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RAHN: The necessity of failure

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The expression "Failure is not an option" may be a motivator for very high-risk situations, but failure must always be an option for players in a properly functioning market economy. If you had a choice between buying a bond issued by a company considered "too big to fail" - which is an implicit government guarantee of its debt - would you buy that bond or one issued by a company without a government guarantee? Companies with government guarantees will be able to borrow at less cost, and, ultimately, their unfair competitive advantage will drive the companies without guarantees out of business.

You may believe that the housing bubble and the subsequent financial meltdown were caused primarily by the Fed or Fannie Mae and Freddie Mac (the two multitrillion-dollar government-sponsored secondary mortgage buyers) or by the very largest commercial and investment banks. But whichever theory you choose, note that it was either the government or those heavily regulated by the government that were the source of the problem - and all were considered "too big to fail." Fannie and Freddie, as everyone knew, had an implicit government guarantee. And the very largest banks grew into the financial behemoths they became largely through mergers rather than internal growth. Former Federal Reserve Gov. Martha R. Seger recently reminded me that every one of those bank mergers was approved by the Fed and, in some cases, encouraged by the Fed.

The cry from the political class is, as always, "We need more government regulation" - and the establishment media, as always, are cheering. Do we really need more government regulation? Play detective. Congress, in the form of Sen. Christopher J. Dodd's financial regulatory reform proposal, is flirting with giving the Fed much more power over many more institutions, yet the Fed was a major player in the financial meltdown and missed all of the warning signs. If you were in a military campaign and had to pick a reconnaissance team to warn you of the next possible attack, would you pick the team that had missed the previous attacks?

Under the Dodd bill, a new Financial Stability Oversight Council (FSOC) would be established to prevent bubbles, among other things. If the folks at the Fed now admit they cannot identify bubbles or know how to stop them, how is this new council going to do that? Private-market players identify bubbles by deciding, at some point, that a particular price trend is unsustainable, which causes them to withdraw. If enough other market participants come to the same conclusion, prices fall in the particular market, and some participants lose money or even go bankrupt - that is, they fail. The failure of some participants sweeps away the least innovative and/or poorly managed companies.

When government becomes a player and tries to prevent the failure of market participants, its decisions are almost invariably corrupted by the political process. Government overseers tend to be less attentive and careful because they are playing with taxpayers' money rather than their own. Fannie Mae and Freddie Mac are the poster children for what is wrong with "state capitalism" or "economic fascism," in which the government leaves nominal ownership in the hands of private individuals but exercises control by regulation and taxation. Despite warnings from knowledgeable critics, Fannie and Freddie engaged in unsound financial practices for years, often at the behest of their political masters in Congress. Rather than being allowed to go into bankruptcy, broken up, truly privatized and reorganized, they were bailed out by Congress. As a result, bad practices continue, and the taxpayers will once again be stuck with hundreds of billions of dollars in additional liabilities.

Congress is supposed to regulate the Fed, but few members of Congress understand what the Fed does or is supposed to do. The Fed regulates banks, in part, to stop bank failures, which is next to impossible for a variety of reasons. It is supposed to provide sound currency, with a constant value, which is possible. It also is tasked to ensure full employment, but it cannot do this alone. So what sense does it make to give the Fed expanded authority over financial institutions devoid of problems, rather than limiting it to those with problems, which were largely of the Fed's own making? Last year, Congress set up the Financial Crisis Inquiry Commission, which will soon issue a report, so why is Congress trying to legislate cures for problems that it has yet to understand?

There is an illusion that when people are appointed to regulatory commissions, they somehow become smarter and know things they didn't know before. They don't! This is why they do not see "bubbles," "systemic risk," "economic downturns," etc. before other market participants see them. Politicians give regulators the impossible job of preventing "failures," which only leads to larger failures. What is needed is an orderly process in which banks and other private financial institutions are allowed to fail when they make mistakes - and in which the stockholders and even lenders lose money. Depositors can be protected so that

bank "runs" can be prevented, but that is a different issue. Actually, there is such a process, and it is bankruptcy, which, when allowed, has worked well for hundreds of years.

Allowing financial and other firms to fail in an orderly way through bankruptcy provides the most direct and effective discipline upon those bankers and others who take too much risk, are incompetent or mismanage. The idea that society is going to get better outcomes by having a bunch of government regulators second-guess private business decisions and the market is contrary to history and what we know about the political process.

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