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Commentary

Needed: a new industrial policy that responds to things as they are now, not as they used to be

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'Efficient Market Theory' failed; banks and big industry shared directors (and profits) and they failed. Nevertheless, writes Martin Lobel, until now the Obama administration has been more inclined to protect large financial institutions than to prevent a recurrence of failure.

Job seekers at a New York jobs fair last November. (AP photo)

(Part of our series on "Reporting the Economic Collapse.")

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In trying to prevent the economic meltdown from becoming a Depression, the federal government has spent huge amounts to enable financial institutions to recover from their self-created liquidity and solvency crisis and to try to spur the economy in hopes of creating jobs.

What is badly needed is a new industrial policy to correct the financial institutions' failure to allocate capital efficiently. They were far more concerned with developing new financial instruments which brought them huge profits and bonuses in the short term but which left them and our economy at risk. This misallocation of capital hurt growth industries and America's ability to compete in the world market.

Too often until now it seems that in looking for solutions to the collapse, political judgments have been substituted for economic ones. We have seen the inability of the Administration to withstand the power of large, labor-intensive industries, such as the auto industry, seeking huge "loans" or tax subsidies to maintain their existing structures. Are such loans or subsidies economically viable? Probably not. And such an allocation of capital deprives the government of funds needed for more cost effective uses, such as retraining workers and repairing the infrastructure, generating jobs and making industry more efficient in the process.

Financial institutions failed to meet our needs in part because the government adopted the "efficient market theory," which holds that markets self-correct and by themselves block overly risky behavior. Under this theory, government should not interfere with the functioning of the market by attempting to regulate it. This allowed the financial institutions - banks, investment banks, insurance companies, pension funds, etc. - to take on excessive risks.

They failed in part because of the concentrated power of the large financial institutions and their institutional bias in favor of large corporations with whom they shared directors who "understood" each others problems. Many of these interlocking directors knew how to succeed in large corporations but lacked the entrepreneurial skills needed to respond to changing markets. Finally, the problem was compounded by their ability to get government support for their actions through the tax code and legislation for whatever they deemed in their own economic interest.

Unfortunately, until now the Obama Administration, despite its pledge to protect the public from the financial industries' risky behavior, has been more inclined to protect the large financial institutions than to prevent a recurrence of financial failure. It has adopted a policy that some institutions are too big to fail, giving them a huge, unfair advantage in the market because of their access to federal funds and the implicit government guarantee.

Essentially, the Administration has created a two tiered economy. One tier, funded by public money, consists of the too-big-to-fail banks. They are making record high profits by controlling about 95 percent of the derivatives that brought us to the brink of a Depression, and are likely to be paying their employees about $140 billion this year. The second tier consists of the rest of the economy in which community banks are failing at a record high rate, loans to small and mid-sized businesses are difficult to obtain and unemployment is headed above 10 percent.

Phone records show that Treasury Secretary Geithner speaks privately on almost a daily basis with executives of Citibank and Goldman Sachs, but not with representatives of the community banks or small businesses. The SEC is considering curbs on short sellers who help the market price assets accurately because they threaten inflated asset prices. Even its vaunted regulatory reform proposals are so weak that both the SEC and the Commodities Futures Trading Commission testified that Congress needed to plug some gaping loopholes that allow the same risky trading in derivatives to continue without government supervision or regulation. Meanwhile, the Depository Trust Corporation continues to shift the very risky derivatives called Credit Default Swaps, which are essentially naked bets and which were a significant cause of the economic meltdown, into non-regulated affiliates. We need to do better.

Here's a small list of actions the government should consider, and that the press should focus on:

1 - Provide more transparency and regulation of the financial markets to prevent the kind of risky behavior that brought us to the brink of a Depression and raised unemployment rates to unacceptably high levels. If the government provided more accurate, timely information to the public,

business could react more rationally;

2 -Reform the tax code by eliminating most subsidies and lowering rates so people can make decisions for economic, not tax, reasons and allow domestic companies to compete on a level playing field against multinational corporations that pay far less in taxes. When I speak of lowering tax rates, I mean for everyone, although there would still be different tax rates for different income levels. One example: we could lower the corporate tax rate from a nominal 35 percent to about 24 percent and raise the same amount of money if we eliminated the special tax subsidies (loopholes) in the corporate tax code;

3 - Discourage the interlocks between big business and big financial institutions so they will make more rational investment decisions, to the benefit of growth industries;

4 - Work harder to provide more markets in the world for our exports;

5 - Help retrain workers and encourage cooperation between labor and management to efficiently produce better products;

6 - Rebuild the infrastructure, which will provide more jobs per dollar spent than anything else and will help make our economy more efficient.

All institutions tend to go through three stages: achieving goals, rationalizing the decision making process and making sure the rules are followed. Unfortunately, the last stage leads to stagnation – to responding to the past, not the present.

Government can help prevent that stagnation by providing an institutional framework to encourage the development of new businesses. But only business can revive the entrepreneurial spirit needed to succeed. Whether "mature" industries can regain an entrepreneurial spirit remains to be seen. It is clear that the current government subsidies and capital allocation schemes aimed at the big financial and industrial corporations are likely to smother, rather than encourage, the requisite entrepreneurship.

Next: Even now, much of the media may be missing the real story.

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