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In Turmoil, Capitalism in U.S. Sets New Course

By DAVID WESSEL

This past week marks a decisive turn in the evolution of American capitalism.

Black September, the biggest financial shock since the Great Depression, is prompting a Republican Treasury secretary and Federal Reserve chairman to devise the most muscular government intervention in the economy since the Great Depression in an effort to prevent the economic devastation of the Great Depression.

Abandoning its one-rescue-at-a-time strategy of recent months, the government suddenly has shifted to a broad attack on what Treasury Secretary Henry Paulson calls "the root cause of our financial system's stresses," the rot on the balance sheets of America's financial system.

Gone is the faith, shared by the nation's leadership with varying degrees of enthusiasm, that the best road to prosperity is to unleash financial markets to allocate capital, take risks, enjoy profits, absorb losses. Erased is the hope that markets correct themselves when they overshoot.

Also scrapped is the notion that government's role is to get out of the way, limiting itself to protecting consumers and small investors, setting the rules of the game and stepping in -- only rarely -- to cushion the economy from shocks like the 1987 stock-market crash or the 1998 collapse of hedge fund Long-Term Capital Management. Both of those episodes involved government jawboning and flooding the markets with money. In contrast to today, neither time did the U.S. take significant amounts of taxpayer money or anything approaching the nationalization of a major firm.

As recently as Spring 2007, Mr. Paulson, among others, was arguing that onerous regulations were crippling American finance in intensifying global competition. Those cries are silenced.

"The last 20 years saw people actually mouthing the idea that government should keep hands off," says Richard Sylla, a financial historian at New York University. "We had this free market ethos: Reagan's 'government isn't a solution, government is the problem.' Now people are saying, 'The market is the problem. The government is the solution.' "

The Depression triggered, among other things, sweeping new rules governing the financial system -- including the 1933 Glass Steagall law that separated commercial and investment banking until its repeal in 1999. The inevitable result of this crisis, once it ends, will be more government control of the financial system. The only questions now are how much tougher the new oversight will be, what form it will take and how long until the restrictions are loosened or evaded?

In March, the Federal Reserve shattered a half-century of tradition in which it had lent money only to banks whose deposits were insured by the government. Declaring circumstances to be "unusual and exigent," as required by a little-used statute, it lent to investment bank Bear Stearns and eventually risked $29 billion of taxpayer money to induce J.P. Morgan Chase to buy Bear. It seemed a very big deal at the time.

But in the past two weeks, the U.S. government, keeper of the flame of free markets and private enterprise, has:

-- nationalized the two engines of the U.S. mortgage industry, Fannie Mae and Freddie Mac, and flooded the mortgage market with taxpayer funds to keep it going;

-- crafted a deal to seize the nation's largest insurer, American International Group Inc., fired its chief executive and moved to sell it off in pieces.

-- extended government insurance beyond bank deposits to $3.4 trillion in money-market mutual funds for a year;

-- banned, for 799 financial stocks, a practice at the heart of stock trading, the short-selling in which investors seek to profit from falling stock prices.

-- allowed or encouraged the collapse or sale of two of the four remaining, free-standing investment banks, Lehman Brothers and Merrill Lynch;

-- asked Congress *by next week* to agree to stick taxpayers with hundreds of billions of dollars of illiquid assets from financial institutions so those institutions can raise capital and resume lending.

It was less than a week ago that Mr. Paulson appeared to draw a line at government bailouts, rebuffing Lehman's plea for a Bear Stearns-like rescue and allowing the investment bank to collapse into bankruptcy. "The national commitment to the free market lasted one day," Barney Frank, the Massachusetts Democrat who chairs the House Financial Services Committee, quipped earlier this week. That one day was Monday, Sept. 15. The day before the government rejected Lehman's cry for help; the day after it seized AIG.

The shift in strategy reflects the realization by Mr. Paulson and Federal Reserve Chairman Ben Bernanke that the financial crisis was intensifying in recent days, endangering the entire economy. Confidence deteriorated markedly. Distrust spread. Credit markets weren't functioning and lending dried up. Normal business wasn't getting done. The two remaining free-standing investment banks were under severe pressure. The panic was spreading to ordinary Americans, who were beginning to pull money out of money-market mutual funds.

"This convulsion that we've had in the past two weeks? I don't think there's anything like it in history. I want to go back and check the week in 1933, when all the banks were closed," says Robert Aliber, a University of Chicago economic historian who updated Charles Kindleberger's 1978 classic and newly relevant book, "Manias, Panics and Crashes."

But there is a big difference between then and now. The authorities moved quicker this time. "In the '30s, the intervention that mattered came after the disaster," Mr. Sylla says. "Now the interventions are designed to prevent the disaster we had in the '30s." About the only pleasant surprise of the past year is that the U.S. economy hasn't done worse.

It is too early to say whether Mr. Bernanke and Mr. Paulson have made the right call and will bring the crisis to a close, despite global stock markets' ebullient reaction Friday. If the fear does subside, then talk will turn to writing new rules for a financial system that has changed more in the past six months than in the previous decade. The government has bailed out financial institutions -- and particularly their creditors -- and taxpayers will pick up the tab for many of the institutions' bad decisions. That could encourage bad behavior in the future. So, the government needs to craft a new regulatory regime to reduce those incentives.

Some observers look to history, and predict the government will overdo the regulatory remedy. Bubbles often begin with products created to get around regulations, says Stephen Quinn, an economic historian at Texas Christian University in Fort Worth, Texas. "Smart regulation looks forward to prevent the next regulation-circumventing ... idea from turning into a bubble without stymieing the flow of new ideas. Dumb regulation looks backward. You can guess which kind of regulation most crises produce."

But Frederic Mishkin, who recently left the Fed to return to teaching at Columbia University's business school, takes hope in the resolution of the savings and loan episode of the 1980s. "It was handled disastrously at first," he says. Regulators and politicians were slow to respond, allowing thrifts to make more and more bad loans instead of shutting them down. Then, in 1989, the first

Bush administration swallowed hard, closed thrifts, paid off depositors and sold the thrifts' assets at fire-sale prices. The cost to the taxpayers came to about $124 billion.

Congress and the president moved to reduce the chances of a repeat, enacting a 1991 law that, among other things, increased the minimum amount of capital banks were required to hold. As a result, Mr. Mishkin says, big banks entered the current crisis with far more capital than they had in the early 1990s. "That's one reason this crisis hasn't led to a complete disaster. It put banks on a stronger footing so they had a larger cushion when they blew it," he says. The other reason, he says, is the Fed's rapid response to the current crisis.

The rub: The 1991 law didn't apply to institutions other than banks -- the investment banks, mortgage companies and even insurance companies that have been central to this episode. That puts writing new rules for them high on the agenda for the new president and the next Congress.

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