Jan Winiecki
University of Information Technology and Management (WSIZ)
Rzeszow, Poland
&
Monetary Policy Council, Polish National Bank (NBP)

Where Are We Now And Where Are We Heading - If Anywhere...

1. Introduction

This paper sees strong interlinkages between three areas of an institutional framework of the U.S. economy and policies pursued within these institutions: monetary policy of the FED, housing regulations and policies toward, as well as the piecemeal regulations of the financial sector. It is within this "u n h o l y t r i a n g l e" and its interactions with the real economy that both scale 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 of or subtract from the scale and/or pattern of these developments. In the case of America–initiated financial crisis, the prime role is difficult to ascertain: all three areas strongly qualify to be such factors.
It is monetary policy that may be seen as a c a t a l y s t of crisis, but not a prime factor. For the impact of other factors, that is housing regulations and policies, as well as piecemeal regulatory intrusions into the financial sector, would not have been as amplified as it was without the loose monetary policy of the preceding dozen or so years. A good graphic summary of the foregoing is Fig. 1 [from John Taylor's book of 2009] showing the housing boom and bust under traditional and super-expansionary 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 still 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 of and more interventions in the financial and other markets.
As this author (and many other) stress, 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 some 3-5 years only. However, there is no guarantee that the 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 hear now...

2. An "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; either earlier or later. The recipe was straightforward: Russian crisis? Let's cut interest rates. *Dot.com*'s bubble? The same. Terrorist attack on 9/11? The same. No matter what had been the malady, the cure was the same. Cutting deeply interest rates was the answer.

Greenspan was not alone. There were many economists, mostly (but not exclusively!) of interventionist persuasion, who were delighted by such approach to business cycle. Some of them fervently wished it would 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 by Alan Greenspan. Consequences of drowning the economy with money – in Prof. Roubini's terms – in order to forestall a n y economic downturn were, however, disastrous in the end.

What it means 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 by the central bank? It means that nearly all projects look (artificially!) profitable. A r t i f i c i a l l y, because interest rate cannot be kept forever near the zero level. Alan Greenspan had maintained that "*not only have individual financial institutions became 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 confined 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 pretensions of being able to banish recessions and, alongside, eliminate risk could not hold forever. With a rising federal interest rate in response to rising inflation, many investments (including residential housing) turned out to be financially unviable. The risk, artificially reduced for the time being, returned with a vengeance. It was only a matter of time when and where some bubble will burst. It turned out to be the

housing sector and the reasons why add to our evidence of the distortionary, moral hazard-generating role of the state in the economy.

3. An "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 monetary policy flooding the economy with money. It would do a lot of damage, but not t h a t much! It was also a consequence of a long trend in regulations and policies of successive American governments, which pressured 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 *in*famous) Community Reinvestment Act of 1977 warned banks in no uncertain terms about negative consequences of not spending a part of their money in that manner. And spending they did, 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 in early 1990s.

Consequences were, expectedly, negative, but some more harmful than other. 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 had been forced to search for some projects of above-average profitability – and therefore more risky – in order to stay close to long term profitability levels, a classical case of perverse incentives 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 mortgages*, that is loans to the *ninja*, people who under normal rules of the game could never dream of obtaining a mortgage loan.

Another, more varied category, has been 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 30 years repayment period, were progressively weakened. The required downpayment was shrinking over the years and other lending standards as well (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 the 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 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 originating banks in increased quantities as a 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 more any claim on the holder. As banks lose up to 30% of the value of the repossessed houses, massive foreclosures undermined financial stability of many originating banks. Their losses were estimated to be around 1 trillion $ and were a major cause of the collapse of a 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 have also been 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 from 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!) has been a very much lower foreclosure rate than in America.

4. An "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., with an eye the deteriorating balance-of-payment. The intended effect was achieved to a marginal extent. However, u n i n t e n d e d consequences were enormously 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 West European banks. At the time of strong controls on capital flows a new international financial market has been created as a result. For European banks decided to use dollars kept on these accounts for lending purposes. A Eurodollar lending market very quickly exceeded 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 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 mischief if it had no 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 in unintended consequences. More often than not unintended consequences of regulatory arrangements upset the regulated market and undermine its harmonious 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 s t r u c t u r e o f i n c e n t i v e s the firms in a regulated sector face. If incentives are strong 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, 2080, 2010].

The same *modus operandi* applies to many – undoubtedly well intentioned – regulations affecting the financial markets [a story is well told in Jeffrey Friedman, 2010]. The Basel I agreement had set the level of reserve capital of commercial banks for loans to and bonds from business firms at 8%. However, the urge to perfect the rules on the basis of differentiated risk of a given category of assets moved the regulators to set the reserve capital for mortgage loans at 4%. On stand alone basis that made sense; after all the repayment ratio for mortgages have historically been markedly higher than those for businesses. But, as stressed in the preceding section, that had historically been true with respect to standard mortgages. With the flood of s u b s t a n d a r d ones, the old patterns ceased to be valid, which was not either noticed or predicted in 1991, when the U.S. adopted Basel I standards.

The result of differentiated levels of reserve capital has been 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 a repayment stream 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, mortgage-backed securities on the surface 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 could not use an e x c u s e o f i g n o r a n c e with respect to an ominous trend of ever lower mortgage standards. Thus, they are – apart from traditional good intentions-reinforced *naivete* – guilty also of negligence.

With Recourse Rule 2001 requiring so low level of reserve capital, incentives for banks and other financial institutions have become overwhelming to shift activities from those requiring 8% to those requiring only 2% of reserve capital. Thus, demand for asset-backed securities increased sharply.

There was, however, yet another problem, generating unintended consequences. The requirement of high ratings for the new type of instruments – that asset-backed securities (ABS) were – 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 and kind of regulation-promoted oligopoly. Adam Smith had been fond of saying already in XVIII century that the spirit of a monopolist is characterized, *inter alia*, by laziness. Therefore, unsurprisingly, rating agencies did not do enough homework to recognize the nature of asset-backed securities and dangers resulting from softened standards. The consequence has been 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].

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

5. Why an 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 at some length. It is obvious that the sheer size of the American economy influences world economy developments to a substantial extent. Next, an even larger size of the American financial sector relative to that sector elsewhere amplifies the effects of American financial developments on the world at large. 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 American financial assets is highly important for all buyers.

These are very obvious statements. However, one special aspect of that phenomenon should be stressed 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 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, 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 at the 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 about equal in volume to that of the U.S. government!! This expansion is shown diagrammatically in Fig. 2 [taken from Lachman, 2010]. When they went broke 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 s u b s t a n d a r d 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 i m p l i c i t g o v e r n m e n t g u a r a n t e e. In that, at least, they turned out to be right – to

the chagrin 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 has little doubt that the present crisis does not seem to be understood much better. In fact, this author suggests that the similarity goes even further than Prof. Simpson suggests. For just as Keynes and his disciples did not understand too well the dynamics of Great Depression and yet recommended the solutions, so a range of economists of largely interventionist persuasion recommend solutions without understanding too well 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 so unbelievable progress in wealth creation.
I quoted Prof. Meltzer who stressed that regulations are static, while markets are dynamic. Therefore, the former usually do 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 do! – suggest c o m p r e h e n s i v e 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 systems. For only the latter give us an idea of both expected and u n e x p e c t e d 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 Nirvana is 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 n o t h i n g can – and should – be done. On the contrary. Since, in contrast with many popular beliefs, markets – especially financial markets – have n o t been left unregulated, what could improve the performance of markets is the substitution of the present, erroneous and internally contradictory, regulations with new ones that

conform with 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 "*chose their* [banks – J.W.] *size and asset composition. Trust stockholders incentives, not regulators' rules*" [Meltzer, 2010].
However, certain regulations have already been embedded in the particular markets. These regulations have modified the structure of incentives. An example of such regulations is governmental deposit insurance scheme. Although it has its share of pro's and con's, it is here to stay in the fractional banking system. Here the reality check should suggest to reduce certain risks by 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 more risky investment banking was 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 investment moves collapse, they present an unpalatable – and dramatically costly – alternative: either to save the commercial/investment whole at an enormous cost to the taxpayers or to allow the whole 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 with 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, tells us about the foregoing in no uncertain terms.
Finally, as another reality check, this author would like to offer a note of warning. There is still quite high probability that the thrust of regulation would 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 early 1950s to 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 and their decisions will not necessarily reassure classical liberals like the present writer.

REFERENCES:

Barro, Robert, 2002, *Nothing Is Sacred*, The MIT Press: Cambridge, Massachusetts.

Demsetz, H., 1989, Information and Efficiency: Another Viewpoint, in: *Efficiency, Competition, and Policy*. Vol. II of *The Organization of Economic Activity*, Blackwell: Cambridge, Massachusetts (originally published in 1969 in *The Journal of Law and Economics*).

Friedman, Jeffrey, 2010, A Perfect Storm of Ignorance, *Cato Policy Report*, January-February, vol. XXXII, no.1, pp. 1, 6-8.

Krugman, Paul, 2008, *The Guardian Review*, December 6.

Lachman, Desmond, 2010, Detour Ahead. The Great Recession Is Not Over Yet, *The American Interest Magazine*, March-April

Meltzer, Alan H., 2008, Regulatory Overkill, *Wall Street Journal*, March 31

Meltzer, Alan H., 2010, Market Failure or Government Failure, *Wall Street Journal,* March 18.

Simpson, David, 2009, The Recession: Causes and Cures, mimeo, Adam Smith Research Trust: London.

Sowell, Thomas, 2009, *The Hausing Boom and Bust*, Basic Books: New York, N.Y.

Stiglitz, Joseph E., Jonathan M. Orszag, and Peter R. Orszag, Implications of the New Fannie Mae and Freddie Mac Risk-based Capital Standard, *Fannie Mae Papers*, Vol. 1, No. 2.

Taylor, John B., 2009, *Getting Off Track*, Hoover Institution Press: Stanford, California

Wallison, Peter.J., 2009, Not a Failure of Capitalism – A Failure of Government, CFA Institute: Insight into the Global Financial Crisis. Working paper, December 2.

Wallison, Peter J., and Charles W. Calomiris, 2008, The Last Trillion-Dollar Commitment, *Financial services outlook*, AEI Online, September 30.