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Robert Feinberg: Banker Offers Cure for Financial Crisis

By Robert Feinberg - Tuesday, 06 Nov 2012

The Cato Institute recently held a book event featuring the new book by John Allison, Cato's new CEO and former CEO of BB&T Corp., titled "The Financial Crisis and the Free-Market Cure: Why Pure Capitalism is the World Economy's Only Hope."

The event offered an opportunity for viewers and readers to evaluate the arguments being advanced for dealing with a persistent financial crisis that has caused losses approximating the entire annual gross domestic product of the United States and crippled the ability of the economy to generate sufficient economic activity to support people when they seek employment.

In his introduction, moderator David Boaz, executive vice president of Cato, stated that it is important to understand the 2008 financial crisis, "partly because it was important to our economic and personal lives, but partly also because it will shape our political dialog for years or decades, just the way the Great Depression did." He went on to say that "it's important to know what actually happened," and he criticized journalists who have blamed capitalism.

However, Boaz acknowledged that it is unlikely there will be agreement soon as to the causes of this crisis, given that the causes of the Great Depression are still debated. Boaz quoted the late Christopher Hitchens: "There are many causes of the subprime and derivative horror show that has destroyed our trust in the idea of credit, but one way of defining it would be to say that everybody was promised everything, and almost everybody fell for the populist bait."

Allison was then introduced as only the second president of Cato, after spending almost 40 years at BB&T. He has been sometimes criticized for not getting on the train of cheap money and subprime and for not growing BB&T as fast as other banks. Boaz said of Allison, "In the long run, he feels pretty good about the decisions he made during that period."

He came to public attention when BB&T announced it would no longer lend to projects supported by eminent domain, and this led Cato to see him as "different from the standard bankers."

Allison began by explaining that he wrote the book in order to offer a book "by someone who actually knew what happened." Second, he said he wanted to get rid of "the myth that the financial crisis was caused by the deregulation of the financial services industry and by greed on Wall Street." His critique of this argument is that, first, the industry was not deregulated but rather subjected to "a massive increase in regulation," so the industry was "misregulated, not deregulated." As for greed, he said, there have always been greed and fear, and this was not "a sudden plague that swept across Wall Street."

There are six basic themes in the book, which Allison proceeded to list. First, the primary cause of the financial crisis was government policy, and he observed that, "We don't live in a free market in the U.S.; we live in a mixed economy." He suggested that technology is the least-regulated industry and has done very well, whereas the banking industry is the most regulated and has caused the most problems.

Second, government policy created a bubble, focused primarily in residential real estate, that burst, "destroying millions of jobs and trillions of wealth."

Third, Wall Street institutions made a number of major mistakes, and they should have been allowed to fail. Nevertheless, he asserted, "Those mistakes were secondary, and they were all incented by government policy."

Fourth, almost everything we've done in response to the financial crisis "despite any short-term benefit, will reduce, and in some cases, materially reduce, our standard of living in the long term."

Fifth, and most important, he said, "The real cause of the financial crisis is not economic, it's philosophical, and the real cure is philosophical."

Finally, he predicted serious long-term consequences if the government doesn't change the direction of policy soon.

Returning to the question of "what happened," Allison estimated that the nation invested between $3 trillion and $8 trillion too much in residential real estate, building "too many houses, too big houses, built houses in the wrong place," instead of investing in productive technology, manufacturing, agriculture, education and savings.

He called the overinvestment in real estate "particularly destructive," because houses represent, in fact, consumption, not investment. One of the consequences was that millions of people were taught how to be real-estate lenders and attorneys, and that contributes to structural unemployment. Also, upward pressure on construction wages spilled into manufacturing, which made it less competitive and led to manufacturing jobs being moved overseas.

Allison went on to cite specific errors, beginning with the action of former-Federal Reserve Chairman Alan Greenspan, who acted to head off a needed correction in the economy in the early 2000s. Greenspan printed money and created negative real interest rates, which incented massive borrowing and investment in real estate, thus providing funding for a bubble. This creation of money also caused consumers generally to think they were wealthier than they were.

Also, in the 1970s, government-housing policy began to create incentives for people to buy homes before they had saved enough to afford them. Later, in 1999, President Bill Clinton announced a goal for Freddie Mac and Fannie Mae to devote half of their portfolios to affordable housing, which is to say, subprime loans. Now, Freddie, Fannie and the Federal Housing Administration control 90 percent of housing finance in the country.

Allison told of working on a committee at the Financial Services Roundtable to try to reform the government-sponsored enterprises and recalled talking with former Sen. Chris Dodd, D-Conn., and Rep. Barney Frank, D-Mass. He called Frank "the evil one, because he was actually smart." Both of the legislators, Allison found, had a religious devotion to home ownership and were also influenced, as were both political parties, by huge contributions from Freddie and Fannie.

Other factors Allison blamed for the crisis were fair value accounting, misconceptions about the nature of the derivatives market and gross exaggeration of contagion risk.

He then returned to the philosophical basis of the crisis, which he said was "a combination of altruism and pragmatism." Altruism places the community above the individual, who is considered irrelevant. Thus, everyone has a right to a free house and free medical care, "provided by whom?" he asked. He called this ethos contrary to American values.

In business, by comparison, the rule is pragmatism, which is to say, what works. But he allowed that, "Lots of things work in the short term that are incredibly destructive in the long term."

Allison concluded that he is optimistic that the skepticism of Americans would ultimately allow the country to deal with its problems.

Robert Feinberg served on the staff of the House Banking Committee for the 10 years that encompassed the savings-and-loan debacle and the beginning of its migration to the banking sector. Subsequently, he has consulted on issues related to the crisis for law firms, accounting firms, securities firms and trade associations.

Feinberg holds a BS.E. from the Wharton School and a J.D. from the Law School of the University of Pennsylvania. He has drafted dissenting views on landmark banking legislation, contributed to a financial blog and written hundreds of reports for clients to document the course of the financial crisis as it has unfolded over *the past three decades.*