Forbes

To Understand The Financial Crisis - And Its Cure - You Must Read John Allison's Book

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10/07/2013

This week marks the fifth anniversary of the partial nationalization of America's top banks by Washington in 2008, through the "TARP" legislation. That un-American, unconstitutional act neatly deflected public attention away from the real instigators of the crisis: the policy-makers, especially those at the Fed and FDIC, as I explained in July 2011 ("How Bernanke's Fed Triggered the Great Recession") and last month too ("The Financial Crisis Was A Failure Of Government, Not Free Markets"). No solid evidence appearing since 2008 has materially altered the basic judgment that I offered two years ago: "TARP After Three Years: It Made Things Worse, Not Better."

TARP also helped intensify the public's traditional resentment of banks, entities which politicians simultaneously blamed and bailed out in 2008-2009. Did no one notice that contradiction? "Why shouldn't we also be bailed out?," asked those on Main Street who suffered collateral damage. "Exactly," said the interventionist politicians, "so we'll bail you out too – the banks, car companies, food stamp recipients, those who stay out of work for up to two years – and thanks for asking, for we can now say good riddance to whatever may remain of America's free market!"

In fact, TARP (and its "sister act" from July 2010, "Dodd-Frank") has made conditions particularly inhospitable for America's *better*-managed, *less*-guilty banks. The handful of insolvent banks, which should have been left to fail, instead eagerly took TARP funds, with its attached strings, and lived to do harm for another day, thanks to political friends. America's healthy banks didn't need, seek, or require the public monies that were forcibly thrust upon them by Washington; they would have survived without those funds, and indeed would have been better off, by attracting funds transferred out of weak banks. When all banks were compelled to take TARP funds, all were smeared in reputation, and all were subjected to still more stringent regulations and larger subsidies (FDIC coverage was increased from $100,000 to $250,000) than they saw before 2008. In some cases, the better banks have been forced to pay huge fines without any proof of a legal tort. Even well-managed banks must now get permission from the Fed before paying executives or dividends. Not knowing all the facts, and colored by a long-term prejudice against finance and Wall Street, much of the public condones or applauds the political abuse of banks (to their own harm).

Yet not all is gloom and doom. One needn't feel hopeless about America's banking system or financial status. Real solutions are possible, as I've explained, although few of them, as yet, are both popular and politically viable. Why? As I wrote in my essay last month, "thousands of misguided articles, and dozens of poorly-researched books have appeared" since 2008, because "many people attribute the financial crisis to 'greed,' Wall Street, and free-market capitalism, even though the *real* cause –which has yet to be fully acknowledged – was *government intervention* in markets. [Yet] one account gets both the diagnosis and prescription just right: John Allison's book, *The Financial Crisis and the Free Market Cure: Why Pure Capitalism is the World Economy's Only Hope* (McGraw-Hill, 2013). A long-time CEO of BB&T Corporation and president of the Cato Institute for the past year," his book explains "*what* happened five years ago, *why* it happened, and why it'll happen *again* unless interventions are removed."

Mr. Allison has written the book that probably couldn't have been possible had he not spent decades as the longest-serving CEO of a top-25 financial institution (BB&T, 1989-2008), efficiently and profitably managing and growing it, through all types of cyclical conditions and monetary-regulatory policies, while *simultaneously* finding the time and energy to read, research, and speak publicly about the theory and history of banking, monetary-banking policy, and even ethical-political philosophy. Allison is that rare combination: a reality-oriented, intellectual businessman able to recognize the ethical and productive superiority of laissez-faire capitalism and its rule of law. For the past year he has headed the renowned, libertarian policy institute – the Cato Institute – armed with first-hand experience not only in business, but also in the complex, often strange intersection of politics and finance. Allison was no "crony" whose success was due to politics; he earned his great success *despite* the harm politics often inflicts.

In *The Financial Crisis and the Free Market Cure,* Mr. Allison contends that the crisis of 2008 was "the most important economic event in 80 years," and predicts that its fallout will have a "significant impact on the quality of your life and that of your children." His purpose, he says, is "to provide an integrated insider's perspective" on the crisis, including the closely-associated Great Recession (2007-2009), and further, to explain why the economic recovery since the trough in mid-2009 has been so feeble. In all respects his account is fresh and unconventional.

In his opening chapter Mr. Allison names six "fundamental themes," all of which he documents and proves in subsequent chapters: 1) "government policy [was] the primary cause of the financial crisis," 2) "government policy created a bubble in residential real estate," 3) "individual financial institutions (Wall Street participants) made very serious mistakes that contributed to the crises," 4) "almost every government action taken since the crisis started, even those that may help in the short term, will reduce our standard of living in the long term," and 5) "the deeper causes of our financial challenges are philosophic, not economic." In elaborating on this fifth theme, he insists that destructive government policies are typically based on "philosophic ideas taught in our elite universities to future elitist leaders," that such ideas "are inconsistent with the founding principles that made American great," and, furthermore, "are inconsistent with individual rights, especially property rights." At a deeper level, he adds, such ideas are "inconsistent with humans' fundamental nature as thinking beings who must make independent judgments that are based on the facts and that use their ability to reason." From this comes his final, predictive theme: 6) "If we do not change direction soon, the United States will be in very serious financial trouble in 20 to 25 years."

In subsequent chapters Mr. Allison explains "what happened" in 2008, and why the Fed's monetary policy, including its artificially low interest rates in 2004-2005 (followed by its inversion of the yield curve in 2006-2007) was the "primary cause" of the 2008 crisis. There is a deeper problem, he says, because "in 1913 the monetary system in the United States was nationalized," such that "the federal government owns the monetary system," so when it makes mistakes, the effects are ubiquitous. Systemic and excessive risk wouldn't be possible in a purely private monetary system. Given our current system, he argues, "if there are problems in the monetary system they are, by definition, caused by the federal government, because the federal government owns the monetary system."

In one entire chapter Mr. Allison explains how federally-provided bank deposit insurance, from the FDIC, which has been sold as a means of ensuring safe and sound banking, in truth increases bank leverage and risk-taking, the latter because the "premiums" paid by banks aren't risk-based. As such, the worst-performing banks get subsidized funding and bail-outs, while the better banks which remain after crises occur are compelled to replenish the FDIC's depleted reserves. In another chapter Allison explains how the quasi-public mortgage agencies (Fannie Mae, Freddie Mac, FHA) promoted risky housing finance, including the sub-prime mortgage debacle, and how an explicit government policy to artificially boost home ownership fostered lending to unqualified borrowers who put too little down and paid too much for increasingly over-priced homes. No rational, profit-seeking banker in a free-market (i.e., a market neither subsidized nor over-regulated by government) would act in so reckless a manner.

Mr. Allison also ably analyzes the various roles played by the securitization of residential mortgages, the rating agencies, political mandates on "fair value accounting," derivatives, the SEC, the back-door government bailout of Goldman Sachs (and sabotage of AIG), TARP, the "too-big-to-fail" policy (which he opposes), and what he calls the "myth" that the financial crisis and Great Recession were caused by a preceding "deregulation" of banking and mortgage finance. On this latter point he explains and documents how the U.S. financial sector's "regulatory burden was increased significantly during the [George W.] Bush years [2001-2009]" and how "regulatory cost was at an all-time high during the peak of the bubble (2005-2007)." In 2002, moreover, President Bush and a GOP-controlled Congress enacted the Sarbanes-Oxley Act, which was heralded at the time, by sponsors and interventionists alike, as the biggest increase in regulation of Wall Street, finance, and accounting since FDR's interventions in the 1930s.

Above all, Allison argues, the mortgage-housing boom-bust and its fallout were made possible by the risk-boosting policies of Fannie Mae and Freddie Mac, hardly "free market" entities. In truth, he says, these agencies were long known to be trouble-makers, yet were enabled, by emotional appeals to such things as the "American dream of home ownership," by Senators like Chris Dodd (CT) and Representatives like Barney Frank (MA), who in 2010 co-sponsored and helped enact an 800-page web of legislation (the Dodd-Frank Act) that in turn has generated multiple thousands of minute, indecipherable financial rules and mandates, a law that curbs none of the interventions that caused the *last* crisis, and in fact brings new interventions that'll likely trigger the *next* crisis.

As something of a bonus for the more curious and serious reader, Mr. Allison devotes his closing few chapters to such intriguing topics as the increasingly precarious financial condition of the U.S. government itself (caused, in large part, he notes, by the massive deficit-spending it pursued in reaction to the same Great Recession which it helped cause) – Fed money-printing and ZIRP – persistently high unemployment – the erosion of the ethic of self-responsibility and self-reliance – the century-long shift into anti-capitalist philosophies and policies – and the rather decadent status of America's schools and universities. As in the banking system, so also in the education system, Mr. Allison is keen on promoting policies that foster rational incentives, business principles, and humane outcomes. Without radical reform, he says, the same false theories (and destructive policies flowing therefrom) which caused the debacle of 2008-2009 will stay with us and continue to erode our political liberty, economic prosperity, and national security.

In an exclusive comment to Amazon.com, soon after the November 2012 election, Mr. Allison wrote this:

"The U.S. has a simple choice – return to the principles that made us great or face economic decay and social unrest. One of the reasons I wrote my book is because it seemed to make sense to have someone who had an inside and comprehensive understanding of the causes of our financial problems to comment on the issue. In the aftermath of the recent election, it's even more important for the public and policy makers to understand what drove the financial crisis and what choices we must make to revitalize our economy. The media and other statists have created a myth that the financial crisis was caused by banking deregulation and greed on Wall Street. However, banks were not deregulated. In fact, three major new regulations were passes during the Bush Administration: The Privacy Act, The Patriot Act, and Sarbanes-Oxley. Banks were mis-regulated, not de-regulated. Also, there has always been plenty of greed (and fear) on Wall Street. However, there is not one shred of evidence there was a greed plague that swept the Street. The financial crisis and failed recovery were primarily caused by government policy. The two main culprits were errors made by the Federal Reserve and government housing policy, specifically as executed by Freddie Mac and Fannie Mae, the giant government-sponsored enterprises that would never have existed in a free market. My book covers this and other economic myths and misunderstanding such as the 'shadow' banking system, fair value accounting, Pick-a-Payment mortgages, and the like. However, as interesting as the economic discussion is, the real solution for our financial problems is philosophical and the cure was espoused by Thomas Jefferson in the Declaration of Independence: 'Life, Liberty, and the Pursuit of Happiness.' People on all sides of the political spectrum defend liberty, but few people understand why liberty is essential to human well-being. Government regulations put 'balls and chains' on innovators and entrepreneurs and thereby, slow and eventually stop progress. Given man's nature, socialism and communism are doomed to failure. So, again, I say, the U.S. has a simple choice: The laws of mother nature and human nature are not subject to popularity or political whim. Capitalism or decline. You choose."

In the interest of full disclosure, I should report that I assisted Mr. Allison in research for his book, as he himself indicates (page 278) . But this doesn't bias my judgment. I agreed to participate precisely because I could see, early on, how true and great was his book. The achievement is wholly Mr. Allison's. It's gratifying to see his effort attain best-seller status, on lists compiled by both the *New York Times and Wall Street Journal*. More than I myself suspect, perhaps there exists a greater willingness by a material portion of the public to seek valid analysis and worthy reform in the realm of finance. I hope Mr. Allison's book has lasting power, over the coming years, while the far-greater number of journalistic, anti-market fables fade away, because his book conveys, objectively, both an array of important facts and a handful of timeless truths.