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Orange Grove: Finance crises could hit more often

Regulatory emphasis on safety, stability has been dismantled

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During his mea culpa last week during a congressional hearing on the turmoil in the financial system, former Federal Reserve Chairman Alan Greenspan lamented that "those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief."

Greenspan said he was "partially" wrong in opposing regulation of modern derivative markets and acknowledged that financial institutions didn't protect shareholders and investments as well as he expected. Greenspan explained his error by noting the infrequency of banking panics. Greenspan called the current financial crisis a "once-in-a-century credit tsunami."

Greenspan's centennial metaphor is roughly accurate. The previous financial crisis of this magnitude began in 1929 and continued until 1933. Afterward, despite Herculean efforts to reconstruct the financial system and recapitalize weakened banks, the U.S. economy remained in the doldrums for a decade.

But, with our current regulatory regime, rather than "once in a century," we should expect financial cataclysms like the current crisis to occur, on average, every 15 years.

After the Great Depression, financial regulations emphasized stability and prohibited banks from behaving in ways that risked market meltdowns.

Congress began dismantling that safety-first system in the late 1980s and overturned the last significant Depression-era restrictions in 1999. In other words, the current financial system – which emphasizes efficiency and innovation – has been in place for less than 20 years. The bulk of the system came into operation in the mid-1990s, a little more than 10 years ago.

If we take 1987 as the starting point of the current financial system, then the average time to failure – which is what statisticians mean when they say a "once in a something event" – is 20 years. If we date the starting point of the system in the mid-1990s and recognize that the subprime-meltdown began in 2007, then the average time to failure is little more than 10 years.

No matter how you arrange the data, the message is the same: The modern American financial system is unstable. During the life of the current system, it has been beset by recurrent booms and busts (e.g. the Internet-stock bubble, the housing boom and the subprime mortgage bust) and by events that

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might have triggered a system-wide shutdown (e.g. the collapse in the late 1990s of the hedge fund Long Term Capital Management). The system recently hovered near the edge of a catastrophic meltdown. Only government intervention of hitherto unimagined magnitude kept the system afloat.

How unstable is this system? Let's examine historical evidence. Under the post-Depression financial regime, which lasted approximately 1934-84, our nation experienced no financial panics.

Under the national and Federal Reserve banking regimes, which lasted about 70 years, from approximately 1863-1933, our nation experienced four panics that afflicted the central money market (1873, 1893, 1907, and 1933).

Only the 1933 panic surpassed the magnitude of the current crisis. America's 19th-century financial system, in other words, suffered perturbations of a similar periodicity as our current system, but back then truly traumatic meltdowns occurred with one-fourth the frequency.

The bottom line is bleak. Our current system appears to be no more stable (and may be less stable) than the financial systems that operated during the century preceding the Great Depression.

We should keep this fact in mind during the months ahead when we reform our financial system. Without fundamental change, financial panics will recur, in all likelihood, with unpleasant regularity.

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