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The Causes of and Response to the Financial Panic of 2008: A Cautionary Tale

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Introduction: Don't Panic about the Panic

Perhaps no financial event of the past half century has so puzzled people as the mortgage and financial market collapse of 2008. Not only members of Congress, but the also the Chair of the Federal Reserve and the Secretary of the Treasury have seemed as lost as the general public in the face of a panic that apparently threatened to consume the whole of America's financial sector and plunge the nation into a second Great Depression. So I do not claim here that what follows is a complete and perfect explanation. As the economist Tyler Cowen has written about this crisis, "beware of anyone pretending to offer you simple answers."[1] But what I can do is explain at least a few of its causes—because no single factor caused it—that can provide some insight into how government ought to respond and, more importantly, what we can do to prevent a similar crisis in the future. The financial crisis of 2008 was far from the first economic crisis to hit the United States. Such "panics," as they used to be called, occurred in 1819, 1837, 1857, 1873, 1893, 1907, and 1929. The last one, the panic of 1929 that turned into the Great Depression, was the longest and also the one with the most intensive government intervention. Its length and severity is commonly used to justify the government's subsequent intervention. It is probable, however, that the common wisdom has reversed cause and effect, and that, in reality, it was the over-active government intervention along with bad monetary policy that deterred economic investment for most of the 1930s, , turning an otherwise normal financial panic into a the worst decade in the country's history. [2] But America has recovered so strongly from each of these economic setbacks that today the country's real gross domestic product per capita is five times what it was in 1929. That is, averaged across the country's entire population, the United States is five times wealthier today than it was before the Great Depression. This strongly suggests that while the short-term situation may be difficult, there is little reason to panic over the long-term future, and that the government's most important task is to smooth the pain of the current recession without causing it to last longer than necessary.

It is precisely because we do *not* want to make matters worse and because the current crisis is so poorly understood that we should be wary of the call to act quickly. The critical question is whether the crisis is a consequence of a market failure or a government failure. Failure to understand which one it is—or which combination of the two—will only lead to poorly designed policies that will exacerbate our economic problems even further. Those who believe it was primarily a market failure blame the greed of financial speculators operating in an unregulated market. For example, corporate critic Ralph Nader claims "It is corporate greed … It was a spree, and they … went over the brink."[3]

But greed is a poor explanation because it is *always* present in the market, while financial crises happen only occasionally. As an explanation, greed fails to explain why markets work so well so much of the time, and why even in the current crisis it was primarily the mortgage financing sector that imploded. It is foolish to argue that greed only existed in the mortgage market, especially as greed or, less pejoratively, self-interest is the fundamental factor that makes markets work at all. As Adam Smith famously pointed out "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest."[4] Additionally, this financial collapse did not, contrary to popular wisdom, happen in a completely unregulated market.

To call the housing and credit crisis a failure of the free market or the product of unregulated greed is to overlook the myriad government regulations, policies, and political pronouncements that have both reduced the "freedom" of this market and channeled self-interest in ways that have produced disastrous consequences, both intended and un-intended.[5]

The financial crisis was, in fact, primarily a government-caused failure. My goal here is to show exactly how a set of well-intended "regulations, policies, and political pronouncements" interacted to "channel self-interest" in a way that at first led to a housing boom, then to a housing bust with a mortgage crisis, and ultimately to a financial crisis. With a new administration taking office, one that is enamored of the "Camelot" idea that government can solve our problems if we just put the right people and policies in place, it is more imperative than ever that we recognize that rather than being a simple solution, government policy was in fact a primary cause of this problem.

Government Failure I: How Government Policies Interacted to Create a Housing Boom

At least three separate government policies were involved in creating the housing boom that formed the structural framework for this crisis: (1) the Federal Reserve's (the "Fed") easy money policy in the early 2000s, (2) President Clinton's reduction of capital gains taxes on home sales, and (3) the Fed's pressure on mortgage firms to lend to

low-income homebuyers. Probably no one of these alone would have caused serious trouble, but in combination they reinforced each other and created an unsustainable housing bubble.

Policy 1: The Fed's Easy Money Policy from 2002-04

The Fed, as America's central bank, determines how much money will be available in the national economy. When the economy slows, the Fed pumps in more money to boost economic growth by making borrowing less expensive; when the economy grows too quickly, the Fed pulls money out to prevent it from overheating. The Fed has several tools for doing this, but the one most visible to the public is its adjustments of the discount rate (the interest rate banks pay on the money they borrow from the Fed). Increasing the discount rate makes borrowing more costly; decreasing it makes borrowing cheaper.

Following the post-9/11 economic slump, the Fed reduced interest rates to as low as 1.25% in late 2001 to help boost the economy. Although the economy was growing strongly again[6] by the second quarter of 2003, the discount rate remained low, averaging 3.1% from mid-2003 to mid-2005. In contrast, the discount rate during the 1990s averaged 4.9%. According to Stanford economist John Taylor

> *… the [Fed's] actual interest rate decisions fell well below what historical experience would suggest policy should be … There was no greater or more persistent deviation of actual Fed policy since the turbulent days of the 1970s. So there is clearly evidence that there were monetary excesses during the period leading up to the housing boom.*[7]

The Fed was not simply being careless. Although the economy was growing again, the recovery was accom-panied by great gains in productivity, resulting in what many called a "jobless recovery."[8] The low interest rates were implemented to spur more economic growth and put more people back to work.

The problem with pumping too much money into the economy is that it is likely to lead to inflation, which simply means that too much money is chasing too few goods and services. If the economy's productivity grows at a slower rate than the money supply, not enough additional goods and services would be produced to soak up the extra money. Therefore, prices would increase as consumers compete for those comparatively scarce goods and services. Federal Reserve Chair Alan Greenspan was a perpetual inflation fighter, so if inflation had clearly resulted, he would most likely have raised interest rates. But inflation as a whole was low during that time period (most likely due to that strong productivity growth, which kept product-ion costs low).

However, one sector of the economy—housing did show strong inflationary price pressures. Although the general inflation rate in 2004 was only 3.4%, home prices increased by 12.5% that year, and the increase in the third quarter of 2004 "surpassed any increase in over 25 years."[9] A historical comparison is helpful: From 1992-96, the average quarterly increase in home prices was 3.1%, while from 2002 through 2004 the average quarterly increase was 8.8%.[10] The housing boom, in short, was primarily an inflationary spiral in the housing market.

Clearly, inflation was at work in the housing market. But this just begs the question of why that particular sector was inflationary during this period. The next two government policies explain how and why this easy money policy was translated into a housing boom.

Policy 2: President Clinton's Reduction of Capital Gains Tax on Home Sales

One of President Clinton's successful legislative efforts was the elimination of capital gains taxes on home sales for the first $250,000 for a single person, or $500,000 for a couple, provided that they had lived in it for at least two years. The goal was to pro-tect homeowners who, through no fault of their own, found themselves living in a home that had dramatically escalated in value and who would take a large capital gains tax hit if they decided to sell it. But any time government policies change the rate of return on an investment they also change the investors' strategies. In this case, this change had the unintended effect of making short-term home purchases a particularly good investment, because unlike just about any other investment, one could get up to $250,000 or even $500,000 with no capital gains tax. Nobel Prize-winning economist Vernon Smith credits the capital gains reduction with…

> *fueling the mother of all housing bubbles … enabling so many of us [to buy] second or third homes, and homes before con-struction began, which we then sold to some-one else who dreamed of riches from owning homes long enough to sell to another fool.*[11]

Undoubtedly such investment began in the late 1990s. The Fed's easy money policy in the early 2000s, however, made the strategy even more attractive. Lower interest rates increased the real return on housing invest-ments because investors paid out less interest before sell-ing. They also brought more people into the housing market, resulting in greater competition for homes and pushing up the prices so that investors gained even more when they sold. It was not uncommon in the boom's heyday for homes to sell for more than the asking price.

Policy 3: The Federal Reserve's Pressure on Mortgage Firms to Lend to Low-Income Homebuyers

For many decades the American government has actively promoted home ownership through such federal policies as the mort-gage interest deduction on federal taxes and the creation of the Federal Home Loan Mortgage Consolidation Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae). In the words of President George W. Bush "I believe when somebody owns their own home, they're realizing the American Dream … The goal is, everybody who wants to own a home has got a shot at doing so."[12]

But not everyone who wanted to own a home qualified for a home loan, and because income is still strongly correlated with ethnicity in this country, members of minority groups were most likely to fail to qualify. This led the Fed's Boston branch to publish "Closing the Gap: A Guide to Equal Opportunity Lending," which says in part

Lending bias is in-separable from the broader issue of race in our society … Unintentional discrim-ination may be observed when a lender's underwriting policies contain arbitrary or outdated criteria that effectively disqualify many urban or lower-income minority applicants. [13]

The "arbitrary or outdated criteria" included the applicants' ability to make down payments, their credit and employment history, their sources of income, and their ratio of debt to income. In addition to encouraging lenders to be flexible with such applicants, the booklet contained a subtle threat under a "Did You Know?" sidebar:

Failure to comply with the Equal Credit Opportunity Act or Regulation B can subject your financial institution to civil liability for actual and punitive damages in individual or class actions.*[14]

Many financial institutions took these admonishments to heart (undoubtedly helped by the Fed's easy money policy and the inflationary spiral of home prices) and created or expanded the use of such unconventional mortgages as zero-down payment loans, interest-only loans, loans with higher interest rates, and adjustable rate mortgages.

Of these, the adjustable rate mortgage (ARM) is the most significant. An ARM begins with a low interest rate that, at some specified future date, resets to a higher rate. The two common types are the 3/27, a 30-year mortgage that has the lower rate for the first three years and the higher rate for the remaining 27 years, and the 2/28, which has the lower rate for only the first two years. The lower interest rate makes it possible for low-income borrowers to make their monthly payments; however, because they have a higher probability of default than do prime borrowers, mortgage holders need a higher interest rate to cover their risk. The purpose of the interest rate increase is to force mortgage holders to refinance their home by paying off the original mortgage with a new one. With housing prices constant-ly increasing, homeowners would have gained equity in their home just by staying in it for two or three years, which would make it easier for them to get a regular fixed rate loan when they refinanced. For example, assume a borrower bought a $100,000 home with a zero-down, interest-only, 3/27 ARM for the full purchase price. After three years, having paid only interest, the borrower still owes $100,000 on the home and has to refinance. But if home prices had increased 10% per year during those three years, the borrower would now be ask-ing for a $100,000 loan for a home worth $133,000. A lender is more willing to grant that loan because if the borrower defaults, the lender is assured of a satisfactory return if forced to repossess the home.

For countless lower-income people, these loans worked exactly as intended by get-ting people into home-ownership who otherwise could not have afforded to do so. But ARMs were not confined to the subprime market; two types of prime borrowers also found them attractive. The first type was the middle-class or upper-middle class people who saw the opportunity to get into a nicer home than they otherwise could not have afforded. For example, rather than buying an older 1,500 square foot home, they could now aspire to a newly built 2,500 square foot home.

The second type was property speculators (home flippers) who could get a lower interest rate for the short period they expected to hold the home. Note the similarity between the time one needs to own the home to avoid capital gains taxes and the length of the ARMs' first portion. By a curious coincidence of federal tax policy and mortgage lenders' efforts to reach out to lower-income customers while minimizing their own risks, people could get a low interest rate on a mortgage for the same amount of time they needed to own the home in order to avoid capital gains taxes. This particular group of ARM holders never in-tended to refinance at the end of the low rate period, but rather sought to own the house just long enough to get the capital gains exemption and then sell it before the higher interest rate kicked in.

Flipping was the real poster child of the real estate boom. To many it seemed like a way to get rich quick, and it helped push the inflationary spiral of home prices upward.

The problem came when the housing bubble popped and home prices stopped in-creasing. Without constantly increasing home prices, the homeowners could neither sell for the amount necessary to pay off the loan nor gain the equity needed to refinance with a new loan. And very often they could not afford the dramatically higher mortgage payments. This resulted in the wave of defaults that came to be known as the mortgage crisis. While the media focused on the specter of "subprime loans," the specific culprit was the adjustable rate mortgages, both subprime and prime, as University of Texas economist Stanley Liebowitz shows in the following figures. While subprime mortgage holders defaulted at higher rates than prime mortgage holders, as one would expect for higher risk borrowers, it is important to note that the default rate for *fixed* rate subprime mortgages did not increase during the mortgage crisis. But default rates for both subprime *and* prime *adjustable* rate mortgages increased dramatically in late 2005 and early 2006.[15]

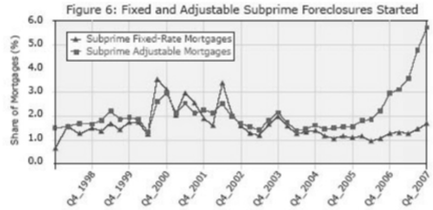

Figure 6: Fixed and Adjustable Subprime Foreclosures Started

Figure 7: Fixed and Adjustable Prime Foreclosures Started

Fixed rate mortgages did not need to be refinanced, so when housing price increases stalled there was little to no effect on the holders of such mortgages. Only the adjust-able rate mortgages, which relied on increasing home prices to create the equity necessary for refinancing, were at greater risk when housing prices stopped rising.

In 2005, the Federal Reserve finally began to reverse its easy money policy through a series of increases that took the discount rate from 3.5% to 6.25% in 2006. One motive behind these increases was to dampen the continuing spiral in home prices. In September 2005, as he was moving toward higher interest rates, Federal Reserve Chair Alan Greenspan said "In the United States, signs of froth have clearly emerged in some local markets where home prices seem to have risen to unsustainable levels."[16]

The dampening on home prices worked, but much more effectively than desired. By the end of the year, the increase in default rates of adjustable rate mortgages had begun. In September 2006, the Office of Federal Housing Enterprise Oversight (OFHEO) reported that while home prices continued to increase, the decline in the rate of increase was "the sharpest since the beginning of OFHEO's House Price Index … in 1975."[17] Even more significant, the report noted "a drop in speculative activity,"[18] as one would expect if one of the bubble's primary causes was the ARM-using house flippers. The housing bubble had popped, the mortgage crisis had begun, and the present financial crisis was on the horizon. We must now detour away from government to the financial sector, the most complex and least understood portion of the story.

Market Failure: Financial Firms' Inability to Properly Evaluate Bundled Mortgages

The mortgage business consists of two segments: the primary and the secondary mortgage markets. The companies that originate mortgages—those that lend directly to homebuyers—constitute the primary market. Many of these companies then sell the mortgages to other financial institutions, using the cash received from the sale to originate new mortgages. The resale occurs in the second-ary market, where Fannie Mae and Freddie Mac were the largest buyers. They were not, however, the final destination for most of these loans. Rather, Fannie and Freddie "bundled" thousands of mortgages together and sold the bundles, now known as Residential Mortgage Backed Securities (RMBSs), to such investment firms as Lehman Brothers and Bear Stearns. RMBSs were not new, but the proportion of subprime loans financed through such securitization increased rapidly in the early 2000s, from 50% in 2001 to 81% in 2005.[19]

RMBSs were then often bought to be repackaged as part of Collateralized Debt Obligations (CDOs), another type of security composed of a pool of bonds, loans, and other interest-paying assets. These were then bought by investment firms that made profits off the interest being paid on the various assets contained in the CDOs. The CDOs, however, tended to be opaque—that is, it was hard to see the real value of the assets contained within them. According to Yale University's Gary Gorton "There is no data on the amount of subprime exposure in CDOs … to figure out the subprime exposure in a CDO requires a "look through" to the subprime RMBS bonds in the portfolio of the CDO and then looking through those bonds individually to determine what subprime mortgages are associated with each RMBS bond in the portfolio."[20]

Think of an RMBS as a suitcase filled with mort-gages, a bond based on an RMBS as a box filled with suitcases, and a CDO as a shipping container filled with suitcases and boxes. Then try to assess the shipping container's net value from the outside, based on what is inside those suitcases. Trying to do such a "look through," says Gorton, is "literally not possible."[21]

Although this very basic sketch is a far-from-complete picture of how the financial markets worked, it should illustrate how the ability to evaluate the risk, and hence the real value, of the mortgage-backed securities got lost. It is easy to deride wheeling and dealing Wall Street financiers playing around with a "paper economy," but such sim-plistic criticism misses the point. As long as housing prices continued to increase—which investors could see had been happening—these investments would pay off. And because they were paying off well, the firms that invested heavily in them made larger profits than the firms that did not, thereby putting great pressure on the others to stop being so "stodgy" and get in the game. Many investment firms' clients were eager to move their portfolios from lower performing to higher performing firms, so the companies that remained uninvolved stood to lose, even if their own investments were solid. It is also easy to overestimate the acuity of Wall Street investors, as Ralph Nader does. "These guys knew exactly what they were doing. They were stretching the rubber band, stretching the rubber band to get another million and another $5 million another $10 million."[22]

But if Gorton is correct, they literally did not know *exactly* what they were doing. They were making decisions based on the best information they had, which also happened to be very incomplete. And they were stretching for the extra millions because their job is to make those millions for their clients, who would have gone elsewhere if they had not so stretched. It is, of course, true that they were focused on their own self-interest. But like Adam Smith's butcher and baker, their pursuit of those millions—until the crash—also brought more into the accounts of average Americans. It is too simple to focus on losses to average Americans' retirement accounts without also ad-mitting that those same average Americans were thrilled with the returns they had been receiving. In add-ition, the investment firms' willingness to stretch and make such investments kept the flow of cash coming for mortgages, helping yet more average Americans take the step into home ownership.

Still, it was not impossible to look ahead and see that housing prices could not continue their upward price spiral forever. At some point they had to slow down, and at that point adjustable rate mortgage holders would start to default and the RMBSs would rapidly decline in value. So why did everyone invest in such an obviously risky investment vehicle? In part, it was because nobody could predict when the bubble would burst. Those who got out too soon and those who got out too late would be the losers, whereas those who got out just before the bubble popped would make the highest profits. In addition, the structure of the CDOs made it impossible to assess just how much risk was held. But to determine the final cause, we must turn once again to government policy: the federal govern-ment's implicit promise to bail out failing financial firms.

Government Failure II: The Federal Government's Implied Promise to Bailout Failing Firms

In 1998, a little-known investment firm called Long-Term Capital Management was on the verge of collapse due to a series of unsound investments. As it owed large amounts to other financial firms, including some banks, there was concern about ripple effects from its collapse. Therefore, the Federal Reserve Bank of New York stepped in to engineer a bailout, putting together a consortium of other firms to buy it and take responsibility for its debts.[23] Turmoil in the financial markets was avoided, but a precedent was set: financial firms might be able to avoid responsibility for their bad decisions.

When people are protected from the consequences of their actions, they are prone to engage in risky behavior. Economists call this *moral hazard*. Just as gamblers tend to be more reckless with other people's money, so firms are likely to be more reckless if they think other people's money will be used to cover their losses. This problem was especially acute in the current case because so many of the firms in-volved, from Fannie Mae to Lehman Brothers, was presumed to be "too large to fail." That is, they were not too large to get themselves into a position of failure, but they were seen as too large for the government to *allow* them to fail.

It is impossible to know just how much influence this idea had in the specific case, but as a general problem it is quite clear. For example, thirty years ago the federal government bailed out Chrysler. This has tradition-ally been seen as an example of a successful government bailout. Yet in the inter-vening thirty years, all three of America's domestic auto manufacturers failed to make decisions that would put them in a position to compete effectively against their Japanese, Korean, and German competitors, and today all of them—including Chrysler—are again asking the government for assistance.

The best long-term strategy, although it is nearly un-thinkable in the short term, is to refuse to bail out failed firms, thereby sending the message that they must bear responsibility for their own business decisions. Only in this way can the discipline of the market pressure firms to avoid unnecessary risk. Every bailout simply subsidizes and further encourages bad business practices. It is, un-fortunately, already too late for the federal government to give a credible signal that it will no longer protect firms from the consequences of their own bad decisions. The list of companies that have already received government help is a Who's Who of Wall Street: Bear Stearns, Citigroup, and AIG, among others. One large firm, Lehman Brothers, was allowed to fail; however, since no one understands why it was singled out, there is no lesson for other firms to learn.

Current government actions may (or may not, no one really knows) be necessary to prevent a much larger world-wide financial crisis that could plunge the global economy into a long-term depression. But once stability is restored, the federal government should give the cold shoulder to firms asking for assistance. By subsidizing their risky business decisions we ensure more and larger failures in the future—failures that we will then feel compelled to rescue—than we would if the firms knew that they were wholly on their own.

The Moral of the Story

Many Americans, including President Obama, have a "Camelot" vision of govern-ment. They believe that all will be well if we can just get the right people in power, people who will create the right government policies. The unsettling reality is that the government policies that created this financial crisis were all examples of such "good" policies: the Fed's easy money policy was intended to put more people to work, the capital gains tax reduction on home sales was intended to protect Americans from punitive taxes when their home's value had risen, adjustable rate mortgages were designed to help lower-income Americans and reduce racial disparities in home ownership, and corporate bailouts were intended to prevent greater economic turmoil. In a very real sense there is no villain in this story, for it is no more than a Greek tragedy whose well-intentioned heroes' noble actions collectively created a terrible outcome.

In other words, there are no simple solutions. President Obama will no doubt tinker with public policy just as his predecessors did, trying to find the formula that will create prosperity without chaos. But no such policy exists. We can, however, apply a few lessons from this financial crisis to try to minimize the inevitable future financial panics.

First, the Fed must continue to be leery of an easy money policy. When the economy has more money than can be put to productive use, it will inevitably be put to spec-ulative use, and speculation almost inevitably results in bubbles, which inevitably burst. Second, the govern-ment should be wary of tax policies that favor certain investments far more than others. By reducing capital gains taxes on home sales but not on other asset sales, President Clinton inadvertently made homes an ideal short-term investment. If the goal is to protect homeowners from punitive capital gains taxes, the timeline should be set long enough to protect long-term homeowners without encouraging short-term speculation. And finally, the government should commit to not bailing out failing firms. Failed firms waste assets that could be better employed elsewhere and subsidizing failure creates a long-term drain on our economy. Such failures are a bitter pill to swallow. But as with all bitter medicines, it is better to take them quickly rather than to let the illness linger.

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