

What went wrong? A major economic crisis--again

Comparing 1929 and 2009—What's different

In the days of the Great Depression, we were on a gold standard. The Federal Reserve could not simply print money to increase the money supply. Today, it can. In 1929 the price of gold had to be raised before the money supply could be increased, and even then, the action taken was slow and too late. One big difference today is the action of our Federal Reserve. This time the response was fast and appropriate—the “whatever it takes” approach. This approach puts a big financial burden on our children and grand children, and will likely fuel inflation. But let us hope it is controllable and the loans are paid back as the economy improves and the taxpayer is made whole.

Common elements that brought on both crises were greed and fear, along with a strong dose of unethical behavior. Industry leaders allowed their minions to take risks which should have been prohibited. And, this is where they, Congress, and Federal Agencies dropped the ball--in fact, Congress encouraged questionable loaning practices and discouraged enforcing existing regulations.

An example: The uptick rule was established by the SEC in 1938 to stop good stocks from being crushed by aggressive short selling. In June of 2007 that rule was abolished in a frenzy of deregulation. The mood in Congress was “the market will regulate itself”. Wrong! Greed replaced common sense. What lesson did they learn from the 1929 crash? None.

That uptick rule stopped short sellers from pushing the price of a stock down. They had to wait for an uptick, or a rise in price, before they could sell short. With the rule abolished, we saw the same abusive short selling again—the same as was seen before the rule was put into effect in 1938.

There is another practice Wall Street traders use to drive a stock price down. It's called “naked short selling”. It's even more destructive. Normally a short seller must first borrow the stock before selling it. Traders who sell “naked” neither borrow the stock nor deliver it to the buyer on time—within three days of settlement. This practice continued to be allowed by the SEC even after thousands of complaints were registered. Add in the alleged Madoff fraud, and others the SEC missed, and a definite pattern begins to emerge. Congress has been asleep at the switch for more than a decade, and so have the regulatory agencies. The Senate Finance Committee is an embarrassment. Worse yet, they see themselves as savors, not part of the problem.

With the last several administrations telling lenders to find a way to put people in homes and allowing large fees to be collected while doing so, greed took over and people were put into homes all right, but with mortgages there was little chance they could pay off, particularly after the “teaser rate” expired. NINJA loans (No Income No Job no Assets) became prevalent, and through fees, highly profitable for the lenders.

But the real damage has been done to those who lost their job due to the economic downturn or were financially devastated by illness or medical bills. They are the ones who could afford to

pay their mortgage, until a personal disaster struck. They lost their homes and were financially devastated as well. The greed and inept industry leaders in our system have marked those lives forever. But there is plenty of blame to go around. Congress started the ball rolling, the Regulatory Agency followed that lead, and industry leaders greedily followed.

The SEC is currently asking for comments from investors about reinstating the uptick rule and/or installing a circuit breaker to stop short selling if the price of a stock declines greater than 10% in a day. Yes, folks, yes! Reinstating the rules, and then actively enforcing them. And another thing—stop companies from growing before they become too big to fail. Congress could do that by placing a special tax on companies based on their total capital, relative to the economy. Make it unprofitable to become too big to fail. A modernization of our anti-trust thinking is imperative.

But, let's end this on an up-tick. The present sense of pessimism is so great there are now \$9.3 trillion (Yes, Trillion) in cash on the sidelines. Cash on the sidelines has been a positive signal for stocks in the past. And while the economy didn't recover from the crash of 1929 until the early 1940s, the stock market was in full recovery by 1935, and heading higher.