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The Real Causes of the Financial Crisis

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I'm going to attempt to bring you a different perspective on the financial crisis today. I'm a real world business person, who was CEO of a large financial institution for 20 years and worked within the banking industry for 40 years. In that context, I view myself as having worked under the Federal Reserve. In theory, CEOs report to boards, who then report to shareholders. While that's true of most businesses, in the financial services industry, we only quasi-report to boards, quasi-report to shareholders, and definitely report to regulators.

I've known many people who have worked for the Fed. In my experience, they've all been guilty of what F. A. Hayek called "fatal conceit." It's the belief that smart people can do the impossible—and I don't care how great your mathematical models are, you cannot integrate the economic activity of seven billion people around the planet.



John A. Allison is the former chairman and CEO of BB&T, where he was named one of the top 100 most successful CEOs in the world by Harvard Business Review. He spoke at the Cato Institute's 29th Annual Monetary Conference in November.

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The fundamental question—which I’m going to analyze from a human action perspective—is what does government policy incent real world human beings to do? I strongly believe that the recent financial crisis, the ensuing recession, and the slow recovery were caused primarily by government policies. To explain this, I’m going to focus on two components: regulation and monetary policy.

The foundation for regulation in the banking industry is insurance from the Federal Deposit Insurance Corporation (FDIC). It’s used to justify regulation because the banks are supposedly being “protected by the federal government.” In my opinion, FDIC insurance is one of the main contributors to the financial crisis—with Fed monetary policy errors and Freddie/Fannie’s affordable housing loans being the primary causes.

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FDIC insurance has destroyed market discipline in the banking system. Most of the large institutions that failed financed their high-risk lending business using FDIC-insured deposits. They absolutely could not have done that in the private market-

place. In fact, if private deposit insurance had been in place, it would not have been available to most of the failed institutions unless they had double or triple their capital. With a private deposit insurance fund, I believe that the financial crisis would have been dramatically less severe.

The regulators used fair lending laws—designed to eliminate racial discrimination in lending—and the Community Reinvestment Act to force banks to make loans to unqualified borrowers in order to increase homeownership. Of course, the primary drivers of excessive investment in residential real estate were Freddie and Fannie, government-sponsored enterprises that would not exist in a free market. They had \$2.5 trillion in subprime loans where they failed. Banks were not designed to be low-income lenders, but we were forced to do that on a fairly large scale. It was a moral crusade—and there was a decidedly political aspect as well. The regulators aggressively pursued racial discrimination claims in the early Clinton and Obama years only to reverse these claims after the Republican congressional victories of 1994 and 2010. Subprime lending is now viewed as bad, but then it was a moral imperative.

On safety and soundness regulations, I don’t know of a single case where the regulators identified a significant problem in advance of the market. They’ve gotten involved a lot of times, and most of the time

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they've made the problem worse. Why is that? Look at public choice theory. In the good times, regulators always underregulate. The examiners didn't identify the problem because they didn't understand the business. They had never lived through bad times before.

Even if they had, they would have done nothing. Why? Politics. It's not worth bringing heat on the agency.

In the course of my career, every time we've had a correction, the regulators have tightened lending standards—even for banks that have good credit histories. So, the Fed is currently printing money in an attempt to boost the economy, and the regulators have tightened up. Why? If you're a local regulator, the only way you can get in trouble is if your bank gets in trouble. It's a one-sided bet. It's a classic public choice paradigm.

Finally, the cost of regulation is enormous. If you asked me would I rather eliminate taxes on banks or regulations, it would be a no brainer: regulations. BB&T alone has added nearly a thousand people to its regulatory staff in the past year. And of course what we've done is reduce production. You can only do so much.

Let's consider monetary policy next. I've asked numerous Fed policy decisionmakers a basic question over the years: Do central bankers believe in price controls? Do they think that the government can, for instance, set the price for automobiles? The answer, of course, is no—to which I've asked a follow-up. When the Fed sets interest rates, aren't they setting the most important price in the econo-

my—the price of money? I've never gotten a credible answer.

With respect to human action, the Fed created a number of incentives that led directly to the recent financial crisis. It began in the early 2000s, when Alan Greenspan created negative real interest rates. This was a big deal in the residential real estate market because prices were appreciating so rapidly, creating a huge incentive to expand construction. Eventually, Greenspan—and then Bernanke—started raising interest rates. In two years, they increased the federal funds rate by 425 percent. This increased the cost of goods in the banking industry, which was particularly destructive because right before the Fed started raising rates Greenspan was warning about excessive savings and deflation. Banks extended their bond portfolios on his advice, which created whopping losses.

Then, Bernanke did another incredibly destructive thing: he inverted the yield curve. Banks make money by borrowing short and lending long. When the yield curve was inverted, short-term rates were higher than long-term rates, and bank margins went negative—which meant they were buying watermelons for \$10 and selling them for \$8.

What did banks do in response? Knowing that they could make higher returns by taking more risks, they went out on the risk spectrum. Most of the bad loans were made in the last part of this cycle—under the inverted yield curve—a phenomenon that only occurs in response to government policy. At the same time, the Fed was adamant that we were not going to have a recession, which had a psychological effect on banks. Academics talk about acting in the long-term on the basis of perfect information. Well, in the real world, the short-term matters and perfect information doesn't exist. So banks went out on the risk spectrum and made bad loans.

With China and India's entry into the global economy, billions of people were suddenly becoming more productive. Prices should've been in free fall in the early 2000s, but Greenspan didn't allow that to happen, which sent a terrible signal to the economy. Those of us in the investment business didn't see the resulting hidden inflation, and by holding prices up, we were in effect telling the Chinese to produce like crazy. This drove jobs out of the United States, drove up manufacturing wages, and encouraged excessive housing consumption.

I'm also convinced that private markets would have come up with a very different interest rate scenario

than the Fed did. Each of us—independent businesses, maximizing profits, not a bit concerned for the public good—would have created an interest rate scenario that prevented many of these economic problems.

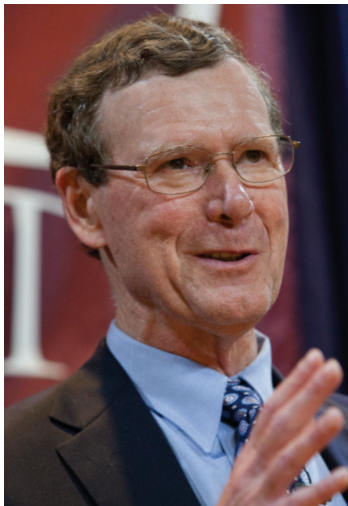
But there's a deeper issue. The Fed says that it's currently holding interest rates below market rates—which means it's redistributing wealth from savers to borrowers. This arbitrary redistribution is unethical and very destructive. That alone would condemn the Fed in my view.

So what should we do? I'm for getting rid of the Fed. As long as it exists, the temptation for Congress to borrow us into economic chaos will be there. Congress will never discipline

itself if the Fed can print money. We need a private banking system with a gold standard.

If ending the Fed is not an option, I think the second best solution would be to cap the growth in the money supply at 3 percent, as Milton Friedman suggested. A more politically acceptable alternative would be to raise capital limits for financial institutions and transfer risk from the public to the bank shareholders. This would require privatizing FDIC insurance and getting rid of 95 percent of the regulations.

The market is based on experimentation. The existence of a government agency, on the other hand,



destroys the learning process. If we'd had a private financial market since 1913, when the Fed was created, many of the issues we're struggling with would have solved themselves a long time ago, and we would have a very advanced monetary system in the United States right now. But we stopped the learning process.

As important as the policy mistakes have been, I believe that the real cause of the financial crisis is philosophical. More specifically, we got into this mess through a combination of altruism and pragmatism, which is what I call "the free-lunch mentality." The Fed is a classic altruistic organization. It has been trying to save indebted borrowers—and failing banks—by driving down rates so they can get out of trouble. It's using pragmatic standards in an "emergency" situation. Unfortunately, this free-lunch mentality leads to a lack of personal responsibility, which is the central issue that underlies all of our financial problems.

Interestingly enough, the solutions are philosophical as well. When most people think about life, liberty, and the pursuit of happiness, they focus on liberty. But the world-changing idea was the pursuit of happiness. Before the Enlightenment, everybody existed for somebody else—for the good of the king, the state, or the church. Nobody existed for their own good. What Thomas Jefferson said was that each of us has a moral right to pursue our own personal happiness. It was that idea that created the most successful

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society in history.

One of the main problems in this crisis has been a failure of leadership. What is leadership? It's creating an environment in which people can pursue their personal happiness—in which people are clear about their purpose and can use their capacity to think. This environment is the key to raising self-esteem—which means doing the best you can do, given your level of knowledge and skill. This, in turn, has an enormous social implication.

Take an entry-level construction worker—a bricklayer. He has a very tough life, but he gets something very precious for his work. He gets to be proud of himself. Take that same bricklayer and give him welfare. He's better off financially, but he loses his pride. He loses his self-esteem. There has been a lot of focus recently on security. The Fed is there to make us "secure." But this is not the land of security. The United States is the land of opportunity—the opportunity to be great, the opportunity to fail and try again, and most importantly the opportunity for that bricklayer to live life on his own terms, to pursue his personal happiness. That is the American sense of life, and that is what is so precious to protect. ■



Cato Scholar Profile: **NAT HENTOFF**

NAT HENTOFF is a senior fellow at the Cato Institute. A celebrated writer and civil libertarian, he is considered one of the leading authorities on the First Amendment and the Bill of Rights. Hentoff was a columnist with the *Village Voice* for 51 years, from 1957 until 2008. A jazz expert, he currently writes about music for the *Wall Street Journal* and *Jazz Times*. Hentoff was recently honored with the ASCAP Deems Taylor Award for his latest book, *At the Jazz Band Ball: Sixty Years on the Jazz Scene*.

What do you see as the biggest threat to the First Amendment today?

The biggest threat to the First Amendment—and all other parts of the Constitution for that matter—is the widespread ignorance of what is contained within that document. We have witnessed a mostly passive citizenry as the Constitution has been razed over the last decade or so.

James Madison, the father of the First Amendment, insisted that “the great right” of freedom of speech must be placed beyond the reach of any branch of government. Importantly, there is a connection between the Fourth Amendment—which protects every one of us from unreasonable searches by the government—and the First Amendment. As our right to privacy has been violated under Bush and now more so under Obama, many Americans are becoming careful about what they say.

If our government keeps tracking us in so many ways, we will no longer be a self-governing republic dependent on the First Amendment, our fundamental freedom.

You recently wrote that the Declaration of Independence and the Constitution “should often be in the rhythm section of the symphonies that are our classroom discussions and debates.” What do you mean by this?

There are many problems in education right now, but one of the biggest is the fact that there are very few civics classes. When I went to school long ago, you’d learn about the Constitution, about our liberties, about how a big part of our country’s history was dedicated to protecting those liberties.

Now, because of Bush’s No Child Left Behind Act, most of the civics classes were done away with. The focus is instead on collective standardized tests in reading and math. As a result, our children have little understanding of how this republic works.

Our founding documents are a critical part of the learning process. It was Thomas Jefferson who told future generations to never forget who they are: “What spectacle can be more edifying or more seasonable, than that of Liberty and Learning, each leaning on the other for their mutual & surest support?”

You recently received the Deems Taylor Award for your book *At the Jazz Band Ball: Sixty Years on the Jazz Scene*. Do you see a connection between jazz and our civil liberties?

In a November *Wall Street Journal* article, I wrote about Ehsan Khoshbakt, a young Iranian dissident in his late twenties who has managed to write a blog about jazz outside of the reach of that country’s censors. As a young boy, Ehsan came across a compilation cassette with Louis Armstrong on it, and it changed his life.

“It doesn’t matter if you’re old or young; man or woman; a billionaire or a bellboy; free or inside a prison; Muslim or Christian, or Jew,” he writes in one of his posts. “As long as you can be part of this democratic conversation known as jazz, you’re in, and nothing else matters.”

That is the best answer to the question. Ehsan was able to understand what liberty was once he heard these musicians express themselves. Jazz, simply put, is freedom music. ■

So Much Accomplished . . . So Much to Do

For the Cato Institute, 2011 will stand out as a year of achievement, growth, and accomplishment. A successful capital campaign coupled with a headquarters expansion will provide the foundation for a vastly expanded policy reach. More Cato scholars covering more policy areas will ensure that Cato keeps ideas about small government, freedom, and the rule of law in the forefront of our national debate.

We thank you, our Sponsors, for making this groundswell of activity possible. But while we are proud of what has been achieved, we are also mindful of how much more needs to be done—because there are never enough resources when one struggles against a statist behemoth. So we ask you to continue to journey with us.

To be a little more specific about what has been happening . . . Cato's Liberating the Future capital campaign is drawing to a close: \$44.5 million of our \$50 million goal has already been raised and we are on track to raise the rest. Some of the funds raised are being used to double the size of Cato's headquarters at 1000 Massachusetts Avenue in Washington, D.C. Remarkably, this expansion is running on time and on budget. Floors four through seven are now complete and the rest of this renovation/expansion will be finished by March 2012. Our new facility is simply beautiful and will feature commodious policy centers, an expanded F. A. Hayek auditorium, a new George M. Yeager Conference Center



that will seat 200 people for dinner, the Ken and Frayda Levy Liberty Garden, and the Melvyn Jay Kushner Library.

More important, the new facility will enable the launch of new policy centers, such as

- Money and banking
- Labor and employment
- Environmental and energy issues
- Government transparency
- And much more!

The “more” is only limited by the resources that we can bring to the task. So we thank you again for what you have already done and we ask you to be a part of the future. As always, we welcome whatever is comfortable for you: annual gifts, gifts to the capital campaign, gifts for a specific purpose, or planned gifts involving a bequest or a beneficiary designation.

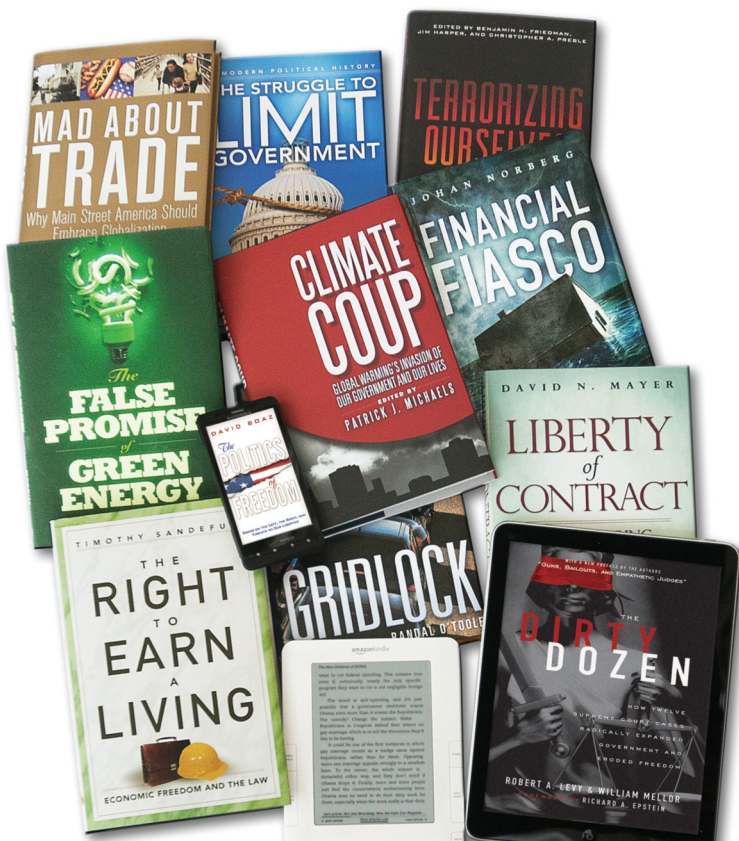
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