Editors

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RE: Madrick on Stiglitz, "Can They Stop the Great Recession?," April 8, 2010 edition

To the editors,

I would like to take this opportunity to augment the analysis in Jeff Madrick's "Can They Stop the Great Recession?" in the April 8, 2010 edition of your always very insightful and interesting bi-weekly, to which I have been subscribing since moving to New York four years ago. Where Mr. Madrick seems to be lacking in his analysis of the Great Recession is by not going far enough back in history to fully articulate the root causes of the financial crisis.

In the 1930s the Roosevelt Administration made a conscious decision to (over-) encourage home ownership in the United States to keep the populace from voting for radical political parties, particularly the communists and the socialists. The idea was the original "ownership society" if you will. If people own homes, and need to work to cover the mortgage, they would be less likely to become involved in radical politics. Thus was Fannie Mae created in 1938.

The idea of the American Dream and home-ownership has continued, and has been successively strengthened with increasingly perverse economic incentives through successive administrations, with the final assaults on economic reason being the 1998 decision by the Federal Housing Administration to encourage 0% down-payment mortgages and the Bush Administration's 2001 decision to step-up enforcement of the Community Reinvestment Act of 1997, which encouraged people who were not yet ready to buy homes to do so as opposed to the otherwise reasonable economic alternative of renting a home until they were ready to buy a home. At the same time, between 2001 and 2006, the Fed had an 'easy money' policy which then helped encourage the bubble based on the unintended institutional incentives that were a consequence of the US Government's home-ownership policy. Like all bubbles in economic history, asset prices cannot go up indefinitely, leading to the popping of the bubble in 2008 in tandem with a tightened monetary policy.

Madrick rightly highlights the "principal – agent problem" as described in his review of Stiglitz's book, however, Madrick highlights the wrong problem with the right theory. The problem is that the US Tax Code encourages the taking-on of debt, not least, with a nod towards the real estate and mortgage industry special interests. Americans are encouraged through the tax code to borrow for home-ownership, as opposed to rent, because the mortgage interest can be written-off on personal income taxes. The same is true with debt taken-on by financial institutions. Debt too is a tax write-off on corporate taxes. So like Madrick rightly points-out, financial institutions have the incentive to create debt. When you add the 'financialization' of the Fannie Mae and Freddie Mac 100% guarantees of mortgages packaged into bonds, giving virtually risk-free financial derivatives and government incentives for creating the derivatives in the first place, there is indeed a disconnect between what is good for the economy (and the individuals who make up the economy) and what is good for the financial firms. Here is not the place to say whether Fan and Fred, the CRA, the Fed and the tax code are 'regulation' or not, because this will just draw the ire of Mr. Madrick, who after-all, has written a book in praise of big government. I think it is just fair for the readers of the *NYRB* to know that there are more narratives to the story than Madrick has been relating.

Two other points need to be addressed at this point to give a fuller picture than what Madrick has written in this article and in other *NYRB* articles on the crisis. First is the fallacy that the rating agencies weren't "restricted" enough. This is not quite right. It is exactly because, starting in 1975, the top-three rating agencies were given a monopoly on the issuance of ratings that they were able to be free of the competition that would have given more accurate ratings and a less-skewed fee structure, a monopoly that encouraged the agency-capture to under-state the risk of the mortgage-backed derivatives. Additionally, it should be noted that it was international banking regulation that again created the incentives for banks to stock-up on the derivatives. Banks were entitled to hold fewer reserves against government-backed (Fan and Fred-backed) paper than regular paper, again helping to create the 'financialization' and bubble. The massive volume of this paper, encouraged by both the US government's overt incentives for home-ownership as opposed to rentals and the special banking reserve requirements, lead to the very same systemic risk that Madrick decries.

Of course we need to address the bailouts, the subject of much popular discontent. Madrick states the bailouts were necessary to prevent an even worse world-wide recession or even depression. Yet he states that "the banks still have an enormous volume of bad mortgage assets on their books, which means that there are high financial hurdles ahead". Of course there are. The bailouts prevented the necessary cleansing of the financial system from the over-investment in home-ownership and mortgage-backed paper. The system was bailed-out before the bad assets could be liquidated to free-up capital for job-creating investment. Madrick states that "it is not too late" to ensure that any new financial regulations require banks to make new mortgage lending. This is the type of thinking that has, since the 1930s onward, distorted the American economy, and needs to be addressed, finally and once-and-for-all, in order to remove the "financial hurdles ahead". After all, communism and socialism are no longer in competition with the Democrats and the Republicans.

Madrick states, "The responsibility for on-going economic recovery and adequate financial regulation lies squarely with the President". The President is the chief executive of the federal government, whoever is in that office does not create wealth ("economic recovery") through acting in the market with economic incentives. A government can redistribute wealth or set the rules of the game but cannot create wealth. Yes, the rules of the game ("regulation" in Madrick's oft-used phrase) do need to be changed, but I am suggesting here that we should re-evaluate a tax code which encourages debt over equity (Thorstein Veblen's "absentee ownership") and encourages what some Marxists call 'financialization' of the economy, in this case through government-guarantees of financial derivatives based on home mortgages. Any future financial reforms that do not address these underlying distortions in our economy are illusionary and in the long-run will perhaps do just as much harm as good, much as past reform after past crises has not addressed the underlying distortions of financialization and absentee-ownership (the principal-agent problem) in the U.S.

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