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OP-ED COLUMNIST

The Market Mystique

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On Monday, Lawrence Summers, the head of the National Economic Council, responded to criticisms of the Obama administration's plan to subsidize private purchases of toxic assets. "I don't know of any economist," he declared, "who doesn't believe that better functioning capital markets in which assets can be traded are a good idea."

Leave aside for a moment the question of whether a market in which buyers have to be bribed to participate can really be described as "better functioning." Even so, Mr. Summers needs to get out more. Quite a few economists have reconsidered their favorable opinion of capital markets and asset trading in the light of the current crisis.

But it has become increasingly clear over the past few days that top officials in the Obama administration are still in the grip of the market mystique. They still believe in the magic of the financial marketplace and in the prowess of the wizards who perform that magic.

The market mystique didn't always rule financial policy. America emerged from the Great Depression with a tightly regulated banking system, which made finance a staid, even boring business. Banks attracted depositors by providing convenient branch locations and maybe a free toaster or two; they used the money thus attracted to make loans, and that was that.

And the financial system wasn't just boring. It was also, by today's standards, small. Even during the "go-go years," the bull market of the 1960s, finance and insurance together accounted for less than 4 percent of G.D.P. The relative unimportance of finance was reflected in the list of stocks making up the Dow Jones Industrial Average, which until 1982 contained not a single financial company.

It all sounds primitive by today's standards. Yet that boring, primitive financial system serviced an economy that doubled living standards over the course of a generation.

After 1980, of course, a very different financial system emerged. In the deregulation-minded Reagan era, old-fashioned banking was increasingly replaced by wheeling and dealing on a grand scale. The new system was much bigger than the old regime: On the eve of the current crisis, finance and insurance accounted for 8 percent of G.D.P., more than twice their share in the 1960s.

By early last year, the Dow contained five financial companies — giants like A.I.G., Citigroup and Bank of America.

And finance became anything but boring. It attracted many of our sharpest minds and made a select few immensely rich.

Underlying the glamorous new world of finance was the process of securitization. Loans no longer stayed with the lender. Instead, they were sold on to others, who sliced, diced and puréed individual debts to synthesize new assets. Subprime mortgages, credit card debts, car loans — all went into the financial system's juicer. Out the other end, supposedly, came sweet-tasting AAA investments. And financial wizards were lavishly rewarded for overseeing the process.

But the wizards were frauds, whether they knew it or not, and their magic turned out to be no more than a collection of cheap stage tricks. Above all, the key promise of securitization — that it would make the financial system more robust by spreading risk more widely — turned out to be a lie. Banks used securitization to increase their risk, not reduce it, and in the process they made the economy more, not less, vulnerable to financial disruption.

Sooner or later, things were bound to go wrong, and eventually they did. Bear Stearns failed; Lehman failed; but most of all, securitization failed.

Which brings us back to the Obama administration's approach to the financial crisis.

Much discussion of the toxic-asset plan has focused on the details and the arithmetic, and rightly so. Beyond that, however, what's striking is the vision expressed both in the content of the financial plan and in statements by administration officials. In essence, the administration seems to believe that once investors calm down, securitization — and the business of finance — can resume where it left off a year or two ago.

To be fair, officials are calling for more regulation. Indeed, on Thursday Tim Geithner, the Treasury secretary, laid out plans for enhanced regulation that would have been considered radical not long ago.

But the underlying vision remains that of a financial system more or less the same as it was two years ago, albeit somewhat tamed by new rules.

As you can guess, I don't share that vision. I don't think this is just a financial panic; I believe that it represents the failure of a whole model of banking, of an overgrown financial sector that did more harm than good. I don't think the Obama administration can bring securitization back to life, and I don't believe it should try.

