THE AGE OF DYSFUNCTION

February 23, 2009 Otto P. Geier, Jr.

Several years ago I delivered a paper entitled "What in the World is Going On Today" which described how some inventions were around long before they were commercialized and also took a look at some of the revolts against present science. At that time I was beginning to see that the proliferation of technological improvements and competing disruptive technologies might start to interfere with our ability to use all these developments effectively. Also, I wondered if our educational system could cope.

In May of 2007, I heard a financial commentator noting that there was about 700 trillion dollars in financial "garbage" floating around in a world when the combined GDP of the most prominent nations was less than 70 trillion. Just how much substance was there in the world's financial system? With several family members in the banking/investment banking system, I had many concerns. We heard a few doomsayers, but most politicians and analysts felt the boom was likely to continue.

All of this made me wonder if might be we are entering a new age of dysfunction with three elements—one a failure to learn from the past, second an emerging inability to grasp the relationships that tend to hold society together, and third an emerging process that makes it harder to use or employ competing technologies.

AREAS OF DYSFUNCTION: OUR FINANCIAL SYSTEM

From the beginning of our republic we have experienced a number of financial panics. I will touch upon a few. In 1791 with a huge national debt from the war, Alexander Hamilton created a national bank to raise capital and pay off the debt. It was so successful that European investment capital poured in large amounts. Nevertheless, when James Madison became President he allowed the bank to expire in 1811. The consequences of this were felt during the War of 1812 without a central bank to finance the War. Another bank, the Second National Bank was created in 1816 but the charter expired under President Andrew Jackson. The Panic of 1819 lasted for five years during which there were widespread foreclosures, unemployment, and a slump in manufacturing and agriculture. The failure of Jay Cooke and Company, our largest bank, launched the panic of 1873, which lasted for 6 years and burst the post-Civil War speculative bubble. The price of silver was depreciated by The Coinage Act of 1873 and affected North American mining companies. During 1893 to 1896 the failure of the Reading Railroad led to a withdrawal of European capital and led to a stock market and banking collapse. A run on the Knickerbocker Trust Company in 1907 set events in motion leading to a severe monetary contraction, which was primarily solved by J.P. Morgan and other bankers injecting money into the system. This crisis ultimately led to the creation of the Federal Reserve Bank in 1913. After World War I we had a boom that ran out in the summer of 1920. There was severe inflation and then sharp deflation in 1921. Autos were particularly hard hit. Ford Motor Company was close to bankruptcy.

The crash of 1929 started the great depression of the 1930's. Because stocks had quadrupled between 1922 and 1929, people were buying stocks on 10% margin. Even before 1929, real estate had crashed in Florida and was slowing down elsewhere. Industrial production peaked in the summer of 1929. In 1954, some 25 years later, the Dow matched the 1929 high. I was in the second year at Harvard Business School. Because much of our time was devoted to working on cases requiring workouts and refinancing, I took the time to look at the Wall Street Journals and New York Times from the summer of 1929 to 1934. There were seven bear trap rallies in the market before it hit bottom in 1932. In late 1932 and early 1933 more and more banks were failing. At the beginning of 1933 President Roosevelt declared a bank holiday to close the bad banks and then reopen those that were solvent. Prior to this the Federal Reserve had tightened the money supply and the Smoot Hawley tariff bill helped to curtail trade.

The Glass-Steagall Act of 1933 was designed to separate banking from investment banks by putting a firewall between the two to prevent the abuses that occurred in the twenties. The Securities and Exchange Act of 1933 regulated initial public offerings and The Act of 1934 secondary offerings. These acts brought some order to the markets but the Securities and Exchange Commission was understaffed. It was thought that surveillance by Moody's, Standard and Poor's and others would provide some sort of regulatory collar on the market. There were some scandals (empty McKesson warehouses, Billy Sol Estes, the DeAngelis salad oil scandals, National Student Marketing.)

Between the 1950's and the 1970's bankers practiced redlining which allowed them to avoid lending in many inner city areas. In 1977 after much pressure from Congress, a bill entitled the Community Reinvestment Act was passed in the belief that home ownership should be extended to a wider segment of population including those previously unable to qualify. Subsequent to that there was a rapid expansion of housing credit. This effort caused major thrift institutions to become insolvent. The crisis led to the creation in 1989 of the Resolution Trust Corporation, which assumed the assets of $50 billion dollars of the Savings & Loan Companies.

In 1997, the Gramm-Leach-Bliley Act broke down many of the firewalls created by Glass-Steagall. Banks were allowed to be national rather than just regional or local. Banks and investment banks could sell securities and insurance as well. Rating agencies could be corrupted by the companies they were evaluating. Brooksley E. Born, chairwoman of the Commodities Future Trading Commission sought in 1998 to extend its regulatory reach into the derivatives world but was overruled by Treasury, Federal Reserve and S.E.C. In 1999 Robert Rubin invented the Credit Default Obligations to help banks bundle and sell their loans. In 2000 Gary Gensler of the Treasury Dept. helped write the Commodities Futures Modernization Act or CFMA that essentially deregulated complex financial instruments called credit default swaps--ultimately leading to the collapse of Lehman Brothers and other troubled companies. There was no attempt to regulate these transactions. The S. E. C. in 2004 let securities firms raise their leverage from 12 to 1 to 33 to 1. Paulson got an exemption on large financial firms from S.E.C. review. At the same time in 2005 the House and Senate Finance Committees, ignoring many warnings, told the FDIC and S.E.C. to back off. From 2004 to 2007 sub-prime lending ballooned to enormous proportions. Many of these loans originated outside the banking system beyond the reach of any federal regulator. By 2007 the CDO market starts to fall apart. In 2008-2009 losses ballooned in the banks that purchased the CDOs.

It isn't just housing but also commercial real estate, consumer credit, and sub par commercial loans that are now under attack. How did we get in this mess? Blame the politicians for trying to make everyone a homeowner. Liar loans—no credit check needed. Easy money---the Federal Reserve System made it too easy. All the financial parties as well as the rating agencies ignored credit standards. We sold this junk all over the world. The bankers made money. The investment banks made money. The politicians were deliriously happy to get money from the lobbyists. Nobody cared until the bubble began to burst. *We were robbed by the people in the system.* We all should be mad as hell. If tighter credit standards had been applied, we might have avoided or mitigated this mess. A potpourri of suggestions from Washington is being proposed as remedies. Will anything work without full disclosure or is that remedy too painful?

Is our congress really ready to fully fund a regulatory system covering all financial entities that require attention? For decades we have lacked the patience, understanding, and political will to do this. In the future we will need to have regulations that keep up with new complex financial instruments. We will also need to monitor hedge funds, derivatives, and commodities. Or, should we keep on being gullible?

AREAS OF DYSFUNCTION: OUR EDUCATIONAL SYSTEM

We need to take a very critical look at the educational system of this country. In the sixties there was a widespread revolt among the young against conventional thinking. The young felt they had insights that overturned the views of their elders. At some point this culture began to infect our universities so most colleges now tend to have a left wing bias in their faculties.

Many publications are telling us how wonderful digital learning is without addressing the nature and effectiveness of screen habits and Web reading. What we have found is that users read screen images differently than regular book learning. They don't get the content that comes with conventional reading.

The next generation has become much more focused on achievement with our best students focusing on success at any cost. The tools we have now give us faster information retrieval but we are not using it to study problems in depth or make comparative analyses. There is a price for this. Too much time is devoted to looking at screens, social networking, peer-to-peer contact, and blogs.

The digital world has provided us with a wealth of tools such as Google, Wikipedia, Twitter and many other sites to gather information. Younger users tend to scan one or two lines to extract information without further analysis. Most reading has become superficial with little or no attention given to the subject matter. It isn't funny anymore. To quote Mark Bauerlein, author of the *The Dumbest Generation,* "This generation cares little for history books, civic principles, foreign affairs, comparative religions, and serious media and art, and it knows less. Careening through their formative years, they don't catch the knowledge bug, and *tradition* might as well be a foreign word."[1] For many people, not just the younger people, the net is becoming a universal medium; through which they can quickly retrieve information. However, the process by which we get information is changing the way we look at things. As Nicholas Carr notes in "Is Google Making Us Stupid" our brains are being reprogrammed making it more difficult to do protracted reading. We can expect the neural circuits in our brains will differ from those woven from reading books and other printed works.[2] As a result, we are slipping behind many nations in writing, reading and the understanding of simple concepts.

We need to find some way to balance our digital learning processes with the ability to do rigorous, in depth analyses. Right now we are at a competitive disadvantage with other leading industrial nations. Newspapers are closing because more of the ad content has migrated to the Web. The Internet has changed advertising. Ads are shorter and more succinct. We no longer get the content, history and substance we once treasured in these publications. Traditional education covering our cultural history and traditions seem irrelevant. We are losers.

A FEW OTHER ASPECTS OF A DYSFUNCTIONAL SOCIETY

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Comment:

How do we develop a digital system for preserving information? Storage media keep changing so how do we maintain continuity between generations?

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[1] Mark Bauerlein, The Dumbest Generation, (New York, NY: Jeremy P. Thacker, Penguin 2008)

[2] Nicholas Carr, "Is Google Making Us Stupid", The Atlantic July/August 2008

How do we develop some kind of compatibility between different computer systems?

We are forced to replace still useful computer systems because software and protection systems become obsolete and won't work anymore.

How do you develop standards for a health records system that is easy to use, respects privacy, is interchangeable and free from politics? Can't we put our records on smart cards like those in Europe?

How can an older person find a simple 3G portable cell phone system that's not difficult to operate and isn't overloaded with gadgets?

CONCLUSIONS

We are becoming dysfunctional. Do we remain silent or do something about it?