Cato Blames the Government

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The libertarian Cato Institute blames the government for the current financial crisis in a recent briefing paper. Here is why they are wrong.

Introduction

The libertarian Cato Institute blames the government for the current financial crisis in a recent briefing paper, "How Did We Get into This Financial Mess?" by Lawrence H. White (Cato Briefing Paper No. 110, November 18, 2008). With this briefing paper and other publications, Cato joins the campaign by many conservative, libertarian, and business sources to blame the current financial crisis on the government. The briefing paper claims:

The actual causes of our financial troubles were unusual monetary policy moves and novel federal regulatory interventions. These poorly chosen policies distorted interest rates and asset prices, diverted loanable funds into the wrong investments, and twisted normally robust financial institutions into unsustainable positions.

To many, especially on the Left, such claims seem utterly astounding. After all, the Bush Administration was in power for eight years (2001-2009) with a Republican Congress for six years (2001-2007). The Bush Administration was widely seen as a very pro-business, pro-free market, anti-regulation Administration. The Federal Reserve was headed first by Alan Greenspan, a former devotee of free market advocate Ayn Rand and a Reagan Administration appointee, and then by Ben Bernanke, a monetarist. Over the last thirty years a variety of Depression era regulations of the financial industry such as the Glass-Steagall act have been repealed or weakened either by legislation or by regulators. How then could any sane person blame the government?

Blaming the government is nothing new. Conservative, libertarian, and business writers, publications and think tanks (such as Cato) have a long history of blaming the government for economic and financial fiascoes that followed the adoption of public policies initially billed as "free market" or "deregulation". Previous examples include the Great Depression, the savings and loan deregulation fiasco of the 1980's, the failure of conservative author George Gilder's high tech investment advice in the 1990's and the California electricity market deregulation fiasco of 2000. (See Appendix)

Blaming the government for the housing bubble and associated financial crisis is being used to explicitly or implicitly exonerate the leaders of several very large banks that appear to be in severe trouble: Citigroup, Goldman

Sachs, Morgan Stanley, and several other major banks. These banks appear to be surviving on over a trillion dollars in government funds from the Federal Reserve under Chairman Bernanke and the US Treasury through the Troubled Assets Relief Program (TARP). TARP has already spent $350 billion of the $700 billion authorized in 2008. The Federal Reserve has already committed at least one trillion dollars to support various banks. The blame the government arguments are being used to argue implicitly that the government, ultimately the taxpayer, *owes* the banks an ever growing amount of bailout funds. Despite or more likely because of this huge subsidy, the US and global economy is in a tailspin.

The Cato briefing paper trots out a laundry list of government scapegoats for bad decisions by major banks. This is also a common pattern in previous blame the government exercises. The government is quite large with numerous programs, laws, and regulations. Essentially any and all government programs, laws, and regulations that have any relationship to the fiasco, however tenuous, may be blamed. A list of several scapegoats makes a comprehensive rebuttal difficult.

The Government Scapegoats

The Cato briefing paper starts by blaming the single most prominent and common government scapegoat for the housing fiasco: the Federal Reserve and Alan Greenspan. The paper attacks the Fed and Greenspan for keeping interest rates low after the 2001 recession, especially from 2003 to 2005, comparing the interest rates unfavorably to the interest rates suggested by the so-called Taylor rule assuming a policy of targeting inflation at 0-4%.

Loose monetary policy does not force banks or bankers to make bad loans. Nor does it force people to buy overpriced homes in a speculative housing bubble. In fact, banks have a fiduciary responsibility to their stockholders to make sound loans. Even if the federal funds rate is 0%, the banks have an obligation to make loans that will be paid back. If they cannot find appropriate loans, then they should not borrow money even at 0%.

The Federal Reserve is now pursuing extremely loose monetary policy, even looser than in 2001. Yet, housing prices are in free fall. The housing bubble is largely independent of the monetary policy. Loose monetary policy makes it easier for an asset bubble to form, but it is neither a necessary nor a sufficient condition for a bubble. Notably, banks are now explaining their failure to lend TARP funds to strapped businesses and households by citing their fiduciary responsibility to make sound loans. The Federal Reserve did not force banks to make the unsound loans that created the housing bubble.

If the Federal Reserve is guilty of anything, it is guilty of failing to regulate the banks and stop the unsound loans. The Federal Reserve failed either to prevent the housing bubble or deflate it before it turned into a financial disaster.

After blaming the Federal Reserve and Alan Greenspan for somehow creating the housing bubble, the Cato briefing paper moves on to attacking alleged government "mandates and subsidies to write risky mortgages". Mandates and subsidies are important. The Federal Reserve did not, in fact, force banks to make bad loans. But, what if the government forced the banks to make bad loans? Then, there might be a genuine case that the government caused the financial crisis.

The paper specifically cites four government programs as "mandates and subsidies". These are loosening the down-payment standards on mortgages guaranteed by the Federal Housing Administration (FHA), strengthening the Community Reinvestment Act (CRA), alleged pressure on lenders by the Housing and Urban Development department, and "most important" the dramatic expansion of the government-sponsored mortgage buyers Fannie Mae and Freddie Mac.

It is difficult, of course, to see how lowering the down payment required for FHA mortgage insurance *forced* Citigroup, Goldman Sachs, Morgan Stanley, Countrywide, Wachovia, Washington Mutual, IndyMac, and the other private banks that are in trouble or have already folded to make unsound loans. Nor does it explain why these banks failed to properly value these unsound loans in their annual reports, SEC filings, and other legally required financial statements.

Regarding the CRA, the paper says:

Further amendments in 1995 gave the CRA serious teeth: regulators could now deny a bank with a low CRA rating approval to merge with another bank – at a time when the arrival of interstate banking made such approvals especially valuable – or even to open new branches.

Conservative, libertarian, and business pundits have heavily blamed the CRA for the housing crisis. There are many problems with these claims. But, in particular, CRA did not actually *force* the banks to make unsound loans. Even if the CRA was aggressively used (during the Bush Administration!) to force banks to make unsound loans *that would bankrupt the banks*, the banks had the option of refusing to make the loans, getting the bad CRA rating, and forgoing mergers and branch openings. The bank officials had a fiduciary responsibility not to make bad loans that would bankrupt their bank. Even if they decided to do so, they had a legal responsibility to report the bad loans in their corporate annual reports, SEC filings, and other financial statements.

Regarding HUD, the Cato briefing paper says:

Meanwhile, beginning in 1993, officials in the Department of Housing and Urban Development began bringing legal actions against mortgage brokers that declined a higher percentage of minority applicants than white applicants. To avoid legal trouble, lenders began relaxing their down-payment and income qualifications.

Apparently, the banks could not find some way to obey anti-discrimination laws without going bankrupt and failing to warn their stockholders that they were being forced to go bankrupt. Implicitly, as with the CRA excuse, poor minority borrowers are blamed for a vast housing bubble that blossomed in affluent regions such as Northern California (where most middle class and even upper middle-class people could not afford a home before the bubble).

Finally, most importantly, the briefing paper blames the government sponsored enterprises Fannie Mae and Freddie Mac for the failure or near failure of the private banks such as Citigroup, Goldman Sachs, Morgan Stanley, Wachovia, Washington Mutual, Countrywide, and so forth. Fannie Mae and Freddie Mac had no power to *force* the private banks to make bad loans or acquire mortgage-backed securities backed by bad loans. Now, clearly something went wrong at Fannie Mae and Freddie Mac, but we are discussing a financial crisis in the "private sector", meaning "private" banks such as Citigroup that seem to enjoy a special favored relationship with the government.

Conservative, libertarian, and business writers, publications, and think tanks heavily attacked Fannie Mae and Freddie Mac during the housing bubble. One can, for example, find numerous anti Fannie Mae and Freddie Mac editorials in the *Wall Street Journal* over the last eight years. Conservative, libertarian, and business sources have loudly touted this track record with a "we told you so" message.

However, what exactly was the attack on Fannie Mae and Freddie Mac during the housing bubble? Fannie Mae and Freddie Mac were compared unfavorably to the "private sector" and the new financial innovations of mortgage backed securities. At the peak of the bubble, Fannie Mae and Freddie Mac shrank to about 40% of the mortgage market as "private" mortgages prospered. Then, the putative "private sector" tanked. Now, Fannie Mae and Freddie Mac appear to have almost 100% of the market because…yes…Citigroup, Morgan Stanley, Goldman Sachs, and all the rest – which are not Fannie Mae or Freddie Mac – are in deep trouble or have gone bankrupt.

None of the four government scapegoats is compelling. None, in fact, exonerates the banks from charges of appalling bad judgment.

Leading into its list of government scapegoats, the Cato briefing paper says:

The enumeration of regrettable policies below is by no means exhaustive.

This is one of the problems with rebutting blame the government excuses for bad business decisions. The government is vast and has many policies, programs, laws, and regulations that may relate in some way to the situation. Similarly, several different government scapegoats have been blamed for the Great Depression: allegedly tight monetary policy by the Federal Reserve (famously by Milton Friedman), the Smoot-Hawley tariff, various taxes under Hoover and Coolidge, and the New Deal government programs. One can expect more government scapegoats as the current financial fiasco unfolds.

Conclusion

In the current financial crisis, the US and indeed the world is confronted with a small group of very large and very powerful banks such as Citigroup, Goldman Sachs, Morgan Stanley, and a few others. These mega-banks have been protected by a series of ad hoc interventions such as the Long Term Capital Markets bailout during the Clinton Administration, culminating in the recent Wall Street bailout, coupled with selective deregulation of the banking industry.

These banks have extensive political connections in both major parties, Republican and Democratic, and in both liberal and conservative political circles. This is epitomized by the spectacle of Robert Rubin of Goldman Sachs as Treasury Secretary in the Clinton Administration followed by Henry Paulson, also of Goldman Sachs, as Treasury Secretary in the Bush Administration. Both political parties ignored public outrage to pass the failed TARP act. Despite this public outrage, both Senator McCain and Senator Obama voted for TARP. As of this writing, it appears that President Obama will continue and expand TARP despite the dismal results.

The paradox is that massive government intervention on behalf of a few politically favored banks is being promoted through selective use of "free market" rhetoric and blame the government excuses such as those in the Cato briefing paper. Blame the government claims are being used to argue that the government *owes* the banks the bailout funds. Simultaneously, "free market" arguments are used against government oversight of the now government funded banks, executive compensation limits, or any other restrictions or reforms of the banks (such as firing the Boards of Directors and senior executives).

In addition, the debate is framed (as in the Cato briefing paper) by equating this small circle of mega-banks with the US financial system and the "free market", ignoring smaller banks and institutions not involved in the housing bubble or dubious mortgage backed securities. Sadly, as "free market" and "blame the government" arguments are discredited, this small circle of mega-banks may switch seamlessly to selective "pro-government" and "pro-regulation" arguments to advance the same flawed and dangerous policies.

The cost of these policies is already very high, running over $1.3 trillion to date (over $4,000 per US citizen). Officials are proposing an even larger bank bailout through the proposed "bad bank". Remarkably, in this era of cheap super-fast computers that supposedly enhance productivity *especially in finance*, almost no one questions a computerized financial system that costs trillions of dollars to keep operating.

These policies reward and increase the already vast power of a small group of men who have proven grossly incompetent and have no significant experience in agriculture, mining, manufacturing, research and development, or other substantive economic activities essential to human life and future economic growth. Most people -- Republican or Democrat, liberal or conservative, rich or poor, purple or polka-dot – are losing money due to these policies. An increasing number are losing their jobs, homes, and savings.

Most worrying, these policies risk recreating the dire social and economic conditions of the Great Depression that led to World War II. This nightmare scenario would require a combination of a negative bubble in housing and other assets and a precipitous poorly managed crash in the dollar, which is almost certain to fall in the future. World War III would be fought with far more destructive weapons than World War II.

Appendix: A Short History of Blaming the Government

Blaming the government is nothing new. Conservative, libertarian, and business writers, publications and think tanks (such as Cato) have a long history of blaming the government for economic and financial fiascoes that followed the adoption of public policies initially billed as "free market" or "deregulation". Previous examples include the Great Depression, the savings and loan deregulation fiasco of the 1980's, the failure of conservative author George Gilder's high tech investment advice in the 1990's and the California electricity market deregulation fiasco of 2000.

The Great Depression

Several different government scapegoats have been blamed for the Great Depression: allegedly tight monetary policy by the Federal Reserve (famously by Milton Friedman), the Smoot-Hawley tariff, various taxes under Hoover and Coolidge, and the New Deal government programs.

To quote a noted expert on the Great Depression:

However, in 1963, Milton Friedman and Anna J. Schwartz transformed the debate about the Great Depression. That year saw the publication of their now-classic book, A Monetary History of the United States, 1867-1960. *The* Monetary History*, the name by which the book is instantly recognized by any macroeconomist, examined in great detail the relationship between changes in the national money stock--whether determined by conscious policy or by more impersonal forces such as changes in the banking system--and changes in national income and prices. The broader objective of the book was to understand how monetary forces had influenced the U.S. economy over a nearly a century. In the process of pursuing this general objective, however, Friedman and Schwartz offered important new evidence and arguments about the role of monetary factors in the Great Depression. In contradiction to the prevalent view of the time, that money and monetary policy played at most a purely passive role in the Depression, Friedman and Schwartz argued that "the [economic] contraction is in fact a tragic testimonial to the importance of monetary forces" (Friedman and Schwartz, 1963, p. 300).*

To support their view that monetary forces caused the Great Depression, Friedman and Schwartz revisited the historical record and identified a series of errors--errors of both commission and omission--made by the Federal Reserve in the late 1920s and early 1930s. According to Friedman and Schwartz, each of these policy mistakes led to an undesirable tightening of monetary policy, as reflected in sharp declines in the money supply. Drawing on their historical evidence about the effects of money on the economy, Friedman and Schwartz argued that the declines in the money stock generated by Fed actions--or inactions--could account for the drops in prices and output that subsequently occurred.[1]

Monetary policy is only one of several government scapegoats for the Great Depression. The Smoot-Hawley tariff is probably the second most popular scapegoat. Here is a recent restatement of the Smoot-Hawley excuse:

The prevailing view in many quarters is that the stock market crash of 1929 was a failure of the free market that led to massive unemployment in the 1930s-- and that it was intervention of Roosevelt's New Deal policies that rescued the economy.

It is such a good story that it seems a pity to spoil it with facts. Yet there is something to be said for not repeating the catastrophes of the past.

Let's start at square one, with the stock market crash in October 1929. Was this what led to massive unemployment?

Official government statistics suggest otherwise. So do new statistics on unemployment by two current scholars, Richard Vedder and Lowell Gallaway, in their book "Out of Work."

The Vedder and Gallaway statistics allow us to follow unemployment month by month. They put the unemployment rate at 5 percent in November 1929, a month after the stock market crash. It hit 9 percent in December-- but then began a generally downward trend, subsiding to 6.3 percent in June 1930.

That was when the Smoot-Hawley tariffs were passed, against the advice of economists across the country, who warned of dire consequences.

Five months after the Smoot-Hawley tariffs, the unemployment rate hit double digits for the first time in the 1930s.

This was more than a year after the stock market crash. Moreover, the unemployment rate rose to even higher levels under both Presidents Herbert Hoover and Franklin D. Roosevelt, both of whom intervened in the economy on an unprecedented scale.[2]

Various tax increases under Presidents Coolidge, Hoover, and Roosevelt have been blamed at times for the Great Depression. This is one of the less common government scapegoats. An example may be found in the Cato Institute Tax & Budget Bulletin No. 23, dated September 2005, "The Government and the Great Depression" by Chris Edwards, Director of Tax Policy, Cato Institute:

Tax Hikes*. In the early 1920s, Treasury Secretary Andrew Mellon ushered in an economic boom by championing income tax cuts that reduced the top individual rate from 73 to 25 percent. But the lessons of these successful tax cuts were forgotten as the economy headed downwards after 1929. President Hoover signed into law the Revenue Act of 1932, which was the largest peacetime tax increase in U.S. history. The act increased the top individual tax rate from 25 to 63 percent.*

Remarkably, even the New Deal has frequently been blamed for the Great Depression. A recent example is the book *FDR's Folly: How Roosevelt and His New Deal Prolonged the Great Depression* by Jim Powell (Random House, September 2004). Here is a brief review quote from Milton Friedman:

"Admirers of FDR credit his New Deal with restoring the American economy after the disastrous contraction of 1929—33. Truth to tell–as Powell demonstrates without a shadow of a doubt–the New Deal hampered recovery from the contraction, prolonged and added to unemployment, and set the stage for ever more intrusive and costly government. Powell's analysis is thoroughly documented, relying on an impressive variety of popular and academic literature both contemporary and historical." – ***Milton Friedman****, Nobel Laureate, Hoover Institution*

Another recent book with a similar theme is *New Deal or Raw Deal?: How FDR's Economic Legacy Has Damaged America* by Burton W. Folsom Jr. Here is a brief reviews:

"History books and politicians in both parties sing the praises for Franklin Delano Roosevelt's presidency and its measures to get America out of the Great Depression. What goes unappreciated is the fact that many of those measures exacerbated and extended the economic downturn of the 1930s. New Deal or Raw Deal? *is a careful documentation and analysis of those measures that allows us to reach only one conclusion: While President Roosevelt was a great man in some respects, his economic policy was a disaster. What's worse is that public ignorance of those policy failures has lent support for similar policies in later years. Professor Burt Folsom has produced a highly readable book and has done a yeoman's job in exposing the New Deal."-- Walter E. Williams, John M. Olin Distinguished Professor of Economics, George Mason University*

Another popular source of claims that the government caused the Great Depression is Alan Reynolds article "What Do We Know About the Great Crash" in the November 9, 1979 of the conservative *National Review*.

The Savings and Loan Fiasco of the 1980's

In the 1980s, the US Savings and Loan industry was "deregulated" with disastrous consequences. This is a case where the putative "deregulation" was, in fact, selective deregulation. After the collapse of most of the savings and loan industry, costing billions, conservative, libertarian, and business sources blamed the government, even citing the fiasco to argue for further "deregulation".

A clear example of this is "Lessons from the Savings and Loan Debacle: The Case for Further Financial Deregulation" by Catherine England (Regulation: The Cato Review of

Business & Government, Summer 1992, The Cato Institute). Here is an excerpt:

An April 28, 1992, Washington Post editorial warned, "Over the past decade the country has learned a lot about the limits to deregulation." The savings and loan crisis was, of course, one exhibit called forth: "Deregulation also has its price, as the savings and loan disaster has hideously demonstrated. Deregulation, combined with the Reagan administration's egregious failure to enforce the remaining rules, led to the gigantic costs of cleaning up the failed S&Ls."

Such editorials demonstrate that the S&L fiasco continues to be misdiagnosed. Unfortunately, this misdiagnosis is being applied by many to the ailing banking industry, and there are those who would introduce the S&L cancer into the insurance market and compound that industry's problems. In the absence of more careful attention to the roots of the S&Ls' problems, taxpayers may face further financial industry bailouts.

The S&Ls' experience yields three important lessons. First, excessive regulation was the initial cause of the industry's problems. Second, federal deposit insurance was ultimately responsible for the high costs of the debacle. Finally, government-sponsored efforts to protect the industry only invited abuses and increased the ultimate cost of restructuring.

George Gilder's Investment Advice

During the 1990's conservative author and supply-side economics advocate George Gilder became a prominent high technology stock investment adviser, publisher of the stock market advice newsletter *Gilder Technology Report* and a book *Telecosm*[3]. In particular, Gilder promoted investments in the telecommunications industry such as Global Crossing, one of his famous bad stock picks. Most people who followed Gilder's investment advice, including apparently Gilder, did quite poorly in the long run[4].

When the Internet and telecom stocks and businesses crashed, Gilder blamed the government, most notably in a Wall Street Journal commentary published on August 6, 2001 titled "Tumbling into the Telechasm". Here is a brief excerpt.

The Bush economy, unfortunately, not only possesses no such immunity to bad policy, but also is gravely vulnerable to policy mistakes accumulating by the end of the Clinton term. A high-tech depression is under way, driven by a long siege of deflationary monetary policy and obtuse regulation that has shriveled hundreds of debt-laden telecom companies and brought Internet expansion to a halt.

In a nutshell, the Federal Reserve and government regulation caused Gilder's stock picks to go bad. Significantly, Gilder blames deflationary monetary policy. Alan Greenspan and the Fed are now being accused of creating the housing bubble with too loose monetary policy in the wake of the Internet and telecom crash. The only constant is that it is the Federal Reserve, the government's, fault and not business leaders.

The California Electricity Market Deregulation Fiasco of 2000

In the late 1990's, California "deregulated" its electricity market. The "deregulation" was promoted by conservative, libertarian, and business groups to increase competition and *lower electricity rates*. The putative deregulation culminated in a fiasco with shortages and blackouts in 2000 and sharp increases in electricity rates. This is one of the most notorious failures of ostensible deregulation in recent years. A similar deregulatory fiasco has occurred more recently in Texas[5].

Conservative, libertarian, and business sources blamed the government. Here is an example from Walter Williams May 23, 2001 syndicated article "Orchestrating Energy Disaster":

ONE needn't be a rocket scientist to create California's energy problems. According to the California Energy Commission, from 1996 to 1999 electricity demand, stimulated by a booming economy, grew by 12 percent while supply grew by less than 2 percent.

Here's how California created its supply crunch. It takes two years to build a power plant in business-friendly states but four years in California. Sunlaw Energy Company wants to build a $256 million natural-gas-fired plant in Los Angeles; community activists are stopping it. San Francisco activists killed a proposal to float an electricity-producing barge in the bay, even as the city faced blackouts. Computer software giant Cisco Systems has led the charge against a proposed Silicon Valley power plant.

Conservative, libertarian, and business sources blamed surviving price controls and environmental regulations and environmentalists. The fiasco was cited as evidence for additional policies labeled as "deregulation".

Concluding Comments

Conservative, libertarian, and business writers, publications, and think tanks have a long history of blaming the government for economic and financial fiascoes that follow the adoption of policies initially promoted as "deregulation", "free market", or similar terms. Many more examples may be found and detailed with further research (left as an exercise to the reader). Not infrequently the fiasco will actually be cited as evidence for further policies promoted as "deregulation".

It is important to distinguish "true deregulation" from policies labeled as "deregulation," "free market" or something similar. As in some of the examples above, many policies labeled as "deregulation" turn out on close examination to be selective deregulation or even simply changes in regulation that favor certain individuals, companies, or groups. Before the fiasco, conservative, libertarian, and business groups often ignore this, embrace the policies, and tout them. Once the fiasco unfolds, they back away shrieking "it is the government's fault!" and "it wasn't true deregulation!".

Many historical examples do not answer the question whether "true deregulation" would work as conservative, libertarian, and business sources claim. They do show, over and over again, that policies promoted as "deregulation" or "free market" can be much worse than existing regulations. *Selective deregulation* can be much worse than prudent regulation.

Often policies promoted as "deregulation" or "free market" do not benefit most people, even most business or wealthy people. For example, many businesses in California embraced the electricity market deregulation in the belief that it would lower their corporate electricity bills. Didn't happen. Many conservative, libertarian, and business people lost significant amounts of money following George Gilder's free-market tinged investment advice.

The clear lesson is to beware policies (or investments) promoted as "deregulation" or "free market". Examine the fine print closely and skeptically.

The government is vast with many agencies, departments, laws, regulations, and programs. In a given situation or fiasco, there are often many laws, regulations, policies, and programs that have some relationship to the situation or fiasco. Thus, it is often possible to cite a long list of government scapegoats. Blame the government excuses are difficult to comprehensively rebut for this reason.

Blame the government excuses substitute an abstract concept – "the free market" or "the private sector" – for individual businesses or groups of businesses that may have made substantial mistakes or even engaged in deliberate misconduct. Blame the government excuses enable individual business leaders to escape personal or professional responsibility for their decisions.

About the Author

John F. McGowan, Ph.D. is a software developer, research scientist, and consultant. He works primarily in the area of complex algorithms that embody advanced mathematical and logical concepts, including speech recognition and video compression technologies. He has many years of experience developing software in Visual Basic, C++, and many other programming languages and environments. He has a Ph.D. in Physics from the University of Illinois at Urbana- Champaign and a B.S. in Physics from the California Institute of Technology (Caltech). He can be reached at jmcgowan11@earthlink.net.

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[3] Om Malik, *Broadbandits: Inside the $750 Billion Telecom Heist,* John Wiley and Sons, Hoboken, New Jersey, 2003

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