Montreal Economic Institute
Ideas for a More Prosperous Nation

ECONOMIC NOTE

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THE ORIGINS OF THE ECONOMIC CRISIS

Both the left and the right view the present economic crisis as a consequence of greed and a failure of capitalism. On the far left, for example, a spokesman for Britain's Socialist Workers Party talked about a "crisis of capitalism."[1] The Front National, a far-right French political party, makes the same diagnosis and defends "a powerful state as a regulator and a referee against international financial speculation."[2] Is it true that the current crisis represents a fundamental challenge for capitalism?

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In order to answer this question, we will review the origins of the crisis. Can they be traced to some unavoidable economic cycle, to bad market incentives, to mistaken monetary policies, to special characteristics of the American real estate market, or perhaps to regulation or deregulation of financial markets? Each of these potential factors will be examined in turn.

Bubbles and the business cycle

Capitalism – an economic system based on private property and free markets – seems to generate occasional bubbles and booms followed by crashes and recessions. This is called the business cycle. In the first two-thirds of the 19th century, there was one crash roughly every 10 years; in the last third of the century they occurred less frequently. The 20th century witnessed two minor crashes before the Great Depression of 1929-1933 and a few others since.[3]

Figure 1 follows quarterly changes in Canadian GDP (in constant 2000 dollars) from the second quarter of 1961 to the third quarter of 2008. Defining a recession as two consecutive quarters of negative growth, we observe three recessions: over the second and third quarters of 1980; from the third quarter of 1981 to the last quarter of 1982; and from the second quarter of 1990 to the first quarter of 1991.

The current crisis appears to be related to a bubble that started in the American residential market in the late 1990s. From the beginning of 2000 to the first quarter of 2006, home prices increased by 11% annually. Then the bubble burst and, by the third quarter of 2008, home prices had dropped by 21%.[4]

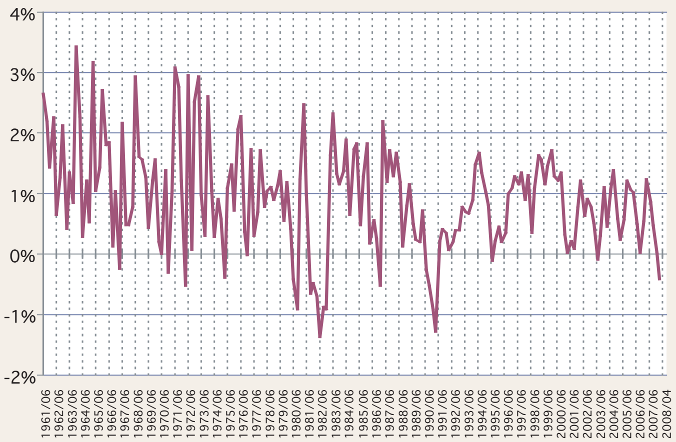
The business cycle is not a cause of concern in itself. It may be necessary for what economist Joseph Schumpeter (1883-1950) called "creative destruction" and, thus, for economic growth. Moreover, when a bubble builds in a market economy, market participants have incentives to find out and get out. As famous economist Harry Johnson (1923-1977) pointed out, for every destabilizing speculator, there must be a stabilizing one;[5] in other words, for every market participant who follows the herd and buys a piece of the bubble asset, there is another one who sells, thereby restraining the price increase.

A planned economy could perhaps have no such cycles, but it would also produce little growth and little prosperity. In fact, there is evidence that former Communist-bloc

1. Stephen Moss and Jon Henley, "What do opponents of capitalism make of the credit crunch?," *The Guardian*, September 17, 2008, http://www.guardian.co.uk/business/2008/sep/17/recession.labour.
2. Front National, "Les conséquences de la crise financière," News release, October 9, 2008, http://www.frontnational.com/communique_detail.php?id=1804.
3. Charles P. Kindleberger and Robert Aliber, *Manias, Panics, and Crashes*, John Wiley & Sons, 2005, p. 24 and *passim*.
4. According to the S&P/Case-Shiller Home Price Indices, http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/2,3,4,0,0,0,0,0,0,0,0,0,0,0,0,0.html.
5. Reported in Charles P. Kindleberger and Robert Aliber, *op. cit.*, footnote 3, p. 46.

Figure 1

Real GDP growth by quarter (annual rates) in Canada (1961-2008)



Source: Statistics Canada, CANSIM, Table 380-0002. For example, "1961/06" refers to 1961's second quarter (ending with the sixth month).

economies did suffer from business cycles.[6] Political and bureaucratic processes may very well amplify social and economic fads (that is, bubbles) instead of dampening them.

Innovation and incentives

Some analysts have argued that the current crisis can be traced to counterproductive innovations and incentives. Financial innovations like asset-backed securities,[7] complex derivatives (credit default swaps, for example)[8] and hedge funds (which make broad use of the latter) are blamed. One problem with this diagnosis is that sophisticated financial instruments have been in existence for a number of decades. As for hedge funds (with assets of US$1.9 trillion at the end of 2007), they did not start the crisis and have apparently not lost more value (-17.7%) than the stock market (-32.3% for the Dow Jones Industrial Average).[9]

As for self-interest and greed, they are present at all times in any social system, capitalist or socialist. Why would this universal feature of human nature be more problematic now? Certainly, greed can drift into fraud, but the large Wall Street fraud recently alleged was simply revealed by the crisis, not the source of it.

Some analysts trace perverse incentives to mark-to-market accounting rules, which forced corporations to mark down their asset values, contributing to contagion and economic meltdown. Such regulations are made under regulatory powers delegated by the state: in the U.S., it is the Financial Accounting Standards Board that exerts these delegated powers on behalf of the Securities and Exchange Commission (SEC). The main fault of this sort of top-down, non-contractual rule lies in its inflexibility to adapt to different or changing circumstances. The related perverse incentives are thus traceable more to regulation than to the market.

Monetary policy

At this point, one question must be asked: why do some crashes, instead of remaining shallow recessions like, say, the dotcom bust of 2000, become deeper recessions or depressions?

Destabilizing monetary policy provides one strand of explanation. Monetary policy (expansion or contraction of the money supply) can create or exacerbate booms and busts. For example, it is generally accepted that the crash of 1929 was turned into a depression in large part because the U.S. Federal Reserve (the American central bank, which had been created in 1913) reacted by reducing the money supply.[10]

Many economists argue that the recent housing bubble was fuelled by the Fed's increase in the money supply from 2000 through 2003, which led to short-term interest rates as low as 1% in 2003.[11] Based on the work of Ludwig von Mises (1881-1973) and Nobel laureate Friedrich Hayek (1899-1992), the so-called Austrian school of economics sees arbitrary increases in the money supply as the main cause of deep recessions. It is argued that a money-fuelled boom is artificial and must come to a halt at some time. Some of these economists forecasted the crash of the housing bubble.[12]

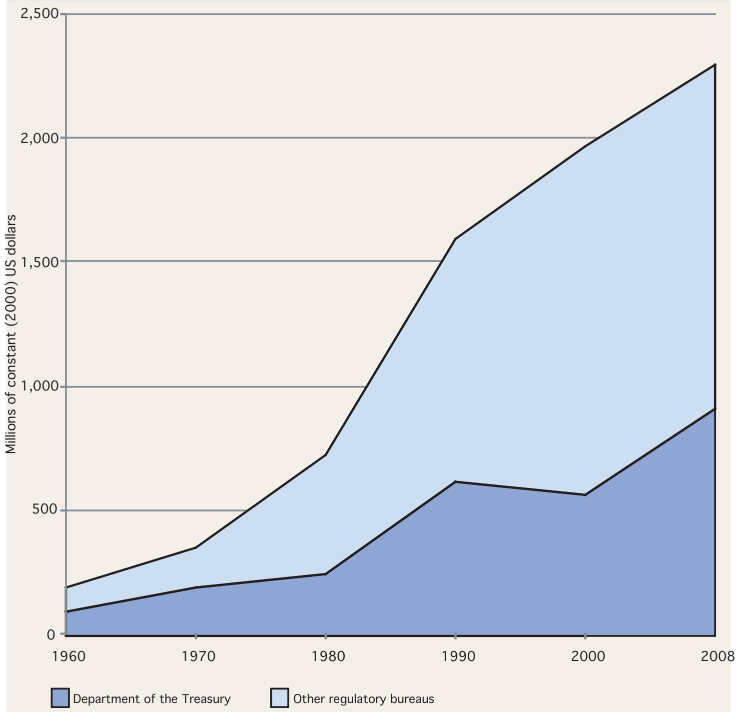
Dissenters from the money inflation bubble thesis note that, under Alan Greenspan's Fed, some measures of the money supply show slower growth after 2003.[13] Indeed, inflation rates

Political and bureaucratic processes may very well amplify social and economic fads (that is, bubbles) instead of dampening them.

6. Barry W. Ickes, "Do Socialist Countries Suffer a Common Business Cycle?," *Review of Economics and Statistics* 72-3 (August 1990), pp. 397-405.
7. John M. Quigley, "Compensation and Incentives in the Mortgage Business," *The Economists' Voice*, October 2008, http://www.bepress.com/ev/vol5/iss6/art2/. See also Luigi Zingales, "Plan B," *The Economists' Voice*, October 2008, http://www.bepress.com/ev/vol5/iss6/art4/.
8. G-20, *Declaration of the Summit on Financial Markets and the World Economy*, November 15, 2008, http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html.
9. For the first 11 months of 2008. See "Locked Away," *The Economist*, December 11, 2008; and Yahoo Finance for the DJIA data.
10. Milton Friedman and Anna Jacobson Schwartz, *The Great Contraction 1929-1933*, Princeton University Press, 2008.
11. See, for example, George A. Selgin, "Guilty as Charged," *Mises Daily*, November 7, 2008, http://mises.org/story/3200.
12. Mark Thornton, "Is the Housing Bubble Popping?," *LewRockwell.com*, August 8, 2005, www.lewrockwell.com/thornton/thornton27.html.
13. David R. Henderson and Jeffrey Rogers Hummel, "Greenspan's Monetary Policy in Retrospect," *Cato Institute Briefing Papers*, No. 109 (November 3, 2008), http://www.cato.org/pub_display.php?pub_id=9756.

FIGURE 2

Regulatory Expenditures on Finance and Banking
U.S. Federal Government*



* Regulatory bureaus in the Department of the Treasury: Comptroller of the Currency, FinCEN, Office of Thrift Supervision. Other bureaus that regulate finance and banking: Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Farm Credit Administration, Federal Housing Finance Board.
Source: Véronique de Rugy and Melinda Warren, *Regulatory Agency Spending Reaches New Height: An Analysis of the U.S. Budget for Fiscal Year 2008 and 2009*, Mercatus Center and Weidenbaum Center, August 2008.

have thus far remained low. Moreover, the housing bubble started before the large increases in the money supply. If mistaken monetary policy played a role in the present crisis, it was not necessarily the most important factor.

The American mortgage market

A basic fact should not be forgotten: the crisis began during the summer of 2007 in the American residential mortgage market. It should also be remembered that this market was encumbered by a large number of government interventions and distortions.[14]

A series of laws and regulations starting with the *Community Reinvesment Act* (CRA) of 1977 forced financial institutions to relax mortgage underwriting standards so as to fight alleged discrimination. In the 1990s, banks were threatened with sanctions if they did not maintain a good CRA rating, and were sometimes sued by the federal government. "Failure to comply with the Equal Credit Opportunity Act or Regulation B," warned a Boston Fed booklet about CRA mortgages to minority customers, "can subject a financial institution to civil liability for actual and punitive damages in individual or class actions."[15]

Subprime mortgages were thus offered to individuals with insufficient incomes, poor credit, and very low if not zero down payments. Countrywide Financial, the largest American mortgage lender, which was saved from bankruptcy by Bank of America in early 2008, was just one of the "ethical businesses" that lowered their underwriting mortgage standards to unrealistic levels. A 2002 Fannie Mae report hailed this as "mortgage innovation." Historically, subprime mortgages were foreclosed at 10 times the rate of prime mortgages. Adjustable-rate mortgages, which are especially enticing when property prices are rising, also contributed – and perhaps even more powerfully – to the crash.[16]

Why did American mortgage lenders not fear what would happen when house prices stopped increasing and payment defaults jumped? Because many did not keep the mortgages on their books as interest-bearing assets but, instead, packaged them into securities (asset-backed securities) sold to investors. The buyers of these securities considered them safe because the underlying mortgages benefited from explicit or implicit guarantees from the U.S. federal government.

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Two government-sponsored enterprises (GSEs), Fannie Mae, born in 1938, and Freddie Mac, created in 1970, played a crucial role in government guarantees of subprime mortgages. Starting in the 1990s, the Department of Housing and Urban Development directed the two GSEs to increase their mortgage financing to the poor. Just before the crisis started, the two GSEs owned or guaranteed about half of the residential mortgages in the United States.

These housing policies increased the proportion of homeowners among American households from 64% in the early 1990s to 69%

14. See Stan J. Liebowitz, "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown," *Independent Policy Report*, October 3, 2008, http://www.independent.org/publications/policy_reports/detail.asp?type=full&id=30. See also Lawrence H. White, "How Did We Get into This Financial Mess?," *Cato Institute Briefing Papers*, No. 110 (November 18, 2008), http://www.cato.org/pub_display.php?pub_id=9788.
15. Quoted in Liebowitz, *op. cit.*, footnote 14, p. 8.
16. *Id.*, pp. 18 and following.

in 2004. This contributed to the housing bubble that started in the late 1990s. Falling interest rates from 2000 to 2004 further fuelled the bubble. After house prices peaked in 2006 – partly because of the return of higher interest rates – the bubble crashed. Mortgage owners who had put in little cash found their mortgages worth more than their houses, and some simply walked away. The fact that, in certain states including California, mortgage lenders cannot seize assets other than the mortgaged house made "walking away" more enticing. The consequent decline in the value of mortgage loans and securities reverberated through the financial system.

Banking and financial deregulation

Is the financial crisis a consequence of deregulation in financial markets? There has been some deregulation, but it was essentially related to the abolition of the 1932 *Glass-Steagall Act* by a series of laws enacted between the 1980s and the late 1990s. This deregulation essentially permitted American banks to do what European banks had been allowed to do all along, like operating brokerage houses or opening branches anywhere in the country. As in Canada, this limited liberalization strengthened commercial banks.

Other pieces of legislation, however, increased the regulatory burdens of financial firms. For example, the *Federal Deposit Insurance Corporation (FDIC) Improvement Act* of 1991 and the *Federal Deposit Reform Act* of 2002 increased the powers and authority of the FDIC. Non-financial laws also created new obligations for banks and financial firms. The SEC has seen its powers continuously expanded over the years up to the 2002 *Sarbanes-Oxley Act*, which imposes costly governance requirements. Detailed accounting rules (like mark-to-market valuation) have been forced upon financial firms.

Since 1960, the U.S. federal government's regulatory expenditures on finance and banking have been multiplied by 12 in constant dollars.

Examples do not prove anything, and the evolution of finance and banking regulation must be measured more objectively. One way is to measure regulatory budgets, which should show positive correlation with changing levels or enforcement of regulation.

Figure 2 reproduces data compiled by two American think tanks, the Mercatus Center and the Weidenbaum Center. We see that, since 1960, regulatory expenditures on finance and banking have been multiplied by 12 in constant dollars. Even during the 1980s – the Reagan decade – total regulatory expenditures on finance and banking more than doubled in constant dollars.[17]

Before the 2008 economic crisis, banks operating in the U.S. had to comply with more than 80 laws and regulations.[18] As pointed out by Léon Courville, former chief operating officer of the National Bank of Canada, "the growth of financial intermediation in recent years is much less the result of liberalization than of new rules imposed on banks and other financial institutions."[19]

Conclusion

It seems that the current crisis is not traceable to lack of regulation. The markets where the troubles started were characterized by substantial government intervention. More generally, Stanford economist John B. Taylor concludes from his empirical analysis that "government actions and interventions [including monetary policy] caused, prolonged, and worsened the financial crisis".[20] Despite conventional wisdom, the turmoil points more to government failure than to market failure.[21]

17. Véronique de Rugy and Melinda Warren, *Regulatory Agency Spending Reaches New Height: An Analysis of the U.S. Budget for Fiscal Year 2008 and 2009*, Mercatus Center and Weidenbaum Center, August 2008, http://mercatus.org/PDFDownload.aspx?contentID=20574.
18. See Banker's Academy, *Banking Regulations*, http://www.bankersacademy.com/bankingregs.php.
19. Léon Courville, "Socialized Risk," *Financial Post*, October 17, 2008.
20. John B. Taylor, *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong*, November 2008, www.stanford.edu/~johntayl/FCPR.pdf.
21. On government failure, see Pierre Lemieux, *Comprendre l'économie: ou comment les économistes pensent*, Belles Lettres, 2008, Chapters 18 and 19.

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