Ludwig von Mises Institute
Advancing the scholarship of liberty in the tradition of the Austrian School

The Financial Crisis and the Free Market Cure

Thursday, February 27th, 2014 by Pierre-Guy Veer posted in Banking, Capitalism, Economics.

Many statists keep repeating that unfettered capitalism and deregulation have caused the crisis we are currently living. Nothing could be farther from the truth; a crisis this big can only have one source, which is government intervention. With its immense coercive powers, it can force anyone to act irrationally against their self-interest. John Allison, CEO of the Cato Institute and former CEO of BB&T (an East-Coast bank), has experienced such coercion first hand during his tenure at the bank. In his excellent book *The Financial Crisis and the Free Market Cure*, he talks great lengths about the causes of the 2008 financial and housing crises and proposes very good solutions on how to avoid another one.

Following the tradition of great Austrian economists, he talks about the economy for what it really is: an observation of human action. In summary, humans are creatures who act rationally according to the best information available to them – what seems irrational in retrospect maybe wasn’t at the time. It is precisely this irrationality that causes economic crises because, like physics, every action has an opposed reaction.

And one of the main triggers of the actual crisis was the popping of the housing bubble in 2007-2008. Like every bubble, its origins can be traced back to government policies, which are numerous in the housing sector. According to Allison, housing is the most heavily subsidized domain since the New Deal of the 1930s.

These incentives are meant to push people to buy a house, in spite of the fact that: 1) it’s not for everyone, especially for people who move a lot, and 2) it is not an investment from an economics point of view, i.e. something that can create value. Once the house is built, it becomes a consumption good like a car or a bag of carrots. Furthermore, many jobs directly involved in construction become obsolete once the bubble pops, adding to the deadweight.

In the 1990s, these incentives were brought (almost literally) at gunpoint. Indeed, in order to satisfy his African-American electoral base, Bill Clinton suddenly decided to apply rules that forbid racial discrimination on loans. To do that, he used a very suspicious study from the Fed that said that African-Americans were discriminated against by being refused a loan a white person with a similar debt ratio would obtain.

This reasoning is faulty, as there are factors like length of employment and payment of debts, or the lack thereof, that are also to be considered. But since almost every regulator knows nothing about loans, these petty details are of no importance whatsoever; good intentions must prevail over bankers' common sense.

And this common sense was greatly affected when Clinton forced Fannie Mae and Freddie Mac, two government-sponsored enterprises that guarantee mortgages, to offer 50% of their mortgages to low-income people who wouldn't normally be able to get one – the infamous subprimes. In other words, in the name of a "charitable" policy, the Clinton administration (George W. Bush wasn't able to change much of it) started the inflation of the housing bubble by exponentially decreasing mortgage requirements.

RIP for the Rule of Law

Going beyond housing regulations, Allison shows how regulation in general affects the actions of business leaders, wherever they may work. A rule that seems unimportant one day because the economy is doing well becomes vital six months later because things have taken a bad turn. When that happens, "The humble bureaucrats are then energized with the moral certainty and clarity of the Gestapo". They will, of course, blame the business person for not applying the rule, which can lead to decline a loan. To add insult to injury, Allison says that a banker can't point out to his customer, however loyal he may be, that his loan was declined because of a sudden burst of bureaucratic zeal.

This arbitrary ruling can also be found in the way that some banks were bailed out rather than others. Normally, a business that is badly managed will fail on the free market, and its assets will be bought off by more competent competitors. But when government pitches in, it can decide to bail out a bankrupted company by using such reasoning as "The whole system will fall apart if we do nothing." In clear, government is saying: "It doesn't matter if you are badly managed, we will cover your rear" – the infamous too-big-to-fail mentality.

For example, former Secretary of Treasury Paulson had a substantial investment in Goldman Sachs when it failed. He did everything he could to save his money while letting Lehman Brothers fail. The simple fact that ONE company was bailed out sends a message to others to take inconsiderate risks, especially when they are encouraged by government, since they will be "rewarded" anyway.

Shocking but Necessary Solutions

In order to avoid another crisis like the one we are still experiencing – Allison believes another major one is looming around if nothing changes – radical-but-necessary solutions must be brought forward. The majority of banking regulations, especially the Dodd-Frank Act adopted in the midst of the crisis, must be abolished. Also, Fannie Mae and Freddie Mac must be liquidated and/or privatized, which will put some sanity back in the mortgage industry – without government support, subprimes will be almost non-existent. He also suggests, like every person knowledgeable of human action and incentives, to lower taxes in order to boost production.

Indeed, when taxes are high, people spend more time and money on avoiding them rather than on innovation, keeping us from increasing our standards of living.

Another radical solution brought by Allison wants to attack the root of economic crises, which is philosophical and not economical. And this philosophy is altruism, the way Ayn Rand defines it, i.e. sacrificing others for our own benefit. This is exactly what happened with the housing crisis: Because everyone is “entitled” to a house, government must take the means necessary to reach that goal. This means “sacrificing” people like bankers, by forcing them to loan to anyone and taxpayers, by forcing them to pay for the mistakes of the bankers.

In conclusion, Allison’s *The Financial Crisis and The Free Market Cure* should be a part of anyone’s book collection. The author uses very detailed information to show the crisis from the point of view of the “culprits” and shows that their actions were rather rational in their context – some did take more risk than others, but that can still be considered rational. Although some pages are hard to understand – probably because regulations themselves are impossible to understand – the book is made accessible to all in a way that that the layperson can easily understand. The book will give a few more pieces of ammunition so you can find what to say to those who still think free markets are to blame for the crisis.