Contraditório Think Tank

Article

Who caused the global financial crisis? An inconvenient truth | Vinay Kolhatkar

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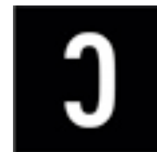
You must have heard the wrong explanation, something that goes like this:

1. American banks knowingly sold unrepayable home loans to a gullible public;
2. Unregulated Wall Street greed resulted in poor investments being sold to retirement funds the world over;
3. Credit derivatives, collaterized debt obligations (CDOs), and credit default swaps, were those evil toxic securities which banks created and which led to a loss of wealth;
4. This house of cards collapsed, leading to corporate insolvencies, stock market crashes, real estate value declines, and increased unemployment;
5. If governments had not stepped in to rescue the banks and insurance companies, we would have had a depression that could have lasted decades;
6. It proves once and for all, that in a system of unregulated capitalism, the greedy and the corrupt will take advantage of the simple and the virtuous;
7. So we must now regulate the financial system even more to prevent this from ever occurring again, and rescue us, the people, from the current malaise—via '*economic stimulus*' that the government alone is an expert at providing.

There are almost no major media outlets anywhere—newspapers, television, radio, magazines, even Hollywood movies and television serials, that have not repeated a version of this mantra. Nevertheless, it is



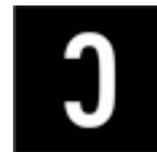
imperative that serious students of finance and economics maintain a critical perspective and look behind-the-scenes for what the true story may be. For example, students of investment theory know that derivative contracts are zero-sum games in which wealth can neither be created nor destroyed. Explanations which merely lay the blame at the feet of 'financial instruments' and 'greed' are either incorrect, or at least missing something crucial.

So what is the real story, and who has been voicing it?

In recent times, some of the prominent voices of reason have been: George Reisman; Thomas E Woods and other economists associated with the Ludwig Von Mises Institute; Ron Paul, a libertarian ex-congressman and a candidate for the Republican nomination for president in 2008 and 2012; Governor Gary Johnson, the Libertarian Party candidate for president in 2012; investment maven Peter Schiff; and the disciples of Ayn Rand. In times past, the real story was narrated several times by Ludwig Von Mises, Henry Hazlitt, and Friedrich Hayek— some of the greatest economists associated with the Austrian tradition of economics, and also by an outstanding exponent of free market capitalism—philosopher Ayn Rand.

The principles of the free market have long since been discovered. *An Inquiry into The Nature and Causes of The Wealth of Nations* was written by Adam Smith in 1776, and the principles were refined in the 19th century. Those who follow the rules of logic, and are objective in their judgment, have not a shred of doubt as to the efficacy of the free market.

Wherever there is a systemic economic problem—collapsing asset prices, widespread unemployment, a cluster of insolvencies, inflation, depression, stagflation, or recession—the source of the problem is almost always that elected officials have not allowed the free market to work. Governments interfere with the market economy using various devices such as subsidies, tax incentives & other legal distortions, unwarranted regulatory burdens, price or volume controls, dictates about which consumers are to be served, or outright nationalisation. This is the generic form of the story.



The particulars of this story (the lessons of history wasted, yet again)

In *Meltdown: A Free-Market Look at Why the Stock Market Collapsed, the Economy Tanked, and Government Bailouts Will Make Things Worse*, Tom Woods, an Austrian economist, discusses the particulars of this story and the GW Bush Administration carrots thus:

The Clinton Administration revived legislation that was designed to 'encourage' banks to issue home loans to minorities. Even though Asian Americans were getting more home loans in percentage numbers than white Americans, an apparent lower rate of lending to African Americans and Latino Americans was taken as *prima facie* evidence of discrimination. The *stick* of reputation-destroying discrimination lawsuits became quite ominous as regulators began to collect data regularly from the banks. Later studies found that there never had been any evidence of discrimination when the data was adjusted for credit risk, but the media uproar drowned out the follow-up studies. The American dream was being denied to some on account of their race, said the media. The market, already tied up in subsidies and regulation, was further nudged into an uneconomic direction. The fire ignited.

The Bush Administration then added *carrots* to the stick, and the financial party morphed into an inferno. Far more capital was diverted into real estate construction than was justifiable. Eventually there was glut of construction, and prices collapsed. Even though banks were packaging the risk of price downturns and selling them in the form of securities, they did hold significant portions of it themselves, and their solvency came into question. In the thinly capitalised industry of banking, it was not easy to tell which of the banks were solvent and which were not, so banks grew wary of lending to each other. In the modern economy, financial markets cannot function easily without financial intermediaries carrying large levels of risk to each other, and the contagion of panic spread.

So what were the Bush-era carrots?

First, the Government created or revitalized institutions that they owned to give them an appearance of government-supported credit risk. You may have heard of Fannie Mae and Freddie Mac, the colloquial names used respectively for the Federal National

Mortgage Association, and the Federal Home Loan Mortgage Corporation. These institutions were granted over USD 2 billion in a line of credit by the Department of Treasury. Moreover, their quasi-government status helped them to raise money cheaply. These institutions bought the worst of the risk, embedded in the form of securities, from the banks.

Government alone can counterfeit money

Further, Governments everywhere have allowed their central banks to create paper money out of thin air—so that they can spend money on vote-grabbing schemes without '*raising taxes*', which is an electoral no-no. It is a two-step process—governments raise money by issuing bonds, and the central banks boost the prices of those bonds by the money created out of thin air. The central bank may intend to reverse the price boost down the road. This money creation exercise also creates a temporary illusion of prosperity, a perfect device for getting re-elected when in power. In this case, it added fuel to the fire. The prosperity illusion, however, begins to fade. More money needs to be printed to kick the can down the road again. Eventually the problem gets too big to avoid, and the central bank can no longer reverse the price boost.

From 2003, and leading up to the crisis in 2007, the stick & carrot regime created an irresistible cycle of profit for the banks. The cycle began with unwarranted construction, followed by lending to the undeserving, who would then buy homes to keep the construction going, followed by the banks selling major portions of the risk to the Fannies, the Freddies, and anyone else who would buy it—and there were more of those when the illusion of prosperity was created, and finally, pocketing structuring fees for the CDOs so issued. The cycle took about a year from end to end. But at any given time, many such unfinished profit cycles would overlap. Thus when the bubble burst, the banks were left holding a lot of the risk.

Overinvestments in one sector of the economy must be painfully liquidated and the capital redeployed to restore equilibrium. The problem cannot be cured by simply looking the other way, or by propping up the sector overinvested in, with even more government handouts. In fact, the more the market is prevented from functioning normally, the longer it will take to cure the problem. The

cure is never costless either. The longer it is postponed, the more it will cost.

The unavoidable inference

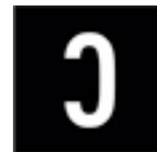
The U.S. Government, due to its desire to force its will on the market, was the primary culprit behind the large-scale mal-investment, and the consequential crisis that followed.

Why is this obvious truth hidden from the public?

As governments are in the business of getting re-elected, they and the economists in their lucrative employ, do not wish to acknowledge, sometimes even to themselves, their principal causative role in the boom and bust cycle.

In 1936, a mathematics lecturer by the name of John Maynard Keynes gave a vacuous scholarly credence to the notion that free markets do not work, and that governments, undoubtedly advised by utopian macroeconomists, must step in to 'fix' the market. This idea elevated the role of politicians, and opened the gates of fame and fortune to the macroeconomist government advisers. As Hunter Lewis amply demonstrates in *Where Keynes Went Wrong: And Why World Governments Keep Creating Inflation, Bubbles, and Busts,* this so-called treatise was mired in obfuscations, incorrect assumptions, and bad logic, but came replete with elegant and opaque prose, and equally elegant but dense and diversionary mathematical equations. With the publication of *The General Theory of Employment, Interest, and Money*, a quack was elevated to the level of a superstar.

Soon after, Keynes was duly anointed as the father of modern economics, and the science of money suffered so serious a setback that it has never recovered. With government control of curriculum in public and private education, hordes of future academics, newspaper columnists, elected officials, film & television producers, and even investment professionals and company presidents, have been trained to think in terms of the *avarice myth* ("markets left to themselves must necessarily reward avarice over conscientious work"), and the *fixed pie myth* ("wealth is never newly created, it is always taken by the powerful from the vulnerable").



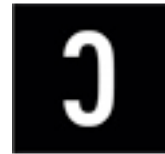
In historic times, monarchs did dilute gold money to cheat their subjects but at least the classical economists (Adam Smith, David Ricardo, and John Stuart Mill) never pandered to the monarchs by offering a scholarly cloak of respectability to this deceptive practice. Following the Keynesian era's extraordinary intellectual regression however, *fine-tuning the economy* by creating money out of thin air to stimulate the economy, and arbitrarily reversing this to *slow down the economy*, has been converted into a *pseudo-intellectual art form*. But in practice, the cumulative action over a decade or more in almost any part of the world is a savage level of net money printing, which results in an inflation tax that governments do not ever acknowledge as being entirely of their own making. Productivity has a natural tendency to get better and will rarely decline—thus prices should in general be reducing, yet endless inflation is now a world-wide phenomenon.

Where to, next?

Investment practitioners should not assume that market events are so unforeseeable that diversification across asset classes is the only rational avenue to pursue in an increasingly volatile world. It is befitting to try and understand the macro causes of why asset prices and economies as a whole are volatile, and why markets *appear* to fail. Modern finance theory does not illuminate the practitioner in this regard.

If classical and Austrian perspectives are correct, various world economies are headed for a severe downturn when the music stops for unrepayable levels of government debt. Keynesian solutions to print even more money and to recklessly divert capital to economically unprofitable election promises are dangerously in play in the U.S., the U.K., Japan, China, in some Eurozone economies, and in Australia.

Regulation of the finance sector has increased. Meanwhile, subsidies to the finance sector abound in terms of increasing government bond prices—through money printing for which the banks are the first beneficiaries, and prop-ups of the banks' severe illiquidity & outrageously low levels of capital via the central bank *lender of last resort* credit facilities. Yet these subsidies are not even reported by the mainstream media, much less fought against.



Vast numbers of politicians are untrained in Austrian or classical macroeconomics, and are ill-advised, often by advisers who are themselves similarly untrained. Thus, many who carry the courage of their convictions, could be taking ill-informed decisions, unaware of the deleterious longer-term effects of their policies.

There is no substitute for thinking, and a bit of quiet reflection. Read widely, ponder, and decide for yourself.

Here is a collection of readings that may help:

1. *Where Keynes Went Wrong: And Why World Governments Keep Creating Inflation, Bubbles, and Busts* by Hunter Lewis

2. *Meltdown: A Free-Market Look at Why the Stock Market Collapsed, the Economy Tanked, and Government Bailouts Will Make Things Worse* by Thomas E Woods

3. *Capitalism: The Unknown Ideal* by Ayn Rand

4. *Economics in One Lesson: The Shortest and Surest Way to Understand Basic Economics* by Henry Hazlitt

5. *The Government Against the Economy* by George Reisman

6. *How an Economy Grows and Why It Crashes* by Peter D Schiff and Andrew J Schiff

7. *The Frankenstein Candidate: A Woman Awakens to a Web of Deceit* by Vinay Kolhatkar

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