

# Lessons from the Subprime Crisis

On the front page and atop every policymaker's agenda is the ongoing financial crisis. Is the United States heading for a recession? If so, how bad will it be? What should policymakers do about it? What shouldn't they do? Economists wrestled with those questions at the 26th Annual Monetary Conference, an all-day event held on November 19 at Cato's F. A. Hayek Auditorium in Washington, DC. Panelists offering varied perspectives and prescriptions ranged from Austrian economists to the vice chairman of the Federal Reserve Bank.

## **GERALD P. O'DRISCOLL JR., Cato Institute:**

We remain in an economic crisis and financial crisis, one that Gary Gorton has named "The Panic of 2007." Monetary policy has played a pivotal role. Under Greenspan and now Ben Bernanke, the Fed has conducted monetary policy so as to foster moral hazard among investors, notably in housing. Not money alone, for the crisis is the product of a "perfect storm" of misguided policy. Policies to encourage affordable housing fostered the growth of subprime lending and complex financial products to finance that lending. Regardless of the desirability of the social goal, the financial superstructure depended on housing prices never falling. Housing prices do fall sometimes, and did so decisively beginning in 2007.

It is a myth that unregulated financial capitalism failed and new regulation is needed. Aside from health care, financial services is the most heavily regulated industry in the economy. No part of it completely escaped regulation and most parts were heavily regulated, typically with multiple government agencies overseeing the activities of financial services firms.

There was no financial deregulation during the boom of 2002–2007. The last legislative deregulation occurred in 1999 during the Clinton administration. The most significant change it wrought was to permit commercial and investment banks to combine into universal banks. (In reality, the statute legalized and regularized activities

already in place.) All such entities, such as Citigroup and JP Morgan Chase, have survived the debacle. Stand-alone investment banks, the legacy of the Glass-Steagall Act, have fared much worse. Of the five major investment banks operating at the beginning of 2008, Merrill Lynch merged with a commercial bank, Bank of America; the Fed financed and arranged for the shotgun marriage of Bear Stearns with JP Morgan Chase; Lehman failed; and Goldman Sachs and Morgan Stanley each sought protection by transforming themselves into bank holding companies. Born in one crisis, Glass-Steagall's 75-year-old separation of commercial and investment banking was undone by another.

Regulation certainly failed, but not for lack of quantity. Financial services regulation pretty much functioned as public choice economists would have predicted: agencies were largely captured by the industries they regulate. It is unclear how adding more regulation would change that outcome.

## **ANNA J. SCHWARTZ, National Bureau of Economic Research:**

The disruption of credit flows can be traced to the asset price bubble in housing. It has become a cliché to refer to an asset boom as a mania. The cliché, however, obscures why ordinary folk become avid buyers of whatever object has become the target of desire. An asset boom is propagated by an expansionary monetary policy that lowers interest rates and induces

borrowing beyond prudent bounds to acquire the asset.

The Fed was accommodative too long from 2001 on and was slow to tighten monetary policy, delaying tightening until June 2004 and then ending the monthly 25-basis-points increase in August 2006. The rate cuts that began on August 10, 2007, and escalated in an unprecedented 75-basis-points reduction on January 22, 2008, were announced at an unscheduled video conference meeting a week before a scheduled FOMC meeting. The rate increases in 2007 were too little and ended too soon. This was the monetary policy setting for the housing price boom.

The federal government encouraged the housing boom by stimulating demand for houses. Congress was more than a bit player in this campaign. Beginning in 1992 Congress pushed Fannie Mae and Freddie Mac to increase their purchases of mortgages going to low- and moderate-income borrowers. In 1996, the department of Housing and Urban Development, gave Fannie and Freddie an explicit target: 12 percent of their mortgage financing had to go to borrowers with incomes less than 60 percent of their area's median income. That number was increased to 20 percent in 2000 and 22 percent in 2005. The 2008 goal was to be 28 percent. Between 2000 and 2005, Freddie and Fannie met those goals every year. They funded hundreds of billions of dollars worth of loans, many of them subprime and adjustable-rate loans made to borrowers who bought houses with less than 10 percent down. Fannie and Freddie also purchased hundreds of billions of subprime securities for their own portfolios to make money and help satisfy HUD affordable-housing goals. Fannie and Freddie were important contributors to the demand for subprime securities. Congress designed Fannie and Freddie to serve both their investors and the political class. Demanding that Fannie and Freddie do more to increase home ownership allowed Congress and the White House to subsidize low-

income housing outside of the budget, at least in the short run.

Unfortunately, that strategy remains at the heart of the political process, and of proposed solutions to this crisis.

**DONALD L. KOHN, Federal Reserve Board:**

The identification of bubbles in real time is tricky because not all of the fundamental factors driving asset prices are directly observable; thus, any judgment by a central bank that an asset is overpriced is by nature uncertain. My views on this aspect of the identification problem have been reinforced by my experience during the inflation of the housing bubble. Over the first half of the decade we saw a sustained, rapid rise in both home values and mortgage debt. As this process continued, concern about its sustainability grew and many observers started speculating that a bubble was in place. During this period, staff throughout the Federal Reserve System examined whether house prices were overvalued and arrived at a wide range of answers. For example, one set of models that linked rental rates and house prices indicated as early as the start of 2004 that the market was significantly overvalued, while another set of models suggested, even as late as December 2005, that house prices could be justified by fundamentals. Thus, controversy over the existence of a bubble persisted almost right up to the actual peak in the housing market.

**BERT ELY, Ely & Company:**

The greatest single factor contributing to overleveraging by individuals is the tax deductibility of home mortgage interest and, for corporations, the combination of the tax deductibility of interest paid on debt and the double-taxation of dividends—once at the corporate level and again at the individual level. Given this tax-code favoritism toward debt, it is hardly surprising that individuals will borrow a much higher percentage of a home purchase price than would be the case if mortgage interest was not tax-deductible.

There may not be a direct cause-and-effect, but one cannot help but notice that the net international investment position

of the United States declined from a positive \$67 billion at the end of 1985 to a negative \$2.44 trillion at the end of 2007. One can reasonably wonder about the relationship between the 1986 Tax Act, the tremendous \$5.6 trillion growth of home mortgage debt since then, the decline in the U.S. savings rate from almost 10 percent of disposable personal income in 1985–87 to slightly negative in the 2005–07 period, and the United States’ emergence as the world’s



Gerald P. O'Driscoll Jr.

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largest debtor nation. Two other pieces of housing data also show the possible impact of the increased tax-deductible, mortgage-debt utilization by households—the 9.6 percent increase in the size of owner-occupied homes, from 1,712 square feet in 1985 to 1,876 square feet in 2007, driven by a 49.2 percent increase in the average size of a new home, from 1,544 square feet in 1985 to 2,304 square feet in 2007.

**WILLIAM POOLE, Cato Institute:**

Those who want more regulation should keep two facts in mind. First, regu-

lation will inevitably be bent to serve political purposes. Of course, that is exactly what some pro-regulation observers want. Before the financial crisis, many members of Congress cheered subprime mortgages because they served affordable housing goals. Second, the financial economy is inherently competitive. With access by Internet, many financial firms could relocate abroad, thus escaping federal jurisdiction.

Actions this year are creating moral hazard to an unprecedented degree; unwinding this situation will be costly. We are clearly seeing the effects already. Lehman, I believe, delayed raising capital expecting that it would receive the same sort of support Bear Stearns did. Lehman was instead permitted to fail. Investment banks have become bank holding companies so that they would qualify for Federal Reserve resources. There are reports that GMAC is trying to convert to a bank charter to become eligible for Fed support and for the Treasury’s capital infusion program for banks. Auto companies are asking for access to the \$700 billion TARP fund.

The Federal Reserve and federal government need to move quickly to limit which firms have access to government resources. The Federal Reserve should put a moratorium on all conversions of corporate charters to commercial bank charters. Congress should refuse to bail out any more firms; weak firms should be required to seek protection under the bankruptcy law. The clear fact is that the greater the number of firms bailed out in coming quarters, the greater will be the number of applicants for bailouts. I see no way to decide which firms are “deserving” of a bailout and which are not.

It appears that the federal government will operate Fannie Mae and Freddie Mac for the indefinite future. Fannie and Freddie have increased their market share over the past 20 years and this trend is likely to continue until the entire mortgage market is effectively federalized. Fannie and Freddie rules on what mortgages can be securitized will control the structure of mortgages. These rules will



stifle innovation and prevent emergence of strong private competitors. The only way around this prospect is to phase out Fannie and Freddie over time.

**LAWRENCE H. WHITE, University of Missouri-St. Louis:**

The Federal Reserve's new interventions into financial markets over the past year have proceeded at its own initiative, without precedent, and without congressional oversight. None of the new lending facilities have anything to do with acting as a lender of last resort in the traditional sense. Through all the recent turmoil there has been no threat of a shrinking money stock, and only one run on a commercial bank, Indy Mac. Investment banks do not issue checking deposits, are therefore not subject to depositor runs, and are not part of the payment system. Neither are securities dealers. The Fed's expansions of its own activities therefore had nothing to do with protecting the payment system or stabilizing the money supply.

The Fed's new activities instead seem to aim at protecting banks and nonbanks from the consequences of holding portfolios overweighted with mortgage-backed securities, or derivatives based on such securities, while keeping levels of capital inadequate for such portfolios. Attempting such a bailout is a worrisome role for the Fed to take on, especially at its own initiative, without oversight. That the Fed's bailout is "self-financed" does not mean that it provides a free lunch. It is ultimately financed by the Fed's power to levy an implicit tax on dollar-holders, putting us all at risk of inflationary depreciation of the dollar. Thus far, because it did not require an appropriation from Congress, the Fed's bailout efforts seem to be enjoying the complete freedom from oversight that Secretary Paulson unsuccessfully sought for the Treasury's bailout. That should change. The threat of a financial meltdown should not be the occasion for a constitutional meltdown. It is time for a public debate on the wisdom of the Fed's remarkable departure from its traditional roles.

**JEFFREY M. LACKER, Federal Reserve Bank of Richmond:**

The critical policy challenge for our time is to reestablish the boundaries of central bank lending and public support. In doing so, the prime directive should be that the extent of regulatory and supervisory oversight should be commensurate with the extent of access to central bank credit in order to contain moral hazard effectively. The dramatic expansion in Federal Reserve



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lending, and government support more broadly, has extended public sector support beyond existing supervisory reach, and thus could destabilize the financial system, absent corrective action. Re-storing consistency between the scope of government support and the scope of government supervision is essential to a healthy and sustainable financial system. One option is simply to adapt our regulatory and supervisory regime to the new wider implied reach of government lending support. This strikes me as an unattractive option, if for no other reason than the cur-

rent uncertainty about the outer bounds of that support. Constraining moral hazard in such a regime would be an immense and daunting task. I take it as given, therefore, that the scope of the financial safety net ultimately must be rolled back.

**JEFFREY A. MIRON, Harvard University:**

The obvious alternative to a bailout was letting troubled financial institutions declare bankruptcy. That does not mean the institutions would have disappeared; rather, they would have been bought up (at low prices) by other institutions and absorbed. It also does not mean that lending would have frozen up; if one financial institution cannot make productive loans, a profit opportunity exists for someone else. Allowing more failures, or even many failures, might well have contributed to, or at least sped up, the recession, but that would have been a price worth paying. Economies have recessions and failures; capitalism works because it allows failures. And, by letting the process of failure occur, we would reverse, to some degree, the temptation to bank on government largesse in the future. Thus, the right response was for government to do nothing at all.

**ANDREW A. SAMWICK, Dartmouth University:**

Though their stories seldom make the news, there were borrowers who could have afforded a new home with a subprime mortgage but not a prime mortgage who chose not to buy a home. There were banks that lost market share to mortgage originators because their lending standards precluded them from extending credit in such a risky manner. There were investors that were willing to forgo the additional yield on subprime-backed securities because the opaqueness of their design made them too risky a proposition. There were consumers who lived within their means and tried to save some money for the future, refusing to max out their credit cards or their home equity lines of credit to boost their consumption even further above their income. Those were the participants in financial markets who behaved prudently.

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Dershowitz, Posner, Friedman ponder the expanding criminal law

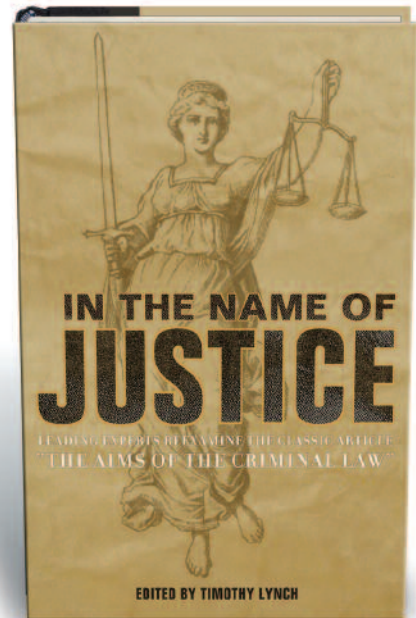
## Are We All Criminals Now?

**O**ur criminal codes are so voluminous that they bewilder not only the average citizen, but even the average lawyer. Our courthouses are so busy that there is no longer time for trials. And America now has the highest per capita prison population in the world. Are these trends desirable, satisfactory—or disturbing? *In the Name of Justice*, edited by Timothy Lynch, director of Cato's Project on Criminal Justice, consults America's leading legal experts to answer this question through a critical examination of American criminal law.

In "You're (Probably) a Federal Criminal," Alex Kozinski, chief judge of the U.S. Court of Appeals for the Ninth Circuit, points out the problems with the criminalization of almost everything. Half of Americans have tried illegal drugs, and nearly everyone has transgressed against some arcane law or another. What sanction does the "rule of law" have when almost every American is a criminal of some sort? Richard A. Posner, a judge on the U.S. Court of Appeals for the Seventh Circuit, largely concurs, adding a cost-benefit calculation to the mix: A utility-maximizing

criminal justice system would have few prohibitions but they would be strictly enforced. Such a regime would tend to deter the most heinous, anti-social acts, while allowing a great amount of freedom for the vast majority of citizens.

Alan M. Dershowitz of Harvard Law School asks whether such a regime could handle the "new reality" of suicide terrorism. When would-be terrorists are willing to kill themselves to accomplish their destructive ends, what kind of punishment could deter them? And in their contribution, Milton and Rose Friedman argue that the war on drugs has made a mockery of the criminal justice system. The criminal law is not a moral crusade but a means of deterring socially detrimental acts, yet drug use is plainly a personal matter. Legalize drugs, and street crime would drop dramatically and immediately, they contend.



Meanwhile, respect for and deference to the law would increase.

Other contributors to *In the Name of Justice* include Pepperdine public policy professor James Q. Wilson and Anthony M. Kennedy, associate justice of the U.S. Supreme Court.

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How have those prudent actors fared in the policy response to the subprime crisis? Banks that first lost market share to reckless lenders are now seeing the government inject capital into the balance sheets of these same reckless lenders. Their net interest spreads are also being narrowed as the Fed lowers interest rates down close to zero to prop up the value of troubled assets across the economy. Households that delayed a home purchase because the prices were too high now see any number of proposals designed to prop up housing prices, keeping them out of reach and in the possession of the speculators and the profligate. Investors that stayed out of subprime-backed pools now see government pro-

grams designed to prop up the value of those pools for those who invested less wisely. Households that delayed a home purchase because the prices were too high now see any number of proposals designed to prop up housing prices, keeping them out of reach and in the possession of the speculators and the profligate. Investors that stayed out of subprime-backed pools now see government programs designed to prop up the value of those pools for those who invested less wisely. Households who didn't treat their housing equity like an ATM and faced higher prices for everyday goods and services in competition with those who did not see programs to forgive the debt being proposed. They also face negative real rates of return on their savings. And every

entity showing positive profits or higher income as a result of their prudence must also shoulder the burden of funding the trillion-dollar bailout proposals.

When the government has intervened, it has done so on behalf of the profligate at the expense of the prudent. The inevitable result is that it breeds more profligacy and less prudence in financial markets in the future. The government always has a choice in how it intervenes. From the standpoint of preventing the next crisis, it is better to let an insolvent institution fail and use the government's funds to assist those solvent institutions damaged by that failure than to use the government's funds to reward the behavior that caused the insolvency in the first place. ■