Notes for *Hardfire* program on "Liquidationist" response to Financial Crisis

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Historical Perspective I

Some of FDR's advisors during the 1930s argued that the over-investment made through the stockmarket bubble of the 1920s should be 'liquidated'. (The bubble was caused by the Fed's expansion of the money supply and a newly created retail market for finance based on the issuance of War Bonds during WWI as well as by American exports to a World War One-devastated Europe. The Fed purposefully 'popped' the bubble with interest rate increases and a slow-down of money supply creation in 1928.) For the "liquidationists" the best government response was then to let the market determine which companies should go bankrupt in order to allow a more rational capital structure in the economy, one which would efficiently create jobs and growth once the bad investments were worked out of the economic system. The 'liquidationists' lost the argument and the government instead intervened with production quotas, price and wage supports, tariffs and financial regulations. Unemployment averaged 17% during the 1930s.

Cause of Current Crisis

Freddie /Fannie 100% guarantees; Corporate and mortgage interest tax write-offs; FDIC deposit guarantees; and Fed "too big to fail" and "lender of last resort" all underpriced risk (socialized risk and privatized gain) and created a 'financialization' of the economy based on increasing housing prices (50% of the wealth in the USA is in real-estate) due to the above-mentioned policies creating incentives for over-investment in housing. This over-investment was made worse by the Fed setting artificially low interest rates. The Community Reinvestment Act required lenders to lend to more risky borrowers, this then, along with Fed interest rate increase, set-up the first defaults and popping of the bubble.

Some regulations exacerbated the problem. The policy-driven financialization created overly-complex derivatives which banks traded with each other; the assets were based-on, but far removed through increasing repackaging, the Fannie/Freddie 100% guaranteed mortgage-backed bonds. Regulation required that the banks "mark-to-market" these assets on their balance sheets; all banks followed the same model as proscribed by regulation. So when prices started to fall, a downward spiral ensued. Banks do not like to lose money so they did not trade these assets at a loss, knowing that they would be bailed out by the government. In addition, Freddie / Fannie financial statements were not auditable to the same standards as other corporations who list on American stock exchanges. (Fannie / Freddie were, after all, Government Sponsored Enterprises (GSEs) and like the largest economic entity created in the history of mankind, the US Government, audited financial statements are secondary to the "public purpose").

Suggested Response to the Crisis

The set of government policies which create "socialized risk and private gain" need to be removed. Because policy prioritizes debt over equity, the ownership of companies (equity holders) are far removed from the management of the companies (the high-paid executives). Tax policies which prioritize debt-financing over equity financing need to be removed; this will create incentives for the ownership of banks and financial firms to take a more active interest in preventing these firms from overly-risky investment.

Therefore, the Fed's "too big to fail" and "lender of last resort" policies need also be removed. There is no reason for financial firms to curtail overly-risky behavior if they know that they Fed has a mandate to bail them out.

The bailouts should be halted forthwith. By infusing additional capital into sectors which were already bloated by over-investment the economy is not being allowed to cleanse itself of bad assets. Firms which hold these assets should not be supported. The stock price of these companies should be revalued by the market. If bankruptcies occur, then other investors will take over any remaining assets, reprice them through negotiation and provide rationality to the asset prices and capital structure in the economy. Only a cleansed capital structure can allocate resources efficiently and thus create long-term job growth and economic growth.

The only bailouts which should occur are those which were promised by contract prior to the crisis; in other words, if banks fail, those that have deposits with these banks should be reimbursed by the FDIC up to the guaranteed limit. This is the only social contract for which the taxpayer is liable.

One recommended reform is to demonopolize the Fed, and allow private banks to compete with other and to offer private insurance for deposits. The Fed trying to second-guess interest rates in the economy creates inconsistent interest-rate and price signals and thus investment decisions are not as sound as they might be without Fed interventions. In addition, Fed policy exacerbates cycles. Fed-created lower interest rates during period of stagnation provides incentives for investment in unsound activities. As the cycle upswings this “mal-investment” continues and becomes over-investment, creating an unsustainable capital structure, which worsens the cleansing period of the downward portion of business cycles.

Moral Considerations

When the government makes a pro-active decision to intervene in the markets, by definition, it must pick the firms it is to bail out. Logic tells us that those with political connection are to be prioritized for bailouts over the political unconnected. (It is no mystery why Bear Stearns was allowed to fail while the government stepped in to bailout its competitor Goldman Sachs, not least because the Secretary of the Treasury, and at least four other Treasury officials, were Goldman Sachs executives prior to working for the government.)

A Fed policy of money expansion also decreases the wealth of the poor relative to the rich. Money increases means that real wages go down. The less wealth you have the more a downward movement of real wages hurts your purchasing power. A competitive monetary system would prevent a monopolistic expansion of money supply and money expansion would be based on market forces, not second guessing by experts.

Historical Perspective II

During the 1930s economists debated over whether socialism was economically viable. This was known as the ‘calculation debate’. Free-market economists argued that there was no way a central planner could know and replicated the hundreds of millions of economic transactions necessary to best use the scarce resources in large societies. This argument against the socialists was won when the USSR collapsed in 1989. The current nationalization-socialization of banks during the bailout is repeating this ‘central planner’ mistake. This is another argument for liquidation not bailout.

Historical Perspective III

The first great financial bubble was that of the 1500s when the Spanish Empire increased the volume of gold 8 times over its pre-Americas conquest level. The Kingdom taxed this gold at 40% all of which was used to fight wars to maintain its Kingdom. As the gold made its way though continental Europe, the price level increased 300% from 1500 to 1550. This ‘easy money’ did nothing for the Spanish and in fact caused them to consume more than invest. Only the English, without access to easy money, were able to actually “develop” the Americas, while the Spanish went into slow decline and were one of the last European nations to industrialize. The parallel with Fed money expansion is not overly coincidental.