The Treasury Department's Titanic Takeover

"Regulatory reform" is a favorite Beltway euphemism for bigger, more expensive, and more intrusive government. The new Treasury plan should be styled more accurately "Blueprint for a massive new federal power grab," because that's precisely what it is. Such power grabs are usually accomplished under the camouflage of crisis, when public emotions — and the widespread sentiment that government should "do something" — are easily exploited.

And the Obama administration has been only too happy to take advantage of the turbulence, with dire warnings laying the groundwork for an expansion of federal power the likes of which America has not seen since the New Deal.

"Over the past 18 months, we have faced the most severe global financial crisis in generations," Treasury Secretary Geithner told the House Financial Services Committee. "To address this will require comprehensive reform. Not modest repairs at the margin, but new rules of the game."

Nationalize the Entire Financial Sector

True to Secretary Geithner's words, the new Treasury plan contemplates "reform" in four general areas, to wit: "addressing systemic risk," "protecting consumers and investors," "eliminating gaps in our regulatory structure," and "fostering international coordination." The plan has not yet been fully fleshed out, but such scraps of information that the Obama Treasury has seen fit to make public are evidence enough of the end that the Obama administration has in mind: effective nationalization of the entire financial sector. By the time the "gaps in our regulatory structure" have been plugged, the freedom to make financial transactions, large and small, free of federal government oversight, will be gone.

Nor will there be any refuge overseas, if Obama and his like-minded associates overseas — Britain's Gordon Brown, for example — have their way. "International coordination" means that new U.S. financial regulations will be harmonized with those of the EU and other major economic powers, and brought under the authority of an international organ, presumably the IMF.

At the April 2 meeting in Great Britain of the G20, the top action items included new powers and reserves for the IMF and a global clampdown on tax havens, hedge funds, and bank secrecy — precisely the kinds of things that Timothy Geithner and his counterparts overseas are demanding. According to Britain's Finance Secretary Stephen Timms, "the era of banking secrecy is over."

In point of fact, the era of financial secrecy of any kind will be over if the Treasury plan, or even a reasonable facsimile thereof, is voted into law by Congress. "Transparency" — another delicious Beltway euphemism, meaning total government surveillance — will be the order of the day, with few financial transactions more complex than putting a quarter in a gumball machine exempt from the Federal Government's all-seeing eye.

Just one of the four areas of contemplated reform — addressing systemic risk — was described in any detail in the Treasury's press release, but it was a fair indicator of things to come. The Treasury intends to create a new regulatory body with responsibility for determining which firms are large or interconnected enough to pose "systemic risk." This body will have the authority to decree which firms are "systemically important" and to exert controls over systems of payment and the disposition of derivatives, those pesky financial innovations devised in the first place to dilute systemic risk that government regulations had imposed on financial transactions like mortgages. Firms deemed "systemically important" will be subject to rigorous new regulatory requirements for capital reserves and credit risk management. All hedge funds larger than an asset threshold to be determined will be registered and subjected to detailed federal scrutiny.

OTC (over-the-counter, or privately traded) derivatives will also be brought under Big Brother's benevolent oversight. "In our proposed regulatory framework, the government will regulate the markets for credit default swaps and over-the-counter derivatives for the first time," the Treasury proposal explained. The proposal went on in smugly dictatorial cadences to describe the coming regime:

> We will *subject* all dealers in OTC derivative markets to a *strong regulatory and supervisory regime* as systemically important firms.... We will *force* all standardized OTC derivative contracts to be cleared through appropriately designed central counterparties (CCPs).... We will *require* that all non-standardized derivatives contracts report to trade repositories and be subject to robust standards for documentation and confirmation of trades; netting; collateral and margin practices; and close-out practices.... Central counter-parties and trade repositories *will be required* to make aggregate data on trading volumes and positions available to the public and make individual counterparty trade and position data available on a confidential basis to appropriate *federal regulators*.... Finally, we will *apply robust eligibility requirements* and, where appropriate, standards of care; and will require that they meet recordkeeping and reporting requirements. [Emphasis added.]

It doesn't take a Ph.D. in finance or an expertise in the arcane of derivatives to understand what is happening here. OTC derivatives, an innovative new financial sector in which transactions are private and entirely voluntarily, are to be transformed into yet another compliant arm of FedGov-directed financial activity. Henceforth the federal government will oversee all such transactions and will determine, in its allegedly superior wisdom, whether or not such voluntary transactions are permitted.

In addition, the Treasury proposal contemplates strengthening the regulation of money-market funds and setting up an FDIC-like guarantor of last resort — to be paid for by those systemically-important firms coerced into accepting its coverage.

All of this may seem unimportant to the man on the street, applicable only to the rarefied upper atmosphere of high finance. But it is the activities of the hedge fund and money-market fund managers, the stockbrokers, the currency traders, the dealers in derivatives, and other prime movers in the world of finance, that help to determine the values of retirement portfolios and other assets near and dear to the American middle class. And the engine that has powered American economic and financial growth has always been voluntary, free-market exchange. Government intrusion into such activities always and everywhere hampers the market and encourages misallocation of resources.

Fallacy: The Economy Can Be Managed

The entire Treasury plan, along with all the other half-baked attempts to reform or bail out "the financial system" perpetrated by this and the preceding administration, is based on an almost-universally accepted fallacy, namely, that the economy is a "system" that must be managed for optimal performance. But the economy, including the financial sector, is not a system like a man-made electrical grid or even a natural phenomenon like the solar system. Those systems, whether man-made or natural, operate according to laws that allow any observer to predict future states.

But an economy is something altogether different. It is less a system than a spontaneous order. While it obeys the laws of human action, it is impossible to predict future states because the economy itself is constantly in flux. The countless billions of decisions made each moment by economic actors (people) are impossible to quantify, and their future consequences impossible to predict. The most that can be said about the spontaneous order of free market economic activity is that it will bring about dramatic improvements in the human condition if not interfered with.

Nor is a free-market economy fragile or unstable by nature, despite what politicians are wont to claim. The fragility and instability that have brought about the recent meltdown are consequences of government mismanagement, not defects in the inherently self-regulating free market.

The extent that we have an economic or financial "system" at all is a direct consequence of interfering in the workings of the market, of trying to micromanage and predict outcomes for something that is neither manageable nor predictable. The "system" is not the market itself but the web of regulations and controls that know-it-all federal regulators — like Geithner — have foisted on banks, investment houses, insurance companies, and the rest of the financial sector. That this system has failed so spectacularly is now being touted as an excuse to impose another, more severe system of controls that may well squelch free market financial operations altogether.

As for the "systemic risk" that Geithner wants to reduce, the Byzantine complexity of modern finance has come about primarily as the market has tried to find innovative ways of avoiding the regulatory burden, unnatural levels of risk, and moral hazard imposed by government interference. Much-maligned "credit default swaps" and similar derivatives, for example, were created to dilute the irrational levels of risk introduced by the federal government’s compelling of banks to loan to high-risk borrowers. "Hedge funds," which the Treasury now intends to bring under the malignant umbrella of federal regulation and oversight, came about as the wealthy sought to put their money where the grasping hand of government could not confiscate or control it. Absent the efforts of government everywhere to control financial activity, market forces would have tended towards greater transparency, as interest rates and lending found natural levels.

In this same spirit, the Treasury’s plan for "protecting consumers and investors" means "making more regulations to relieve consumers and investors of the responsibility of making informed choices and accepting the consequences of risk." Few Americans would buy a car or household appliance without doing a lot of research and comparison shopping. This is because, if we spend our money on things that don’t work, we know that we have no one to blame but ourselves. If we have genuinely been cheated, the courts provide recourse.

But very few do much research before plunking their savings into a bank account or mutual fund. The most that consumers typically think to ask is how much interest will be paid. But because we know (or think we know) that the government will guarantee our bank accounts and keep an eagle eye on investment houses, we almost never trouble ourselves to check the books of the banks and investment houses.

Free Market Is Better Than Regulation

In reality, the free market is a much better watchdog than government could ever be. This is not to say that fraud will never occur absent government regulation. The infamous Ponzi scheme run by the Swedish "match king" Ivar Kreuger in the early years of the Great Depression defrauded individuals and entire countries of hundreds of millions of dollars. Yet in our day, a modern Ivar Kreuger, Bernie Madoff, accomplished a similar feat under the very noses of supposedly watchful federal regulators. In point of fact, a private financial analyst, Harry Markopolos, informed the SEC back in 1999 that Madoff was likely a con man, since the returns on investment he was claiming were mathematically implausible. But the SEC refused to get involved, despite repeated warnings from Markopolos spanning a number of years. Do we really need more of the kind of protection that the SEC gave to Madoff's victims?

The new Treasury plan is riddled with the sorts of conceits that Big Government know-it-alls love. It is founded in the inane notion that government overseers can somehow successfully micromanage the free market with its trillions of independent decisions every day. Like other such Big Government conceits, it will both diminish human liberty and stifle market productivity and innovation.

Not only that, the entire Treasury plan is completely unconstitutional. Nothing in the original Constitution was intended to give the federal government carte blanche to nationalize financial operations as it sees fit. But the lack of constitutional legitimacy has never troubled the Beltway know-it-alls in the past, and it doesn't bother them now.

The new Treasury proposal amounts to illegitimate nationalization of the nation's finances in everything but name, the culmination of a decades-long process that began in the 1930s with the creation of the SEC, the FDIC, and other first-generation financial command-and-control systems. Now that the regimentation of the once-free financial markets has failed so spectacularly, Obama, Geithner, and company are proposing to cap decades of federal mismanagement by a financial power grab unexampled in American history, and complete the work begun by Herbert Hoover and FDR.