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CONTAINING WASHINGTON'S POWER BULGE

The economy will be rescued, but at what cost to private-sector dynamism and vitality?

By David Malpass

BIG GOVERNMENT IS WALKING AWAY AS THE KNOCKout winner over the private sector in the latest financial crisis. Washington spinmeisters have placed the blame for the crisis on too much capitalism and too little regulation, with no blame left over for Washington's own bad regulatory, monetary and tax policies.

The solution offered by big government is even bigger government. If unchecked, the Washington "fix" for the financial crisis would create its biggest power expansion since the New Deal. Luckily, there's a key weakness in Washington's timing: The power expansion coincides with Washington's lowest-ever public approval ratings and perceptions of competence. This leaves an opening for the private sector to cut its losses, working with the new Administration as it sets the economic tone for the next decade. Rather than Washington cementing its 2008 power bulge, it might still choose a more pro-growth course—it could sunset or limit some of its new superpowers, letting the nation rebuild its lost competitiveness.

In creating a new fund within the Treasury, Washington gains responsibility for extracting $700 billion from the private sector. It will decide what debt instruments to purchase and how to manage and eventually sell them. It will also make massive purchases of bank stocks and guarantee bank loans, competing with Warren Buffett and sovereign wealth funds. The most dangerous outcome: a public/private partnership in which many banks operate more like utilities than vital capital allocators.

In a major expansion the Treasury is moving into the business of guaranteeing money market funds, drawing on obscure language in the 1934 Exchange Stabilization Fund that authorizes it to "deal in gold, foreign exchange, and other instruments of credit and securities." If only it had used this seemingly unlimited authority to provide a stable dollar in recent decades. We could have avoided the global deflation crisis of 2000 and the killing weak-dollar capital drain to the Middle East and China in recent years.

Like the Treasury, the Federal Deposit Insurance Corp. is in a Washington-size expansion phase, protecting much of the nation's

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banks' deposits and many loans and directing the bank consolidation process. Not to be left out, the Department of Transportation is guiding massive new funding to the automobile industry, using a $25 billion lending earmark and another huge cache from Treasury's new $700 billion fund.

Meanwhile, the caps on the Federal Reserve's balance sheet have been lifted, a critical step in dealing with the crisis but a far-reaching challenge to the Constitution's promise of limiting government by checks, balances and the enumeration of powers. The Fed's size used to be constrained by the monetary base—the number of paper dollars people chose to hold plus a nominal level of reserves the Fed held for banks. In recent years that has amounted to a roughly $900 billion ceiling on the Fed's assets, most of which were invested passively in Treasury securities.

Those limits are gone. The Fed can now pay interest on excess bank deposits, competing head-to-head with the private sector and Treasury for funds. This creates a scalable Fed balance sheet that will likely exceed $2 trillion by the end of the year.

Though the Fed is responsible for price stability, it now has many other often conflicting tasks. It intervened in Bear Stearns and AIG; it is invested heavily in banks and foreign currencies; and it is supporting the commercial paper market. It will also undertake intense regulation of former investment banks as they transform themselves into universal banks.

Because the Fed has an expandable balance sheet and is off-budget—not subject to any appropriations or debt limits, basically free money to Congress—the Fed's status as the go-to agency for big assignments will be embedded in Washington's crisis-management playbooks.

A much larger Fed might be worth it if it promised the private sector a strong and stable dollar. But it hasn't. With the dollar's collapse, inflation hit 4.7% during 2005, 4.3% at times in 2006 and 2007 and 5.6% in July 2008. The Fed will likely take little or no blame for the deflation-inflation cycle plaguing U.S. economic stability in recent decades. Indeed, it has become materially more powerful yet is still free to fuel wide antigrowth swings in the dollar's value and in commodity prices.

Each of these emergency measures may have been necessary at the moment, but things didn't have to go this way.

- The Treasury could have resolved financial failures in ways that invited more capital into the industry rather than scaring it away. It created a catch 22 in which banks had to raise more equity capital, yet shareholders had to be wiped out to avoid the Treasury's being accused of bailing out a banker.
- At any point through June Washington could have ended the financial crisis by strengthening the dollar. During the yearlong erosion of U.S. bank capital, offshore pots of gold (the primary repository of the trillions of excess Greenspan dollars created through superlow interest rates from 2003–06) have shown substantial interest in investing in America but not into the ever weakening dollar.

Instead of inviting this capital back to the U.S., Washington repeatedly rejected dollar-strengthening measures. It watched idly as gold hit $1,000 per ounce, the dollar slumped to an economy-crushing panic bottom in July and oil climbed to $145 per barrel.

- Now that the Treasury controls Fannie Mae and Freddie Mac, it could push mortgage rates down sharply to support home purchases. Instead, mortgage rates have been going up.
- Months ago Washington could have reviewed or suspended the mark-to-market accounting procedures that were sapping equity capital from the banking industry and were based on obscure, little-understood derivatives markets and auditors' fears of trial lawyers.
- The Securities & Exchange Commission and Treasury should have found a way to break the unhealthy link between the unregulated credit default swap market, the bond-rating agencies, capital adequacy regulations and arbitrary accounting rules—all within Washington's control and responsibility. The combination fueled the downward spiral in financial and insurance stocks.

The deep irony of the financial crisis is the lack of Washington accountability. The Treasury, Fed and FDIC will enjoy massive expansions of personnel and influence. Congress will legislate more, filling tens of thousands of pages in the Federal Registry and collecting hundreds of millions in campaign contributions. Fannie Mae and Freddie Mac may come out of this bigger than ever.

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Washington is arguing that its job now is to "protect the taxpayer." Rather than expanding Washington or rushing through another pork-laden "stimulus" package, the best way to do this is with fast growth, more jobs and the tax revenue that comes with it. Instead, FBI investigations will be launched, hearings convened and indictments passed down, all aimed squarely at the private sector.

The latest "comprehensive Washington solution" should help stabilize markets, a clear value to all. But it should also crystallize the deep loss to America from years of regulatory, monetary and banking mistakes—repeated congressional mandates enlarging Fannie Mae and Freddie Mac without restricting their campaign contributions, Sarbanes-Oxley's antimarket spite, the Community Reinvestment Act's "fairness" requirements that push banks into making millions of weak mortgages, the Fed's inexplicable manipulation of interest rates below 2% from 2003–05 and Wall Street's penchant for looking the other way as long as profits are growing.

The near-term prospect is a painful recession while we wait for Washington's superpowers to save the economy. By 2009 the key issue will be whether to entrench Washington's expansion—assuring Washington's place as the world's fastest-growing center of financial power and private-sector dominance—or reverse it, adding private-sector growth and jobs. **F**

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