REALITY CHECK

The Forgotten Lessons of Deregulation and Unsung Successes of Sensible Safeguards

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FIRST, they said the market could govern itself.

"There is nothing involved in federal regulation per se which makes it superior to market regulation."

– Federal Reserve Board Chairman Alan Greenspan

"The sophisticated counterparties that use [over-the-counter] derivatives simply do not require the same protections" as other investors.

– President Clinton's Working Group on Financial Markets

Mortgage lenders should be given a "wide breadth of freedom from regulatory intrusion."

– Office of Thrift Supervision Director James Gilleran

THEN, they realized they were wrong.

For a brief moment after the housing bubble burst and the financial sector crashed in 2008, the deregulators were chastened. Greenspan said he was in a state of ***"shocked disbelief"*** over the failure of market forces to compel responsible practices, and many other long-standing deregulators acknowledged a need for greater government oversight.

BUT THEN, they forgot.

Partisans and industry leaders soon began blaming alleged ***"job killing regulations"*** for the troubled economy that deregulation wrought, and they embarked on a new campaign to stifle the creation of needed public safety rules.

IT'S TIME FOR A *REALITY CHECK*.

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“Under my reforms, the American people will be protected by comprehensive regulations.”

—Republican presidential nominee John McCain (2008)

INTRODUCTION

For a fleeting moment in the fall of 2008, it appeared that the United States’ nearly 30-year drift toward deregulation had run its course.[1]

On September 15, investment bank Lehman Brothers submitted the largest bankruptcy filing in U.S. history.[2] The next day, the Federal Reserve announced that it would spend $85 billion to rescue insurance giant American International Group to prevent a crippling cascade of failures among financial institutions.[3]

These developments came a week after the government seized mortgage buyers Fannie Mae and Freddie Mac, both of which had succumbed to a housing crash caused by reckless and unchecked mortgage lending. The government committed up to $100 billion—which would eventually grow to at least $185 billion—to keep the firms solvent.[4]

The financial industry, which had spent decades lobbying to reduce government regulation, now relied on the government for survival. Congress would soon commit $700 billion in taxpayer-funded bailout money to Wall Street to prevent the economy from seizing up.[5]

Poor regulation was widely blamed for the unraveling state of affairs. On September 16, Republican presidential nominee John McCain, who had earlier in the campaign pronounced himself “fundamentally, a deregulator,” promised that “under my reforms, the American people will be protected by comprehensive regulations.”[6]

"There is nothing involved in federal regulation *per se* which makes it superior to market regulation."

—Federal Reserve Board Chairman Alan Greenspan (1994)

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"Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself especially, are in a state of shocked disbelief."

—Greenspan (2008)

McCain was not the only unlikely advocate for more vigilant oversight. Top officials in the unabashedly deregulatory administration of President George W. Bush joined the chorus.

As the housing market and investment banking industry teetered in March 2008, Treasury Secretary Henry Paulson said "regulation needs to catch up with innovation."[7]

Securities and Exchange Commission Chairman Christopher Cox, who had pushed for deregulation when he served in the Congress, lamented "significant regulatory holes, significant regulatory gaps" in the oversight of the mortgage market, financial derivatives and investment banks in general.[8]

"The lessons of the credit crisis all point to the need for strong and effective regulation," Cox testified in October 2008.[9]

Even former Federal Reserve Chairman Alan Greenspan, likely the most influential champion of deregulation in recent decades, performed a stunning about-face.

Greenspan had once opined, "There is nothing involved in federal regulation *per se* which makes it superior to market regulation."[10]

But in late October 2008, Greenspan admitted that his ideology had led him astray. "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself especially, are in a state of shocked disbelief," he said in House testimony.[11]

For the famously inscrutable Greenspan, that was about as clear as it gets.

By October 2008, Americans believed by a 50 to 38 percent margin that government regulation of business was necessary to protect the public.[12] Just nine months earlier, Americans' views were 50 to 41 percent the other way.[13] This marked a shift from an anti-regulatory consensus that had prevailed roughly since President Reagan declared "government is the problem" in his 1981 inaugural address.[14]

In November 2008, Barack Obama was elected president. Few would dispute that his candidacy was aided by the nation's appetite for more vigilant government oversight.

But America's embrace of regulation proved to be short-lived. Soon after Obama took office, opponents of government oversight and those who simply opposed the new president launched a relentless campaign to make regulation the scapegoat for the bleak economic conditions that deregulatory policies left in their wake.

Pundits, lobbyists and Republican politicians charged that Obama was perpetrating a "regulatory tsunami,"[15] a "regulatory onslaught,"[16] or a "regulatory state,"[17] among other claims. The GOP and its allies adopted the epithet "job-killing regulations" as their cudgel.[18]

Republican members of Congress put forth a series of bills that would impose moratoriums on issuing new rules.[19]

The 2012 Republican presidential candidates sought to outdo themselves with anti-regulation rhetoric. "Day by day, job-killing regulation by job-killing regulation, bureaucrat by bureaucrat, [President Obama] is crushing the dream," said former Governor Mitt Romney, the eventual nominee.[20]

Among the other hopefuls, Texas Governor Rick Perry blamed regulations for "strangling the American entrepreneurship out there."[21] Former Speaker of the House Newt Gingrich said that the nascent Dodd-Frank Wall Street Reform and Consumer Protection Act was "killing small banks, killing small business, killing the housing industry."[22]

Former Senator Rick Santorum said the nation should simply "repeal every regulation the Obama administration put in place."[23]

The assault on regulations succeeded in changing public opinion. By 2012, 52 percent of Americans said regulation of business "usually does more harm than good," up from 38 percent in October 2008.[24]

This book aims to reawaken awareness of how deregulation and lax regulation failed us, and to inform the debate with case studies showing how regulations actually work.

Part I, *The Forgotten Lessons of Deregulation*, provides a reminder that the nation's experiment with deregulation plainly did not succeed. This section discusses five distinct areas in which deregulation or lax regulation yielded undesirable—and, at times, disastrous—outcomes.

Part II, *Regulations in the Real World*, provides case studies illustrating both that developing new regulations is an enormously careful process and that regulations often yield spectacular benefits.

Our *Appendix* reviews numerous academic studies that discredit the oft-repeated claim that regulations "kill jobs." Many studies have found that public safety rules actually aid job creation by prompting investments, particularly during recessionary periods, when businesses' incentive to invest is otherwise reduced.

It is time for the arbiters of our public policy debates to catch up with reality. This book's documentation of the costs of eschewing sensible safeguards shows that we cannot afford to capitulate to anti-regulatory hyperbole.