Mommy, the Government Made Me Do It! (II)

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Conservative, libertarian, and business writers blame the government for the financial crisis as in previous debacles. Here is why they are wrong.

Monday's Wall Street Journal (Monday, January 26, 2009) contains yet another in the barrage of blame the government propaganda from conservative, libertarian, and business publications, writers, and think tanks: an editorial titled "Bad News Is Better Than No News" by L. Gordon Crovitz (page A13). In the midst of arguing that the government should (surprise, surprise) spend the remaining Troubled Assets Relief Program (TARP) II funds (about $350 billion, over $1,000 per US citizen) to buy valueless mortgage backed securities from the giant banks that routinely advertise in the Wall Street Journal (see appendix), Crovitz makes the following claim:

It's now clear that the data that banks used were distorted by years of government initiatives to promote home ownership. Government-mandated loans led house prices ever higher and house-price volatility ever lower. When the VaR models [ostensibly sophisticated models that didn't work] looked back, they wrongly modeled a low risk of default. Wall Street shouldn't make the mistake again of ignoring the impact of politics on economics – and politicians should find ways to achieve social goals without undermining the integrity of the market.

Here we go again. As in previous financial fiascos, such as the Great Depression, the 1980's savings and loan debacle, and the California electricity market deregulation fiasco, conservatives, libertarians, and business pundits are blaming the old reliable scapegoat: the government. At least this editorial admits Wall Street must have made a mistake.

Mistake, indeed. First, what exactly are these supposed government mandated loans and how did they cause the housing bubble and crash? This is probably a reference to the Community Reinvestment Act (CRA). Did the CRA mandate loans? How many? To whom? Why didn't the banks protest these government mandated bad loans loudly? In fact, there are many problems with blaming the CRA for the housing bubble and crash. In particular, by most accounts, the lever that CRA actually provided to "mandate" loans was a scoring system allegedly used in approving bank mergers, branch openings, and possibly other bank actions. Why didn't the banks refuse to make mergers, open branches, or perform other actions that required making bad loans *that would bankrupt the banks*? Even if the banks made a suicidal decision to make trillions of dollars in bad loans to satisfy CRA or other government mandates, they had a legal responsibility to properly value the bad loans on their books and report the trillions of dollars in bad loans in their corporate annual reports, SEC filings, and other legally required documents for shareholders and others.

This brings us to an important point. Regulation is a part of life. Business people and financial professionals (as Crovitz likes to call them) may not like regulation or certain regulations, but they must assess the regulations and make business decisions based on the existence of regulations. For example, if Joe's Restaurant wants to open a second restaurant, they must check the zoning and other regulations before acquiring or renting a facility for the new restaurant. They cannot just ignore the rules and then say "Oh, I didn't realize the land was zoned for residential use only! It is the government's fault that I lost money!"

The government – federal, state, and local – has played a central role in the housing market since at least the Great Depression. In fact, after the Second World War, the federal government heavily subsidized home ownership through the GI Bill, the FHA, Fannie Mae, Freddie Mac, and numerous other programs. One can argue that the rapid expansion of home ownership and the suburbs was on the whole a highly successful policy during the post World War II era. Significantly, this was mostly based on conservative lending policies: substantial down payments, 30 year fixed rate mortgages, small efficient affordable homes such as Eichlers, and so forth. This was a far cry from the recent housing bubble.

As the current housing bubble shows, zoning plays a central role in housing prices, driving prices up sometimes heavily in regions with restrictive zoning. The housing bubble developed largely in urban areas with substantial zoning requirements. In rural and other areas with little or no zoning, one simply buys some land and builds a house. This generally limits house prices to the cost of building the house. Thus, it was difficult for the bubble to develop in many areas. Regions such as Northern California with heavy zoning, earthquake safety, and other restrictions developed large housing bubbles, and have always had extremely high housing prices.

Any financial professional involved in valuing mortgage backed securities should have been well aware of the central role of the government in the housing market and housing prices. Of course, any government mandated loans such as the alleged CRA program should have been factored into any models or projections. This does not and did not require a Ph.D. in theoretical physics from Princeton to figure out. In fact, the financial professionals responsible for these models are usually extremely intelligent people as conventionally measured, often with advanced degrees from top schools and so forth. They are highly compensated and supposedly work long hours. But apparently the fact that government regulations and policy play a central role in the housing market escaped them.

Nor was the housing bubble, whether caused by the private sector or the government or both, difficult to see. Barron's columnist Alan Abelson lampooned the housing bubble in his regular column in 2004. Numerous economists including Robert J. Shiller, Nouriel Roubini, and Dean Baker warned strongly about the bubble for several years. Housing prices in most bubble regions far outstripped prices that would be expected based on the rental rates in the region. But, again, apparently the housing bubble was invisible to the super-geniuses of Wall Street.

Of course, the article is blaming the government in the context of pleading for $350 billion (over $1,000.00 per US citizen) in government money to purchase probably valueless mortgage backed securities from giant banks that are often advertisers in the Wall Street Journal. This is part of the implicit argument. The government, meaning ultimately the taxpayer, owes Wall Street the $350 billion *because the government screwed up*.

Sadly, blaming the government is not new. The housing bubble and mortgage backed securities fiasco is only the latest in a series of worsening public policy debacles over the last thirty years. Similar arguments appeared in the aftermath of the savings and loan fiasco in the 1980's and the electricity market deregulation fiasco in California in 2000. The strategy is to enact a policy favoring certain politically connected businesses using free market and deregulatory rhetoric. All goes well for at most a few short years. There is often a speculative financial bubble associated with the policy. Then, there is a fiasco, a crash. Then, blame the fiasco on the government, if possible get a government bailout as in the current housing bubble, and actually cite the fiasco as supporting evidence for the next purported "free-market" or "deregulatory" policy. Repeat until the world economy collapses completely.

These pseudo-free market, pseudo-deregulation policies benefit very few people: Republicans or Democrats, rich or poor, purple or polka dot. They frequently add little or nothing of substance to the economy. They are not a substitute for real economic growth or prosperity. Exotic financial models for derivative securities are not working and they do not represent real technological progress. They are most definitely not new energy sources, better food production methods, better propulsion systems, cures for major diseases, or even better kitchen gadgets that can be worth billions or even trillions of dollars to the US and global economy. The world economy is in a tailspin in part because of the lack of these substantive advances combined with a growing population. The self-styled "private sector" in the United States needs to get its act together, quit whining for government subsidies in the name of free markets, and deliver substantive results.

Appendix: TARP Recipient Advertising in Wall Street Journal

Curiously, despite its' frequently stated free market principles the Wall Street Journal editorial page is a firm supporter of the Troubled Assets Relief Program (TARP) in which the federal government is spending $700 billion (over $2300 per US citizen) to bailout giant banks.

Maybe here is why:

Over three quarters page advertisement for JPMorgan Chase & Co. asserting that JPMorgan Chase is lending. (seventh in a series).
Wall Street Journal, Thursday, January 29, 2009, page A5

Over three quarters page advertisement for Wells Fargo announcing that Wachovia Securities is now part of Wells Fargo.
Wall Street Journal, Thursday, January 29, 2009, page A11

Over three quarters page advertisement for JPMorgan Chase & Co. on Chase mortgage loan modification program (sixth in a series).
Wall Street Journal, Tuesday, January 27, 2009, page A5

Over three quarters page advertisement for Wells Fargo announcing that Wachovia wealth management is now part of Wells Fargo.
Wall Street Journal, Tuesday, January 27, 2009, page A9

Full page advertisement for Citi CashReturns credit card (Citigroup)
Wall Street Journal, Tuesday, January 27, 2009, page A16

Of course, one can find many more specific examples by reviewing the Wall Street Journal issues in recent months.

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.