The Real Six Causes of the Recession

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In the eyes of many, the current recession represents a major failure of capitalism and competitive markets. However, these observers have dramatically misunderstood matters. In fact, the recession is the result of a variety of government interventions into markets, all done in the name of limiting capitalism. Below I present the *real* causes of the current recession.

1. The U.S. Federal Reserve System

The Fed's expansion of the money supply during the last decade caused interest rates to be much too low, to the point of being negative when accounting for inflation. These low interest rates provided the funds for the borrowing binge that fueled the dramatic increase in housing prices and the variety of fancy financial instruments that were built on top of those rising prices. Without the Fed financing it, the housing bubble and the financial instruments it gave birth to would never have happened, sparing us the bursting of the bubble and the ensuing recession.

2. Fannie Mae and Freddie Mac

The U.S. government imposed a variety of other institutions and policies that encouraged the lending binge that led to the recession. Fannie and Freddie are not products of "capitalism;" they are organizations created by the U.S. government, which has given them special privileges as well as an implicit taxpayer guarantee. Fannie and Freddie were mandated to purchase a certain percentage of the mortgages that banks originated with the credit created by the Fed, giving mortgage lenders every incentive to keep on making loans, even if the borrowers didn't meet traditional lending criteria.

3. Affordable housing policy

Not only were these "government-sponsored entities" given special privileges, they were also directed to ensure that a certain percentage of the mortgages they bought were given to poorer households. At least half of the mortgages they held had to come from borrowers below the median household income in the U.S. Freddie and Fannie's government mandate to buy up mortgages to lower-income households further fueled easy mortgage terms and increased the demand for, and price of, housing. It is worth noting that the very policy designed to make homes "affordable" to poorer households had the unsurprising effect of driving up housing prices to heights never seen before.

4. Tax policy

In the 1990s, the U.S. government stopped taxing the capital gains on home sales (for most homes). The result was that real estate became more attractive than other forms of investment, providing another reason that housing prices were driven extremely high and that people created the risky financial derivatives based on those prices. In addition, the international Basle tax rules made it artificially profitable for banks to originate a mortgage, sell it to an organization like Fannie Mae, and then buy it back as part of package of mortgages in fancy instrument. This was not capitalism at work, but failed government policy.

5. The "Greenspan Doctrine"

In the late 1990s, former Fed chair Alan Greenspan announced that the Fed could do nothing to stop asset bubbles, like that in the housing market, but would always be prepared to soften the blow when they burst. This policy removed much of the risk of failure facing the financial industry, so when housing prices began to take off, the industry assumed that if those prices ever collapsed, they would be rescued. They thus felt safe taking all kinds of risks over the last few years and their expectation of a bailout turned out to be largely correct. The costs to the economy and the average citizen, however, were enormous.

6. The ratings agency cartel

Even though the big financial firms were creating new instruments that were based largely on junky mortgages, those instruments were still being rated highly by the various securities ratings agencies. This was also not a failure of markets because those agencies were not truly competitive, but the product of a government created cartel that gave the big three firms the exclusive right to rate these kinds of securities. To no one's surprise, they began to rate the way the sellers wanted them to, if only because the big financial firms said they'd take their business to one of the other two if they didn't get the rating they wanted. With no possibility of a new firm entering in to truly serve consumers, this government-created cartel subverted the normal operation of markets and allowed junk securities to be passed off as highly-rated investments.

What all six of these causes share is that each is a way in which the U.S. government intervened into the market. These attempts to improve upon markets created the housing bubble and the recession that resulted when it burst. This was not a failure of markets or capitalism, but the very predictable failure of government policies attempting to prevent markets from working. If we want to avoid recessions, we need to let markets work and stop thinking we are smart enough to improve upon them.