home Loan Mortgage Corporation) for the failure or near failure of the private banks such as Citigroup, Goldman Sachs, Morgan Stanley, Wachovia, Washington Mutual, Countrywide, and so forth. Fannie Mae and Freddie Mac had no power to *force* the private banks to make bad loans or acquire mortgage-backed securities backed by bad loans. Now, clearly something went wrong at Fannie Mae and Freddie Mac, but we are discussing a financial crisis in the "private sector", meaning "private" banks such as Citigroup that seem to enjoy a special favored relationship with the government.

Conservative, libertarian, and business writers, publications, and think tanks heavily attacked Fannie Mae and Freddie Mac during the housing bubble. One can, for example, find numerous anti Fannie Mae and Freddie Mac editorials in the *Wall Street Journal* over the last eight years. Conservative, libertarian, and business sources have loudly touted this track record with a "we told you so" message.

However, what exactly was the attack on Fannie Mae and Freddie Mac during the housing bubble? Fannie Mae and Freddie Mac were compared unfavorably to the "private sector" and the new financial innovations of mortgage backed securities. At the peak of the bubble, Fannie Mae and Freddie Mac shrank to about 40% of the mortgage market as "private" mortgages prospered. Then, the putative "private sector" tanked. Now, Fannie Mae and Freddie Mac appear to have almost 100% of the market because…yes…Citigroup, Morgan Stanley, Goldman Sachs, and all the rest – which are not Fannie Mae or Freddie Mac – are in deep trouble or have gone bankrupt.

After blaming the two most common government scapegoats for the financial crisis, the Federal Reserve and Fannie Mae/Freddie Mac, Taylor discusses the federal government's dismal handling of the crisis since 2007, arguing the government prolonged and aggravated the crisis. Here he is on firmer ground. But, one should be clear, the banks as well as conservative, libertarian, and business sources frequently lobbied on behalf of these disastrous policies such as the Troubled Assets Relief Program (TARP) and fawned over Treasury Secretary Paulson's dismal public performance while the general public reacted in dismay. It is the height of *chutzpah* to express shock and dismay at the government for enacting policies that one supported.

The Perils of TARP

Like many conservatives, libertarians, and business people (as well as officials in the Obama Administration such as the new Treasury Secretary Timothy Geithner), Taylor appears to support TARP but is now attributing the apparent failure of TARP I (a $350 billion giveaway to banks followed by an economic collapse) to a "failure to communicate", Secretary Paulson's confused and chaotic public performance. "If only we could communicate our bad policy to the public, it would work." Nonsense.

The Troubled Assets Relief Program (TARP) and its irresponsible promotion by politicians and business leaders probably transformed a serious banking crisis into a global economic meltdown. Sadly, the government is continuing TARP, has floated the idea of a "bad bank" that would substantially expand TARP, and is suggesting other expansions of TARP.

TARP and the Federal Reserve's massive covert bailout of incompetent Wall Street firms divert trillions of dollars from productive sectors of the economy to demonstrably incompetent organizations.

To the extent that sound banks have been forced to accept TARP funds, as has been reported in the press, TARP spreads the stigma of incompetence to banks that exercised prudent judgment and further undermines the financial system and the economy.

TARP has caused a national panic and undermined confidence in the financial system, the economy, and the federal government, especially the US Treasury and the Federal Reserve. Please note that I do not equate the major TARP recipients such as Citigroup, Goldman Sachs, Morgan Stanley and others with the financial system. The financial system includes thousands of banks, many of which exercised better judgment than the TARP recipients.

TARP provides funds for the TARP recipients to take over banks and other financial institutions that exercised sound judgment, lay off bank and financial executives who have exercised sound judgment, and otherwise increase the power of people who either do not know what they are doing or are deliberately destroying the US and global economy.

Foreign creditors and potential creditors such as China, if they have any sense, can only be alarmed by the US policy of rewarding gross incompetence represented by TARP and most of the Federal Reserve's programs to date. This can only contribute to a catastrophic crash of the dollar and US bonds in the near future.

TARP has been justified by the claim that removing so called "toxic assets" from the TARP recipients' balance sheets will bring private capital back into these banks from some unidentified source. Banking is a service industry. The problem with the TARP recipients is not just the toxic assets but the toxic asset managers who purchased the assets. So long as these toxic asset managers remain in place no private investor or foreign government *in their right mind* would invest in these banks.

Computers are now so powerful that the substantive financial transactions of the entire US population (300 million), perhaps one trillion transactions per year (10 transactions per day X 365 days X 300 million Americans), can be handled by at most a room full of high end computers costing at most a few million dollars. In fact, in principle, a single laptop with a large hard disk has the computing power, memory, and disk space to handle this volume of financial transactions. DVD video playback, something easily handled today, has similar computational requirements and uses sophisticated mathematics that actually works unlike the dubious financial models used on Wall Street. There are various technical reasons such as handling the peak transaction load that a single laptop probably could not run the financial system; a room full of computers would probably be required in reality. There is no excuse for a "financial system" (the TARP recipients) that costs trillions of dollars of public money to keep operating.

Is the Government Blameless?

Of course not. Professor Taylor's article should be titled "How Government Contributed to the Financial Crisis". Contributed is not the same as created. Loose monetary policy contributed to the housing bubble. Selective deregulation and the failure to develop and adopt prudent new regulations for the mortgage-backed securities and other "innovations" undoubtedly played a major role. Something clearly went wrong at Fannie Mae and Freddie Mac. The implicit "too big to fail" doctrine evidenced in the Long-Term Capital Markets bailout and in TARP and current Federal Reserve actions is almost certainly a major contributor to the crisis. But, bottom line, the banks and bank executives made appalling bad decisions. The "private sector", which really means a large chunk of the private sector such as Citigroup and Goldman Sachs with good political connections, screwed up. As in the past, American business is talking tough, dropping the ball, and passing the buck.

Conclusion

In the current financial crisis, the US and indeed the world is confronted with a small group of very large and very powerful banks such as Citigroup, Goldman Sachs, Morgan Stanley, and a few others. These mega-banks have been protected by a series of ad hoc interventions such as the Long-Term Capital Markets bailout during the Clinton Administration, culminating in the recent Wall Street bailout, coupled with selective deregulation of the banking industry[9].

These banks have extensive political connections in both major parties, Republican and Democratic, and in both liberal and conservative political circles. This is epitomized by the spectacle of Robert Rubin of Goldman Sachs as Treasury Secretary in the Clinton Administration followed by Henry Paulson, also of Goldman Sachs, as Treasury Secretary in the Bush Administration. Both political parties ignored public outrage to pass the failed TARP act. Despite this public outrage, both Senator McCain and Senator Obama voted for TARP. As of this writing, it appears that President Obama will continue and expand TARP despite the dismal results.

The paradox is that massive government intervention on behalf of a few politically favored banks is being promoted through selective use of "free market" rhetoric and blame the government excuses such as those in Taylor's article. Blame the government claims are being used to argue that the government *owes* the banks the bailout funds. Simultaneously, "free market" arguments are used against government oversight of the now government funded banks, executive compensation limits, or any other restrictions or reforms of the banks (such as firing the Boards of Directors and senior executives).

In addition, the debate is framed (as in Taylor's *Wall Street Journal* article) by equating this small circle of mega-banks with the US financial system and the "free market", ignoring smaller banks and institutions not involved in the housing bubble or dubious mortgage backed securities. Sadly, as "free market" and "blame the government" arguments are discredited, this small circle of mega-banks may switch seamlessly to selective "pro-government" and "pro-regulation" arguments to advance the same flawed and dangerous policies.

The cost of these policies is already very high, running over $1.3 trillion to date (over $4,000 per US citizen). Officials are proposing an even larger bank bailout through the proposed "bad bank". Remarkably, in this era of cheap super-fast computers that supposedly enhance productivity *especially in finance*, almost no one questions a computerized financial system that costs trillions of dollars to keep operating.

These policies reward and increase the already vast power of a small group of men who have proven grossly incompetent and have no significant experience in agriculture, mining, manufacturing, research and development, or other substantive economic activities essential to human life and future economic growth. Most people -- Republican or Democrat, liberal or conservative, rich or poor, purple or polka-dot – are losing money due to these policies. An increasing number are losing their jobs, homes, and savings.

Most worrying, these policies risk recreating the dire social and economic conditions of the Great Depression that led to World War II. This nightmare scenario would require a combination of a negative bubble in housing and other assets and a precipitous poorly managed crash in the dollar, which is almost certain to fall in the future. World

War III would be fought with far more destructive weapons than World War II.

In the current crisis, American business is talking tough, dropping the ball, and passing the buck. It is time to actually be tough, pick up the ball, and take responsibility[10].

Appendix A: A Short History of Blaming the Government

Blaming the government is nothing new. Conservative, libertarian, and business writers, publications and think tanks (such as the *Wall Street Journal* editorial page) have a long history of blaming the government for economic and financial fiascoes that followed the adoption of public policies initially billed as "free market" or "deregulation". Previous examples include the Great Depression, the savings and loan deregulation fiasco of the 1980's, the failure of conservative author George Gilder's high tech investment advice in the 1990's and the California electricity market deregulation fiasco of 2000.

The Great Depression

Several different government scapegoats have been blamed for the Great Depression: allegedly tight monetary policy by the Federal Reserve (famously by Milton Friedman), the Smoot-Hawley tariff, various taxes under Hoover and Coolidge, and the New Deal government programs.

To quote a noted expert on the Great Depression:

However, in 1963, Milton Friedman and Anna J. Schwartz transformed the debate about the Great Depression. That year saw the publication of their now-classic book, A Monetary History of the United States, 1867-1960*. The* Monetary History*, the name by which the book is instantly recognized by any macroeconomist, examined in great detail the relationship between changes in the national money stock--whether determined by conscious policy or by more impersonal forces such as changes in the banking system--and changes in national income and prices. The broader objective of the book was to understand how monetary forces had influenced the U.S. economy over a nearly a century. In the process of pursuing this general objective, however, Friedman and Schwartz offered important new* *evidence and arguments about the role of monetary factors in the Great Depression. In contradiction to the prevalent view of the time, that money and monetary policy played at most a purely passive role in the Depression, Friedman and Schwartz argued that "the [economic] contraction is in fact a tragic testimonial to the importance of monetary forces" (Friedman and Schwartz, 1963, p. 300).*

To support their view that monetary forces caused the Great Depression, Friedman and Schwartz revisited the historical record and identified a series of errors--errors of both commission and omission--made by the Federal Reserve in the late 1920s and early 1930s. According to Friedman and Schwartz, each of these policy mistakes led to an undesirable tightening of monetary policy, as reflected in sharp declines in the money supply. Drawing on their historical evidence about the effects of money on the economy, Friedman and Schwartz argued that the declines in the money stock generated by Fed actions--or inactions--could account for the drops in prices and output that subsequently occurred.[11]

It is worth noting that the Keynesian interpretation of the Great Depression is the exact opposite. The Keynesian theory is that expansionary monetary policy was tried and failed due to a liquidity trap in which businesses and households refused to borrow even at very low interest rates and saved, rather than spent, any extra funds.

Monetary policy is only one of several government scapegoats for the Great Depression. The Smoot-Hawley tariff is probably the second most popular scapegoat. Here is a recent restatement of the Smoot-Hawley excuse:

The prevailing view in many quarters is that the stock market crash of 1929 was a failure of the free market that led to massive unemployment in the 1930s-- and that it was intervention of Roosevelt's New Deal policies that rescued the economy.

It is such a good story that it seems a pity to spoil it with facts. Yet there is something to be said for not repeating the catastrophes of the past.

Let's start at square one, with the stock market crash in October 1929. Was this what led to massive unemployment?

Official government statistics suggest otherwise. So do new statistics on unemployment by two current scholars, Richard Vedder and Lowell Gallaway, in their book "Out of Work."

The Vedder and Gallaway statistics allow us to follow unemployment month by month. They put the unemployment rate at 5 percent in November 1929, a month after the stock market crash. It hit 9 percent in December-- but then began a generally downward trend, subsiding to 6.3 percent in June 1930.

That was when the Smoot-Hawley tariffs were passed, against the advice of economists across the country, who warned of dire consequences.

Five months after the Smoot-Hawley tariffs, the unemployment rate hit double digits for the first time in the 1930s.

This was more than a year after the stock market crash. Moreover, the unemployment rate rose to even higher levels under both Presidents Herbert Hoover and Franklin D. Roosevelt, both of whom intervened in the economy on an unprecedented scale.[12]

It is worth noting that foreign trade constituted about seven percent (7%) of the total US economy at this time. It is debatable whether shrinking foreign trade whether due to Smoot-Hawley or the widening global slowdown accounts for the Great Depression.

Various tax increases under Presidents Coolidge, Hoover, and Roosevelt have been blamed at times for the Great Depression. This is one of the less common government scapegoats. An example may be found in the Cato Institute Tax & Budget Bulletin No. 23, dated September 2005, "The Government and the Great Depression" by Chris Edwards, Director of Tax Policy, Cato Institute:

***Tax Hikes**. In the early 1920s, Treasury Secretary Andrew Mellon ushered in an economic boom by championing income tax cuts that reduced the top individual rate from 73 to 25 percent. But the lessons of these successful tax cuts were forgotten as the economy headed downwards after 1929. President Hoover signed into law the Revenue Act of 1932, which was the largest peacetime tax increase in U.S. history. The act increased the top individual tax rate from 25 to 63 percent.*

Of course, an alternative interpretation is that the tax cuts and other policies of the Coolidge and Hoover Administration created a short term boom, a bubble, followed by a catastrophic bust as the hidden costs of the policies became visible.

Remarkably, even the New Deal has frequently been blamed for the Great Depression. A recent example is the book *FDR's Folly: How Roosevelt and His New Deal Prolonged the Great Depression* by Jim Powell (Random House, September 2004). Here is a brief review quote from Milton Friedman:

"Admirers of FDR credit his New Deal with restoring the American economy after the disastrous contraction of 1929—33. Truth to tell–as Powell demonstrates without a shadow of a doubt–the New Deal hampered recovery from the contraction, prolonged and added to unemployment, and set the stage for ever more intrusive and costly government. Powell's analysis is thoroughly documented, relying on an impressive variety of popular and academic literature both contemporary and historical." – ***Milton Friedman****, Nobel Laureate, Hoover Institution*

Another recent book with a similar theme is *New Deal or Raw Deal?: How FDR's Economic Legacy Has Damaged America* by Burton W. Folsom Jr. Here is a brief reviews:

"History books and politicians in both parties sing the praises for Franklin Delano Roosevelt's presidency and its measures to get America out of the Great Depression. What goes unappreciated is the fact that many of those measures exacerbated and extended the economic downturn of the 1930s. New Deal or Raw Deal? *is a careful documentation and analysis of those measures that allows us to reach only one conclusion: While President Roosevelt was a great man in some respects, his economic policy was a disaster. What's worse is that public ignorance of those policy failures has lent support for similar policies in later years. Professor Burt Folsom has produced a highly readable book and has done a yeoman's job in exposing the New Deal."-- Walter E. Williams, John M. Olin Distinguished Professor of Economics, George Mason University*

Another popular source of claims that the government caused the Great Depression is Alan Reynolds article "What Do We Know About the Great Crash" in the November 9, 1979 of the conservative *National Review*.

The New Deal is quite complex with its notorious alphabet soup of agencies and programs. In addition, the New Deal changed direction several times. Although most people don't realize this, the New Deal featured extremely pro-business programs such as the National Recovery Administration (NRA) headed by financier Bernard Baruch in its first few years. The New Deal shifted to the left in 1934 when faced with a revolt by Louisiana Senator Huey P. Long and other earlier supporters who threatened to organize a third party.

The Savings and Loan Fiasco of the 1980's

In the 1980s, the US Savings and Loan industry was "deregulated" with disastrous consequences. This is a case where the putative "deregulation" was, in fact, selective deregulation. After the collapse of most of the savings and loan industry, costing billions, conservative, libertarian, and business sources blamed the government, even citing the fiasco to argue for further "deregulation".

A clear example of this is "Lessons from the Savings and Loan Debacle: The Case for Further Financial Deregulation" by Catherine England (Regulation: The Cato Review of Business & Government, Summer 1992, The Cato Institute). Here is an excerpt:

An April 28, 1992, Washington Post editorial warned, "Over the past decade the country has learned a lot about the limits to deregulation." The savings and loan crisis was, of course, one exhibit called forth: "Deregulation also has its price, as the savings and loan disaster has hideously demonstrated. Deregulation, combined with the Reagan administration's egregious failure to enforce the remaining rules, led to the gigantic costs of cleaning up the failed S&Ls."

Such editorials demonstrate that the S&L fiasco continues to be misdiagnosed. Unfortunately, this misdiagnosis is being applied by many to the ailing banking industry, and there are those who would introduce the S&L cancer into the insurance market and compound that industry's problems. In the absence of more careful attention to the roots of the S&Ls' problems, taxpayers may face further financial industry bailouts.

The S&Ls' experience yields three important lessons. First, excessive regulation was the initial cause of the industry's problems. Second, federal deposit insurance was ultimately responsible for the high costs *of the debacle. Finally, government-sponsored efforts to protect the industry only invited abuses and increased the ultimate cost of restructuring.*

The savings and loan deregulation was a selective deregulation in which price controls, limits on risky investments such as junk bonds, and other precautions from the Depression era were eliminated while government guarantees through the Federal Savings and Loan Insurance Corporation (FSLIC) were increased. This is, of course, the problem with partial or selective deregulation. Prudent regulations form an interacting network of components like a mechanical clock or similar complex system. Experiences like the S&L fiasco show over and over again that removing some of the regulations can break the system and create disastrous problems. Conservatives, libertarians, and business people routinely promote the idea that deregulation is a simple linear scale where less regulation is always better, *until* the fiasco unfolds. Then, they use the fiasco to argue for further policies labeled as "deregulation", pointing out the selective or partial nature of the "deregulation" that failed.

George Gilder's Investment Advice

During the 1990's conservative author and supply-side economics advocate George Gilder became a prominent high technology stock investment adviser, publisher of the stock market advice newsletter *Gilder Technology Report* and a book *Telecosm*[13]. In particular, Gilder promoted investments in the telecommunications industry such as Global Crossing, one of his famous bad stock picks. Most people who followed Gilder's investment advice, including apparently Gilder, did quite poorly in the long run[14].

When the Internet and telecom stocks and businesses crashed, Gilder blamed the government, most notably in a *Wall Street Journal* commentary published on August 6, 2001 titled "Tumbling into the Telechasm". Here is a brief excerpt.

The Bush economy, unfortunately, not only possesses no such immunity to bad policy, but also is gravely vulnerable to policy mistakes accumulating by the end of the Clinton term. A high-tech depression is under way, driven by a long siege of deflationary monetary policy and obtuse regulation that has shriveled hundreds of *debt-laden telecom companies and brought Internet expansion to a halt.*

In a nutshell, the Federal Reserve and government regulation caused Gilder's stock picks to go bad. Significantly, Gilder blames deflationary monetary policy. Alan Greenspan and the Fed are now being accused of creating the housing bubble with too loose monetary policy in the wake of the Internet and telecom crash. The only constant is that it is the Federal Reserve, the government's, fault and not business leaders.

There were significant technical problems with Gilder's technology investment advice. He also largely ignored the impact of regulations until his stock picks went bad. Gilder frequently promoted a vision of digital video direct into homes, a vision that is now coming true. It is important to understand that in the 1990's, DSL was not widely available and DSL could only achieve bandwidths of around 384 Kilobits per second to most homes. Laying fiber optic cables into homes would have been extremely difficult and costly. DSL bypasses the need to lay fiber optic cables because DSL uses the existing copper telephone wires. Prior to 2003, usable digital video such as the basic MPEG-1 video compression used in Video CD's and similar 1990's era video systems required one megabit per second. The new MPEG-4 and similar video compression algorithms can achieve almost DVD quality video at bit rates of 275 Kilobits per second, within basic DSL rates. These technical problems do not even begin to address the issue of how to make money from digital video to the home, so-called "video monetization". YouTube, after all, is currently free.

The California Electricity Market Deregulation Fiasco of 2000

In the late 1990's, California "deregulated" its electricity market. The "deregulation" was promoted by conservative, libertarian, and business groups to increase competition and *lower electricity rates*. The putative deregulation culminated in a fiasco with shortages and blackouts in 2000 and sharp increases in electricity rates. This is one of the most notorious failures of ostensible deregulation in recent years. A similar deregulatory fiasco has occurred more recently in Texas[15].

Conservative, libertarian, and business sources blamed the government. Here is an example from Walter Williams May 23, 2001 syndicated article "Orchestrating Energy Disaster":

ONE needn't be a rocket scientist to create California's energy problems. According to the California Energy Commission, from 1996 to 1999 electricity demand, stimulated by a booming economy, grew by 12 percent while supply grew by less than 2 percent.

Here's how California created its supply crunch. It takes two years to build a power plant in business-friendly states but four years in California. Sunlaw Energy Company wants to build a $256 million natural-gas-fired plant in Los Angeles; community activists are stopping it. San Francisco activists killed a proposal to float an electricity-producing barge in the bay, even as the city faced blackouts. Computer software giant Cisco Systems has led the charge against a proposed Silicon Valley power plant.

Conservative, libertarian, and business sources blamed surviving price controls and environmental regulations and environmentalists. The fiasco was cited as evidence for additional policies labeled as "deregulation".

Curiously, although California's electricity market had been regulated for decades and activists had been protesting power plants for decades, actual major shortages only occurred after "deregulation" was enacted.

It is also worth noting that the initial argument for deregulation was that increased competition in the wholesale electricity market would lower costs for the electricity suppliers. Thus, there would be no need to deregulate retail prices, since wholesale costs would drop due to the miracle of the market. In regulated electricity systems, the utilities usually have their own proprietary electric power plant which, for example, is supposed to protect them from someone cornering the "free" wholesale electricity market. The electricity deregulation in California forced utilities to divest their electric power plants. Regulations are often a system of regulations that work together as in electricity markets, so that removing one regulation can have catastrophic consequences.

Concluding Comments

Conservative, libertarian, and business writers, publications, and think tanks have a long history of blaming the government for economic and financial fiascoes that follow the adoption of policies initially promoted as "deregulation", "free market", or similar terms. Many more examples may be found and detailed with further research (left as an exercise to the reader). Not infrequently the fiasco will actually be cited as evidence for further policies promoted as "deregulation".

It is important to distinguish "true deregulation" from policies labeled as "deregulation," "free market" or something similar. As in some of the examples above, many policies labeled as "deregulation" turn out on close examination to be selective deregulation or even simply changes in regulation that favor certain individuals, companies, or groups. Before the fiasco, conservative, libertarian, and business groups often ignore this, embrace the policies, and tout them. Once the fiasco unfolds, they back away shrieking "it is the government's fault!" and "it wasn't true deregulation!".

Many historical examples do not answer the question whether "true deregulation" would work as conservative, libertarian, and business sources claim. They do show, over and over again, that policies promoted as "deregulation" or "free market" can be much worse than existing regulations. *Selective deregulation* can be much worse than prudent regulation.

Often policies promoted as "deregulation" or "free market" do not benefit most people, even most business or wealthy people. For example, many businesses in California embraced the electricity market deregulation in the belief that it would lower their corporate electricity bills. Didn't happen. Many conservative, libertarian, and business people lost significant amounts of money following George Gilder's free-market tinged investment advice.

The clear lesson is to beware policies (or investments) promoted as "deregulation" or "free market". Examine the fine print closely and skeptically.

The government is vast with many agencies, departments, laws, regulations, and programs. In a given situation or fiasco, there are often many laws, regulations, policies, and programs that have some relationship to the situation or fiasco. Thus, it is often possible to cite a long list of government scapegoats. Blame the government excuses are difficult to comprehensively rebut for this reason.

Blame the government excuses substitute an abstract concept – "the free market" or "the private sector" – for individual businesses or groups of businesses that may have made substantial mistakes or even engaged in deliberate misconduct. Blame the government excuses enable individual business leaders to escape personal or professional responsibility for their decisions.

Appendix B: TARP Recipient Advertising in Wall Street Journal

Curiously, despite its' frequently stated free market principles the *Wall Street Journal* editorial page is a firm supporter of the Troubled Assets Relief Program (TARP) in which the federal government is spending $700 billion (over $2300 per US citizen) to bailout giant banks.

Maybe here is why:

Over three quarters page advertisement for JPMorgan Chase & Co. asserting that JPMorgan Chase is lending. (seventh in a series).
Wall Street Journal, Thursday, January 29, 2009, page A5

Over three quarters page advertisement for Wells Fargo announcing that Wachovia Securities is now part of Wells Fargo.
Wall Street Journal, Thursday, January 29, 2009, page A11

Over three quarters page advertisement for JPMorgan Chase & Co. on Chase mortgage loan modification program (sixth in a series).
Wall Street Journal, Tuesday, January 27, 2009, page A5

Over three quarters page advertisement for Wells Fargo announcing that Wachovia wealth management is now part of Wells Fargo.
Wall Street Journal, Tuesday, January 27, 2009, page A9

Full page advertisement for Citi CashReturns credit card (Citigroup)
Wall Street Journal, Tuesday, January 27, 2009, page A16

Of course, one can find many more specific examples by reviewing the *Wall Street Journal* issues in recent months.

Appendix C: Government Scapegoats for the Financial Crisis

The list of government scapegoats for the financial crisis cited by conservative, libertarian, and business sources is long and growing. The list (so far) includes:

The Federal Reserve and Alan Greenspan (for keeping interest rates too low during the housing bubble, especially from 2003 to 2005)

Fannie Mae and Freddie Mac (for somehow forcing Citigroup, Goldman Sachs, Morgan Stanley, Washington Mutual, Wachovia, and dozens of private banks to either make bad home loans or purchase mortgage backed securities backed by bad home loans.)

The Community Reinvestment Act (CRA) (for somehow forcing Citigroup, Goldman Sachs, Morgan Stanley, Washington Mutual, Wachovia, and dozens of private banks to either make bad home loans or purchase mortgage backed securities backed by bad home loans.)

The Federal Housing Administration (for lowering the down payment required to qualify for FHA mortgage insurance)

The Housing and Urban Development (HUD) Department (for anti housing discrimination efforts and regulations)

Former New York Attorney General Elliot Spitzer for bringing charges against AIG and Maurice Greenberg. AIG was the major player in the credit default swaps (CDS) that theoretically insured the mortgage backed securities that went bad.

Government regulations requiring mark-to-market accounting which shows or would show many banks are insolvent. Formerly embraced when the market said the banks were doing great.

Regulations requiring that various institutions use credit ratings in bond and other security purchases thus giving a special status to the credit rating agencies that somehow rated bundles of bad mortgages as AAA securities.

US Treasury Secretary Hank Paulson’s dismal handling of the financial crisis.

Stay tuned. More to come.

About the Author

John F. McGowan, Ph.D. is a software developer, research scientist, and consultant. He works primarily in the area of complex algorithms that embody advanced mathematical and logical concepts, including speech recognition and video compression technologies. He has many years of experience developing software in Visual Basic, C++, and many other programming languages and environments. He has a Ph.D. in Physics from the University of Illinois at Urbana-Champaign and a B.S. in Physics from the California Institute of Technology (Caltech). He can be reached at jmcgowan11@earthlink.net.

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