

THE 2008 CRISIS

A Failure of Crony Capitalism

Gene Epstein

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“Capitalism”

A private enterprise system of profits, losses, and prices.

- Profits encourage risk-taking.
- Losses encourage prudence.
- Unimpeded prices determine profit and loss.

Crony Capitalism

An economic system in which:

- Profits stay privatized, but losses are absorbed by government.
- Prices, including the price of credit, are distorted by government intervention.
- Economic activity, as in housing, is actively engaged in by government.

Two Main Factors

1. Enabling factor: central bank's negative interest-rate policy, 2002-05
2. Propelling factor: U.S. government's housing policy beginning in 1992

1

Enabling factor: central bank's negative
interest-rate policy, 2002-05

Krugman on the Fed

...[M]acroeconomists were divided in their views. But the main division was between those who insisted that free-market economies never go astray and those who believed that economies may stray now and then but that any major deviations from the path of prosperity could and would be corrected by *the all-powerful Fed*. Neither side was prepared to cope with an economy that went off the rails *despite the Fed's best efforts* [italics added]

--"How Did Economists Get It So Wrong?"
New York Times Magazine, Sept 6, 2007

Alternative view

The U.S. crisis was actually made by the Fed ...
The Fed pumped money into the US economy and slashed its main interest rate – the Federal Funds rate – from 3.5% in August 2001 to a mere 1% by mid-2003. The Fed held this rate too low for too long.... Monetary expansion generally makes it easier to borrow, and lowers the costs of doing so... What was distinctive this time was that the new borrowing was concentrated in housing.

–Jeffrey Sachs, Professor of Economics, Columbia Univ., 2008

Negative Interest Rates

Year	Interest rate on federal funds (%)	Inflation rate (%)	Difference
2001	3.9	1.6	2.3
2002	1.7	2.5	-0.8
2003	1.1	2	-0.9
2004	1.4	3.3	-1.9
2005	3.2	3.4	-0.2
2006	5	2.5	2.5

Sources: Federal Reserve Board, Bureau of Labor Statistics

“Monetary Policy and the Housing Bubble”-Ben Bernanke 1/3/10

“Economists who have investigated the issue have generally found that, based on historical relationships, only a small portion of the increase in house prices earlier this decade can be attributed to the stance of U.S. monetary policy.¹²”

Endnote 12. See, for example...Jarocinski and Smets (2008)

“We find...that monetary policy has significant effects on housing investment and house prices and that easy monetary policy designed to stave off perceived risks of deflation in 2002-04 has contributed to the boom in the housing market in 2004 and 2005.”

A Keynesian advocates a bubble

“To fight this recession the Fed needs more than a snapback; it needs soaring household spending to offset moribund business investment. And to do that, as Paul McCulley of Pimco put it, Alan Greenspan needs to create a housing bubble to replace the Nasdaq bubble.” –Paul Krugman, Aug. 2, 2002

2

Propelling factor: U.S. government's housing policy beginning in 1992

Univ of Chicago finance professor Raghu Rajan

"The banking sector did not decide out of the goodness of its heart to extend mortgages to poor people. Politicians did that, and they would have taken great umbrage if the regulator stood in the way of more housing credit."

Oct. 1992 Title XIII Housing and Community Development Act

“The purpose of the [affordable housing] goals is to facilitate the development in both Fannie Mae and Freddie Mac of an ongoing business effort that will be fully integrated in their products, cultures, and day-to-day operations to service the mortgage financing needs of low-and-moderate-income persons, racial minorities, and inner-city residents.”—from Senate Committee report on the legislation.

13 Bankers, by Simon Johnson and James Kwak

“The financial crisis was not primarily due to Fannie and Freddie.[77]”

“The riskiest mortgages...were simply off-limits to Fannie and Freddie.”

Endnote 77 in Johnson and Kwak

- *See Charles Calomiris and Peter Wallison, "Blame Fannie Mae and Congress for the Credit Mess"
- "[T]he vast accumulation of toxic mortgage debt that poisoned the global financial system was driven by the aggressive buying of subprime and Alt-A mortgages, and mortgage-backed securities, by Fannie Mae and Freddie Mac. The poor choices of these two government-sponsored enterprises (GSEs) -- and their sponsors in Washington -- are largely to blame for our current mess."

Bill Clinton, 1994

- In 1994 President Bill Clinton directed HUD to boost the homeownership rate to an “all time high by the end of the century,” and HUD secretary Henry Cisneros set a goal of a 70 percent homeownership rate in the National Homeownership Strategy of 1995.--”What Made the Financial Crisis Systemic?” Hendershott and Villani, March 6, 2012

Krugman on inequality

- “[T]he right’s answer is to claim not just that the government did it, but that it caused the crisis by its attempts to reduce inequality! It’s kind of a masterstroke, in an evil way.”
- --Paul Krugman, “Financial Big Lies,” Nov. 7 2011

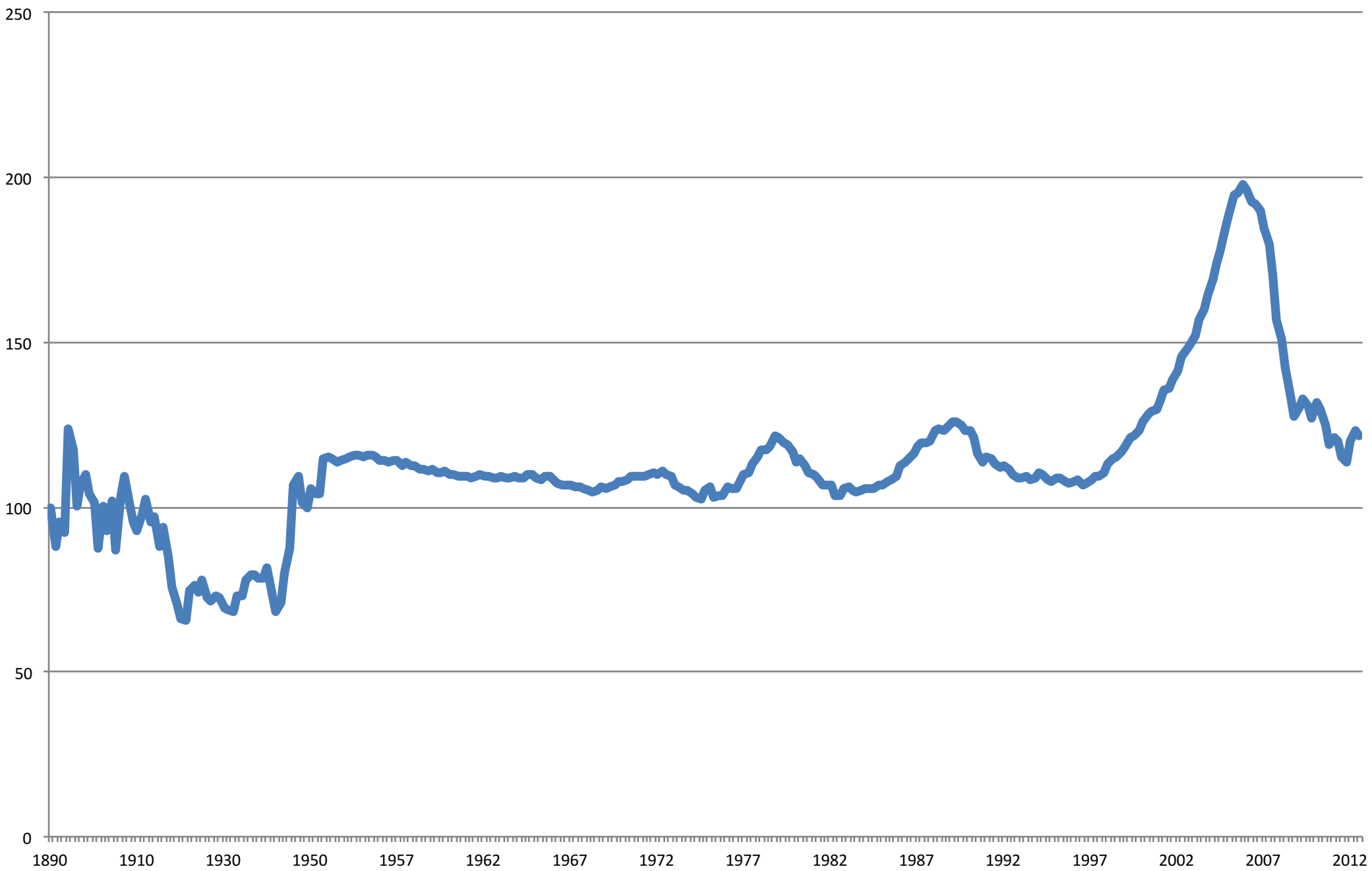
President Bush and inequality, 2002

- “The goal is, everybody who wants to own a home has got a shot at doing so. The problem is we have what we call a homeownership gap in America... And we need to do something about it... We are here in Washington, D.C. to address problems. So I've set this goal for the country. We want 5.5 million more homeowners by 2010... economic security at home is just an important part of -- as homeland security. And owning a home is part of that economic security. It's also a part of making sure that this country fulfills its great hope and vision.”

President Bush, 2002, cont.

- “And I'm proud to report that Fannie Mae has heard the call and, as I understand, it's about \$440 billion over a period of time. They've used their influence to create that much capital available for the type of home buyer we're talking about here. It's in their charter; it now needs to be implemented. Freddie Mac is interested in helping. I appreciate both of those agencies providing the underpinnings of good capital.”

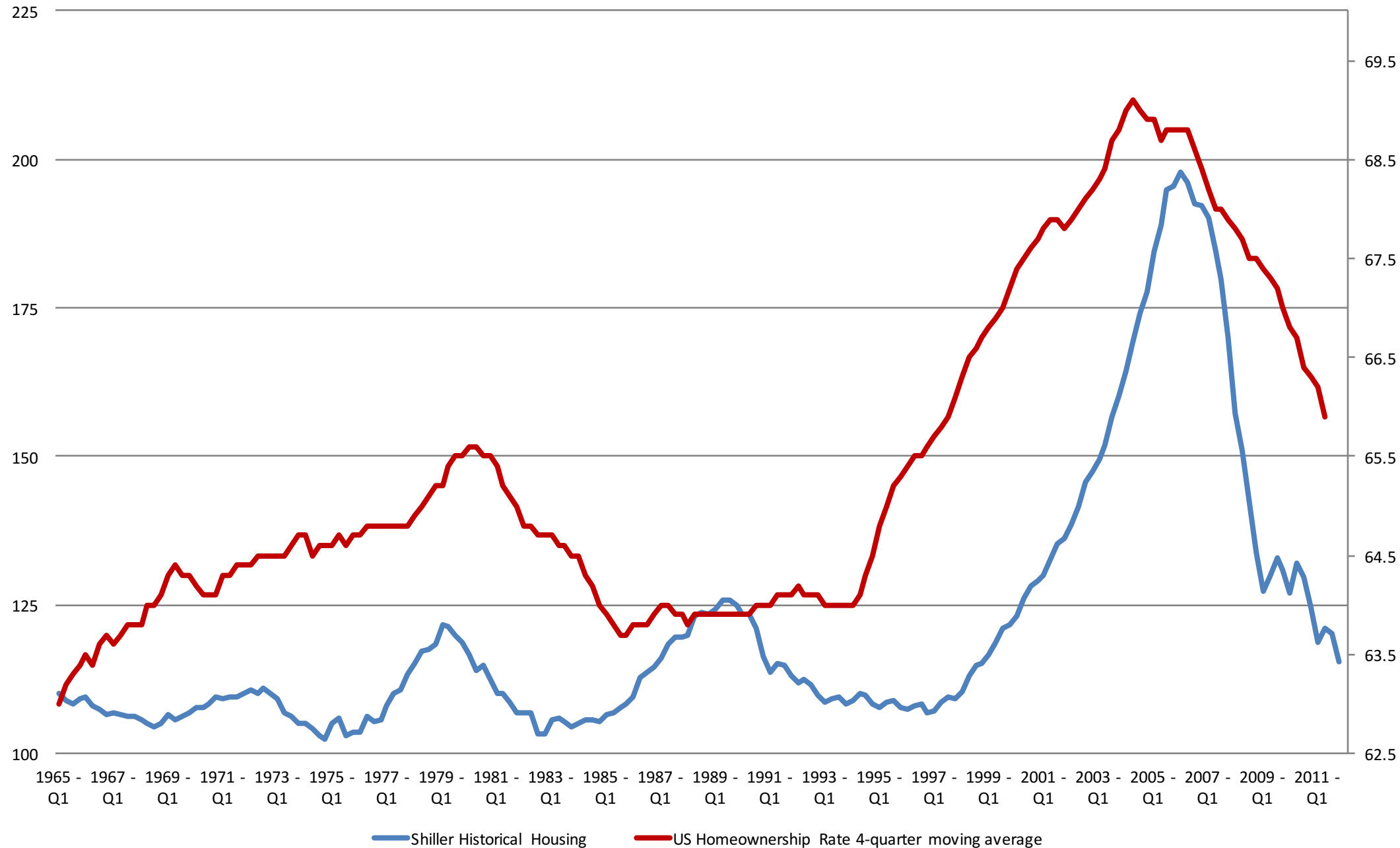
A Gov't Induced Price Bubble—1997-2007: Real Home Price Index (1890-2012)



Note: Home prices deflated by Consumer Price Index; 1890-1952 year end, 1953-2012 quarterly.

Source: Shiller's Irrational Exuberance

Gov't-Induced Rising Homeownership Rate Propels Prices



Note: Data from Q1 1965- Q4 2011; Shiller Historical Housing – Left Scale; Homeownership Rate – Right Scale

Source: Shiller's Irrational Exuberance, Haver Analytics

A Politician's Disingenuous Denial

“But there is no guarantee. There is no explicit guarantee, there is no implicit guarantee, there is no wink-and-nod guarantee.”

-Congressman Barney Frank, Sept. 10th 2003, referring to gov't guarantee of Fannie and Freddie debt

Federal vs. private share of high-risk mortgages—mid-2008

	<u>No of loans</u>	<u>Unpaid Princ.</u>
Federal	19.2 million	\$2.7 trillion
Private	7.8 million	\$1.9 trillion
TOTAL	27 million	\$4.6 trillion

Source: Edward Pinto