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The financial crisis and the free market cure: why pure capitalism is the world economy's only hope: A Review

Marek Loužek[1]

The book by John Allison, the president of the CATO Institute and former US banker, titled "The Financial Crisis and the Free Market Cure" (2013), is an excellent analysis of the recent financial crisis. The economic crisis is one of the most serious economic events that has occurred during the last eighty years. It has had an impact on lives of people all over the world. Yes, a number of people made irrational decisions but the argument that the greed of financial markets is behind all this is infantile.

In Allison's opinion, the key cause of the financial crisis was an erroneous government policy. Financial services are a highly regulated sector. Whoever does not believe that the financial market is highly regulated can look at the federal insurance of deposits, the government bank oversight, the Securities and Exchange Commission and other agencies which influence and control the workings of financial markets. The allegation that a deregulated financial sector is to blame for the crisis is a myth.

The government policy created a bubble on the US real estate market. A bubble in the form of irrational, excessive investment of capital and human resources. The bubble on the real estate market collapsed just like all bubbles collapse sooner or later. The loss of wealth resulting from the decreasing value of real estates was carried over to financial markets, destroyed a lot of wealth and caused a considerable slowing-down of economic activity.

Individual financial institutions (Wall Street participants) made very serious mistakes that contributed to the crisis. However, any errors by these institutions, individually and collectively, are far less important than government policy mistakes, and almost all the errors were directly resulting from government policy incentives. Almost every governmental action taken since the crisis had started, even though it may have helped in the short term, would reduce our standard of living in the long run.

The primary cause of the Great Recession was a massive misinvestment in residential real estates. Americans built too many houses, too large houses, and houses in wrong places. This massive misallocation of capital to residential real estate had its base in a belief that home prices appreciate forever and that housing is a great investment. Spending on housing is consumption, not investment. We live in a house, and therefore we

[1] Associate professor at University of Economics, Department of Economic and Social Policy, Faculty of Economics. E-mail: louzek@post.cz

consume the house. Houses are not used to produce other goods. Thus, the misinvestment in housing shifted resources from production to consumption.

Allison points out that major role in creating the bubbles on the real estate market was played by the US central bank. In the early 2000s, the Federal Reserve made the same conceptual error that it had made in the late 1920s. The most destructive of the decisions that Allan Greenspan made took place during the period of 2000-2003. During this time, the Federal Reserve created a structure of negative real interest rates. Financial investors could borrow at 2 percent, and inflation was 3 percent. This creates a huge psychological and economic incentive to borrow.

After he had became chairman of the Federal Reserve early in 2006, Ben Bernanke rapidly raised interest rates and created and inverted yield curve. When Bernanke raised interest rates rapidly, banks started incurring significant losses in their bond portfolios. In order to offset these losses, they were motivated to make high-risk investments with potentially higher returns. A deep recession followed.

After the onset of the financial crisis the American central bank reduced interest rates down to zero, and even launched three rounds of quantitative easing. Although certain easing of monetary policy was justified during the financial crisis, it did not have to last for long. The record-breaking levels that were reached on the US stock markets indicate that a new bubble had been formed. By holding interest rates below the rate that the market would set, an unelected group of bureaucrats at the Federal Reserve was creating a massive reallocation of wealth. Bernanke redistributed wealth from savers to borrowers (including speculators).

In a free market, where the economic system is in a constant correction process, individuals are aware of risk. Because they realize that risk exists and that no one will bail them out during the down times, they save for those risky times. Individuals save for the future, but they also save to deal with an unknown risk. If the Federal Reserve eliminates the downside risks in difficult times, the private sector will behave in a more risky manner.

Allison points out the unfortunate role the federal deposit insurance (FDIC) had in this. Low-risk, well-run banks have to pay for losses incurred by banks that were run poorly. FDIC insurance destroys market discipline. A typical individual depositor does not worry about the safety and soundness of their bank because they believe that the federal government is insuring their deposits. The existence of the FDIC provides incentives for taking large risks, which lead to bank failures.

In Allison’s career in banking, there have been very few, if any, occasions when the financial regulators identified a problematic bank and acted in such way as to correct the problems. In almost every case of bank problems or failures, government regulators have been the last people to know. The belief that regulators will somehow act differently in the future is extraordinarily naive.

There is overwhelming evidence that regulatory policies increase risks instead of reducing them. In a private banking system, some banks will be making fatal mistakes. However, it is extremely unlikely that the vast majority of banks will be making the same mistake. Government regulatory policy creates incentives that encourage almost all the financial institutions in the market to make the same mistake.

The reason for European banks to have collapsed so rapidly was in the fact that the Basel Accords had been implemented in Europe. The Basel Accords are an international standard used to determine bank capital levels. The first version (Basel I) was launched in 1989: banks were told then (as now) that it was not necessary for them to keep any capital against government bonds because they were "risk-free assets." Also, Basel allowed banks not to hold any capital against "sovereign" risk in the United States and Europe.

In Europe, regulatory capital standard encouraged banks to purchase large quantities of sovereign debt from Greece, Spain, Italy, Portugal, and other countries that were running large deficits. In the European system, the strong countries (such as Germany) were not directly guaranteeing the debt of the weak countries. However, the banks in the strong countries could fail (and cause a collapse of the economy of the strong country) if Italy, Spain, Greece, or some other country were to default.

Allison criticises the US government policy of aiming to ensure that everyone owns their home. Home ownership is not necessarily economically efficient for everyone. For example, for young people who anticipate moving often, the transaction cost (which is substantial) of buying and selling houses may outweigh the economic benefits of ownership. As all homeowners know, maintaining a home is expensive and time-consuming, too.

Under Bill Clinton, giving high-risk home loans to low-income borrowers was given priority over safety and soundness from a regulatory perspective. Most people today view subprime lenders as taking advantage of poorly informed low-income borrowers. But it is important to remember that subprime lending was primarily driven by government policy based on a goal of wealth redistribution.

High level of risk taking could jeopardize the financial viability of Freddie and Fannie. Freddie and Fannie buy mortgages from private banks, consolidate them into larger wholes and trade with them. These institutions were so big that if they failed, it could have a dramatic impact on the U.S. economy. Freddie and Fannie are giant government enterprises that never would have existed in a free market. They are hybrid organizations, which is the worst of all worlds.

Freddie and Fannie traditionally operated with a leverage ratio of 75 to 1. Banks have a leverage ratio on loans of 10 to 1. Even before they experienced severe financial problems, Fannie and Freddie were operating with a leverage ratio of about 1,000 to 1. Freddie and Fannie could operate with this much leverage only because the government had effectively guaranteed their debts. Freddie and Fannie's total liabilities, including loan guarantees, were approximately $5.5 trillion (including $2 trillion in subprime mortgages).

The "bursting" of the bubble (misinvestment) in the residential real estate markets led to the deterioration of capital markets and to the Great Recession. In reality, it was the government actions that led to the misinvestment (bubble) in the first place that were destructive. The bursting of the bubble was both inevitable and healthy for the economy in the long term. The bursting stopped the misinvestment process. It was misinvestment, not the correction that reduced our future standard of living.

A substantial volume of subprime mortgages had been securitized by investment banks and sold into the investment portfolios of pension plans, bond funds, and banks all over the world. Some of the highly rated subprime mortgage bonds started to default as the real estate markets began to deflate. It quickly became clear that the default rates on these subprime mortgages were going to be much higher (worse) than was implied by the credit rating on the bonds.

These subprime-backed mortgage bonds had been rated by rating agencies: Standard & Poor's, Moody's, and Fitch. Because of special approval from the Security Exchange Commission, these three rating agencies have an apparent certification of quality from a U.S. government agency. There is presumption in the capital markets that the government-sanctioned rating agencies know how to grade the risk of financial instruments. Unfortunately, the rating agencies did a terrible job of rating subprime-backed mortgage bonds.

One factor that undoubtedly influenced the rating agencies was the way they were compensated. For years, the agencies had charged the buyers of the bonds for rating the bonds, a system encouraged by S&P, Moody's and Fitch and that led them to be more conservative because their clients were the bond buyers. Tragically, in the early 1970s, the Security Exchange Commission, seeking to expand market access to ratings, forced Moody's and the other rating firms to fundamentally change their compensation model in a way that created serious conflicts of interests.

Under the new methods, the agencies were paid by issuers – bond sellers, not bond buyers. The change in the compensation system created very different incentives for the rating agencies. Of course, the sellers always want the highest rating possible, as a higher rating allows them to borrow at a lower rate. Thus, under the government-mandated "issuer pays" system, the rating agencies had strong economic incentive to assign the highest possible ratings to bonds.

The failure of the rating agencies played a major role in the disruption of the financial markets. The fact that S&P, Moody's and Fitch have apparent sanction from the SEC (a government agency) contributed to the excessive reliance on these institutions, who themselves were misled by other governments, that is, the FED and Freddie and Fannie. The fundamental effect on the overall capital markets was the loss of confidence in the rating agencies.

The explanation typically given for bad decisions by investment bankers is greed. However, there was plenty of greed on Wall Street before the bubble. In fact, in Allison's almost 40-year career in banking, there has always been greed on Wall Street. There was no more or less greed on Wall Street during the bubble. Greed is a constant in capital markets, just as is fear. If greed created the financial crisis, it also created the good times.

Allison also debunks another myth that derivates were the prime driver in the financial crisis because the market was so large. It is easy both to dramatically exaggerate the size of the derivatives market and to misunderstand its nature. In the first place, the vast majority of derivatives are entered into to reduce risk, not as a speculation. CDOs (collateralized debt obligations) were also designed originally to reduce credit risk.

Allison criticises the U.S. Securities and Exchange Commission (SEC). The Securities and Exchange Commission is dominated by attorneys, many of whom have only a superficial understanding of economics, business, and finance. SEC regulations made the financial crisis worse than it needed to be. The argument for regulators is that they are more objective. This is factually incorrect. They are independent, but not objective. Markets constantly make mistakes, but they also constantly correct these. Government bureaucrats constantly make mistakes, but they also constantly magnify these mistakes.

The negative impact of government regulations is far more destructive than the direct cost. While all the productive employees in a business are important, the long-term success of any enterprise is fundamentally dependent on the quality of leadership at the top. If the most important and most productive minds in an organization are spending half their time trying to satisfy government bureaucrats, the whole organization will be less productive and will create fewer jobs.

While economic corrections are a necessary part of the free-market learning experience, panics are not necessary and are particularly destructive. Panics cause lending standards to become too tight, which is destructive. Panics create self-fulfilling downward spirals that unnecessarily destroy wealth. A deep recession was avoidable from a long-term policy perspective but was not avoidable in the short term, given the huge policy mistakes that government agencies had previously made.

Allison does trust even The Troubled Asset Relief Program (TARP) that was bailing out bad assets worth hundreds of billions of dollars. It is very likely that without TARP, we would have had a deeper economic correction. However, is also very probable that the correction would have been shorter and the long-term economic growth trend more healthy. The deeper correction would have quickly destroyed irrational investments but at the same time created an economic foundation with far less ambiguity on which business leaders could make the right kind of investments for the future.

Government decision makers and the majority of academic economists are victims of the Keynesian fallacy. It seems bizarre to believe that spending money you do not have on things that do not need to be done will raise your standard of living in the long term. The reason the United States and Europe entered a recession was not a lack of demand. It was because our resources had been misallocated, so we could not continue to consume (demand) at the same level. The Allison’s book is worth attentive reading.

References

ALLISON, John A. (2013) *The financial crisis and the free market cure: why pure capitalism is the world economy's only hope*. New York: McGraw-Hill, viii, 278 p. ISBN 0071806784.