

# TOOLS FOR A NEW ECONOMY

Proposals for a financial regulatory system

Robert Pollin

**The collapse of the housing bubble and the speculative market for subprime mortgages demonstrates,**

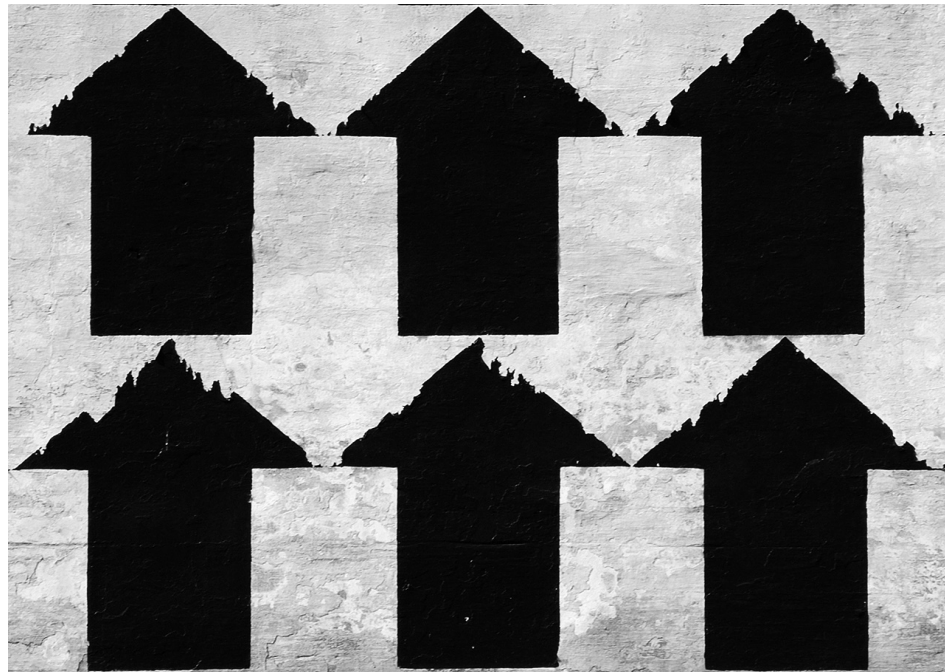
yet again, the simple point that financial markets need tight regulation. Since September 2008 a series of massive bailouts by the U.S. Treasury and Federal Reserve have prevented financial markets from experiencing a 1929-style collapse. These extreme measures, however, have not solved the broader problems at hand. As of this writing, we are experiencing the most severe economic downturn since the 1930s.

American politicians—Democrats and Republicans alike—began deregulating the U.S. financial system in the 1970s. Their premise was that regulations devised during the 1930s—specifically the Glass-Steagall system, which defined separate spheres for commercial and investment banks—would hinder the effective workings of contemporary financial markets. The 2001 *Economic Report of the President*, Bill Clinton's last, unequivocally dismissed Glass-Steagall: "Given the massive financial instability of the 1930s, narrowing the range of banks' activities was arguably important for that day and age. But those rules are not needed today."

The chorus of politicians and economists who for a generation advocated financial deregulation were right about one thing: the financial system has become infinitely more complex since the 1930s. Something that had been as simple as a local Savings & Loan making a home mortgage in their community—recall Jimmy Stewart in *It's a Wonderful Life*—is now part of a speculative global market. The old regulations had indeed become outmoded, but it never followed that financial markets should operate unregulated.

The historical record makes this clear. In the classic text *Manias, Panics and Crashes*, Charles Kindleberger called financial crises a "hardy perennial" within the context of unregulated financial systems. He documented that, from 1725 onward, financial crises have occurred throughout the Western capitalist economies at an average rate of about one every eight and half years.

There is an awful lot about the current financial crisis that is familiar. In 2001 the U.S. stock market crashed after having been driven during the late 1990s to unprecedented levels of speculative frenzy by the dot-com boom. A global financial crisis originated in East Asia in 1997-98 and spread rapidly. The sure-thing investment then was securities markets in developing countries. The U.S. hedge fund Long Term Capital Management—its board of directors guided by two Nobel Prize-winning economists



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specializing in finance—disintegrated in that crisis, requiring a \$4 billion bailout from other Wall Street firms to prevent a market meltdown.

The most severe crash of an overwrought financial market, the 1929 Wall Street crash, produced an economic calamity, which led in turn to a collapse of the U.S. banking system. Between 1929 and 1933, nearly 40 percent of the nation's banks disappeared. In their wake, Roosevelt's New Deal government put in place an extensive system of financial regulations, many of which persisted beyond the conclusion of the Great De-

Similar regulations were imposed on Savings & Loans (S&Ls) in 1932, and continued to operate through the 1970s. In particular, under the old regulatory regime, mortgage loans in the United States could be issued only by S&Ls and related institutions. The government regulated the rates S&Ls could charge on mortgages, and the S&Ls were prohibited from holding highly speculative assets in their portfolios.

But even during the New Deal years themselves, financial-market titans were already fighting to eliminate or at least defang the regulations. Since the 1970s,

ing families. Banks created opportunities for families with less-than-stellar credit records to obtain mortgages and buy their own homes. By bundling thousands of mortgages into securities that were freely traded on global financial markets, banks enabled subprime borrowers to purchase houses that would otherwise have been off limits. This kind of financial engineering, operating on a global scale, could not have been possible under the Glass-Steagall system.

The idea behind bundling mortgages into marketable securities is that the local bank or S&L that lends you money to buy a home does not hold onto your loan once you get your money. Rather, it sells your loan to a big financial institution, such as the government-sponsored Fannie Mae or Freddie Mac, which, in turn, bundles thousands of individual mortgages into securities. Fannie or Freddie then sells these mortgage-backed securities to banks, hedge funds, and other market players. With thousands of mortgages packaged into one security, the dangers of lending to higher-risk borrowers are supposed to decline; within a large portfolio of mortgages, the losses lenders incur from the small share of delinquent borrowers are offset by the much larger proportion of borrowers in good standing.

Market players became convinced that "securitizing" loans made subprime mortgage lending a much safer bet. For a time, optimistic expectations became self-fulfilling. Money rapidly flowed into the market. Housing prices rose, seemingly creating wealth out of thin air for homeowners. Market bulls grew rich while bears seemed out-of-step. Loan officers earned handsome commissions by bringing new customers to their banks. These officers had large incentives to approve subprime mortgages—they did not have to return their commissions years later when, for example, the loans, now held by a Swiss hedge fund, went sour.

The logic here is deeply flawed. Market players believed that the riskiness of subprime mortgages would diminish when pooled. In fact, the opposite turned out to be true. The fortunes of most subprime borrowers rose and fell together with the housing market's boom and bust. In the bust, the problems borrowers faced in meeting monthly payments became pervasive, not limited to isolated cases. This is why major financial institutions such as Citigroup, Merrill Lynch, and Bear Stearns, which were holding huge pools of subprime mortgages, experienced unprecedented losses in 2007, setting off the collapse of U.S. financial markets. Today's crisis is thus the direct consequence of the generation-long project of deregulating financial markets.

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**These proposals need not make the economy less innovative. The dynamism of a leashed financial market would emerge in the way credit moves into productive areas.**

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pression. The most important initiative was the 1933 Glass-Steagall Act, or, as it is officially known, the Banking Act. Commercial banks were limited to the relatively humdrum tasks of accepting deposits, managing checking accounts, and making business loans. Commercial banks would also be monitored by the newly formed Federal Deposit Insurance Corporation (FDIC), which provided government-sponsored deposit insurance for the banks in exchange for close government scrutiny of their activities. Investment banks, by contrast, could freely invest their clients' money on Wall Street and undertake other high-risk activities, but they had to steer clear of the commercial banks.

they have almost always gotten their way. This led cumulatively to the dismantling of Glass-Steagall. The final nail in the coffin came in 1999 when President Clinton signed the Financial Services Modernization Act. He did so with the strong support of then-Senator Phil Gramm, later a top advisor to John McCain's Presidential campaign; then-Federal Reserve Chair Alan Greenspan; and top advisors Robert Rubin and Lawrence Summers, both of whom would later counsel the Obama campaign and transition team.

While the current crisis resembles its predecessors in many ways, it also has some novel characteristics. Its most prominent distinction is that it has resulted from activities that were supposed to benefit work-

We need a new regulatory framework that is capable of both stabilizing markets and, correspondingly, channeling financial resources toward productive and socially useful investments and away from the speculative casino. What follows is a series of proposals to guide the new framework. They offer a decisive break from the deregulatory agenda of the past generation, yet they are all feasible within the existing set of political and regulatory institutions. Enacting them would require insignificant increases in administrative costs and low levels of public outlay. All of these proposals have been debated seriously within mainstream political circles.

U.S. markets, of course, operate within a globally integrated setting, a reality that complicates any regulatory scheme. These proposals are intended to apply to all financial institutions under U.S. legal jurisdiction, whether they are called banks, holding companies, hedge funds, or variations thereof.

My first proposal is the establishment of a small tax on all trading of financial assets. Financial markets do provide an essential service by simplifying the conversion of investments into money. But this benefit must be weighed against the fact that trading has almost nothing to do with raising funds for investment. As of 2007, players in the market traded roughly \$300 worth of stocks and bonds for every dollar that nonfinancial corporations raise for new investments in plant and equipment. This ratio is about three times what it was only a decade ago, at the peak of the dot-com bubble.

A small tax on all financial-market transactions, comparable to a sales tax, would raise the costs on short-term speculative trading while having negligible effect on people who trade infrequently. It would thus discourage speculation and channel funds toward productive investment. Securities-trading taxes are common throughout the world. Roughly forty countries, including Japan, the United Kingdom, Germany, Italy, France, China, Brazil, India, South Africa, and Chile employ or have recently employed such a tax.

In the aftermath of the 1987 crash, securities-trading taxes or similar measures were endorsed by then-House Speaker Jim Wright, then-Senate Minority Leader Bob Dole, and even the first President Bush. Variations on the idea have been introduced in Congress regularly in subsequent years, but never passed into law. Two leading Clinton administration economists, Nobel Laureate Joseph Stiglitz and Summers, argued persuasively for such a tax in the late 1980s. Summers disavowed the idea soon after joining the Clinton Treasury, becoming instead a major supporter of the deregulation agenda of the Clinton years. What Summers might support now, as the head of National Economic Council under President Obama, is an open question.

The technical features of a trading tax are simple. For stocks, the seller could be charged, for example, 0.5 percent of the sale price (Jim Wright suggested this rate in 1987). For bonds, the tax would be proportional to the bond's duration, at a rate of 0.01 percent per year. Thus, the tax on selling a thirty-year bond would be 0.3

percent, and a tax on a fifty-year bond, 0.5 percent. The tax would be adjusted on a comparable basis for derivative financial instruments, such as options, futures, and credit swaps. Brokers would be responsible for collecting the tax from the sellers at the time of sale.

Since the IRS already imposes trade-reporting requirements, a securities trade tax would entail little additional administrative apparatus. Nor would it have a significant impact on anyone who bought an asset and did not promptly resell it for a quick profit. For someone who buys stock at \$50/share and sells it ten years later at \$100/share, the trading tax would be \$0.50 per share, on a \$50 capital gain.

Conversely, a 0.5 percent tax would seriously reduce profit for short-term speculators. It is not uncommon for speculators to buy a stock, hold it for a day or even hours, and then resell it for a small gain. A \$1 capital gain for a \$99 share bought yesterday and sold today \$100 today nets a good return on a one-day investment. The trading tax would garner 50 cents—half the earnings from the trade.

One could use the tax on its own to cut financial speculation dramatically. That would only entail raising the tax rate until the point where traders see little incentive to trade at all. But the aim is not to shut off trading altogether; if that were the case, full nationalization of the financial markets would probably be a more effective approach.

Even at a rate too low to dampen speculation, the securities-trading tax has another benefit. It would provide a new source of government revenue at a time when it is badly needed. Working with 2007 figures, I estimate that a 0.5 percent tax on stock trades, and the sliding scale described above for bonds and derivatives, would raise approximately \$350 billion, if trading did not decline at all after the tax was imposed. Even if trading declined by 50 percent as a result of the tax, the government would still raise \$175 billion, roughly equal to both the entire Iraq war budget for 2008 and the April 2008 fiscal stimulus initiative. The securities trading tax, moreover, could be designed as a major revenue source to fund any new regulatory apparatus for other government initiatives.

But a modest tax on securities trading is not enough, on its own, to discourage speculation and channel credit to where it is most needed. A second proposal, if adopted, would increase democratic accountability within the Federal Reserve System, which would in turn raise accountability throughout the regulatory apparatus as well as in private markets.

Proposals for democratizing the Federal Reserve have long been advanced in mainstream political circles through the efforts of Congressmen Wright Patman, Henry Reuss, and Henry Gonzales, among others. These three men served, respectively, as Chair of the House Banking Committee from 1963-75, 1976-82, and 1989-94.

The best approach to democratization would begin with redistributing power downward to the twelve district banks of the Federal Reserve System, then opening the presidencies of these banks to direct elections. At present, the banks are highly undemocratic, and they have no real power.

I propose the reverse: accountable and empowered district banks.

When the Federal Reserve system was formed in 1913, the twelve district banks were supposed to disperse the central bank's authority broadly and respond to regional needs. This remains a valuable idea, but it has never been seriously implemented. Bank presidents are currently appointed by the banks' boards of directors. These are businesspeople, mostly commercial bankers, who are also appointed, not elected.

At the level of national policy-making, the district banks have influence only because five of the twelve bank presidents sit, on a rotating basis, on the Federal Open Market Committee, the body that votes on all monetary policy initiatives by the Fed. However, under present arrangements, the Chair of the Fed, who is also the Chair of the Open Market Committee, exercises predominant influence over the full Committee, usually acting in consultation with the Treasury Secretary.

The direct election of district bank presidents by residents of the relevant regions would democratize the banks. And creating additional seats for them on the Open Market Committee would increase their power. District bank presidents, once on the Committee as elected representatives from their regions, could explicitly address the concerns of their constituents.

A related proposal would build on an experiment from the 1930s when district banks formed committees of bankers and businesspeople to discuss financial-market issues in a non-market setting. This model could now be extended to include

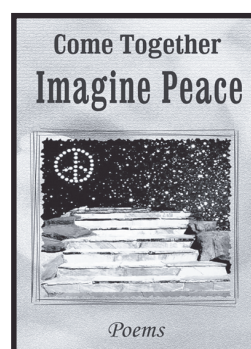
labor, consumer, and community representatives.

Strengthening the Fed's policy toolkit is a third crucial component of any plan to increase democratic accountability. Specifically, the Fed must be able to promote the channeling of credit to productive purposes over speculation. Without this tool, extending democracy within the institution will be largely symbolic.

A system of "asset reserve requirements," which would oblige financial institutions to maintain cash reserve funds in proportion to the high-risk assets in their portfolios, would encourage banks, hedge funds, and the rest to channel credit to high-priority and less-risky areas. This idea has an extensive, if largely neglected, mainstream pedigree. MIT's Lester Thurow, for example, sketched the following arrangement in a 1972 paper written for a conference at the Federal Reserve Bank of Boston:

If national goals called for investing 25 percent of national savings in housing and other preferred sectors, each financial institution would have a 100 percent reserve requirement on that fraction of its assets. As long as it invested 25 percent of its assets in housing, however, it would not have to leave any reserves with the government. If it had invested 20 percent of its assets in housing, five percent of its assets would have to be held with the government in required reserves. If it invested nothing, 25 percent of its assets would be held as reserves.

Other specific versions of asset reserve requirements were outlined in the 1970s



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by former Federal Reserve Governors Andrew Brimmer and Sherman Maisel. Their proposals were, more or less, in support of unsuccessful efforts by Senator William Proxmire and Representative Reuss—then chairs of the Senate and House Banking Committees, respectively—to advance bills establishing procedures for Federal Reserve-directed credit allocation policies.

In fact, the equivalent of asset reserve requirements has long been established practice in the United States. S&Ls, after all, originally had their loan portfolios restricted to fixed-rate home mortgages. That could be described as a 100 percent asset reserve requirement.

Policymakers should first—either within a democratized Federal Reserve or in a broader dialogue—determine which sectors of the economy get preferential access to credit. In my view, we should encourage domestic investments in which risks are relatively well understood, and, correspondingly, discourage speculative investments where risks are relatively opaque. Beyond that, we should give preference to job-creation, subsidizing the growth of green investments and the fight against global warming, and affordable housing. The financing of affordable housing, for example, would then be subsidized directly by public-policy arrangements, and not, as in the last decade, as a byproduct of high-stakes gambling.

With established goals, this policy gives significant social control over major finance and investment activities, while allowing considerable decision-making freedom for both intermediaries and businesses. Intermediaries would still be responsible for establishing the credit-worthiness of businesses and the viability of their projects. Businesses would still be responsible for the design and implementation of their investments. Indeed, business would still have freedom to pursue nonpreferred projects, and banks could still finance them. Financing costs would just be significantly higher.

Implementing requirements as a system of market auctions rather than quotas, as Maisel proposed, would allow more flexibility. Institutions would not have to carry the specified proportion (say, 25 percent) in loans to preferred sectors. Intermediaries that exceed the limit would obtain a permit that they could then sell to institutions whose loans to preferred sectors are below the minimum. Individual institutions could therefore choose to maintain particular market niches. At the same time, the system would ensure that some niches carried an extra burden of either higher reserves or purchases of “preferred asset permits.”

A fourth measure that could channel credit to priority areas and reduce risk in U.S. financial markets would focus and expand the federal government’s already extensive but unwieldy system of direct lending and loan guarantees. The U.S. government has long been heavily invested in domestic financial markets as a direct lender and even more significantly as a loan guarantor. The sectors of the economy receiving substantial support though these loan programs include housing, education, agricultural and rural development, and small business. As of 2007, the government oper-

## As One Bereft of Reason

In ambush with web and pin and broken off not-too-  
Distant pledge, a flax knife handled like failed office, as hobnails  
Hammered through the many careful bodies of a breeze  
By the hundreds let them come; they come corseted in ice.  
I encircle you like sacrifice, a secretary’s desk.  
Between springs, ankles colt-swindled based on sight and  
Artificial things, delight in sound, sound, for melody  
Is a most base might of another artificial strain  
And greets delight like sacrifice, like the seminary  
Of the swindling class, in bare feet taking leave by hundreds.  
Let them come, snow between springs, ankles colt-bearing  
The slack knives of failed office, corseted in vice.  
Husk to stalk I bind you hobnailed ambush, my corsage  
Tangled, thin arms webbed and pinned and broken.

—Ken White

ated about 140 separate loan guarantee and direct lending programs. That year, the government’s \$250 billion of new guaranteed loans and \$42 billion of direct loans together represented about 14 percent of the total borrowing by households and businesses in U.S. financial markets. Outstanding government loans and loan guarantees were \$1.4 trillion, about six percent of total debt. (These programs are separate from the operations of “Government-Sponsored Enterprises.” Fannie Mae and Freddie Mac were the largest GSEs until they were nationalized in September 2008 to stave off financial collapse. Other GSEs include the Federal Home Loan Banks, the Agricultural Credit Bank and Farm Credit Banks, and the Federal Agricultural Mortgage Corporation.)

Despite their formidable size, these programs have not been integrated into a broader policy agenda or tied in any way to the Federal Reserve’s monetary policy and interest rate management efforts. They operate rather as financing vehicles for distinct programs, from student loans to rural business development. Their influence on overall financial-market risk or borrowing costs has not been considered, nor has their effectiveness in leveraging relatively small amounts of public funds to move private financial markets in socially desirable directions.

An expanded loan-guarantee program could be included as a tool to promote financial stability and social welfare. Assume, for example, that the government roughly doubled its 2007 level of loan guarantees. The additional \$300 billion per year could be earmarked for green investments and affordable housing, and we would set an explicit level of guarantee at, say, 75 percent. The government then would be the guarantor for \$225 billion in loans for green investments and affordable housing. Interest rates on these subsidized loans would fall with the reduced level of risk—i.e. by 75 percent relative to the difference between a market interest-rate bond and a risk-free government bond. If the market interest rate is 10 percent and a government rate 5 percent, the subsi-

dized rate would be 6.25 percent—the 10 percent market rate minus 75 percent of the 5 point difference between the market rate and the 5 percent risk-free government bond rate.

Under this arrangement, private lenders would still bear significant risks and therefore have strong incentives to evaluate loan applications carefully. Market forces would be at work, but the policy would rig market activity toward desirable social outcomes.

How much would such a program cost? That would depend on the default rate for the loans. In 2007 the government had to cover about \$50 billion on an outstanding portfolio of guaranteed loans of \$1.2 trillion. This is a default rate of 4 percent. At this rate, our proposed addition of \$300 billion in guaranteed loans would cost roughly \$9 billion more per year in loan receivables, increasing the overall federal budget by 0.3 percent. But it would leverage more than \$300 in private loans for every dollar in government spending. This sort of loan-guarantee program could serve as a carrot to the stick of asset-based reserve requirements for private financial institutions.

Fifth, and finally, I propose the formation of a public credit-rating agency to compete with the private agencies such as Moody’s, Standard & Poor’s, and Fitch. These rating agencies contributed significantly to the housing bubble and subsequent crash of 2007–08 by consistently delivering overly optimistic assessments of risky financial ventures, especially in securitized asset markets.

Rating agencies are supposed to be in the business of providing financial markets with objective and accurate appraisals of the risks associated with purchasing a given financial instrument. In part, they understated risk in recent years because they relied on orthodox economic theories in their appraisals. But more important for our purposes is that market incentives themselves pushed the agencies toward providing excessively favorable appraisals. Giving a favorable risk appraisal was good for the rating agencies’ bottom lines, and the agencies responded predictably.

In principle, marketplace incentives should push the agencies toward accurate appraisals because supposedly the only valuable product agencies offer is credibility. One would expect market competition to reward firms that provide better information. But a large gap exists between the ideal set of incentives and the real ones. In practice, rating agencies show strong bias toward favorable ratings for a simple reason: they are hired by the companies they evaluate. Companies therefore choose agencies that they think are likely to provide favorable ratings; those ratings, in turn, enhance the companies’ ability to sell their financial instruments.

With the benefit of hindsight, the agencies’ misjudgments are now widely recognized. Economics writer Roger Lowenstein recently offered this appraisal in *The New York Times Magazine*:

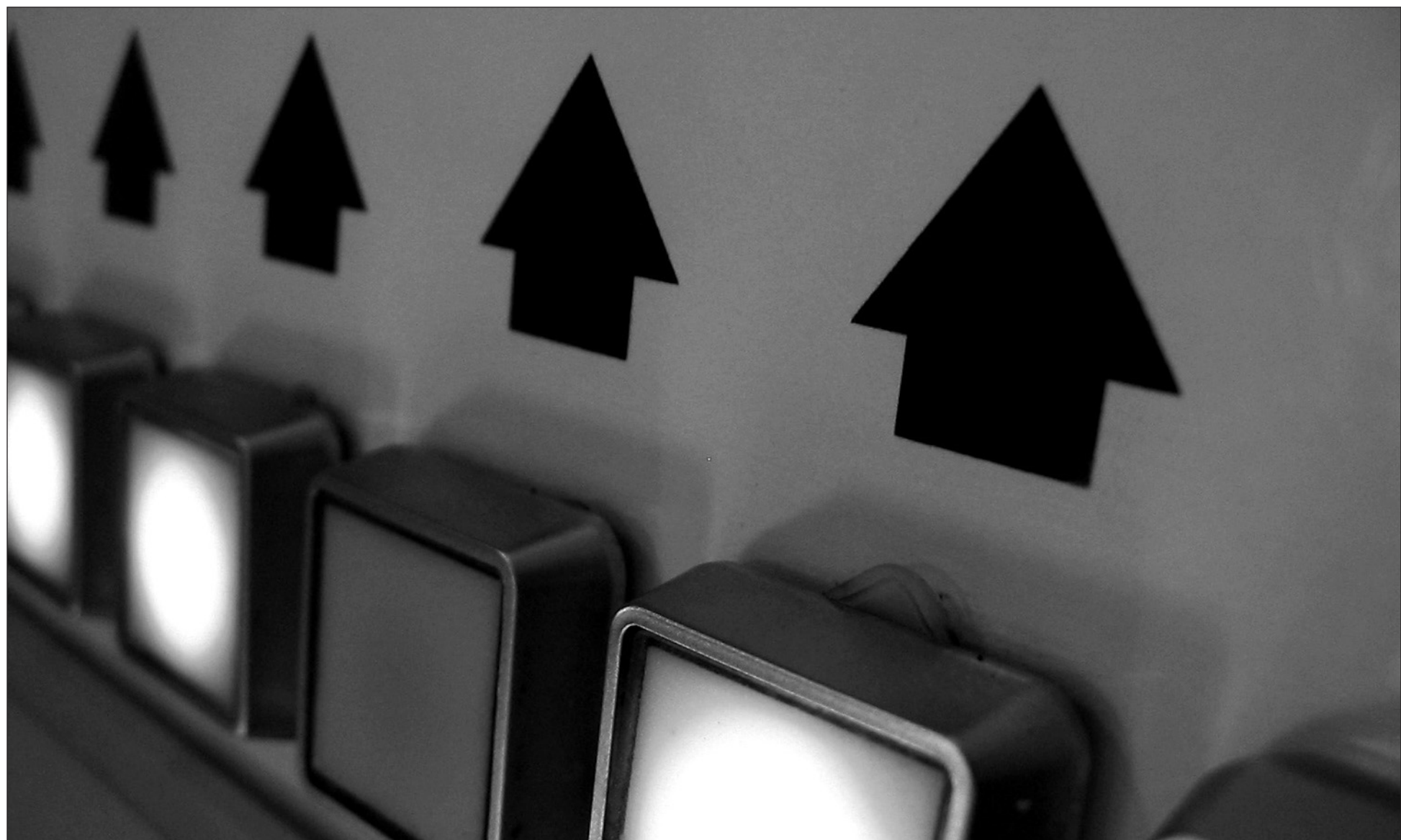
Over the last decade, Moody’s and its two principal competitors, Standard & Poor’s and Fitch, . . . [put] what amounted to gold seals on mortgage securities that investors swept up with increasing élan. For the rating agencies, this business was extremely lucrative. Their profits surged . . . . But who was evaluating these securities? Who was passing judgment on the quality of the mortgages, on the equity behind them and on myriad other investment considerations? Certainly not the investors.

The investors assumed that rating agencies were providing objective and accurate appraisals. Agency evaluations shape how investors price assets, which in turn has a major impact on whether and how investment projects get financed.

The outsized importance of securitized assets as a share of overall market activity only compounded perverse incentives. In financial markets dominated by securitization, the primary way banks or other financial intermediaries earn money is not holding onto loans and collecting interest. Rather, banks earn fees by selling individual loans to entities such as Fannie Mae or Freddie Mac that want to bundle the loans into securities. Fannie and Freddie will themselves earn another round of fees by selling their bundled loans on the market. Still more fees can be earned by selling insurance policies on the securitized bundle of loans.

What makes securitized assets more valuable in the market than the underlying bundle of loans is that the risks associated with those loans have been reconfigured, repackaged, and presumably clarified for market participants. Without a favorable rating, securitized assets are simply not marketable. With a favorable rating, opportunities to earn fees emerge at all points in the chain of securitizing, insuring, and trading, with market traders always keeping their fees, no matter what happens at some later date to the underlying asset.

A public credit-rating agency would counterbalance this perverse incentive system. Its staff would be compensated as high-level civil servants. They would receive no benefits from providing either favorable or unfavorable ratings. Indeed, a compensation system could reflect the accuracy of their risk assessments over time.



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It is true that providing accurate risk appraisals has become increasingly challenging as securitized markets have deepened. The public agency's staff may well conclude at times that an instrument is too complex to allow for an accurate appraisal. But the agency would be obligated to be open with such an assessment—that is, to assess an instrument as “not ratable.” Financial market participants could then decide whether they want to gamble with such an instrument.

Private agencies could still operate as they wish, but would have to explain any large divergence from the public agency in their assessments. Public rating would weaken the biases in favor of greater risk and complexity, and move financial-system operations to a higher level of transparency. It could even provide the basis for establishing the asset-based reserve requirements for loans and other assets held by financial institutions.

As risk assessment would likely become more cautious under a public credit-rating agency, the market's enthusiasm for financial innovation would likely dampen. Indeed, this would partly be the point of such a measure. But it need not make the overall economy less innovative or dynamic. With a public credit-rating agency and the other measures proposed here, the dynamism of a leashed financial market would emerge in the way that credit moves into productive areas.

At the end of 2008, the financial crisis and recession made respectable a question that would have been unthinkable only months earlier: whether privately owned financial institutions—at

least the largest and most important institutions that represent the “commanding heights” of Wall Street—should not merely be re-leashed through regulation, but substantially nationalized, operating with public ownership. After all, the federal government under George W. Bush already nationalized Fannie Mae and Freddie Mac as part of its fall 2008 bailout operations.

The main arguments for nationalization are straightforward. First, the failings of an unregulated financial system are now blazingly apparent. Re-leashing financial markets in some form is no longer a matter of dispute; only the question of how best to do it remains. One path would eliminate private ownership of financial institutions altogether.

Second, even while assuming equity positions in several large financial institutions at the end of 2008, the government did not insist on exercising significant authority over management decisions. Nor did it clearly establish a claim on any profits once the crisis subsides. With banks fully nationalized, the government would be the clear operational manager of the institutions as well as the claimant on profits.

Third, without nationalization, we can be certain that Wall Street will fight vehemently, as it always has, to minimize regulations that might limit its ability to make profits. Such efforts will include attempting to corrupt the regulators and the elected officials overseeing them. Most such efforts will be entirely legal: assuming the regulators are generous toward the industry they are regulating, they will find opportunities for lucrative employment within the industry once they quit their public-sector jobs and move into private-sector positions.

These are important considerations, but they do not constitute an adequate case for nationalization over a new financial regulatory system. We would face significant problems under nationalization. Unlike France or Japan, the United States does not have a longstanding tradition of direct public ownership of major financial institutions. Realistically, we would have every reason to expect a wide range of failures and misjudgments, including “crony capitalism”—privileged back-room dealings with selected non-financial firms.

Even putting aside problems of corruption, we need to recognize that individual financial enterprises, as with all business entities, literally need micro-management. The U.S. government has at times managed the economy at the macro level reasonably well. But the challenges for the government to combine the demands of both micro- and macro-level management would be formidable. The details of day-to-day management aside, the government would have to create an incentive system for the managers of the publicly owned banks that would substitute for the profit-maximizing incentives that guide managers of private banks. If the nationalized banks are not committed to maximizing profits, how should their performance be evaluated?

Resolving such questions would require years of experimentation and fine-tuning. In the meantime, U.S. taxpayers would pay for inevitable breakdowns of the nationalized system. The tolerance for breakdowns would likely be low, and every misstep or mini-scandal could undermine the legitimacy of the new system. In the end, nationalization could undermine the larger project of reestablishing a major

public-sector presence in the financial system. Indeed, the failures of the nationalized system could be the very thing—perhaps the only thing—that could shift the target of public outrage over the collapse of the financial system off Wall Street and onto the U.S. government.

At this juncture, it seems preferable to promote financial stability and social welfare by leashing the markets and thereby reorienting their priorities, not by choking them off altogether.

A range of forces in the U.S. and global economies have combined to create the most severe economic crisis since the 1930s. We will debate for years to come how these forces came together and how they interacted once combined. But one factor stands out as the greatest cause of the crisis. This is the collapse of the U.S. financial system. The financial-system collapse can be traced, in turn, to the dismantling since the 1970s of the Glass-Steagall financial regulatory system. Glass-Steagall was created in the 1930s precisely to prevent a recurrence of that era's economic disasters. Both Democratic and Republican political leaders must now accept responsibility for the current calamity.

We now begin what will necessarily be a long process of building a regulatory system capable of mobilizing the economy's financial resources for productive economic activity instead of casino capitalism. With the collapsed model of the deregulated financial system now before us, the set of proposals offered here are a starting place for forming a stable and equitable financial structure for the U.S. economy. ♦