

November 10, 2009
Real Estate Lenders Association

The Morning After
by Daniel Rose

The financial and economic trauma of 2008-9 challenges us to ask: where have we been, where are we now and where are we going?

Pundits who in 2007 didn't have a clue about what we faced now write authoritatively of its causes; learned journals debate the future of capitalism; and public confidence in short-term and mid-term economic forecasts ranks below confidence in weather forecasts. Most distressing, there has been little informed and thoughtful discussion of what precautions we should take to diminish the prospects of such upheavals from occurring again and again; and the foxes may remain in charge of the hen house.

Many turn to economic icons for insights. John Maynard Keynes, Milton Friedman and Joseph Schumpeter were smarter than their disciples realize, however; Keynes was not a Socialist, Friedman was not an anti-government anarchist and Schumpeter knew that not all business destruction is necessarily creative. Significantly, each would have been horrified to see how our Generally Accepted Accounting Principles (GAAP) have today become Creatively Realigned Accounting Principles (CRAP)!

Home mortgages given to borrowers with no down payment and income insufficient to cover debt service; Triple A bond ratings given to securities of dubious value; 30 to 1 leveraged loans given to shaky borrowers; derivative packages and credit default swaps so opaque that even George Soros and Warren Buffett said they

didn't understand them—all would have been decried, without reference to profound economic theories.

The economic nightmare we are going through represents a failure not of capitalism but of capitalists and their enablers. The colossal short-sightedness of our financial system's referees and scorekeepers—the Federal Reserve, the Treasury and the S.E.C.—has permitted shrewd gamblers to manipulate the system to their benefit and everyone else's loss; and now we are left with the wreckage.

The savings glut in emerging economies, the U.S. Federal Reserve's prolonged easy money policy in the early 2000's and Washington's anti-regulatory climate set the stage for increased leverage and for asset bubbles that were bound to burst. Political pressure on Fannie Mae and Freddie Mac—and the all but criminal failure of rating agencies to assess risk properly—combined to bring the international financial system to its knees, and, in 2008, to cost U.S. households some \$11 trillion—18% of their wealth.

Our vibrant, dynamic free market economy has taken a savage and unnecessary pounding, and much pain will be endured before we regain healthy long-term growth.

The housing crisis seems to be easing somewhat today, although nearly three million home mortgages are in payment default and an estimated 15 million U.S. homes are worth less than their mortgages. Diminished new construction, normal population growth and a drop of 30% so far in nationwide housing prices since their peak in May 2006 will in due course bring housing markets back to equilibrium.

But a fearful storm in commercial real estate still looms, and the

federal government and the financial world seem in a state of nervous wishful-thinking.

Deutsche Bank estimates at \$1.7 trillion the total value of short-term commercial loans on banks' books (some 25% of the assets of the average institution), and Deutsche Bank analysts estimate that as many as three quarters of the loans taken out in 2007 ("the most toxic vintage") will have trouble rolling over. Others place at \$1.4 trillion commercial real estate loans falling due between now and 2012 with uncertain prospects of renewal. The Federal Reserve believes that banks are grossly under-reserved for these loans, at 38 cents on the dollar.

Commercial foreclosures are being avoided. "Extend and Pretend" or "Delay and Pray" is the governmental/banking response, with new accounting rules and low interest rates fueling hopes that maybe, maybe, time will permit some alchemy to "transform baser metal into gold." In the meantime, no one knows what this means about the health of the banking system.

Giving solvent but hard-pressed borrowers elbow room is one thing, keeping "zombies" standing is another; and a distinction should be drawn.

Today, while federal authorities deserve high praise for working energetically to prevent a financial Crash from turning into another Great Depression, unemployment is over 10% and going higher, frightened consumers are increasing their savings and curtailing unnecessary purchases, government (federal, state and municipal) is running staggering deficits that must be faced eventually, and our fragile banking system is unable or unwilling to provide the liquidity our economy needs.

The current “jobless recovery”—fueled by massive government spending on “cash for clunkers,” tax credits for home buyers, expanded unemployment benefits, etc.—is dependent on such stimuli and may peter out as those diminish. And no one knows to what extent newly-replenished inventories will find retail purchasers.

Governmental authorities are caught between the Scylla and Charybdis of short-term fear of destructive deflation and long-term disastrous inflation. We will undoubtedly muddle through, with a “best case” being continuing high unemployment, low growth and some painful dislocation for a few years, or we may face a “worst case” that our experts prefer not to consider.

The dynamism, creativity and entrepreneurial exuberance that stoke capitalism’s powerful engines for growth tend to reinforce each other to speculative excess. Economic stagnation, on the other hand, results from excessive efforts to dampen those necessary “animal spirits.” Others feel that a proper balance between savings, investment, production and consumption is the key to economic health, and that Adam Smith’s “invisible hand” needs occasional outside guidance.

In any case, the capitalistic goose that lays our golden eggs must be kept healthy and safe. “Systemic risk” was not lessened by the Federal Reserve’s mandate to use monetary policy to maintain stable prices and full employment. The S.E.C., like Claude Rains in the old film *Casablanca*, was “shocked, absolutely shocked” to find forbidden gambling going on under their noses. The F.D.I.C. was oblivious to conditions in the banking world, and the Treasury Department just helped everyone to “do their thing.”

The crucial question is what steps we can take to permit us to

benefit from a free market economy's vigor yet not be burned by its excesses; the outlook is not clear. The financial services industry's powerful lobbyists, the strongest in Washington, seem poised to stymie efforts that deal with causes of crises rather than symptoms. Memories in Washington are short, and "business as usual" is likely to be the order of the day.

In the immediate future, we must revive the economy; in the intermediate future, we must return to balanced budgets and then "grow" our way out of the huge debts we are accruing; and in the longer future we must preclude such debacles from occurring repeatedly.

What should be done, and by whom?

- 1) "Too big to fail" is a problem that must be faced. Both explicit and implied government guarantees justify reasonable regulation, transparency, substantial capital reserves, modest leverage, and fair compensation practices (such as "claw backs") to a greater degree than in the past; and, for those who do not want such guarantees, orderly bankruptcy proceedings must be accepted and anticipated as capitalism's answer to incompetent management or bad luck.
- 2) Since the purpose of government regulation is to protect the saving and investing public and the productive business sector, and not to protect financial wheeler-dealers, we must rethink the distinction between savings institutions and gambling houses. Glass-Steagall, where were you when we needed you? Consumer protection groups, wake up!

- 3) The demagogues who promoted sub-prime mortgages cynically invoked the American Dream of home ownership, when they really meant the American Dream of “getting rich quick,” which usually doesn’t work. Renting rather than home-ownership is appropriate for many families, and this must be acknowledged frankly. A 60% rate of home ownership seems to be stable, a 70% rate seems unsustainable.
- 4) The multi-trillion dollar derivatives and credit default swaps industry must be subject to transparency requirements and reasonable regulation. Opaque markets lead to abuse of investors and to insider hanky-panky.
- 5) The “naked short selling” (selling shares one hasn’t borrowed) that destroyed Bear Stearns and Lehman Bros. should be prohibited. “Exchange Traded Funds” and “Dollar Carry Trades,” whose bursting bubbles can be widely destructive, require greater transparency and reasonable regulation.
- 6) Some form of continuing responsibility by the issuers of securitized debt (for the protection of purchasers and to dampen the fee-induced issuance of junk) must be considered.
- 7) Financial services industry compensation and bonuses should relate to long-term, not short-term results (and that, ideally, should be true of U.S. business generally).
- 8) The abject failure of the securities rating institutions must be acknowledged and dealt with. “Let the buyer beware” is not good enough for the 21st century.

9) The Prompt Corrective Action law, which called on the FDIC to rate banks with regard to the level of capitalization and which empowered the FDIC to intervene forcefully with “Critically Under Capitalized Banks,” should be reinstated.

Finally, and most important:

10) We must decide which vehicle or vehicles are to be entrusted with the oversight of systemic risk to the entire financial system and its major components. The ancient Romans loved the phrase “Who shall guard the guardians?” The question remains today, and the answer may be “more than one.” A central bank independent of short-term political pressure is “necessary” but it might not be “sufficient.”

Can our governmental figures stop acting like politicians and start acting like statesmen? Can the financial services industry adjust its incentives to encourage constructive rather than destructive actions? Above all, can the American public, obsessed with rights rather than responsibilities and entitlements rather than obligations, accept a revised tax system that encourages increased savings, investment and production and moderately less personal consumption, with more emphasis on public goods over private, and more long-term thinking rather than short-term?

Furthermore, can we reduce oil consumption, get more value from health care spending, and end electoral gerrymandering so as to strengthen “the vital center” and to reduce the power of ideologues from the left or right? Finally, can we face frankly our unfunded obligations of Social Security and Medicare which now are into the many trillions of dollars?

The future of America depends on our answers.

(Talks by Daniel Rose may be found on www.danielrose.org)