ON THE MONEY

Repeal of Glass-Steagall Act: Not a cause, but a multiplier

Barry Ritholtz
ON INVESTING

When the Titanic set sail from Southampton on April 10, 1912, bound for New York, it was called "unsinkable." This was before that chance encounter in the North Atlantic with a large iceberg. You know how that movie ended.

Many people died, of course, because there were too few lifeboats. But even if the luxury liner had four times as many, the Titanic still would have ended up on the bottom of the ocean, done in by a captain more concerned with speed than safety — and that iceberg.

This simple reality, however, obscures a broader truth.

Before it sank, more than 700 passengers loaded onto the 20 lifeboats on board and escaped with their lives. More than 1,500 others died. The Titanic had the capacity for 64 lifeboats, which could each hold 65 people. Fully loaded, they could have carried more than 4,000 to safety — or every man, woman and child aboard. Thus, many more could have survived.

While the shortage of lifeboats didn't cause the sinking, this insufficiency after the crash was a factor in the 1,502 deaths.

I was reminded of this recently after reading articles that argued over the role the repeal of the Glass-Steagall Act played in the financial crisis. The Depression-era regulation that separated Main Street banks from Wall Street investment firms had a huge impact on the finance sector.

The repeal of Glass-Steagall may not have caused the crisis — but its repeal was a factor that made it much worse. And it was a continuum of the radical deregulation movement. This philosophy incorrectly held that banks could regulate themselves, that government had no place in overseeing finance and that the free market works best when left alone. This belief system manifested itself in damaging ways, including eliminating regulation and oversight on derivatives, allowing exemptions for excess leverage rules for a handful of players and creating dangerous legislation.

As the events of 2007 to 2009 have revealed, this erroneous belief system was a major factor leading to the credit boom and bust, as well as the financial collapse.

I have been unable to find any evidence that the Gramm-Leach-Bliley Act — the legislation that repealed Glass-Steagall — was a primary cause of the financial crisis. Imagine a "but for" scenario where Glass-Steagall had not been overturned but the rest of the deregulatory actions had still taken place. Would the crisis have occurred? Without a doubt, yes.

The Fed still would have taken rates down to unprecedented low levels. This would have led to a global spiral in asset prices. The nonbank, lend-to-sell-to-securitizer mortgage originators were still going to make subprime-mortgage loans to unqualified borrowers. Bear Stearns and Lehman Brothers would still have overwhelmingly increased exposure to subprime mortgages. AIG would still have written trillions of dollars in credit-default swaps and other derivatives with zero reserves set against them. The largest security firms and deposit banks would still have charged headlong into the subprime securitization business. And Fannie Mae and Freddie Mac would still have belatedly chased these banks into the same subprime market, just at the peak of the housing boom.

Lastly, housing prices would still have run up to absurd levels and then collapsed.

So no, the repeal of Glass-Steagall was not a proximate cause of the crisis. But its impact was both nuanced and complex. Consider the context in which it occurred:

- The repeal of Glass-Steagall in 1999 was part of a broad deregulatory push, championed by the likes of Fed chief Alan Greenspan, Sen. Phil Gramm (R-Tex.) and Treasury Secretary Robert Rubin, that eliminated much of the oversight on Wall Street. Freed from onerous regulation, the banks could "innovate" and grow.
- After the repeal, banks merged into more complex and more leveraged institutions.
- These banks, which were customers of nonbank firms such as AIG, Bear Stearns and Lehman Brothers, in turn contributed to these firms bulking up their subprime holdings as well. This turned out to be speculative and dangerous.

So we can say that Glass-Steagall's repeal allowed the credit bubble to inflate much larger. It allowed banks to be more complex and difficult to manage. When it all came down, the crisis was broader, deeper and more dangerous than it would have been otherwise.

Glass-Steagall's repeal, after 25 years and $300 million worth of lobbying efforts, culminated decades of deregulation.

Newfangled derivatives? No oversight, reporting or reserves necessary, courtesy of the Commodities Futures Modernization Act of 2000. Subprime-lend-to-sell-to-securitizers business model? Those are the financial innovators! At least, that is what Greenspan called them, and why he refused to oversee them as Fed chairman. Rules on SEC leverage? Let's create a special exemption from the law for just five investment banks.

Of course "reputational risk" would serve as a deterrent to poor decision making! No bank would ever behave so recklessly as to put their own hard-won status on the line — or its very existence. How'd that idea work out?

With Glass-Steagall, there would not, could not, have been a Citi/Travelers merger, and competitors would not, could not have bulked up the way they did. Major money center banks most likely would have been smaller, more manageable, more easily wound down. Arguably, too big to fail might not have been the rule, and bailouts might not have been necessary. This is, of course, mere supposition.

What we should be discussing is the corrupting influence of crony capitalism and radical deregulation. Instead, we find ourselves forced to defend capitalism and free markets. We should be finding ways to definancialize the U.S. economy and reduce bankers' influence.

There are lots of thing we can do about this, but I have a modest suggestion that would be a good start: No more Wall Street bankers as Treasury secretaries. It would be much better for the nation to find someone from industry who understands finance rather than finding someone from finance who understands industry.

Consider where we would be today if we put Citi and Bank of America into prepackaged bankruptcy (as was done with GM). It would have been much more painful, but ultimately, much healthier.

The past 50 years have seen a dramatic financialization of the American economy. Wall Street has morphed from serving industry to a Titanic leaving a damaged economy in its wake.

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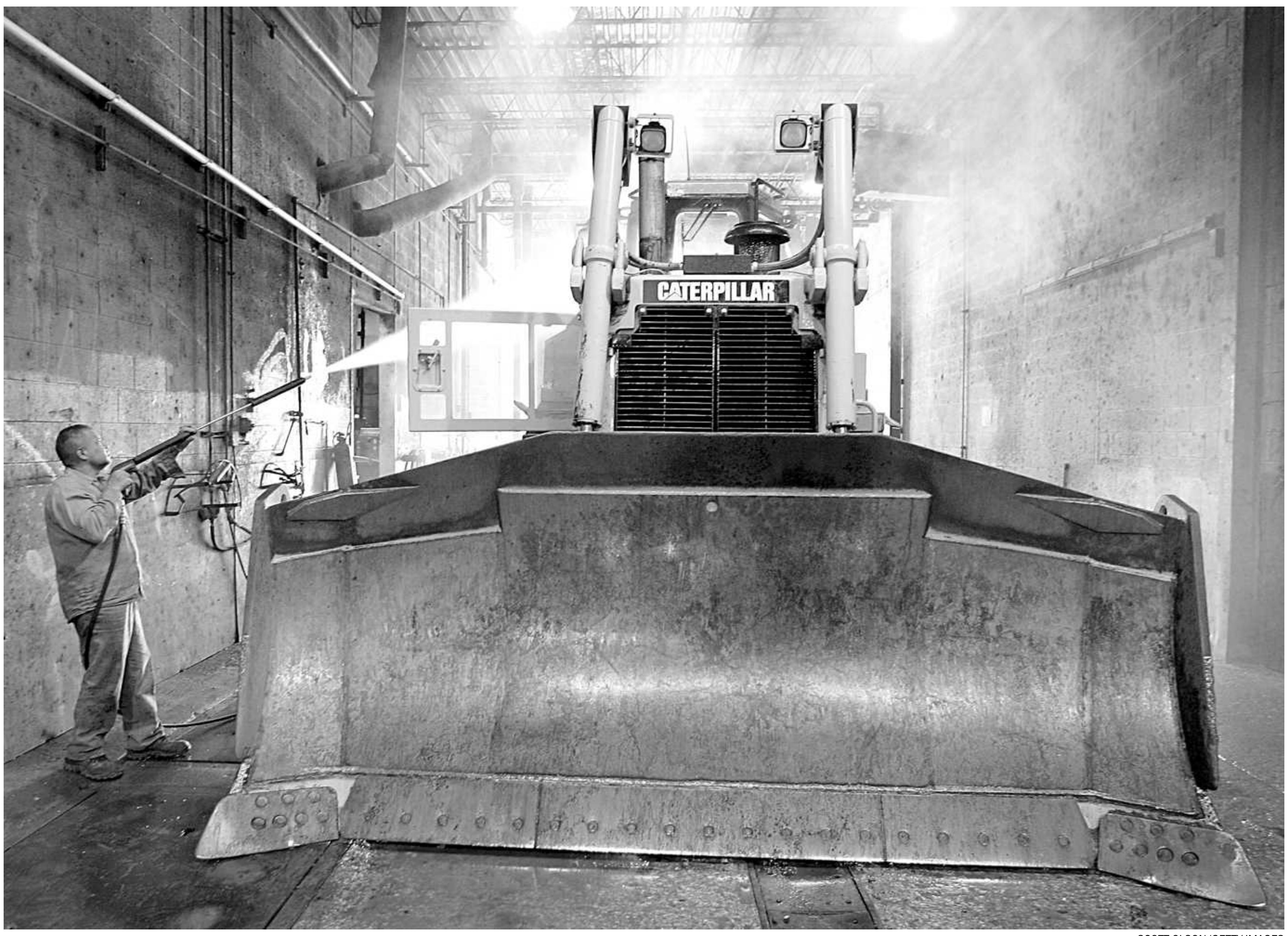
STEVEN PEARLSTEIN

Caterpillar won't negotiate with unions, because it doesn't have to

PEARLSTEIN FROM G1



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Caterpillar has made it clear that it intends to bring its "market-based" approach to worker pay and benefits to every location.

unionized workers.

It's been three months since Local 851 of the International Association of Machinists voted overwhelming to reject Caterpillar's "best and final" offer and go out on strike. In terms of negotiations, there really haven't been any. From the outset, Caterpillar made it clear that there really wasn't anything to negotiate.

In the previous six-year contract, Caterpillar won a two-tier wage structure: Existing employees would get to keep wages that average about $26, but there would be no raises and new employees would be paid wages pegged to the existing market — roughly $12 to $19, depending on the job classification. Instead of the old defined-benefit pension plan, the company would put 3 percent of each worker's base pay into a 401(k) retirement account, and match employee contributions up to an additional 3 percent. The company would continue to pay 90 percent of the premiums for a generous health insurance plan, and profit sharing that averaged $2,300 a year.

Now, six years later, the company is offering pretty much the same — no raises of any sort for the "old" employees, whose compensation the company says is still 34 percent above the market, with pay for new employees continuing to rise only with prevailing market wages. In exchange for more flexibility in shift scheduling and elimination of certain seniority rights, the company was willing to offer a no-layoff pledge. And it demanded that workers increase the share of health premiums to roughly 20 percent, which by the end of the contract would represent an increase of roughly $3,800 if premiums continue to escalate as they have been. The company also offered a one-time $5,000 per worker signing bonus if a contract were signed without a strike.

The union counterproposal was, by historical standards, rather modest: in effect, a 1.5 percent raise each year, along with continuation of most existing seniority rights. The company rejected it out of hand.

The reason Caterpillar has no intention of negotiating with its workers is pretty simple: It doesn't have to. In the three months since the strike began, the company says its Joliet plant has produced all the hydraulic parts it needs. The work is done by supervisors, newly hired employees and employees contracted from temporary help agencies, along with 80 and 100 union members who have crossed the daily picket lines and returned to work. If things really got tight, the company could always import the same parts from other Caterpillar plants around the world.

Caterpillar's success in effectively neutering its unions is the result of decades of disciplined work and billions of dollars in investment. The turning point came in the 1990s when, after two long strikes, 9,000 members of the United Auto Workers at its giant facility in Peoria, Ill., effectively capitulated and went back to work on terms dictated by the company. The strikes demonstrated to Caterpillar's workers that they were not as irreplaceable as they thought, and that their picket lines would no longer deny the company the workers or the raw materials needed to continue operation. As it turned out, the capitulation also allowed Caterpillar to avoid the near-death experience of the Big Three automakers, which accepted the UAW's overly generous contracts for another decade.

Caterpillar makes no bones about the fact it intends to bring its "market-based" approach to worker pay and benefits to every location. That message, apparently, was lost on the 465 unionized workers at a 62-year-old locomotive plant in London, Ontario, that Caterpillar bought a few years ago. Those workers had been getting $35 an hour. Caterpillar's take-it-or-leave-it offer was for half that, along with substantial cuts in benefits. When the workers balked, Caterpillar closed the plant, took its cutting-edge diesel-electric technology and moved production to Muncie, Ind., where workers lined up for a shot at one of $12-to$18-an-hour jobs.

It is easy to get moralistic about a company that pays its chief executive $16.5 million as a reward for squeezing the incomes of employees who, even at the top of the scale, earn about one-half of 1 percent of what he does. It's easy to get nostalgic about the loss of union power that really did make it possible for generations of workers with only a high-school education to enter the middle class. But the reality is that Caterpillar probably has no choice but to bow to the dictates of the markets — not only the markets from which it gets it labor but also the markets from which it raises its capital and the markets into which it sells its products. If it can't sell its products at above-market prices or offer its investors below-market returns, it can't afford to pay its workers above-market wages.

Even from a market perspective, however, there is a valid critique of Caterpillar's hardball tactics.

The first is to note that when it comes to its executives, managers and engineers, Caterpillar does not use the same criteria of paying the average market wage. In those instances, the company has seen the competitive benefit of paying above the average to attract and retain a cadre of above-average employees and give them sufficient incentive to work hard, take risks and deliver superior performance. There is no evidence to suggest that having better-than-average production workers will not have the same beneficial results. To believe or behave otherwise is nothing more than the sort of class snobbery better suited to the country-club locker room than the executive suite of a modern global corporation.

If Caterpillar were really serious about having a world-class workforce, it would be willing to negotiate wage and benefits levels 15 percent above the market. And if it were serious about insuring that all workers share in the company's success, then it would offer production workers a profit-sharing plan that reaches at least 10 percent of base pay in good times.

Because of its size and reputation, companies like Caterpillar also need to acknowledge that they have an outsize impact on the social, political and economic environment in which markets operate. Caterpillar should not expect voters to embrace its aggressive free-trade philosophy if globalization merely gives it license to grind down the incomes of average workers. It shouldn't expect politicians to approve more money for public works projects, or give the green light to increased coal and shale-oil production — both big generators of Caterpillar sales — if the profits from those sales won't be shared fairly with front-line workers. And it shouldn't expect to win the good opinion of investors or the public if its human-resource strategy is to become the recognized leader in the corporate race to the bottom.

The reason the union movement is in trouble is because unions abused their market power and overplayed their hands. Now, it is Corporate America that has gained the upper hand, and if the news from Joliet, Ill., is any indication, it is about to make the same mistake.

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To see previous columns by Steven Pearlstein, see postbusiness.com.