The Financial Panic of ‘08

by

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Money is flying out of Washington like bats fleeing a burning barn. Accusations of fraud, incompetence, and knavery provide the hot breath that drives them. And above the general din one cry rises: “Regulate!” In this instance, as in essentially every other instance, the demand to regulate more is just a plaintive bleat to Do Something! “Give the appearance that we are not the problem, we are the solution.”

***But it is Washington that is the problem*.**

When we understand that, we will better understand what the problem is. Whether that insight helps us cope is an open question. Washington doesn’t want to reform, and as long as they can shift the blame for their mistakes to other people, they won’t have to reform.

Financial Panic.

As long as there is credit and lending there will be financial panics. They can be caused, like this one, by mistakes the government – the regulators – made or they can be caused by mistakes that private business and private citizens make. The one constant is that they will happen. The Panic of 1836 was caused deliberately by President Andrew Jackson. He was opposed to the First National Bank – the central bank of that day, comparable to the Federal Reserve Board today – and took his revenge on them by stopping them from issuing paper money. Strictly speaking they were still permitted to print money, but it had to be backed in full by gold and silver. The monetary base therefore contracted as the bank had to retire its own money, and it was prevented thereafter from creating new monetary base. The commercial banks that had depended on money issued by the national bank as reserves were suddenly unable to extend credit. From this humble beginning, panics have become something of a tradition in America. What they all have in common is that the institutions that extend credit to the public and to farmers and business suddenly find themselves with inadequate reserves to back up their lending. What ensues is a stampede to safety, to rebuild their holdings of relatively safe investments that can be used as reserves to lend against.

Speculative Bubbles.

The one common denominator of a speculative bubble is that many people have taken actions – bought stocks or swamp land – as an investment based on what they see others doing. Since everyone else seems to trust the value of whatever it is, the logic is "I can buy some too. They can't all be wrong." But of course when they are just following each other, they can all be wrong. The model of a liquidity panic follows fundamentally the same logic. You and I think we have real money in our wallets because it is just as good as the money that everyone else has in his or her wallet, when suddenly I begin to doubt. The logic of the things works like this.

Mr. A has $1000, which he lends to B and receives in return an I.O.U. He is sure B can pay him off, so the I.O.U. note is just as good as the cash. Now A and B have, between them, $2000 to spend. Mr. B is a charitable fellow, so he is not averse to lending the cash to C, and gets another note in return. Now A, B, and C have a total of $3000 between them. Let's say this continues until Mr. Z winds up with the cash and everyone else has a note. The whole alphabet has $26,000 between them. Mr. D transfers his note to Mr. N in exchange for a new awning over his porch, and so the money turns. The money works. D knows that he owes C $1000, but he can repay him from his paycheck next week. As long as no one doubts the promises the other have made, everyone has plenty of money to spend and life is, as they say, good.

But the clouds of doubt begin to creep over this pleasant scenery. Many of the letters begin to fear that they will not be paid what they need to meet their obligations to each other. Perhaps someone has taken sick and may lose his job. Perhaps someone is a cheating scoundrel. Since the entire pyramid was built on only $1000, it can fall a long way. We have panic. This captures the barest essentials, but it misses one further key point, which is that in practice most people were cautious enough to partially reserve against the possibility of default.

Mr. B would normally have been a little more cautious right at the start. Instead of lending the entire $1000 to C, he would lend him say $800, keeping the other $200 in case an unexpected need forced him to repay Mr. A out of his own pocket.[1] So C received only $800, and so he is in turn only willing to lend $640 to Mr. D. Each of them

[1] The $200 might not help B pay off his debt to A, because A wants the whole $1000. In reality however, each of these agents has borrowed from many creditors and lent to many different debtors. Then 20% of all the money he is owed can be applied to offset the loss of a few credits that actually fails.

holds back twenty per cent in reserve. Whereas before the $1000 cash could be pyramided into an unlimited amount of money, now reason prevails and the pyramid peaks at $5,000. Prudence, it seems, reigns in the alphabet, and that is true in terms of their dealings with each other, but it does not entirely solve the problem. Suppose the letters begin to doubt the word of whoever issued the original cash. Now they see that their reserves might become worthless and their individual prudence merely a chimera. The panic is on again. The letters played out this little game because they trusted the value of the cash, and they trusted it in large part because everyone else trusted it. If in addition they begin to doubt each other, the collapse becomes even more acrimonious, but in either case the alphabet is going to lose a lot of money.

How Did We Get to 2008?

We trusted a lot of promises that we now have cause to doubt. Specifically, we trusted two general promises. First, we trusted that the Federal Deposit Insurance Corporation could guarantee the safety of all bank deposits. Second, we trusted that the quasi-government agencies, Fannie Mae and Freddie Mac,[2] could guarantee the outstanding principal of all the home mortgages that they bought up and blessed with their seal of certitude. Behind these guarantees stood the U.S. Treasury, ready to do whatever is necessary to make them work. Ready to pay in full the holders of mortgage-backed debt and the bank depositors. It is something of a marvel of propagandistic slight-of-hand, by the way, that Washington is seemingly able to walk away from its guarantee of Fannie Mae and Freddie Mac mortgages while cutting corners, and calling the whole things a ***Bail Out***. When these agencies resold mortgage paper, it came with a promise of a much simpler bail out attached: that the Treasury would come in as needed to provide the funds to make good every mortgage. Now the Treasury wants to walk away from that promise, or rather to substitute a much weaker one, and they expect to be heroes in the bargain!

Why did the federal government create Fannie Mae and Freddie Mac and guarantee payment in full on every mortgage they sold to the public? They did it to

[2] There is a third mortgage agency, called Ginnie Mae, but so far its credit has not come into question. Its guarantee from the Treasury is quite explicit, and therefore more credible.

encourage home ownership and home building, policies that go back to the Depression. Coming out of the Second World War especially, Washington recognized that a painful transition to peacetime was on its way, and that it could be diluted to some extent if the government promoted industries that employ a lot of people: the returning soldiers. Home building was ideal because it did that and more. It created a prosperous middle class of home owners who would see firsthand the fruits of what they had struggled for in the Depression and fought for in the War. The program built slowly however, and Fannie Mae and Freddie Mac really hit their stride about thirty-five years ago. It was one thing to want to build homes. It was also necessary to find a place to locate them: Suburbia. Expressways. Suburban strip malls and mega-malls. Suburban office complexes. Lawns and Barbecue. America. No one is complaining about it; it is a lifestyle that is the envy of the world and the birthright of every American.

Other developments in the American economy served to multiply the importance of homes and homebuilding. It was only after the stock market crash of 2000 and 2001 however that the options available to Washington really narrowed dangerously. Amid the public outcry demanding that Washington get the economy going again, every opportunity to spend money became more attractive, and there were few ways to spend more money than on building.

Many of the sager heads in Washington began at that time to see the dimensions of the growing problem: the growing liability that Fannie and Freddie represented. Alan Greenspan, legendary Chairman of the Federal Reserve Board, repeatedly urged the President and Congress to rein in the mortgage lender before their balance sheets became completely unmanageable, but even his voice went unheard because the politics of homebuilding and everything that it entails – promoting spreading suburbs and ever more strip malls, longer commutes and more and bigger cars – were too powerful to ignore. In an economy where nothing else was growing, this was the only game in town. Writing in the fall of 2006, I made the following observations about Freddie, understanding that Fannie was no better off:

> "In 2005 they [Freddie] reported a net profit of $2.9 billion, which admittedly is not chump change. The problem is how much capital they needed to secure that profit. Their financial assets as of yearend totaled

$790 billion, so their return on assets was less than 0.4%. In order to clear any profit they had to borrow %765 billion, and to borrow it at close to Treasury interest rates. Since Freddie Mac is an agency of the Federal Government, it enjoys a loan guarantee from the Treasury. Based on the guarantee it IS the Treasury and borrows at only slightly higher rates….Without the subsidy from the Treasury, in 2005 they would not have made $2.9 billion, they would have lost $7.1 billion."[3]

Without the Treasury guarantee, which at this very moment we are beginning to see the cost of, builders would have erected fewer homes and other business establishments, and new homes would have been a lot less expensive. From the standpoint of the builder, his calculus is based on how much he can sell his product for, and in the superheated housing market of the last five years those prices were wildly inflated.

This chain of cause and effect, running from the subsidy to the mortgage lending agencies to the overheated housing boom and the over indebted home buyer, is the cause of today's financial embarrassment. The financial institutions that participated in the securitization of mortgage instruments also however are due a portion of the blame.

Wall Street and Leverage.

The securities industry is a people business: it is a business in which the business assets go home for dinner every night, or perhaps go out to party if they are not too exhausted by making money to need their rest. The people who are the business assets, moreover, are also the decision makers and the managers of the corporations that employ them. It is up to them to evaluate the work they do, and to reward themselves when it seems that they have done well. Salaries in the securities industry – which of course is not confined to any single street in New York City – are generous. No one is flirting with a violation of the Minimum Wage Act. Yet the real money is in the performance bonuses. Last year, 2007, Wall Street paid out a total of $39 billion in bonuses.

[3] Joel Clarke Gibbons. Economics in the Present Tense: Dysfunctions of the Welfare State. Vantage Press: new York, N.Y. 2006. Page 57f.

There is a temptation for us to ask whether that large sum was actually earned by the performance of the players, but that is not the right question. The management of every firm evaluates the contribution of every employee scrupulously, to ensure that the rewards match the performance and that no single employee is overpaid relative to his peers. When we view the whole bonus system through the microscope of value added, it is easily justified. No one is cheating.

That is however not to say that the whole system works for the good of the securities industry, or more broadly for the good of the public at large. Short sighted Wall Street professionals cart off every year in their bonuses a large part of the capital base of the industry. They keep their employers poor, impoverished of the capital which ought to provide a reserve against the enormous financial risks they take. When everything is going well, money gushes from the cornucopia like oil on the Persian Gulf. No one focuses on loss reserves when there are only profits. When the inevitable losses hit however, the firms are rather easily driven to the wall because they are under-reserved.

This is the real issue that somewhat unfortunately gets swept up in a public fury about executive buyouts and golden parachutes. Wall Street needs a discipline that would provide for deeper capitalization and stringer risk reserves.

Regulation.

Regulation seldom benefits anyone, for a very simple reason. When things are going well, regulations seem to be unnecessary. When the flood of events is delivering the message that all is well and all decisions are wise and timely – because they are working – there is no taste for regulation. Some dutiful public servants might still try to make their presence felt, but even the other regulatory bureaus will more likely be hostile than supportive. It isn't merely that they don't want to fix it because it isn't broken, it is that they have no way of knowing what sort of fix would help. We only learn what policy changes would be helpful when the absence of those policies leads demonstrably to a crash. No crash equals no evidence that they would be a good idea. This thesis seems, as stated, a bit simplistic, but I would challenge any reader to find even two cases of regulatory reforms that sold themselves to the responsible parties at a time when everyone could plainly see that they were not needed.

The practice of reserving against adverse eventualities is however not new or controversial. Everyone who takes lending or investment risk keeps reserves to soften the blow of adversity. This very sensible precaution has never been enforced as a requirement on Wall Street, and it would probably have provided only limited relief in this panic because the root cause here has been the failure of the Treasury guarantee to the mortgage lenders Fannie and Freddie. That guarantee was understandably treated as a perfect substitute for loss reserves. Indeed, the Treasury issued that guarantee precisely to cause securities dealers to ignore risk and to take on nearly limitless leverage. So in this instance the Treasury, representing the administration and the Congress, would not have wanted Wall Street to add to loss reserves. The idea was to make reserves seem completely unnecessary.

We all know, however, that it is always necessary to accumulate savings in reserve to tide us over hard times and adverse outcomes. Wall Street has to build its capital and to deleverage, or else bigger and badder panics are sure to follow. If it would promote that end to create an institution like the Federal Reserve Board, to police capital adequacy of Wall Street firms, that very well might be a good idea. There is ultimately no way to prevent even the purest of regulators from succumbing to conflicting goals and objectives, and from becoming therefore a cause of risk and panic rather than a steadying rock of stability.

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