

The Sound and the Fury

In my last column ("The Instability of Modernity," January __, 2010), I warned that the United States was about to enter a period of political gridlock. Little did I know that my prediction would come true so quickly! But with the election of a Republican to replace the liberal icon Ted Kennedy, the United States Senate has fallen out of the ironclad control of the Democratic Party and thrown American politics into uncertainty. The immediate casualty of the shift in Senate power was President Obama's healthcare reform bill, which was already hanging by a thread on the eve of the special election in the state of Massachusetts to fill the late Mr. Kennedy's seat. But the people of Massachusetts sent a much louder message to the politicians not only in Washington but around the world – the status quo is no longer acceptable, and incumbents of all parties should be very worried about holding on to their sinecures.

Barack Obama has spent one year in office as America's President and has little to show for it. No major legislation has been passed other than a stimulus plan that has directed little capital to productive or imaginative uses. He has failed to close the prison camp at Guantanamo (which was going to win him few favors with America's enemies) although he has ended the practice of torturing terror suspects, and has been put back on his heels by Al Qaeda's failed Christmas day terror attack on an American civilian airliner. Apart from strengthening the American troop presence in Afghanistan, he has done little to exert American power abroad in an effective manner. The high point of his foreign policy was most likely his speech to an Egyptian university audience in which he reached out to Moslems, but he has followed that up with no action that would bolster peace efforts in the Middle East. Despite the paucity of achievements, he was saddled with the Nobel Peace Prize, which won him more criticism than acclaim. Even the few good things that have happened have gone unrewarded during his very difficult and disappointing first year in office.

According to CBS News, Obama's first year featured 411 public speeches, comments and remarks, 42 news conferences, , 158 interviews, and 23 town hall meetings. The Obama Presidency thus far can best be described as a great deal of sound and fury that has signified nothing. This is particularly disappointing in the economic arena, on which he knew he would have to devote most of his energy during the early part of his term. Despite the fact that the U.S. economy has been pulled out of the sharp decline in which it was caught during the end of 2008 and the early part of 2009, little has been done to establish a sustainable and sound growth path for the future.

Instead, Obama has turned to populist measures attaching large financial institutions that were poorly designed and unlikely to effect real reform. The first reform was a tax on banks to repay American taxpayers for the money they spent bailing out these institutions last year. The second is a proposal to limit banks' ability to engage in certain speculative activities, such as owning private equity,

hedge funds and proprietary trading. Neither of these proposals addresses the heart of the problems causing financial instability

On January 14, 2010, President Obama introduced a proposal levy a tax on the non-depository assets of banks with more than \$50 billion of such assets. The purpose of this tax would be to recover the cost of the bailout for the American taxpayers. This proposal is inadequate from several standpoints. By only taxing the banks, it ignores the complicity of many other speculators who benefitted from the reckless financial practices that led to the financial crisis, such as hedge funds and other investors who continue to speculate in naked credit default swaps and other dangerous financial instruments. It is widely known by knowledgeable market professionals that the vast majority of trading in such instruments is done for the purpose of speculation, not for the purpose of hedging underlying positions. Accordingly, this proposal gives a free pass to much of the speculative activity that comprises the most profoundly flawed practices in the system. The tax also lets the banks off easy. The \$90 billion price tag over ten years is a drop in the bucket compared to the trillions of dollars of damage that banks' reckless practices imposed on the American economy. Merely recapturing the cost of the TARP does not go far enough to compensate society for the damage that modern financial practices have imposed. This tax does not go nearly far enough in imposing a financial responsibility on these public utilities.

President Obama did not stop his financial reform revival with the ill-begotten tax on banks, however. On the day after the Massachusetts massacre, he unveiled a three part plan to limit risk-taking by banks with insured deposits. The "markets," meaning Wall Street, panicked at this announcement as they feared that the game they have been running on the rest of use would be coming to an end. Moreover, just as with the tax on banks, this proposal misses the point, which should be to legislate the financial products that cause damage, such as naked credit default swaps. This legislation promotes the fantasy that something can actually be done to prevent firms from growing "too big to fail" when it is virtually impossible to do so without placing limits on the dangerous products that link firms together. Even if the largest firms in the world were shrunk significantly, they will still be closely interconnected through their trading of toxic financial products; accordingly, the system would still be at risk if one of them failed because the entire system would only be as strong as its weakest link. It is not a question of individual firms being "too big to fail"; products such as credit default swaps effectively turn the entire system into the equivalent of a single firm that is too big to fail! That is why the products must be regulated. The proper approach is significantly strengthening capital requirements and eliminating toxic products. There can be little quarrel with the argument promulgated by Paul Volcker that banks should not be trading with depositors' funds, but that begs the question of the risks they are running with their own funds.

Moreover, as many others have pointed out, while proprietary trading creates its share of blowups, it was not the primary cause of the financial crisis. As much money as it lost during the financial crisis, Wall Street was fairly adept at shifting the risks in its proprietary trading to its counterparties (like AIG, whose losses the government was forced to pick up, a story for another day). The major Wall Street losses were primarily attributable to bad lending decisions, which were driving by a failure to recognize the procyclical monetary policies of the Federal Reserve and the boom and bust cycle that both fiscal and monetary policy has trapped the United States and global economies. That has little to do with proprietary trading, although it does have to do with profound failures of risk management and intellect.

Populist measures of the type that President Obama and his economic advisers are proposing are symbolic of the policy failures that have kept the United States' economic and financial system – and therefore those of the entire world – trapped in a cycle of boom and bust. They are empty gestures that accomplish little. If Mr. Obama wants to salvage his presidency from the disappointment of its first year, he needs to go back to the drawing board and focus on improving the capital adequacy of financial firms and regulating toxic financial products.