Public Policy Choices to Moderate Asset Bubbles

To Regulate or Not to Regulate – That is the Question

Public regulation of financial institutions has a long history. Usually, public policy measures are re-active rather than pro-active. Moreover, what is adopted initially in response to a perceived weakness in the financial system may be tied more closely to the most recent dimension rather than some underlying set of causes of asset bubbles. Insofar as democratic institutions are concerned, it is difficult for elected officials and their regulatory proxies to stand against a rising tide of asset prices. All too often, public officials like to delude themselves into some notion that "this time is different", or "we are in a new economy (Bill Clinton, ca. 1990s in reference to the dot.com boom). What observers such as Kenneth Rogoff and others have noted is in fact, over several centuries, asset bubbles and the financial crises they wreak share common attributes that few seem able to overcome a priori, in part because, as we have noted, asset bubbles often are difficult to anticipate in the presence of heterogeneous preferences across the investing and consuming public.

We do know a few things about how states and markets operate either to nurture a climate of asset bubbles or to deter them in varying degrees. For the Great Recession of 2008, the antecedents of the asset bubble crashes in housing and equity markets can be traced to a series of deregulatory measures that date back to the 1970s, and were only indirectly observable when the dot.com crash occurred in 2000.

1. 1977 – CRA (Community Reinvestment Act) bans redlining, used to increase low-income loans of banks seeking merger approval.
2. 1978 – Supreme Court deregulates consumer interest rates on credit cards; Maine allows entry of out-of-state banks. Similar laws passed in all states except Hawaii by 1992.

3. 1980 – Depository Institutions Deregulation and Monetary Control Act. Eliminates regulation of interest rates.
4. 1982 – Garn-St. Germain Act. Allows for adjustable rate mortgages and interstate acquisitions of troubled banks.
5. 1983 – Federal Reserve allows bank holding companies to acquire discounted securities brokers.
6. 1984 – Secondary Mortgage Market Enhancement Act. Facilitates private issuance of mortgage-backed securities. Preemption of state regulation.
7. 1987, 1989, 1996 – Fed expands securities underwriting capacity of banks.
8. 1989 – FIRREA (Financial Institutions Reform, Recovery, and Enforcement Act) passed to resolve savings and loan crisis, weak regulatory structure implemented.
9. 1990 – Cranston-Gonzalez National Affordable Housing Act (the Home Investment Partnership Act) endorses mergers as a way to extend housing loans to higher risk lower income applicants.
10. 1992 – Housing and Community Development Act – Section VIII; Federal Housing Enterprises Financial Safe and Soundness Act, lowers down-payment requirements).
11. 1994 – Riegle-Neal Interstate Banking and Branching Efficiency Act, allows interstate acquisitions and branching, effectively nullifying the 1956 Bank Holding Act.
12. 1996 – Housing Opportunity Program Extension Act of 1996, increases incentives for low income mortgage loans.
13. 1999 – Gramm-Leach-Bliley, Financial Services Modernization Act. Repeals Glass-Steagall separation of investment and commercial banking.
14. 2000 – American Homeownership and Economic Opportunity Act lowers mortgage Downpayment requirements.
15. 2000 – CFMA (Commodity Futures Modernization Act) deregulates derivatives markets. (AHOEOA) American

Home Ownership and Economic Opportunity Act reduces reporting requirements on housing loans.

16. 2003 – ADDA (American Dream Downpayment Act) effectively eliminates qualification requirements for housing loans. No Income No Job Application (NINJA) loans become widespread, fanning housing prices to unprecedented levels.
17. 2004 – SEC allows investment banks to expand leverage, leaving open the question of whether government is to serve as a lender of last resort.
18. 2005 – Congress unable to resolving predatory lending issue. Republicans seek to eliminate state regulation on lending standards, with Democrats seeking stronger regulation.
19. 2008 – Troubled Asset Relief Program (TARP) endorses short-term credit to bankrupt institutions, replaced in 2009 by ARRA, the American Recovery and Investment Act. Lehman Brothers collapses after merger re-structuring negotiations with the Federal Reserve fail. AIG succeeds in obtaining loans that are later extended to Chrysler and General Motors.
20. 2010 – July 10 adoption of the Dodd-Frank bill that requires a number of regulatory controls: a. financial institutions required to regain a share of all mortgages; b. foreign exchange swaps required to pass through clearing and exchange regulated markets; c. the Volcker rule, which bans proprietary trading by depository banking institutions; d. ends the implicit guarantee of government intervention to save “too big to fail” institutions, e.g. Citibank, Bank of America, AIG, General Motors, and Chrysler, though it has not yet been tested; e. nationalization of Government Sponsored Enterprises (GSE’s) such as Fannie Mae and Freddie Mac; e. creation of the Consumer Financial Protection Agency.

21. 2010 – CFPA (Consumer Financial Protection Agency) established to impose higher reporting standards on bank credit contracts, in particular with regard to credit card terms and conditions.

(**Source**: Nolan McCarty, Keith T. Poole, and Howard Rosenthal, *Political Bubbles – Financial Crises and the Failure of American Democracy* (Princeton, New Jersey: Princeton University Press, 2013), p. 147-148, supplemented by updated information)

As with many pieces of legislation, Congressional officials seek to attract voter support for legislation that would respond to individual segments of the electorate while adding aggregate default risk on a systemic basis.

How Much Regulation Is Needed?

Putting aside the vulnerability of Congress, we consider here how much regulation of financial institutions may be needed to moderate asset bubbles in the future. We first note that individuals come to market decisions with heterogeneous preferences and time frames in response to the presence of risk, a condition that stresses any governance mechanism even under the best of circumstances. This said, here are some options that may not meet the test of political possibility but which may go some way in reducing future asset bubbles.

1. Maintain the independence of the Federal Reserve Bank to adopt decisions immune from political interests and election cycle pressures. (Ron Paul's 2009 book, *End the Fed*, illustrates to near-sighted opposition to a central banking institution, which if adopted, would put the U.S. in the odd position of being the world's largest financial banking system without any direction not just for domestic purposes but for international financial decisions as well).
2. Foster transparency not just in Federal Reserve policymaking but also in terms of financial accounting by businesses and banks. Sarbanes-Oxley and Dodd-Frank set standards for transparency, but as an example, continued use of

special purpose entities for loans increases underlying levels of risk.

3. Have the Fed set capital requirements on a flexible basis for banking institutions, but without government guarantees of bailouts for leveraged risk-taking. In essence, restore the core structure of the Glass-Steagall Act, as Dodd-Frank did on a very limited scale, but in which government is not a guarantor of loans in which investment banks have taken an ownership position.
4. Wind down government ownership of housing financial institutions, i.e. phase out Fannie Mae, Freddie Mac, and other institutions designed to increase home ownership. Instead, rely on direct income taxation to achieve a measure of housing affordability that meets a given political standard.
5. Increase public awareness of asset bubble risks through public reporting on benchmark indicators on housing affordability indices, price-earnings ratios relative to historical norms, and other indicators as part of an effort to educate consumers and investors.
6. Prosecute publicly elected officials who knowingly craft legislation that increases moral hazard which feeds the growth of asset bubbles. In the process, come up with a clear definition of "knowingly", that is, intent in all of its dimensions including and beyond immediate self-interest.
7. Set monetary policy rules in a predictable fashion, emphasizing monetary growth and control in a way that provide clear signals to economic agents.