



Financial Reform: Wrong Diagnosis, Wrong Cure

John O'Leary | August 23, 2010

Will the recently enacted financial reform law fix the problems that caused the economic crisis? That's hard to say, since nobody agrees what caused the crisis in the first place.

In May 2009 President Obama created the Financial Crisis Inquiry Commission to "examine the causes, domestic and global, of the current financial and economic crisis in the United States." The Commission is due to release its findings in December 2010.

Until the Commission's work is completed, there will be no thoughtful bipartisan analysis of what caused the financial meltdown, and certainly nothing even approaching a consensus as to the root cause of the problem. Despite the lack of a diagnosis, however, Congress has passed and the president has signed a 2,300 page financial reform bill. Without a solid diagnosis, what is the chance of choosing the correct cure?

If history is any guide, chances are not very good. There is precedent for this sort of thing, but it isn't very pretty. Two months after taking office, in October of 1974, President Gerald Ford took aim at the greatest economic threat of that time, inflation, which Ford called "public enemy number one." Ford took the unusual step of calling a joint session of Congress to give a nationally televised speech. Coming on the heels of Watergate, it was seen as an important speech for the new president on an important topic.

Ford gravely warned that left unchecked, inflation threatened to "destroy our country, our homes, our liberties, our property, and finally our national pride, as surely as any well-armed wartime enemy." Ford

then used this historic opportunity to urge citizens of the nation to don "WIN" buttons, short for "Whip Inflation Now."

Historians tend to view Ford's "Whip Inflation Now" speech as part of the national laugh track of the 1970s, along with other risible phenomena such as disco and leisure suits. In a recent *Wall Street Journal* column, economist Michael Boskin of Stanford described Ford's WIN buttons as "mostly harmless nonsense." While the buttons themselves did little damage, a closer look at Ford's historic speech shows the significant harm that can ensue from sloppy economic thinking in the White House.

At the beginning of his speech, Ford revealed a critical error in thinking, saying "I will not take your time today with the discussion of the origins of inflation..." Hmmm. Imagine if your doctor told you, "Look, I'm not going to waste your time telling you what's wrong with you, but let me tell you what I am prescribing for treatment."

Ford avoids a discussion of the origins of inflation, not out of a misplaced concern for the value of our time, but because he is ignorant on the topic. Without a clear understanding of what is causing the problem, in this case inflation, won't it be difficult to evaluate ideas for fixing it? Of course. Ford then described the hopeless process of sorting through possible responses to the inflation problem that reveals the challenge of operating in the dark.

During the meetings on inflation, I listened carefully to many valuable suggestions. Since the summit, I have evaluated literally hundreds of ideas, day and night. My conclusions are very simply stated. There is only one point on which all advisers have agreed: We must whip inflation right now.



Ford avoids any discussion of the causes of inflation, admits widespread disagreement among his advisors—and urges immediate action.

We are seeing the same tragedy play out today. There is widespread disagreement among economists as to what caused our recent economic catastrophe. Was it Fannie Mae and Freddie Mac encouraging unsustainable lending? Was it the conflict of interest at bond rating agencies? Or was it the “casino mentality” of Wall Street? The Financial Crisis Inquiry Commission will release its report in a few months, but that will be a little late to make any difference. We have already moved ahead with a 2,300 page prescription.

Stumbling in the gloom groping for answers, Ford in his speech asked Congress and the American people for a bizarre hodgepodge of compulsory and voluntary nostrums, including asking farmers to grow more food, asking everyone to drive five percent fewer miles, and asking financial author Sylvia Porter to organize a nationwide volunteer mobilization effort from the White House, “enlisting” citizens willing to wear “WIN” buttons. These ideas were not only worthless in combating inflation, they gave a false impression that government was “doing something” about the problem.

In general, Ford’s economic program may have been, as Boskin and the Hitchhiker’s Guide to the Galaxy might say, “mostly harmless.” Ford’s flawed understanding about what caused inflation, however, prompted one proposal that was anything but harmless. In a textbook example of what not to do, Ford promised Congress he’d pump more money into an inflationary economy.

I have personally been assured by the Chairman of the independent Federal Reserve Board that the supply of money and credit will expand sufficiently to meet the needs of our economy and that in no event will a credit crunch occur. The prime lending rate is going down.

This is the economic equivalent of pouring gasoline on an inflationary fire. The palliative of “loose money” was exactly the wrong thing to do. Congress was equally in the dark, because Ford’s promise of easy money triggered the spontaneous applause of Congress.

It is tempting to look back at the “Whip Inflation Now” buttons and laugh. The fact that the political leaders of the time were sporting thick sideburns and wearing plaid sports coats make it all seem so ridiculous. We can chortle at the clownish proposals of Ford and his not-so-wise men economic advisors, but misdiagnosing the true cause of an economic problem is no laughing matter.

There are some who are skeptical that the Financial Crisis Inquiry Commission will be able to produce an authoritative report. With a big task and a relatively small \$8 million budget, the Commission itself may fail. The Commission is supposed to examine 22 different aspects of the crisis, from the impact of corporate governance, to securitization practices, to accounting practices such as mark-to-market rules and off balance sheet vehicles. Not surprisingly, The New York Times recently reported that the Commission was beset by internal disagreements. But if an independent commission can’t untangle the root cause of the crisis in 18 months, what hope does Congress have in just a few weeks? Could there be some obscure feature tucked within the massive new reform that will prove to cause, rather than prevent, future financial disasters?

By not waiting for the Financial Crisis Inquiry Commission to do its work, our political leaders have committed an act of economic malpractice. Someday, economic historians may look back at this moment and wonder how on earth we ever expected to prevent the next financial crisis without understanding what caused the last one.