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Have We Learned Anything?

In The Big Picture, The Great Financial Meltdown Of 2008 Can Be Blamed On The Collapse Of A Series Of Bubbles -- Bubbles In Credit, In Housing, In Asset-Backed Securities. In The Aftermath, We Face A New Threat -- A Knee-Jerk Bubble In Regulation And Government Intervention In Financial Markets. You've Been Warned.

Johan Norberg, National Post

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WHAT EXACTLY HAPPENED? How could overly enthusiastic homebuyers in the United States sink the global economy? When the global financial crisis took root last year, many politicians across the world quickly determined that it must have come from inside the financial system, that the reason must have been that market players had been given too free a rein and made too many big mistakes. "Laissez-faire is finished," President Nicolas Sarkozy of France exclaimed in September 2008. "The idea of the all-powerful market, which wasn't to be impeded by any rules or political intervention, was a mad one." At the same time, German finance minister Peer Steinbruck claimed that the crisis revealed that the argument put forth by laissez-faire "was as simple as it was dangerous." German chancellor Angela Merkel drew the conclusion that more financial-market regulation was necessary.

The problem, however, was not that we had too few regulations; on the contrary, we had too many, and above all, faulty ones. Some readers may object that I am mainly quibbling about the meaning of words and fighting an ideological battle. You may have a point. Please feel free to call the problem whatever you like -- just so long as you are aware of what it consists of. Because what would be fatal would be for slogans about "insufficient regulation" to give rise to the idea that the crisis happened because the government was absent, and that the government must therefore intervene and regulate more to avoid a repeat.

Let's look again at the historical background of the crisis. The U.S. housing bubble was pumped up, along with the hunt for even greater risk, when the U.S. Federal Reserve Bank, not wanting the market to set exchange rates, cut interest rates to record-low levels. U.S. politicians pumped up risk-taking and housing prices further through deductions, tax benefits for home savings accounts and restrictions on new construction. By means of legislation, subsidies and government-sponsored enterprises, they managed to generate mortgages even for people that the market deemed uncreditworthy.

The quasi-governmental institutions Fannie Mae and Freddie Mac developed the securitization of mortgages (allowing lenders to package and sell mortgage debt, thus replenishing their capital to make further loans). Wall Street fell madly in love with these mortgage-backed securities once the credit-rating agencies -- which had been given a legally protected oligopoly by the government -- declared them to be safe investments. The central position of Fannie Mae and Freddie Mac reinforced confidence that the government would intervene if the housing market ran into trouble. The Fed's safety net and the federal government's deposit insurance made banks dare to take big risks because they could privatize any gains and socialize any losses.

When home prices began to fall and the market no longer wanted mortgage-backed securities, the financial authorities stepped in and decreed that banks had to write down the value of such securities radically, giving rise to waves of panic selling. This, along with other factors, put such a burden on bank balance sheets that regulations forced them to pile up capital rather than make loans. President Bush and other leading policymakers whipped up a panic to push through laws they wanted. And just as the markets were worried more than ever because they did not know where the big risks were, U.S. authorities banned shorting, thus depriving the markets of liquidity and information when they needed it most.

If this is laissez-faire, then I would like to know what government intervention looks like. If the politicians, central bankers and bureaucrats had intentionally tried to create a crisis, they would have been hard put to find more effective actions.

IT IS A FUNDAMENTAL misunderstanding that the market is rational and at some sort of equilibrium, where all information and wisdom are incorporated in decisions. Neoclassical economic models filled with unrealistic assumptions about humans and the economy should always have warning stickers attached to them. The market is nothing other than all the millions of decisions that we all take as we produce, act and invest -- and the tiniest bit of introspection is enough to realize that we do not behave like the textbook models. Since finding lots of information before acting takes time and costs money, we often go with our gut, following rules of thumb and copying what others have already done. That is why the market has a herd instinct. When others seem to be successful at something and get rich on it, you follow suit. After a while, the hollowness of the enthusiasm becomes apparent, and then it often changes into overblown fear that soon ushers in recession.

A key lesson to be drawn from such events, however, is that borrowers, lenders, bankers and brokers are not the only ones to be affected. Politicians, bureaucrats and central bankers are at least as likely to succumb to the herd instinct -- and they have special power. If you act in a different way from what they have approved, they may take your money or even send you off to jail. This gives them the ability to head the march of the lemmings and set its pace.

Today, the herd is saying that we need strict regulation to ensure that the kind of financial crisis we've endured over the past year will not happen again. Words are cheap. But if it is so easy to avoid crises, why didn't the thousands of new pages of regulation written after earlier crises steer us clear of this one? In fact, the story of this storm in the global markets is the story of how government intervention to solve previous crises laid the foundation for the new one. The Fed started making money cheap in 2001 to avoid deflation and a depression. The credibility of credit ratings became exaggerated because financial authorities believed that government-sanctioned ratings would lead to more stable levels of risk. The capital requirements agreed to under these international banking standards gave rise to increasingly exotic financial instruments and pushed assets off banks' balance sheets. New requirements to mark assets to market were intended to prevent cheating, but in reality they served to amplify the downturn and knock out the investment banks. And so forth.

Nothing looks easier than retrospective regulation to ensure that we do not repeat the particular mistakes that messed things up in the past. But like generals, bureaucrats always fight the last war.

The best outcome to be hoped for is that they will prevent market players from making exactly the same mistake they made last time -- that is, the mistake everybody is focusing on avoiding anyway. On top of that, you also get a whole new battery of regulations that may well make the next crisis considerably worse.

Since no one knows where the next crisis will come from, companies and investors hardly need more bureaucrats looking over their shoulders, trying to guess what they are doing right or wrong. They need room to manoeuvre so that they can adjust or change their strategies as quickly as possible whenever there is new information about what is happening to demand, competition and credit. Nothing is more dangerous than going too far in the search for safety, because that may lead to regulations that block the best paths of action in a crisis.

There is already a dangerous homogeneity in the market in that many rely on the same types of clever computer models that make them buy the same types of securities at the same time as everybody else. We may increase the precision of our models, but the risk is that this will only cause us to rely ever more blindly on them. As Warren Buffet urges us all, "Beware of geeks bearing formulas."

For the same reason, we should also beware of bureaucrats bearing plans. Strict regulations laying down what you may and may not do will add to this homogeneity. If the government prevents market players from holding securities below a certain credit rating, it means that they will all sell at the same time when a security is downgraded past the limit. If the government's capital requirements favour certain ways of holding assets, all banks will hold their assets in those ways, and they'll all be struck by the same type of problems at the same time.

After each crisis, the authorities investigate what worked better at the time and then force the market players to conform to this "best practice." But all these attempts to make the system as safe as possible really make it extremely sensitive to small blows and changes. As professor Lawrence Lessig of Stanford University concludes, a single virus gaining a foothold in a banking monoculture may knock out the market completely. All deviations, diversity and mutations have been eradicated by precautionary principles and regulations, meaning that there's no resistance left anywhere. At a conference in 2007, the risk-management officer of one company said that his firm was fortunate not to have much historical data on business risk, because if it did, the authorities would immediately force the company to use those data to build risk models and act according to those models, rather than use common sense and develop various scenarios for future risks, as the company preferred to do.

As business became increasingly global through the last decades of the 20th century, energetic work was undertaken to develop international rules on capital adequacy, accounting principles and credit ratings. Politics had to catch up in order to increase stability and safety in a new Wild West. But the result was the same as national policies: homogenization of the way banks and companies viewed risk, regardless of where they came from and where they operated. As long as things are going smoothly, this creates predictability and peace and quiet. But it also gives everybody the same Achilles' heel. The likelihood of that particular part of the body being hit is small, but when it does happen, everybody tumbles to the ground in the same way in all countries.

All the salvage operations and bailouts that have been implemented this time will make the problem seven times worse next time, completely regardless of the effect that they may have in the short term to prevent free fall. Banks and companies have learned that the more they do things just like everybody else -- like the rest of the herd -- the more likely they are to be saved by the government if things go wrong. Because then their operations or their market will be too big to be allowed to fail. Those who think differently and do things their own way -- and thus pose no threat of systemic crisis -- cannot hope for any help. A prudent banker is one who is exactly as imprudent as the other bankers, so that he goes bankrupt when others do, as the early 20th-century interventionist economist John Maynard Keynes is claimed to have said. If we really want to make future financial storms less severe, we should be doing the opposite of what is happening now. We should remove the safeguards and untie the safety nets. We should abolish bailout plans and deposit insurance, so that banks would be forced to think about what risks they can really bear and how much capital they need to cover those risks. We should deprive the credit-rating agencies of their official role, so that investors would have to think for themselves about where to put their money. We should systematically put an end to the protections and guarantees that government authorities give to investors and savers, to leave room for their own common sense and their own responsibility. Those who do not trust themselves should not go anywhere near the riskiest markets.

No regulation has had as great an effect on the risk-taking of the banking sector than the lifeguard role of central banks (and now finance ministries, as well). This has taught the major financial players to take hair-raising risks in the knowledge that they can privatize any gains and socialize any losses because they are too big to fail. The dilemma, however, is that they would never have grown so big if they had not had that safety net. Present-day capitalism is sometimes attacked for being nothing more than a "casino economy." But I know of no casino where the head of a central bank and the finance minister accompany customers to the roulette table, kindly offering to cover any losses.

The problem is, we do not have a casino economy. To borrow a metaphor from child rearing, we have a "helicopter economy." Helicopter parents hover over their kids, preventing them falling and hurting themselves. This means their children never grow up and learn to see dangers for themselves. And for this very reason, such children will eventually fall in more serious and dangerous contexts instead, because risk is part of the human condition. The helicopter economy works in a similar way. The government hovers over the banks and investors, making sure they do not get hurt too badly (and cleaning up any messes they leave behind.) Whenever there is an accident, the benchmark rate is lowered, the central bank extends credit and taxpayers' money is pumped in. The players never learn to look out for risks; they just continue their reckless behaviour, and sooner or later they will fall off a ledge that they were not watching out for and pull us all down with them.

Capitalism without bankruptcy is like Christianity without hell -- it loses its ability to motivate humans to be prudent or respect their fears. If completely removing the safety net from under the financial market is not politically feasible, then it is necessary to make a division so that they protect only pared-down banks engaging in simple operations. All other financial institutions should be told in no uncertain terms that the government's only responsibility to them, if they fail, is to wish them luck.

If we chop down the jungle of government support, protection and requirements, investors and savers will be left to their own devices. That is tough. But thinking for yourself should be tough, because the intellectual exercise it provides will train skills that have lain dormant. And they are necessary. Just think about the hedge-fund fraudster Bernard Madoff, who may have cheated his established and well-heeled clients out of an unbelievable $50 billion. Despite the phenomenal returns reported by his fund, the big institutional investors stayed away. One of them explained that the fund made a non-serious impression, "because when you get to page two of your 30-page due diligence questionnaire, you've already tripped eight alarms and said, 'I'm out of here.'" Madoff's con was not rocket science. But how come so many others entrusted Madoff with their fortunes? Like many other victims, the former textile businessman Allan Goldstein said that he trusted Madoff because he trusted the government. "We conducted our affairs in good faith in the belief that the SEC would never allow this sort of scheme to be conducted. ..."

THERE IS A BROAD consensus that the way was paved for this financial crisis by record-low interest rates, huge deficits and large-scale credit-financed consumption. Today, governments around the world are trying to solve the crisis -- by means of low interest rates, huge deficits and large-scale credit-financed consumption. Many people now agree that the Fed's record-low rates of 2001 to 2005 contributed to the financial crisis. Many observers now think it was utterly senseless of Alan Greenspan to cut rates drastically without worrying about the credit boom that might ensue. I would be more understanding of their moralizing if those same observers were not also demanding that central banks do the same today.

Greenspan simply wanted to avoid depression and deflation in the only way he could. For the same purpose -- avoiding depression and deflation -- the central banks of the world have now cut rates significantly faster and further than he did, without worrying about the inflationary boom that may ensue. The feelings, the intentions and the arguments are the same: Now we have a crisis, tomorrow we will worry about when it comes, in the long run we will all be dead.

It was Karl Marx who said that history repeats itself, the first time as a tragedy and the second time as a farce. But he probably could not have guessed that the interval can be as short as eight years. There is no saying where all this will end, but dark clouds are looming.

Johan Norberg is a senior fellow at the Cato Institute, a policy research foundation based in Washington, D.C. This article has been adapted from his new book Financial Fiasco: How America's Infatuations with Homeownership and Easy Money Created the Economic Crisis, published by the Cato Institute.