The Silence of the Banks

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Conservative, libertarian, and business commentators, publications, and think tanks increasingly blame the Community Reinvestment Act (CRA) for the housing bubble and financial crisis, implicitly exonerating the leaders of the major banks such as Citigroup that are in trouble. This claim is used to implicitly argue that the government and taxpayers owe the banks trillions of dollars in public assistance. Yet, the major banks were silent from 2001 to 2007 when CRA was supposedly forcing them to make trillions of dollars in bad loans that would bankrupt the banks.

Introduction

Conservative, libertarian, and business sources are increasingly blaming the Community Reinvestment Act (CRA) for the housing bubble and financial crisis. Although the Federal Reserve and Alan Greenspan usually take top billing in the many attempts to blame the government for the crisis, the CRA excuse is likely to grow in importance. Neither the Federal Reserve and Alan Greenspan nor the government sponsored enterprises Fannie Mae (the Federal National Mortgage Association or FNMA) and Freddie Mac (the Federal Home Loan Mortgage Corporation), the other leading government scapegoats, could *force* the ostensibly "private" banks such as Citigroup, Bank of America, Morgan Stanley, Goldman Sachs, Wachovia, Washington Mutual, and so forth to make trillions of dollars in bad loans. CRA, however, is claimed to have had the power to force banks to make bad loans.

Many conservative, libertarian, and business sources blame the financial crisis on the government rather than the senior executives of the banks that are in trouble[1,2,3,4,5,6,7,8,9,10]. To many, especially on the Left, claims that the government caused the financial crisis 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thirty years a variety of Depression era regulations of the financial industry such as the Glass-Steagall act have been repealed or weakened either by legislation or by regulators.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[11]. 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. 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.

At the moment, conservative, libertarian, and business sources cite three major government scapegoats for the housing bubble and financial crisis, with several lesser scapegoats mentioned occasionally (See Appendix B). The big three, cited the most frequently and prominently, are the Federal Reserve and Alan Greenspan (currently number 1), Fannie Mae and Freddie Mac (number 2), and the Community Reinvestment Act or CRA (number 3, but gaining fast). CRA is especially important of the three major government scapegoats in that it is the only one that could plausibly be claimed to have *forced* Citigroup, Bank of America, Morgan Stanley, Goldman Sachs, Wachovia, Washington Mutual, and the other banks to make bad loans or purchase mortgage backed securities backed by bad loans.

Conservative, libertarian, and business sources have heavily blamed the CRA for the housing crisis. According to the current version of the CRA excuse, government regulators used CRA scores to decide whether to approve bank mergers or the opening of new bank branches. The CRA scores were supposedly produced at least in part by community affordable housing groups such as ACORN. Apparently these liberal Democratic affordable housing groups had such influence in the Bush administration during the 2001 to 2007 period of total Republican dominance that they were able to *force* the banks to make trillions of dollars in bad sub-prime loans to poor minority, often black or Hispanic, borrowers. The CRA excuse often emphasizes the supposed ethnicity (black or Hispanic) of the bad loan recipients.

As the crisis has unfolded, conservative, libertarian, and business sources have taken to either claiming or implying that poor minority homeowners caught up in the crisis are irresponsible neer-do-wells who deserve their problems and should lose their homes. Undoubtedly there have been such people involved in the housing bubble. However, one should recall that the housing bubble was promoted as real growth driven by sound fundamentals, not wild speculation.

The adjustable rate loans with their low teaser rates were extremely complicated. How many people understood what they were getting into? How many people even realized that they were signing a loan agreement they didn't understand? Was there truly informed consent? As a specific example, the adjustable rates are typically tied to the London Interbank Offered Rate or LIBOR. As a highly educated person who follows finance (but not a financial professional), the author has no idea what LIBOR really is, how it is determined, what the real risks of LIBOR suddenly rising are. How many of the lower and middle income people lured into subprime loans by fast talking mortgage brokers understood LIBOR or *realized that they didn't understand LIBOR*? One can be sure the mortgage brokers had some soothing explanation of LIBOR, or somehow distracted the borrowers from LIBOR entirely.

There are many problems with blaming the CRA. For example, most of the bad loans were made by mortgage brokers not subject to CRA at all. CRA applies only to depository institutions such as commercial banks. The housing bubble was worst in many affluent areas such as Northern California (the San Francisco Bay Area) where even upper middle class people had difficulty affording a home prior to the bubble. In many of these affluent bubble regions, the unqualified borrowers who received the mortgages now going bad have quite high incomes.

But, in particular, CRA did not actually *force* the banks to make unsound loans. Even if the CRA was aggressively used (during the Bush Administration!) to force banks to make unsound loans *that would bankrupt the banks*, the banks had the option of refusing to make the loans, getting the bad CRA rating, and forgoing mergers and branch openings. The bank officials had a fiduciary responsibility not to make bad loans that would bankrupt their bank. Even if they decided to do so, they had a legal responsibility to report the bad loans in their corporate annual reports, SEC filings, and other financial statements.

However, for the sake of argument, let us assume that bank regulators at the Federal Reserve under Alan Greenspan and the Treasury Department under Secretary Paulson, formerly of Goldman Sachs, and his predecessors as Treasury Secretary and ultimately President Bush applied extreme "pressure" using the CRA and other "liberal" programs to force the banks to make trillions of dollars in bad loans to unqualified poor, mostly black and Hispanic, people as the conservatives, libertarians, and business folks seem to be claiming (want to believe?). For the sake of argument, let us accept the unlikely premise that the ten million households probably facing foreclosure and the millions more at risk are irresponsible poor minority deadbeats who got their bad loans and McMansions through the baleful application of CRA by regulators during the Bush Administration (2001-2007) when the Republicans controlled both Houses of Congress.

Just to be completely clear, the underlying problem is that loans were made during the housing bubble (2001 to 2007) *during the Bush Administration* at highly inflated prices. With the housing bubble deflating, these loans are worth much less. The problem cannot be with loans made in the 1990's under Clinton *before* the housing bubble. We must be talking about CRA loans from 2001 to 2007 (when the sub-prime crisis began) with at most rare exceptions. Thus, regulators under the Bush Administration used CRA to force the banks to make trillions of dollars in bad loans.

Given this unlikely premise, the question that one should ask is what did the highly compensated CEO's and top executives of the major banks do about a government policy that they knew would bankrupt their banks? Did they mount a lobbying campaign from 2001 to 2007 against the misapplication of CRA? No. Did they flood the *Wall Street Journal* with full page advertisements and opinion pieces protesting and opposing this policy? No. Did they seek to educate the poor minority victims and the affordable housing community groups about the extreme hazards of the adjustable rate loans and other dubious practices that the government was forcing on the banks? No. They were silent.

The banks were silent.

During the 1990's, before 2001 and the Bush Administration, there were conservative, libertarian, and business attacks on the CRA, allegedly firmly enforced and expanded in 1995 by the Clinton Administration[12,13,14]. Conservative, libertarian, and business sources now sometimes cite these Clinton-era attacks on the CRA in recent attacks on the CRA. Here is a pertinent quote from an article in the Manhattan Institute's *City Journal* (Winter 2000) by Howard Husock:

It will take a Republican president to change or abolish CRA, so firmly wedded to it is the Clinton administration and so powerfully does it serve Democratic Party interests [emphasis added]. *When Senator Gramm attacked the CRA for its role in funding advocacy groups and for the burden it imposes on banks, the Clinton administration fought back furiously, willing to let the crucial Financial Services Modernization Act, to which Gramm had attached his CRA changes, die, unless Gramm dropped demands that, for instance, CRA reviews become less frequent. In the end, Gramm, despite his key position as the chairman of the Senate Committee on Banking, Housing and Urban Affairs (even the committee's name reflects a CRA consciousness) and his willingness to hold repeal of the Glass-Steagal Act hostage to CRA reform, could only manage to require community* *groups to make public their agreements with banks, disclosing the size of their loan commitments and fees.*

A new president should push for outright abolition of the CRA. Failing that, he could simply instruct the Treasury to roll back the compliance criteria to their more relaxed, pre-Clintonian level [emphasis added]. *But to make the case for repeal—and ensure that some future Democratic president couldn't simply reimpose Clinton's rules—he might test the basic premise of the Community Reinvestment Act: that the banking industry serves the rich, not the poor. He could carry out a controlled experiment requiring no CRA lending in six Federal Reserve districts, while CRA remains in force in six others. A comparison of lending records would show whether there is any real case for CRA. In addition, CRA regulators should require nonprofit groups with large CRA-related loan commitments to track and report foreclosure and delinquency rates. For it is these that will reflect the true threat that CRA poses, a threat to the health of cities.*[15]

The Gramm-Leach-Bliley Act (GLB or GLBA) of 1999 would originally have eliminated CRA entirely. After protests, CRA was weakened by GLB but not eliminated and President Clinton signed GLB. GLB reduced the frequency of CRA exams for small banks and it imposed disclosure requirements, so-called "sunshine" requirements, on non-profit community group such as ACORN that made CRA agreements with banks. GLB largely eliminated the Depression era Glass-Steagall Act, enabling bank holding companies like Citigroup to combine commercial banking, investment banking, insurance, and other financial services in a single giant firm. GLB enabled the formation of the mega-banks such as Citigroup that are now in trouble. GLB was supported by Treasury Secretary Robert Rubin who moved on to Citigroup after the Clinton Administration. Citigroup reportedly paid Rubin close to $115 million for his services. At least in their published editorials in 1999, most liberal affordable housing groups saw GLB as a defeat that weakened CRA and allowed banks to acquire non-depository affiliates that were not subject to CRA.

GLB did preserve CRA in a seemingly substantially weakened form. US Senator Phil Gramm, who now blames CRA for the housing fiasco, voted for the eponymous GLB with its' (he now says[16]) dangerous CRA provisions. Perhaps there was some reverse psychology here on the part of the diabolical liberal affordable housing groups. While publicly attacking GLB as a terrible rollback of the Depression era Glass-Steagall Act that weakened CRA, they were secretly licking their chops knowing that Citigroup and the other banks would give up without a fight when the liberal affordable housing groups demanded that they make trillions of dollars in bad loans to get approval for the mergers that created the now failing too big to manage banks.

From 2001 to 2007, conservative, libertarian, and business sources largely fell silent about CRA. They did heavily attack Fannie Mae and Freddie Mac during this period, mounting a campaign against the government sponsored enterprises and Franklin Raines who was ousted as head of Fannie Mae. These attacks often compared Fannie Mae and Freddie Mac unfavorably to the ostensibly "private" banks such as Citigroup (rarely identified by name) that are now in trouble, so far at considerably greater cost (approaching $2 trillion if both TARP and Federal Reserve subsidies are combined) to taxpayers than Fannie Mae and Freddie Mac. However, we are concerned with CRA.

An obvious question is did the Republican Bush Administration kill or weaken the CRA further as recommended in Howard Husock's article in the Winter 2000 *City Journal*? The CRA was not repealed, but indeed it was weakened further over the objections of the liberal affordable housing groups (surprise, surprise). In particular, changes were made to the FDIC and other agency rules for enforcing CRA. Amongst other changes, the size for "small banks" as defined for CRA was raised from $250 million to $1 billion in assets, removing many banks from the most stringent requirements. Several other changes were made. The liberal affordable housing groups argued that these changes would make *predatory lending* significantly easier and otherwise weaken CRA (See Appendix C).

In 2007 the sub-prime financial crisis began and several conservative, libertarian, and business sources, notably Thomas DiLorenzo[17], began to blame CRA specifically for the sub-prime problems of 2007. One may ask whether the hundreds of billions of dollars in bad subprime loans that surfaced in 2007 represented the onerous burden of the CRA during the Bush Administration or the *predatory lending* by banks and mortgage brokers that the liberal affordable housing groups have long alleged. Did the Bush Administration in practice alter the enforcement of CRA so that extremely questionable predatory loans were counted as meeting the requirements of the CRA, not only gutting the act but actually turning it into a pretext for predatory lending? Whatever the case, we must ask why the CEO's and senior executives of the mega-banks such as Citigroup kept silent and failed to act to save their banks from the alleged tidal wave of government mandated unsound lending.

In late September and October of 2008, when the Wall Street bailout took place, conservative, libertarian, and business sources began to blame CRA much more loudly for the housing bubble and escalating financial crisis[18,19,20,21]. Again, unlike the Federal Reserve/Alan Greenspan excuse and the Fannie Mae/Freddie Mac excuse, the CRA could *possibly* have *forced* the banks to make the trillions of dollars in bad loans.

The question remains: if CRA was forcing Citigroup and the other giant banks to make trillions of dollars in loans or purchase trillions of dollars in mortgage backed securities backed by bad loans from 2001 to 2007, why didn't the banks fight and fight very hard? They had a fiduciary responsibility to their stockholders to fight such terrible policies. They had a civic duty to the nation to fight. With their substantial skills in sales and marketing, they should have had no difficulty educating the poor about the extreme hazards of these bad loans. Certainly the *sincere* liberal affordable housing activists could have been convinced to oppose such horrific policies. Indeed, some of them like liberal economist Dean Baker recognized the menace as early as 2003 and spoke out repeatedly[22]. Why didn't the banks join forces with Baker *to save their banks* and, incidentally, millions of poor minority Americans who would end up losing their homes?

Conclusion

Of course, the current CRA excuse is ridiculous. Only conservative, libertarian, and business true believers actually believe the CRA excuse in its current form. Most probably the CRA excuse will change or be replaced as the obvious flaws in the current version are pointed out.

The current CRA excuse has strong racial, class, and "moral" overtones. The housing bubble which affected most urban zoned regions in the US, often worst in affluent areas such as Northern California, is presented as a phenomenon of shifty unreliable poor minority, usually black or Hispanic, Americans (and illegal immigrants). The CRA excuse misleads Americans who do not consider themselves part of this "underclass" to believe *their* mortgage is not part of the problem. They were working hard, fixing up their house, investing in the sound fundamentals of the American economy, not like *those* people.

Even though most Americans are at risk from a negative bubble in housing caused by the foreclosure wave, the CRA excuse leads them to see the foreclosures as a problem for *those* people and resist the mortgage principal reduction or similar programs that could prevent the negative bubble. Remarkably, even President Obama has echoed these stereotypes of irresponsible housing bubble borrowers in his speeches instead of pointing out the false claims of sound fundamentals used to sell the loans to Americans. Class and campaign contributions trump race and stated liberal principles.

Corporations like Citigroup, Bank of America, Morgan Stanley, Goldman Sachs, and the other banks that are in trouble are run according to *a military chain of command*. Most American businesses worship the military chain of command like a pagan god. It is "my way or the highway" in the United States (and it is working so well!). There are negligible significant restrictions on the power of the CEOs of Citigroup, Bank of America, and the other banks in trouble. The vast majority of employees other than a few senior executives are "at will" employees who can be laid off or fired at any time for no reason. That is the law. Unlike bailout recipients GM and Chrysler, Citigroup, Bank of America, and the others face little in the way of labor unions that can provide a check against the CEO. Although corporations have stockholders, most corporations are a one party state like the old Soviet Union with the CEO running the one party. What this means or should mean is that the buck stops at the CEO's desk, at the Board of Directors and the senior executives: the CEO, the CFO, the COO, and the other top executives.

Do we want America or the world to be run like Citigroup or the other banks that are in trouble? If the current no strings attached bailouts continue, this is what will happen. There should be no illusions. The President may be a Republican or Democrat, but the mega-banks will be making the decisions. With government backing, they will be able to buy out or crush the banks and financial institutions that exercised prudent judgment. Every other company in the US will have to come to them for financing – for loans, IPO's, stock offerings. They will be in a position to dictate business decisions to the few remaining companies that have expertise in manufacturing, agriculture, R&D, and other activities vital to the functioning and growth of the economy.

It doesn't matter what it is called. It may be called a "bailout", "a financial rescue plan", "bank nationalization", or many other terms. If it happens – it is already happening – in any disguise, the banks that are in trouble, their CEO's and top executives, will be running the nation and maybe even the world.

The silence of the banks speaks volumes about either the character or the competence of the leaders of these banks. Should anyone – Republican or Democrat, liberal or conservative, rich or poor, purple or polka-dot – want these people running the US and perhaps even the world? There is no one who can bailout the US, let alone the world, when they screw up again. They will screw up again. They have a proven track record of screwing up. They have no significant experience in managing or leading the real economy that manufactures goods, grows food, and performs other vital functions. We can't eat their derivative securities and other financial fantasies. The US had better get its act together.

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.[23]

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.[24]

It is worth noting that foreign trade constituted about seven percent (7%) of the total US economy at this time[25]. 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 often 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*[26]. 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[27].

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[28].

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", "free market", or similar terms. 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: 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 Big Three

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 Understudies

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.

Appendix C: Opposition to 2004 CRA Changes

Here is the full text of a letter opposing the CRA Rule Changes in 2004. (URL: www.responsiblelending.org/pdfs/CRAsignon-FDIC-0904.pdf, From the Center for Responsible Lending: A Resource for Predatory Lending Opponents, Accessed February 24, 2009)

September 8, 2004
The Honorable Donald E. Powell
Chairman
Federal Deposit Insurance Corporation
550 17th St NW
Washington DC 20429

Dear Chairman Powell:

The undersigned organizations urge you to withdraw the proposal of the Federal Deposit Insurance Corporation to quadruple (to $1 billion) the minimum asset size for applying the full Community Reinvestment Act (CRA) exam to state chartered non-member banks, which would have a devastating impact on lending, housing, and access to financial services in urban and rural communities across America.

CRA has been instrumental in increasing homeownership, boosting economic development, and expanding small businesses in the nation's minority, immigrant, and low- and moderate-income communities. The FDIC proposal would dramatically diminish banks' obligation to reinvest in their communities. It revises the CRA rules to make the less rigorous CRA exam applicable to an additional 900 banks with assets totaling $401 billion. Adoption of the FDIC measure is likely to mean the loss of hundreds of millions of dollars in loans, investments, and services for local communities and would disproportionately impact rural areas and small cities where the market presence of these mid-sized banks is often great.

FDIC rulemaking on this matter is flawed both in terms of procedure and substance. The draft proposal was adopted on a divided vote at a board meeting that was called on unusually short notice, and that provided some board members with only limited opportunity for prior review. The board provided a minimal 30-day public comment period. This comment period is unusually and unnecessarily brief for consideration of such a controversial rule and began during a traditional summer vacation month. Haste to enact proposed changes as soon as one month after the close of the comment period could be seen by consumers as evidence of disregard for public input.

The FDIC rule, as proposed, would greatly weaken or eliminate extremely important standards necessary to ensure that CRA is effective. The proposed change would weaken the lending test and also eliminate the investment and service parts of the CRA exam for FDIC supervised banks that have assets between $250 million and $1 billion.

The FDIC's plan to add a weak or trivial community development criterion in lieu of the investment and service tests applicable today (that collectively count for 50 percent of a bank's CRA grade) is a wholly inadequate substitute for the present exam standards. The new factor permits these banks to satisfy the community development criterion by choosing whether to provide community development loans, investments or services instead of assessing their performances for all three categories, as is currently required. This change is likely to result in a significant drop-off of lending, investments and services for affordable housing development, Low Income Housing Tax Credits, community service facilities, such as clinics, and economic development projects.

Another harmful element in the proposal is the dramatic weakening of the lending test for midsize banks which could decrease access to credit for many Americans. Under the proposal banks with assets between $250 million and $1 billion will no longer be subject to the rigorous examination of their mortgage, small business, small farm, and consumer lending. Further, these banks would no longer be required to collect and report essential lending information such as small business lending by census tracts or revenue size of the small business borrowers. Without data on lending to small businesses and small farms, it is impossible for the public to know how well these midsize banks help to meet the credit needs of their local communities.

We also fear that the elimination of the service test will have harmful consequences for low- and moderate-income consumers. It takes away the regulatory incentive for midsize banks to maintain and open new branches and ATM machines serving low-and moderate-income geographies. It is also likely to undercut the extent to which these banks provide affordable banking services and checking and savings accounts necessary for bringing unbanked households into the financial mainstream or money transfer and remittance services, which are particularly important to new immigrants and ethnically diverse communities.

According to the FDIC data, the rule change would mean that only 223 of 5,291 (about 4%) of all FDIC-supervised banks would continue to receive the full CRA exam. It would affect some parts of the U.S. more drastically than others. Ninety-nine percent of rural FDIC-supervised banks would be exempted from full coverage. We calculate that no FDIC-supervised banks in eight states (Alaska, Arizona, Idaho, Minnesota, Montana, New Mexico, West Virginia and Wyoming) would be fully covered by CRA. Thirty-six other states would have five or fewer banks facing full CRA scrutiny.

In addition, this proposal would broaden the definition of community development in rural areas so that banks could receive CRA "credit" even if these activities are not particularly directed at serving the needs of low- and moderate-income households, as is presently required. The proposal would be particularly harmful to rural counties, which already have fewer banks. Rural counties have 4.3 banks compared to 10.9 banks in urban counties, on average.

The FDIC proposal and the rule recently adopted by the OTS diminish the CRA requirements for midsize banks and work at cross purposes with the Act's statutory mandate. As you know, this mandate requires that banks, regardless of their asset size, have a continuing and affirmative obligation to serve the credit and deposit services needs of their local communities, including lowand moderate-income areas.

We urge you to withdraw this proposal.

Sincerely,

AARP
ACORN [emphasis added]
AFL-CIO
American Corn Growers Association
Center for Community Change
Center for Rural Strategies
Coalition for Responsible Lending

Coalition of Community Development Financial Institutions
Consumer Federation of America
Consumers Union
Enterprise Foundation
Federation of Southern Cooperatives
Housing Assistance Council
Leadership Conference on Civil Rights
Local Initiatives Support Corporation
NAACP
NAAHL
National Association of Consumer Advocates
National Association of Counties
National Association of Housing and Redevelopment Officials
National Catholic Rural Life Conference
National Community Action Foundation
National Community Capital Association
National Community Development Association
National Community Reinvestment Coalition
National Congress of American Indians
National Consumer Law Center
National Council of La Raza
National Fair Housing Alliance
National Family Farm Coalition
National League of Cities
National Low Income Housing Coalition
National People's Action (NPA)
National Training and Information Center (NTIC)
National Tribal Development Association
National Urban League
Rural Coalition/Coalición Rural
Stand Up for Rural America
United Auto Workers
U.S. Conference of Mayors
U.S. Public Interest Research Group

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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