Written by Bob Adelmann on March 19, 2010

Free Markets, Deregulation, and Blame

Free markets, in the full sense of the phrase, exist only in the minds and imaginations of free-market economists from the Austrian School, such as Ludwig von Mises and Murray Rothbard.

The classic definition is simply a market without intervention or regulation by government. In truth, commerce in any developed country is always controlled to some extent by government. A free market requires the right to own property, which means that the wages, earnings, profits, and gains obtained by providing products and services to others belongs to the individual generating them. The assumption is that an individual with this kind of freedom would only make an exchange that gained him a benefit.

A simple example involves junior high-school students who are just about to get their driver's licenses and purchase their first automobiles. The car dealer has an inventory of cars he would like to sell at a profit. A student has a fixed amount of money to spend (financing is ignored to keep things simple). Once the student has found the car he wants to buy in his price range, he pays up and drives away. Question: Who benefits from this transaction? A student from a government school nearly always answers "the car dealer." He wouldn't sell the car unless he made a profit. Sometimes the student's answer is couched in terms such as "excessive" profit, or "unreasonable" profit. When the question is pressed, Who else benefits?, there can only be one answer as (in this simplistic case) there is only one other party: the purchaser! And it is at this moment in time when the "light" goes on, the "moment of clarity" arrives, and the student realizes, perhaps for the first time, that he also benefits, or else why would he buy the car? He would rather have the car than the money he paid for it.

And this is the core of the private, free-enterprise economy: property rights with the freedom to make voluntary -exchanges.

Framing the Free-market Debate

When America was first discovered, the land mass was barely able to sustain a few hundred tribes of native hunter/gatherers. Today 300 million people live lifestyles that exceed those of kings just a hundred years ago. Though imperfect at the start, and becoming increasingly imperfect, the free market has been underappreciated, misunderstood, and attacked mercilessly almost from the beginning — despite its successes in generating prosperity.

Adam Smith, in his *Wealth of Nations*, said the free market emerged not by design but by behavior. He said the individual who

> intends only his own gain is led by an invisible hand to promote an end which was no part of his

> intention. Nor is it always the worse for society that it was no part of it. By pursuing his own interest [the individual] frequently promotes that of the society more effectually than when he really intends to promote it.

It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their *regard to their own self interest*. [Emphasis added.] We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.

But man is imperfect, and so referees are needed to make sure that everyone plays fair — e.g., that contracts are not violated or the competition not eliminated through violence. The first effort to ensure fairness in America was adoption of the Articles of Confederation, which was later replaced with the Constitution. In the Constitution, the dangers of sovereign citizens giving up some essential rights to government were recognized through limitations on government — spelled out and agreed to in advance. These limitations were crafted by what many consider to be the most remarkable gathering of wise and informed individuals in the history of mankind.

President John F. Kennedy acknowledged that fact when hosting a dinner at the White House attended by every living American Nobel laureate, saying, “There has never been a greater concentration of intellectual power here at the White House since Thomas Jefferson dined here alone.”

Very simplistically, the not-quite-so-free market worked better than any other economic system at any time in recorded history. Ronald Reagan said, “Entrepreneurs and their small enterprises are responsible for almost all the economic growth in the United States.”

Striving to Socialize Markets

The first major attempts to override the limitations of the Constitution occurred in the middle of the 19th century. President Lincoln clearly and deliberately ignored constitutional limitations during the Civil War. The creation of the national park system, beginning with Yellowstone National Park, was hotly debated by constitutionalists defending the issue of the proper role of government. And in 1887 the Interstate Commerce Act created the first agency (the Interstate Commerce Commission) under a new unconstitutional “fourth” branch of government. That “fourth” branch now includes hundreds of agencies with powers only permitted by the Constitution to either the executive, legislative, or judicial branch.

From there, the history of intervention, regulation, antitrust laws, and other interferences is replete with examples of government involvement in the free market, making it much less free than before.

Such interventions are so numerous as not only to exceed the pages available for review of them here, but the patience of the dear reader as well.

One classic example, however, will suffice before moving on to more current attempts to regulate, deregulate, and reregulate the market “for the greater good of the greater number.” In his monumental book *Power and Market*, Murray Rothbard cites intervention in the American farm market:

> In 1929, the government began to support artificially the prices of some farm commodities above their market price. This, of course, brought about unsold surpluses of these commodities, surpluses aggravated by the fact that farmers shifted production out of other lines to enter the now guaranteed high-price fields. Thus, the consumer paid four ways: once in taxes to subsidize the farmers, a second time in the higher prices of farm products, a third time in the wasted surpluses, and a fourth time in the dep-rivation of forgone products in the unsupported lines of production.

All of this was done, of course, to keep prices higher in order to help the farmers. But Rothbard continues:

> The farm program could have been repealed, but such a course would hardly have been compatible with the statist doctrines that had brought about the support program in the first place. So, the next step was to clamp maximum production controls on the farmers who produced the supported products. The controls had to be set up as quotas for each farm, grounded on production in some past base-period, which of course cast farm production in a rapidly obsolescing mold. The quota system bolstered the inefficient farmers and shackled the efficient ones. Paid, in effect, not to produce certain products … the farmers naturally shifted to producing other products. The lower prices of the nonsupported products set up the same clamor for support there. The next plan, again a consequence of statist logic at work, was to avoid these embarrassing shifts of production by creating a "soil bank," whereby the government paid the farmer to make sure that the land remained completely idle. This policy deprived the consumers of even the substitute farm products. The result of the soil bank was readily predictable. Farmers put into the soil bank their poorest lands and tilled the remaining ones more intensively, thus greatly increasing their output on the better lands and continuing the surplus problem as much as ever. The main difference was that the farmers then received government checks *for not producing anything*. [Emphasis added.]

There is no need to multiply examples: they can be found in all phases of government intervention. The point is that the free-market economy forms a kind of natural order, so that any interventionary disruption creates not only disorder but the necessity [either] for repeal [of the disruptive laws], or for [additional] cumulative disorder *in attempting to combat it*. [Emphasis in the original.]

Such efforts to repeal the disruptive laws responsible for the "disorder" have been few and far between, but are based upon the reality that such repeal would make markets freer and more competitive, with higher productivity, more innovation, greater efficiencies resulting in lower prices, and a higher standard of living for everyone involved.

But, you ask, what about banks and deregulation? Aren't our country's present financial troubles the result of bank deregulation?

Money Manipulation

A close look at the financial system reveals very much a "mixed market," with interventions and manipulations dating back 100 years to the creation of the Federal Reserve System. The recent financial crisis has revived much interest in the concept of regulation, and consequently much blame has been directed to three minor attempts at deregulation in that industry.

These minor attempts at deregulation are 1) the Depository Institutions Deregulation and Monetary Control Act of 1980, 2) the Garn-St. Germain Depository Institutions Act of 1982, and 3) the Gramm-Leach-Bliley Act of 1999. We can dispense with the first two attempts quickly. The first act repealed "Regulation Q ceilings" that limited the amount of interest consumers could earn from their savings and checking accounts. The second act allowed banks to compete with money-market funds and slightly loosened restrictions on issuing real-estate mortgages.

The third attempt, the Gramm-Leach-Bliley Act (GLB), repealed the Glass-Steagall Act of 1933, which was passed during a flurry of anti-free-market legislation under the Roosevelt administration. This act had kept deposit-bearing banks and investment banks from competing with each other for over 65 years.

According to the July/August 2009 *Cato Policy Report*, "The deregulation critique posits that once Congress cleared the way for investment and commercial banks to merge, the investment banks were given the incentive to take greater risks, while reducing the amount of equity they are required to hold against any given dollar of assets."

The problems with this criticism are, first, that investment banks were already allowed to trade and hold mortgage-backed securities (MBS), derivatives, credit-default swaps (CDS), and collateralized debt obligations (CDO) before GLB was passed! Secondly, very few financial holding companies decided to combine their investment and commercial banking activities after GLB. Even President Clinton said:

> I don't see that signing that bill [GLB] had anything to do with the current crisis. Indeed, one of the things that has helped stabilize the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn't signed that bill.

The Cato report went on to point out that GLB "had little impact on the trading activities of investment banks. The off-balance sheet activities of Bear [Stearns] and Lehman [Brothers] were allowed prior to the act's passage. Nor did these trading activities undermine any affiliated commercial banks, as Bear and Lehman *did not have affiliated commercial banks*." (Emphasis added.)

Another criticism of the alleged deregulation that caused the crisis is of the increase in leverage allowed by the Securities and Exchange Commission for investment banks. Leverage allows banks to add debt to their original investment to maximize their potential returns. However, this increase in leverage came with a cost. According to SEC spokesman John Heine, "The commission's … rule [also] strengthened oversight of the securities markets," which gave the SEC much broader powers of supervision over these banks. So a fair assessment is that this "deregulation" was simply more regulation under cover.

Some have criticized the credit-rating agencies for failure to warn of the pending implosion of supposedly high-rated, low-risk investments offered for sale by the investment banks. However, once again the SEC created a situation of self-serving because of its attempt to avoid self-serving. The concern was that rating agencies would "sell out" to those it was regulating by offering more favorable ratings than were warranted. And so the SEC determined that only those credit rating agencies that were affiliated with the Nationally Recognized Statistical Rating Organization (NRSRO) would have their ratings recognized by the SEC. Such determination neatly excluded any new entrants to that industry, while grandfathering the existing firms like Moody's and Standard and Poor's, thus guaranteeing little competition and securing their place at the SEC table for their ratings. As Cato put it, "The SEC succeeded in creating a real problem, an entrenched oligopoly in the credit ratings industry." Such an oligopoly would otherwise be impossible without those restrictions put in place by the SEC. This is further proof, if any is needed, that the more restrictions that are put on the market, the more likely are disasters to occur such as the current financial crisis.

"Too Big to Fail"

One more issue needs to be addressed, however: that of a financial institution being "too big to fail." In a free market, failure is one of the guarantees of progress. Not all efforts will succeed. Mistakes will be made. Investments will be lost. Bad decisions will be rewarded with failure. But if any business is "too big to fail," several questions arise. Who determines who is too big? When Lehman Brothers was allowed to fail, it had a balance sheet in excess of $700 million, and 26,000 employees. And yet others were bailed out. Who decides? How do they decide? And, most importantly, who does the bailing?

William D. Cohen, in his book *House of Cards*, revealed a conversation between Bear Stearns CEO Alan Schwartz and CFO Sam Molinaro as they met with Wall Street lawyer Rodgin Cohen to discuss alternatives to the pending threat of bankruptcy facing the company:

> They batted around different ideas about what could be done to help Bear Stearns, including considering whether private equity firms or commercial banks might be able to put together a solution quickly. But soon enough they concluded there was just one answer. "The only people who can do anything about this are the Fed [Federal Reserve System]," Cohen recalled saying to Schwartz and Molinaro. "So that's when I did call Tim Geithner [President of the Federal Reserve Bank of New York at the time] about it very late at night."

Former Federal Reserve Chairman Alan Greenspan spoke about the "too big to fail" (TBTF) mentality in 2009 when he said such thinking "insidiously impairs the efficiency of finance and the allocation of capital. TBTF freezes obsolescent capital in place and impairs creative destruction — the primary means by which output per hour and standards of living are raised."

Such close ties between regulators and the regulated invites behaviors that are almost inconceivably immoral and destructive. Matt Taibbi's article "Wall Street's Bailout Hustle" in *Rolling Stone* magazine provides a nearly obscene description of the behaviors of those who have nothing to lose because the American taxpayer will bail them out. In explicit and unsettling detail, Taibbi describes the activities of Goldman Sachs and other investment banks during the financial crisis. He describes these activities as "cons" played, ultimately, on the American taxpayer: #1) the Swoop and Squat; #2) the Dollar Store; #3) the Pig in the Poke; #4) the Rumanian Box; #5) the Big Mitt; #6) the Wire; and #7) the Reload.

As Taibbi explains in another article, "The Big Takeover": "Wall Street has used the crisis to effect a historic, revolutionary change in our political system — transforming a democracy [sic] into a two-tiered state, one with plugged-in financial bureaucrats above and clueless customers below."

It's most certainly not "deregulation" that was at the root of the current financial crisis. It was regulation run amok.