
Problems and Opinions

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GLOBAL FINANCIAL CRISIS. WHERE WE ARE NOW AND WHERE WE ARE HEADING – IF ANYWHERE...

1. INTRODUCTION

This paper observes potent connections between three areas of institutional framework of the U.S. economy and policies pursued within these institutions: monetary policy of the FED, housing regulations and policies toward the housing sector and finance, as well as the piecemeal regulations of the financial sector. It is within this “unholy triangle” and its interactions with the real economy that both extent and pattern of the crisis has largely been determined.

There is often a tendency to look for a primary factor (or factors) of certain important developments and then point to secondary factors, which either add to or subtract from the extent and/or pattern of these developments. In the case of the U.S. – initiated financial crisis, the primary role is difficult to ascertain: all three areas are strongly qualifying to be such factors.

It is the monetary policy that may be seen as a catalyst for crisis, but not the primary factor. For the impact of other factors, that is housing regulations and

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policies, as well as piecemeal regulatory intrusions into the financial sector, would not have been as amplified as they were without the extremely liberal monetary policy of the preceding dozen or so years [see, for example, an empirically reinforced critique by John Taylor in his book of 2009, showing the housing boom and bust under traditional and very liberal monetary policies of the FED].

With respect to the question: “where are we heading?” it is not possible to be optimistic. The diagnostic attempt presented in this paper belongs to a range of minority views, although better established empirically than at the beginning of the crisis. The dominant view is still that of a failure of capitalism (or at best of an “extreme”, neo-liberal, or free market version – you name it – of capitalism). The political demand continues to be for more regulation and more interventions in the financial and other markets and these *ad hoc* and regulatory intrusions are duly forthcoming.

I (as do many others) point out however, more regulation and policy interventions are not an efficient answer to the problems at hand. It is stressed that neither piecemeal, fragmented, regulations nor comprehensive regulatory framework (a *constructivist* solution in von Hayek’s term) are going to improve the functioning of markets.

The only consolation may be drawn from a sober assessment that the wealth available to be destroyed in such misdiagnosed pursuits is much more severely limited than it was at the time, when most countries of the West entered upon the Keynesian path in macroeconomic management and interventionist regulation. Thus, the period of such experiment may be limited to merely 3–5 years [see my essay: *Keynesian Wars: Episode 2*]. However, there is no guarantee that such sobering process is going to take place. Consequently, institutional and policy changes in the more distant future are not necessarily going to be more sensible than erroneous recommendations we see attempted or imposed now...

2. THE “UNHOLY TRIANGLE” I: FED CREATES A MORAL HAZARD ON A GIGANTIC SCALE

Already in 2002 Robert Barro noted the propensity of the then FED Chairman, Alan Greenspan, to cut, again and again, interest rates: “*The pattern of accelerated rate cuts is worrisome because it might signal that the FED has become less committed to maintaining low inflation and more interested in attempting to forestall any economic downturn.*” [Barro, 2002, p.157] and added that “... *it would be better if Greenspan remained focused on his central mission of monetary policy*” [ibid., p.158].

Unfortunately, Chairman, Greenspan did not; neither earlier nor later. The recipe was straightforward: Russian crisis? Let's cut interest rates. *Dot.com*'s bubble? The same. Terrorist attacks on 9/11? The same. No matter what had been the malady, the cure was the same. Deep cut in interest rates was the answer.

Greenspan was not alone. There were many economists, mostly (but not exclusively!) of interventionist beliefs who were delighted by such approach to business cycle. Some of them fervently wished for it to be banished forever. One of the well known American economists said some years ago that inflation in the US will be at the level wished for by Alan Greenspan. The consequences of drowning the economy with money – in Prof. Roubini's terms – in order to forestall any economic downturn were, however, disastrous in the end.

What does it mean for the economy to be drowned with money? It means for businesses and households to have a nearly unlimited access to inexpensive credit. We all remember the basic diagram from the capital theory on investment project selection. The level of interest rate offers a cut-off point, indicating which projects look profitable (at a given risk level) and therefore should be selected for financing and which should not.

But what if the interest rate tends down to near-zero as a result of intermittent deep interest rate cuts made by the central bank? It means that nearly every project looks (artificially!) profitable. Artificially, because interest rates cannot be kept forever so close to the zero level. Alan Greenspan had maintained that “*not only have individual financial institutions become less vulnerable to shocks from underlying risk factors (sic!!), but also the financial system as a whole has become more resilient*” [Krugman, 2008, s. 264]. Such views were not limited to America. The then Chancellor (later Prime Minister) Gordon Brown stressed that under his (interventionist) economic leadership there would be “No Return to Boom and Bust” [Simpson, 2009].

Over a long period of cheap money available, a widespread moral hazard had been emerging. *The Economist* [9.08.2008] stressed the creation of a “*speculative mentality in financial markets ... Why not take risks if you know that central banks will intervene only in falling, not rising, markets?*” [p.12]. Such sentiment was called the *Greenspan Put* on and around Wall Street.

But pretences of being able to banish recessions and, at the same time to eliminate risk could not hold forever. With rising federal interest rates in response to rising inflation, many investments (including residential housing) turned out to be financially unfeasible. The risk, artificially reduced for the time being, returned with a vengeance. It was only a matter of time when and where some bubble would burst. It turned out to be the housing sector and the reasons why add to our evidence of the distorting, moral hazard-generating role of the state in the economy.

3. THE “UNHOLY TRIANGLE” II: FROM AFFORDABLE HOUSING POLICIES TO A COLLAPSE OF THE HOUSE OF CARDS

The most recent housing bubble in the U.S. was supported not only by the monetary policy flooding the economy with money. It would do a lot of damage, but not that much! It was also a consequence of a long trend in regulations and policies by successive American governments, which put pressure on private financial firms, primarily banks, to spend a part of their money on a variety of projects benefiting “disadvantaged members of the community”. To offer an example, the famous (or infamous) Community Reinvestment Act of 1977 warned banks in no uncertain terms about the negative consequences of not spending a part of their money in that manner. And spending they were at times up to 15–20% of their money on a variety of substandard loans – primarily, but not exclusively, mortgages. The political pressure increased further on in early 1990s.

Consequences were, according to expectations, negative, but some more harmful than others. Clearly, tying a part of the money to low profitability/high risk mortgage loans for low or irregular income customers (sometimes called *ninja*, from: *no income, no job, no assets*) had dual effect. On the one hand, repayment level of the whole mortgage portfolio declined. On the other, banks were forced to search for some projects of above-average profitability – and therefore more risky ones – in order to stay close to long term profitability levels, a classical case of perverse incentives, created step-by-step by the state action, creating moral hazard!

Under the political slogan of “affordable housing”, coined during the Clinton era, banks were *de facto* forced to make substandard loans. The softening of mortgage loan standards proceeded under many guises. One was the so-called *subprime mortgage*, that is a loan to the *ninja*, people who according to normal rules of the game could never dream of obtaining a mortgage loan.

Another, more varied category, were mortgages to people of low-to-moderate, but steady, income, working full time, who simply could not afford standard mortgages. The standards of these mortgages, that is 20–25% downpayment and 20–30 years repayment period, were being progressively weakened. The required downpayment was shrinking over the years and so were other lending standards (as recommended by the government, stressing the need for “flexible standards”!). The process accelerated in the past decade and by 2006, just before the crisis, the share of standard mortgages – according to varying estimates – amounted from one third to one half of the total [see, Sowell, 2009, and Wallison, 2009].

The rapid decline of the quality of mortgages in the most recent period before the bust was also due to intensified activities of *Fannie Mae* and *Freddie Mac*. They were two government-sponsored-enterprises (GSE), created with a mission to maintain a liquid secondary market in mortgage loans. But with a growing political

appetite for reaching the ever lower income levels' electorate with "progressive" housing policies, they were encouraged to expand and, apart from insuring mortgages, they were buying subprime and other substandard mortgages from new banks in increased quantities as part of their portfolio. When they became insolvent and were taken over by the government, their prospective losses were estimated to be between 700 billion and 1 trillion \$ [see, Wallison and Calomiris, 2008]!

With inflation exceeding 3% *p.a.* interest rates went up (albeit moderately, to 5.25%) and the drama began. With such a share of substandard mortgages the traditional pattern of delinquencies and foreclosures exploded. Foreclosures rarely exceeded 2–4% in recessions; now they went into the stratosphere, increasing to 20–30%!!

One more type of regulation added to the problems as well, namely the *no-recourse* rule introduced in some states by local politicians. They allowed the mortgage holder to give back the keys to his house to the bank and the latter had no claim on the mortgagee anymore. As banks lost up to 30% of the value on the repossessed houses, massive foreclosures undermined financial stability of many new banks. Their losses were estimated to be around 1 trillion \$ and were a major cause of the collapse of part of the American financial sector [Sowell, 2009].

Just as in the case of monetary policy propping up the economy in slowdowns, but not restraining it in expansions, governmental regulations and policies were also building up the level of risk in the mortgage sector. The difference was that the level of risk was built more slowly, over a long period, although with the sudden acceleration in the preceding decade. How important was the slow, but accelerating decline in mortgage-related lending standards, may be seen in the comparison between the U.S. and Canada. The latter country also suffered from deep recession, but its regulation of the housing sector was not eroded. The standard mortgage loan is still 20% downpayment and 80% loan-to-value ratio to be repaid in the standard time span of 30 years. There is, moreover, the obligatory insurance to be taken on the loan by the borrower. The outcome (not unpredictable!) was a very much lower foreclosure rate than in America.

American politicians did not learn either from their own experience or from the Canadian one. Recently a Democrat-dominated House of Representatives has rejected the draft that provided for a very modest (barely 5%) compulsory downpayment for mortgages...

4. THE “UNHOLY TRIANGLE” III: REGULATION OF THE FINANCIAL SYSTEM AND THE LAW OF UNINTENDED CONSEQUENCES

Regulation slapped on American multinationals by the government in early 1960s had an intended consequence of controlling the outflow of capital from the U.S., while keeping an eye on the deteriorating balance-of-payment. The intended effect was achieved to a marginal extent. However, unintended consequences were much greater.

Multinationals, in order to be able to use their capital in a timely and flexible manner, decided not to send their dollar revenues back to the U.S., but to keep them on special dollar accounts in the West European banks. At the time of strong controls of capital flows a new international financial market was created as a result. For the European banks decided to use the dollars kept on these accounts for lending purposes. A Eurodollar lending market exceeded very quickly, in terms of the loan volume, the largest Western markets of London and New York!

In 1970s the FED issued Regulation Q, which restricted the level of interest rates that banks and savings societies could pay their depositors. It was a misguided attempt to influence the saving and lending patterns of financial institutions in the face of strong inflationary pressures. It could have done a lot of damage if it had not been for the innovativeness of the regulated sector. Its response was to create money market funds, which circumvented the regulation.

However, we cannot count on too much luck from unintended consequences the whole time. More often than not, unintended consequences of regulatory arrangements upset the regulated market and undermine its efficient operation. The reasons are best summarized by Prof. Meltzer from Carnegie Mellon University. The problem of regulators (and politicians) is that they are good in thinking of restrictions and formulating relevant rules. They are much worse in thinking about the structure of incentives the firms in a regulated sector face. If incentives are strong enough to continue the restricted activity, they are going to try to circumvent the rules, without breaking them. Moreover, regulations are static, while markets are dynamic and sooner or later firms find ways to operate efficiently and profitably in the face of a given regulation [Meltzer, 2008, 2010].

The same *modus operandi* applies to many – undoubtedly well intended – regulations affecting the financial markets [a story is well told by Jeffrey Friedman, 2010]. The Basel I agreement set the level of reserve capital of commercial banks for loans to and bonds from business firms at a rate of 8%. However, the urge to perfect the rules on the basis of differentiated risk of each category of assets moved the regulators to set the reserve capital for mortgage loans at a rate of 4%. On stand alone basis that made sense; after all, the repayment ratio for mortgages have historically been significantly higher than those of loans for businesses. But,

as stressed in the preceding section, such repayment ratios were typical in the past, with respect to standard terms' mortgages. With the flood of substandard ones, the old patterns ceased to be valid, which was neither noticed nor predicted in 1991, when the U.S. adopted Basel I standards.

The result of differentiated levels of reserve capital was a shift in proportions of business vs. housing-oriented lending. But even more ominous unintended consequences emerged from the Recourse Rule of 2001, amending Basel I with respect to a new class of financial assets, namely asset-backed securities. A joint regulation (by FED, FDIC, Comptroller of the Currency, and OTS) decided that commercial banks were required to keep only 2% of reserve capital with respect to bonds backed by the stream of repayment installments of one of the three classes of assets: mortgages, car loans, or credit card debt. The only requirement was that such bonds were AAA or AA rated (or were issued by GSEs).

Again, on the surface mortgage-backed securities looked like very safe papers, indeed. After all, in good old times mortgages were being repaid at worst at 98% rate most of the time. But the sub-prime and other substandard mortgages changed the picture materially. And by 2001 the regulators were no longer able to use the excuse of ignorance with respect to an ominous trend of ever lower mortgage standards! Thus, apart from traditional good intentions-reinforced *naivete*, they were guilty also of negligence.

With Recourse Rule 2001 requiring so low level of reserve capital, incentives for banks and other financial institutions overwhelmingly shifted a part of their activities from business loans or buying commercial bonds, all requiring 8% of reserve capital, to those requiring only 2% of reserve capital. In consequence, demand for asset-backed securities increased sharply.

There was, however, yet another issue, which generated unintended consequences. The requirement of high ratings for the new type of instruments – that asset-backed securities (ABS) were required to have – was undermined (if not annulled) by the oligopolistic position of a small number of rating agencies in the U.S.

The 1975 amendment to the SEC regulation turned three agencies (S&P, Moody, and Fitch) into a regulation-preferred oligopoly of sort. As early as XVIII century Adam Smith was fond of saying that the spirit of a monopolist is characterized, *inter alia*, by laziness. Therefore, unsurprisingly, rating agencies did not do enough homework to recognize the varied characteristics of parties underpinning asset-backed securities and dangers resulting from eroded standards in the case of mortgages. The consequence was a flood of carelessly researched securities: by 2008 almost 81% of all rated mortgage-backed securities held the AAA rating [J. Friedman, 2010, p.6]. A substantial part of these securities later obtained a junk status...

This story of a string of regulations of the financial markets that – in conjunction with various policies – undermined markets' stability and efficiency could be easily

continued. None of them would have done very great harm on a stand-alone basis. Taken together, however, they turned out to be devastatingly harmful in their impact upon the financial markets – and the economy at large.

5. WHY DID THE AMERICAN DISEASE SPREAD SO FAST?

This issue is to be dealt with relatively quickly, as these causes are well known, except the one that will be stressed to some length. It is obvious that the sheer size of the American economy influences world economy's developments to a substantial extent. Next, an even larger size of the American financial sector relative to that sector elsewhere amplifies the effects of the American financial developments on the world financial markets. Finally, the U.S., as the largest borrower in the world, influences the world financial markets to an even greater extent. Thus, the supply of the American financial assets is highly important for all buyers.

These are very obvious statements. However, one special aspect of that phenomenon should be pointed out with respect to the most recent business cycle. The very long global economic boom, strongly supported by super-expansionary FED's monetary policy additionally increased the demand for financial assets. Banks throughout the world were hectically looking for suitable securities in order to invest money flowing to them in the form of deposits.

In such a climate of amplified demand for securities two American government-sponsored enterprises (GSEs), *Fannie Mae* and *Freddie Mac*, dramatically increased their presence in the world market for securities. GSEs, considered strange institutional beasts even by welfare state standards, take the capital endowment from the state and are allowed to borrow, that is issue securities, to finance their activities. They were present on financial markets for decades, but only a combination of political pressure on them to support governmental housing policies and the dramatic growth of demand for financial assets created the environment in which such expansion has become possible.

From the last years of the XX century until their insolvency and the takeover by the state in 2008, *Fannie Mae* and *Freddie Mac* issued securities roughly equal in volume to that of the U.S. government!! This expansion is shown diagrammatically in the figure presented by Desmond Lachman [in the *Wall Street Journal*, 2010]. When they went bankrupt in August that year, they held or guaranteed together 1011 bill. \$ in unpaid balance of mortgage loans [Wallison and Calomiris, 2008]. A very large part of those were substandard mortgages. And since a large part of mortgages were rolled into packages to back mortgage-backed securities, they created in this manner a very large volume of substandard asset-backed securities issued by both GSEs.

How large? In 2003 *Newsweek's* economist, R.J.Samuelson signaled that about 3000 banks held *Fannie Mae* and *Freddie Mac* “debt equal to all their capital” [8.09.2003]. Since then, with a huge acceleration in both GSEs’ activity, banks’ exposure increased accordingly throughout the world. Strangely enough, the disaster took place in spite of earlier assessments that the risk of default and such takeover is “*effectively zero*” [see, first of all, Stiglitz, Orszag, and Orszag, 2002].

The ease with which they tapped the financial markets to finance their (increasingly risky) activities stemmed from their GSE status. Their rating was almost at the level of the U.S. Treasury bonds. Eager buyers perceived the existence of the implicit government guarantee. In that, at least, they turned out to be right – to the dissatisfaction of American taxpayers. Mixing politics with business in yet another way turned out to be as much harmful as more traditional ways of political tinkering.

6. ARE WE HEADING ANYWHERE? DO WE UNDERSTAND WHAT WE PROPOSE?

David Simpson [2009] quotes Lord Keynes assessment of the 1930s: “*We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand*”. Having noted that in the foregoing sincere statement Keynes was more Hayekian than Keynesian, the present writer holds little doubt that the present crisis does not seem to be understood much better than that of 1930s. In fact, I suggest that the similarity goes even further than, in turn, suggested by Prof. Simpson. For just as Keynes and his disciples did not understand too well the dynamics of the Great Depression and yet recommended the solutions, so a range of economists of largely interventionist beliefs recommend solutions without understanding too much the dynamics of the present crisis and the Great Recession.

As signaled earlier, the majority of political, public, and also academic opinion seems to be convinced that the crisis has been caused by greedy and reckless bankers – and demand more regulations accordingly. Yet what has been shown in sections 2–5 of this paper leads the present writer to sharply different conclusions. Expansions and recessions, accelerations and decelerations, explosions of exuberant optimism and waves of deep pessimism are part and parcel of the market economy. The risk of failure is also accompanying the developments in the capitalist market economy. Schumpeterian creative destruction is going to be with us all the time as well. But it is due to such developments that capitalism made such an unbelievable progress in creating wealth.

I quoted Prof. Meltzer who stressed that regulations were static, while markets were dynamic. Therefore, the former usually does more harm than good as stressed

in particular in sections 3 and 4 of this paper. They try to rectify perceived failures or dangers of a failure in a fraction, or a piece, of the dynamic whole of the market. They inevitably come into conflict with each other – and with a whole, that is with the functioning of financial markets.

Some may – and they do! – suggest comprehensive solutions as a cure. But the cure could have been worse than the malady! The already quoted Nobel Prize winner Friedrich von Hayek warned against juxtaposing naturally evolving and constructivist, man-made systems. For only the former give us an idea of both expected and unexpected consequences of their functioning. Crude intellectual constructs tout only the first best scenarios; unintended consequences are not and cannot be known in the case of constructivist theorizing. Harold Demsetz calls such methodologically faulty comparisons *the Nirvana fallacy* [1989]. When Nirvanas are being tested empirically, as the communist system had been in the 1917–1991 period, the realities of intellectual constructs reveal their ugly – and destructive – features.

7. MARKET-CONFORMING AND, MORE WIDELY, REALITY-CONFORMING APPROACHES

What the present writer stressed in the preceding section does not mean that nothing can – or should – be done. On the contrary. Since, in contrast with many popular beliefs, markets – especially financial markets – have not been left unregulated, which could improve the performance of markets is the substitution of the present, erroneous and internally contradictory, regulations with new ones that conform with the structure of incentives in the market economy in general and in these markets in particular.

Thus, following Alan Meltzer, instead of what he called *regulatory overkill* [2008] reformers should try “*to use regulations to change incentives by making the bankers and their shareholders bear the losses. Beyond some minimum size, Congress should require banks to increase their capital more than in proportion to the increase in their assets.*” Then, it is the bankers themselves who would “*choose their [banks – J.W.] size and asset composition. Trust stockholders incentives, not regulators’ rules*” [Meltzer, 2010]. It is to be expected that the former would choose a risk level, and accordingly a size of the bank, reflecting their risk appetite for investing their own money.

However, certain regulations have already been embedded in particular markets. These regulations have already modified the structure of incentives. An example of such regulations is the governmental deposit insurance scheme. Although such a scheme has its share of pro’s and con’s, it is here to stay in the fractional banking system of today’s world. Here, the reality check should suggest the reduction of

certain risks, while taking into account the existence of FDIC and similar schemes around the world.

Since commercial banks as fiduciary institutions take part in the scheme and generally are protected against certain developments in the financial markets, they should not be combined with other types of financial institutions. In the opinion of a number of practitioners and academics a priority regulatory arrangement should be the separation of commercial and investment (merchant) banking.

One hears, *i.a.*, from Paul Volcker, Prof. Mervyn King, Adrian Blundell-Vignal, and Prof. Deepak Lal that much riskier investment banking has been recently “free riding” on the back of deposit-insured commercial banking. Such developments posed a dilemma for central bankers and regulators. If and when risky investments collapse, they present an unpalatable – and dramatically costly – alternative: either to save the commercial/investment as a whole at an enormous cost to the taxpayers or to allow it to go bankrupt at the cost of the panic that may create the systemic risk for the financial market as a whole.

In this as in other similar cases the “Meltzer rule” should prevail. Of course what Prof. Meltzer has been saying of late has been repeated by classical liberal economists since the time of David Hume, Anne-Robert Jacques Turgot, Adam Smith, Adam Ferguson, and others. Detailed arrangements should try to conform to the structure of market incentives. The more they would depart from the conformity to the market rules, the more easily they would be circumvented by market practitioners. The past, including the recent past leading to the financial crisis of our times, suggests us the foregoing recommendation in certain terms.

Finally, as another reality check, I would like to offer a note of warning. There is still quite a high probability for the thrust of regulation to push the regulatory regimes in the U.S., E.U., and elsewhere in the opposite direction to that suggested in this section. The success of traditional interventionist ideas is not going to last long, though. The Keynesian episode lasted from the early 1950s to the late 1970s. But, with the back-breaking load of public debt increasing even more in the years to come, the end of the traditional interventionist road is just a few years from the present. The Western world is going to face difficult choices in the next 3–5 years. I am afraid, however, that choices to be made may not necessarily be reassuring for classical liberals...

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