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Thursday, September 25, 2008

Orange Grove: Bailout's depressing historical parallel

Bailout plan hearkens to Hoover's failed bid to stave off bank failures

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The Bush administration proposes to intervene in financial markets on a scale that our nation has done only once, during the Great Depression of the 1930s. The administration proposes purchasing $700 billion worth of devalued and illiquid assets from financial institutions. The Bush bailout resembles a program which inspired it, a program implemented during the Hoover administration.

Let's consider the obvious analogy. What does the Hoover experience suggest will be the likely impact of the Bush plan?

The administration's emergency intervention will not solve the financial system's underlying problems. Things will get worse before they get better.

Consider what happened during the 1930s. In the fall of 1931, the Hoover administration realized that financial institutions no longer held the trust of depositors, investors, businessmen or each other. These organizations were losing deposits so rapidly that the financial system faced complete collapse. These organizations needed to cleanse their balance sheets of assets, which under current conditions, had little immediate value and could not be used to raise cash.

In January 1932, the Hoover administration created the Reconstruction Finance Corp., an entity authorized to extend loans to all depository institutions in the nation. The RFC could accept as collateral a broad array of assets, including those deemed to be of little immediate worth but of potential long-term value. During its first year, the RFC lent nearly $1.5 billion and acquired equity stakes in thousands of financial institutions. As a share of the capital of the financial industry, this lending would be the equivalent of roughly $100 billion today. During its second and third years, the RFC extended loans to banks and acquired equity positions in financial institutions amounting to more than $3 billion dollars, equal to roughly $200 billion today.

The financial crisis slowed temporarily, but the bleeding continued. Bankers restricted lending to entrepreneurs, consumers and each other. Industrial production plummeted. Unemployment skyrocketed. The financial meltdown resumed, forcing the president to declare a national "banking holiday."

It's worth reiterating the theme of this historical analogy in stark terms. In the past, we faced a similar situation and employed similar policies. The policies marked a deepening of the downturn, not an end to the agony. The policies

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signaled the demise of the financial system and the need to construct new institutions.

During the Great Depression, our nation began rebuilding the financial system after we elected a new administration. The Roosevelt administration insured bank deposits, broke up financial conglomerates and separated the commercial banking, investment banking and insurance industries. The administration centralized the Federal Reserve System, requiring its 12 previously independent district banks to follow the dictates of the new Board of Governors.

Congress expanded the regulatory powers of the national government, for the first time forcing almost all financial institutions to submit to federal inspection and requiring most financial entities to submit to multiple, independent oversight authorities.

After this reconstruction, the financial system recovered slowly. Financial lethargy afflicted the nation. Bankers no longer extended credit in circumstances where they had in the past.

Unless we take the next step and replace the current financial regime, we may never restore confidence in our economy, and, at best, we will experience an extended stagnation similar to Japan during the 1990s. At worst, we will experience a depression of unprecedented length and depth.

In the latter case, we will tell our grandchildren stories about our experiences during the Great Depression of the 21st century.