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The Good, the Bad, and Eliot Spitzer

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I am becoming increasingly worried about the impact Eliot Spitzer is having on the psyche of the small investor. While I applaud Mr Spitzer's desire to take up some of the slack in the regulatory system, his constant presence in the news risks doing more harm than good.

Mr Spitzer's attack on the mutual fund industry has the potential to create damage of two types. First, individuals may be driven to make bigger investment mistakes than they are already. Second, there is the possibility of a shock to the economy as whole. Let me say at the outset that well-functioning financial markets are the bedrock of a modern economy. And for them to work properly, we need rules that are enforced. Those who try to benefit from breaking the rules need to be hunted down and prosecuted.

Mr Spitzer's job is to find bad guys, and I applaud the fact that he does it with such relish. Not only that, but I am also grateful for the fact that he is revealing deficiencies in the supervisory system. What I worry about is the way he is going about it. It may be hard to see how a publicity-hungry New York State attorney-general can have a big impact on the US economy, so let me explain.

Many small investors do not understand investment and the financial system. They do not understand how difficult it is to earn high returns, and how important it is to diversify their investments. And, most importantly, individuals are often suspicious that everyone in the financial industry is trying to steal their hard-earned money.

In recent years, people have put their suspicions aside. Following the advice of financial professionals, individuals have started saving when they are young and building up some wealth. One of the most important vehicles for this has been mutual funds. While some mutual funds are too expensive, and others advertise unrealistically high returns, overall the industry is a godsend. For retirement savings, mutual funds are the best thing out there. They provide the diversification that individuals need, higher returns than a bank and lower risk than shares in individual companies.

This is where Mr Spitzer comes in. He has shown us that some mutual fund firms have been cheating their investors. The practices uncovered are both illegal and indefensible, and those responsible need to be prosecuted. But it is important to keep this all in perspective. The losses for most mutual fund investors have been small, amounting

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to one or two per cent cumulatively over a decade.

Constant bombardment with stories about shady activity in the financial sector is not conducive to maintaining trust in the system. It would be a disaster if people were to forsake mutual funds as a result of these small losses. The worst thing for individuals would be to reduce their diversification, shifting their retirement savings into a small number of individual stocks. For the economy as a whole, the danger is that individual investors will flee stocks altogether, shifting their investments to places they consider safer.

The last serious flight to quality followed the Russian government's bond default in August 1998 and the collapse of Long Term Capital Management a month later. The result was a crisis in the bond market that threatened the entire financial system. The Federal Reserve responded by cutting interest rates. That made it cheaper for bond dealers to finance their inventories, so they became more willing to hold bonds and make the markets that dried up. Disaster was averted.

The real danger is that Mr Spitzer's actions will start a stampede out of mutual funds, precipitating a financial crisis. With the policy-controlled federal funds rate at 1 per cent, the natural policy response to a crisis in financial markets does not exist. If this were to happen, we would all long for the relatively tractable problem of 1998.

Fortunately, none of this has happened yet. Mutual funds have not suffered the outflows that would signal the onset of a crisis. How can we ensure that things stay that way?

The answer is that Mr Spitzer has to start emphasising that the number of crooks is small. And news stories about his actions need to say that we still have every reason to believe that the vast majority of the 8,000 mutual funds in the US are serving investors well. People need help in understanding how small these problems are, and how large the benefits of mutual fund investment. And they especially need reassurance so that small problems do not lead them to make big mistakes.