# Assessing the Financial Market Damage

*George Melloan*

If there is a role for the government to play in restoring financial harmony it would have to be quite the opposite from the role Washington has played over the last decade, which has produced financial chaos. But the chances at this point that Washington will reverse its past practices and quietly withdraw to the sidelines so that the markets can make necessary corrections are quite slim, or, more precisely, non-existent. It is the nature of governments to first interfere with market forces and then make the problem worse by addressing the resulting confusions and dislocations by interfering still more.

## Government Intervention and Financial Chaos

The relevant interference began over a decade ago when Congress and the Clinton administration began forcing banks to make highly risky loans to advance home ownership for Americans whose ability to afford homes and pay off mortgages was marginal, Two government sponsored lending and loan guarantee enterprises, Fannie Mae and Freddie Mac, became a receptacle for most of these dubious loans and folded them into mortgage-backed securities of equally dubious quality.

---

*Cato Journal*, Vol. 30, No. 2 (Spring/Summer 2010). 

George Melloan is the author of *The Great Money Binge: Spending Our Way to Socialism* (2009). He was a deputy editor and author of the weekly "Global View" column at the *Wall Street Journal* before his retirement in 2006. He continues to write occasional articles for the *Journal*.

The credit bubble created by the Federal Reserve Board in 2003–04 provided an environment for further irresponsible lending on a massive scale. Eventually it all came crashing down with a freeze-up in the $7.6 trillion mortgage-backed securities market that left several large players like Lehman Brothers and Bear Stearns insolvent.

The government's response was to double down with a massive bailout of the banking industry and a conversion of the Federal Reserve System from a mere central bank into a putative economic life support apparatus. The federal government took effective control of the vast Citicorp and acquired varying levels of influence over most other large financial institutions by virtue of the $700 billion Troubled Assets Relief Program (TARP). Fannie and Freddie were put into conservatorship in August 2008, which means that they are now effectively nationalized and their losses have been transferred to the taxpayers. There will be more losses to come and don't expect these institutions to be liquidated under the present regime in Washington.

By some estimates, these actions put about 90 percent of home mortgages outstanding either directly or indirectly into the hands of the government, a circumstance altered only somewhat when some banks in 2009 paid off their TARP loans and gained at least a measure of freedom from government control. The Federal Reserve acquired over a trillion dollars worth of tainted mortgage-backed securities. Billions of dollars of other types of assets new to its books were added by its bailouts of the AIG insurance colossus, issuers of commercial paper, and other distressed entities. After all this, it was no longer even a quasi-independent body as was envisioned when it was founded in 1913. It was now simply another arm of the state. The Fed and the Treasury, acting together, now exercise control over the financial sector to a degree unprecedented in history.

Meanwhile, the Democratic Congress and the Obama administration after assuming power in 2009 began piling up federal budget deficits to a degree heretofore unknown, even in terms of the cash flow accounting that makes no allowance for contingent liabilities like Medicare or off-budget agencies. The U.S. government's future obligations are estimated by economist John Williams, who runs a blog called "Shadow Government Statistics," at $75 trillion, more than six times the nation's total production of goods and services. Some estimates go even higher, to as much as $100 trillion. The only answer the Fed has had for this vast spasm of profligacy was to keep printing more and more greenbacks, thereby courting ruinous inflation, or at best, paralyzing stagflation.

The government is not going to get out of the financial sector. It is in fact digging itself in deeper and deeper. Our best hope is that, now that the Fed and Treasury are piloting the craft, they will find some way to avoid a crash. I'm not very optimistic about that prospect. Fed Chairman Ben Bernanke and Treasury Secretary Timothy Geithner are trying to micromanage what economists and engineers refer to as a complex system. I doubt that these two or anyone else, no matter how bright, are up to the task of managing anything as complex as the U.S. financial system without bending it so far out of shape that it no longer serves its basic function of financing private sector economic growth. When it ceases to do that we have socialism and all the stagnation that implies.

## The Fed's Expanding Role

Let's look at the Fed. Over the last 18 months, its economic role has been revolutionized. As professor James Hamilton of the University of California at San Diego wrote in his "Econbrowser" blog on March 29, 2009,

> The new Fed balance sheet represents a fundamental transformation of the role of the central bank. The whole idea behind open market operations is to make the process of creating new money completely separate from the decision of who receives any fiscal transfers. In a traditional open market operation, the Fed buys or sells an existing Treasury obligation for the same price anyone else would pay for the security. As a result, the operation itself does not involve any net transfer of wealth between the Fed and the private sector. The philosophy is that the Fed should base its decisions on economy-wide conditions, and leave it entirely up to the market or fiscal authorities to determine where those funds get allocated.
>
> The philosophy behind the pullulating new Fed facilities is precisely the opposite of that traditional concept. The whole purpose of these facilities is to redirect capital to specific perceived priorities. I am uncomfortable on a general level with the suggestion that unelected Fed officials are better able to make such decisions than private investors who

> put their own capital where they think it will earn the highest reward.

Let me enlarge a bit on Professor Hamilton's point. As economist Ann Lee suggested in a *Wall Street Journal* op-ed on October 15, 2009, what the Fed and Treasury have created is a machine for financing government deficits at the expense of the private economy, in particular the small- and medium-sized businesses that generate most of the nation's jobs. A spendthrift Congress running a $1.4 trillion deficit, not counting the billions of off-budget losses, guarantees, and future obligations, is getting cheap financing from the banks because of the pressure from the Fed on its roughly 7,000 member banks to minimize risk. The banks can borrow in the Fed funds market for practically nothing and buy Treasuries, officially designated as risk-free, at 3 percent or more. Why should they take the risks of lending to private business when they can earn 3 percent at no risk and satisfy their regulators? Keep in mind that under the Basel international risk-based capital rules, Treasuries are considered risk-free and thus require no capital backing.

As a result, the government grows and the private sector starves. Is this any way to run a financial system? Well, it seems to be the way when the Fed and the Treasury collude in that endeavor as they work their will on private sector banks.

As for picking winners, look what the Fed has on its own balance sheet. It has a trillion dollars or more in mortgage-backed securities acquired mainly to keep Fannie and Freddie afloat and hold down mortgage rates. The Fed does not list maturity dates for this paper so it can be presumed that the Fed plans to hold it a while. It has over $100 billion in other federal agency debt, which means that it is not only a big supplier of credit to the U.S. Treasury, reflected by the more than $700 billion of Treasury securities it holds, but a supplier of credit to off-budget federal agencies as well, primarily those agencies that are housing related.

Then of course there are the various "Maiden Lane" tranches, which among other things have funneled credit to AIG so that it could make good on its securities guarantees to Goldman Sachs and other counterparties. It has made loans to keep the commercial credit and money fund industries afloat. These add up to another $100 billion or so.

There is not much in this mix for Joe the plumber, who employs 30 people and is one of the millions of private entrepreneurs who in normal times keep the U.S. economy humming. Economist David Malpass has pointed out that as banks cut back on their private lending to meet risk-based capital requirements, small private businesses suffer the most. According to Malpass (2009: 2), "The current mark-to-market process as applied to regulatory capital, plus the risk of FASB [the Financial Accounting Standards Board] making it more strict, encourages banks to build their government and government-backed corporate holdings and reduce small business loans."

A Fed chart cited by Malpass shows that in the second quarter of 2009 nonfarm, noncorporate debt outstanding actually shrank from a year earlier. This category best reflects small business. By contrast, U.S. government debt grew by 35.9 percent and state debt by 4.1 percent.

## The Perverse Incentive Structure

To be sure, the huge expansion of the Fed's balance sheet that results from agency debt and its massive purchases of mortgage-backed securities was an improvisation to deal with the financial crisis. The Fed and Treasury were under a rather considerable obligation to clean up the mess that federal policies had made in the first place, the mess that had its origins in the federal requirements during the Clinton administration that banks make sub-prime loans. The banks accepted that demand in part because the Clinton Justice Department was exerting pressure and partly because the administration provided a means for banks to get rid of their risky paper. They could sell it to Fannie and Freddie, who responded readily to the missions cooked up for them by the White House and their "regulators" at the Department of Housing and Urban Development. Fannie and Freddie didn't mind acquiring bad paper because they could bundle mortgages, good and bad, and sell them worldwide as mortgage-backed securities with AAA ratings generously supplied by the three federally approved bond-rating firms—Fitch, Standard & Poor's, and Moody's. The business thrived, putting it mildly, particularly when the Fed forgot to turn off the money-supply spigot in 2003 and pumped up a credit bubble that doubled the nation's total borrowing in the space of a few years.

What we have today is government managed credit. Ben Bernanke said in the spring of 2009 that the Fed was trying to manage its balance sheet in a way that would avoid credit risk and credit allocation. From all indications, it hasn't succeeded very well, particularly in avoiding credit allocation.

## Restoring Financial Harmony

How do we restore harmony? We can only restore harmony when the American people come to realize what a hash the current Congress has made of things and elects a Congress that will take seriously the parlous state of the country's finances. The first priority will be to get the government's budget under control. The first place to start will be to forego any further stimulus packages, since the more than a trillion dollars in "stimulus" Congress has voted in the last two years have stimulated nothing and probably has been counter-productive because of the crowding out of private investment I described above.

It may be too late to advise that no more big spending programs be added to the ones that already are piling up trillions in federal deficits. Medicare and Medicaid need to be reformed in an intelligent way, as opposed to the most recent approach involving a total and highly costly reordering of the entire health care system. The cap-and-trade bill that passed the House was advertised as a way of reducing the risk of "global warming" by reducing industrial emissions of carbon dioxide. If enacted, it would not only be costly to consumers, but would have been based on the false premise that somehow a government measure can alter the earth's climate, a totally preposterous assumption on the face of it. There hasn't been any global warming on balance for a decade and even if there had been Congress would have to be able to control sunspot activity to make a difference. I don't think even Al Gore is capable of that.

Fannie and Freddie should be liquidated so that they will no longer be a drain on the public fisc. That would require an end to mortgage modification to reduce payments for over-borrowed householders. But this was a gross abuse of private contracts and at any rate has been largely ineffective in mitigating the economic damage of mortgage loan foreclosures. The Fed should clean up its balance sheet, if that is possible at this juncture, and return to its more limited task of trying to restore and maintain the soundness of the dollar.

What role for the market? Don't worry about the market. It always works, one way or the other. It works under free-market capitalism and it works under socialism. The only difference is that in the first case it yields economic growth and prosperity and in the second it yields perverse incentives and stagnation. We have been choosing the latter over the last year, but I still have hope that the country can change course before it is too late.

## References

Hamilton, J. (2009) "Econbrowser." Available at www. econbrowser.com (29 March).

Lee, A. (2009) "The Banking System Is Still Broken." *Wall Street Journal* (15 October).

Malpass, D. (2009) "Drain on Small Businesses from Banks, Credit Markets and Regulators." *Encima Global Report* (15 October).

Melloan, G. (2009) *The Great Money Binge: Spending Our Way to Socialism.* New York: Simon and Schuster.

Williams, J. (2009) "Shadow Government Statistics." Available at www.shadowstats.com.