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**Policy Failed? Blame Market**  
(or)  
**Regulatory Origins Causing Financial Turmoil  
and Economic Downturn**

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Vilnius

*In this essay I will analyze what actually happened before the financial crisis, explain how the financial markets reacted to those events and who is to be blamed; then I am going to link the financial markets to the economy as a whole using Austrian perspective and finally give an assertion whether next policies are anyhow better.*

*“It is an indisputable fact that one of the most significant contributors to our economic downturn was an unravelling of major financial institutions and the lack of adequate regulatory structures to prevent abuse and excess”*

Barack Obama, President of United States

*“Changing regulators or giving regulators additional power shifts more responsibility away from bankers and on to regulators. That is the opposite of wise policy. We should shift responsibility the other way”*

Allan Meltzer, professor, CMU

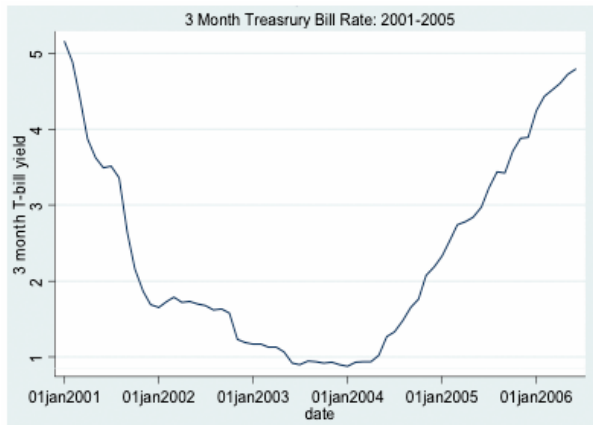
Governments blame the market. They claim that speculation has gone too far. Global volumes of various financial derivatives in June, 2008, amounted to \$684 trillion (Economist, 2008). This is roughly 50 times the gross domestic product of United States. This was proclaimed unsustainable.

Bubbles started bursting. Corporations went bankrupt (or qualified for “too big to fail” scholarship from generous taxpayers without their permission). Even cold country as Iceland overheated and had no choice than to be sold on E-bay... Confidence and \$15 trillion lost in wealth globally. To compare again it is how much United States produce (or at least used to produce...) in a year.

But is it really true? Are the governments the ones which should “correct” what market has done? And was it the market which has initially caused all this turmoil called credit crunch? Interesting it will be.

### **What really has happened**

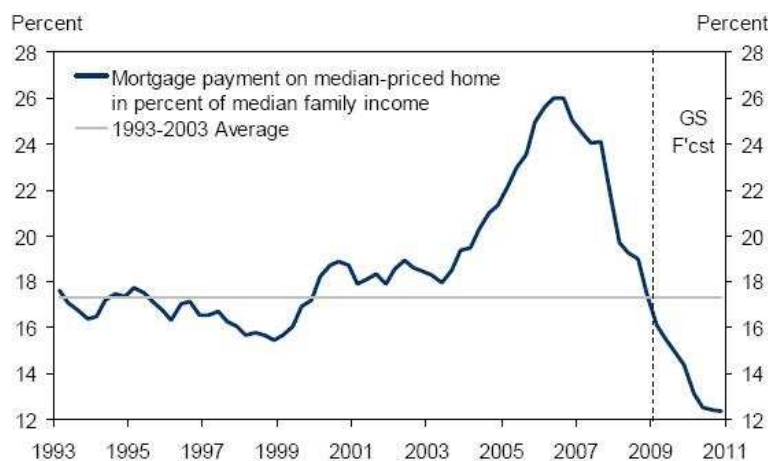
Back in 2000 when downturn caused by the burst of information technology bubble (Y2K) was present, the government also felt that it must do something. Adding also the enormous uncertainty caused by 9/11 events, government felt that it is the right time and the right place to step in. The way of stepping in at that time was “generous” interest rates by the Federal Reserve.



(Federal Reserve, 2006)

Interest rate of 1 percent was cheaper than air. Financial system quickly started breathing it. Soon it turned into abnormality... The economy followed...

Even earlier the obsession about housing started. Government felt that society benefits from house ownership much more than the individuals were rationally willing to pay for it. Argument that it is important to have families more settled and integrated in communities was extremely strong. So strong, that no price seemed too high. Tax deductibility of interest payments, no requirements for initial instalment, artificially low interest rates – everything motivated individuals to refinance their mortgages. Also a role was played by pseudo-private Fannie Mae and Freddie Mac with their help in making the mortgages easier to get. The whole economy and financial system was adjusting towards giving housing to those who were supposed (or not supposed) to have it.



**House Prices Likely to Fall Another 15%**

(Goldman Sachs, 2009)

Real estate was growing as never. In five years housing prices have doubled (Makin, 2009). Industries, especially the financial one, associated with it grew also... The economy followed...

Lastly, even before that there was one hedge fund. Long Term Capital Management it was called. When Russia defaulted on its debts, liquidity in this fund dried up. Nobel laureates lost \$4 billion in less than 4 months (Lowenstein, 2008). Fund was unable to close down its positions. In any other case one should just let hip collapse. But the fund was different. It was very big. And being big, according to our authorities, is a crucial difference in our world. Federal Reserve lifted systematic risk flag. The fund was named "too big to fail". Financial institutions were up to help it. After huge efforts wealth of investors was saved. But there was a large doubt whether the lesson will be taken. And the phrase "too big to fail" cognitively remained in the head of any large investor...

## **Rational investors making rational decisions**

### **Financial market maladjustments**

The Federal Reserve interest rate is supposed to be risk-free. However investors who needed risk-free asset thought of such a low interest rate as too expensive. They started looking for something else. Something with higher return and essentially no risk. And the story of derivatives begins...

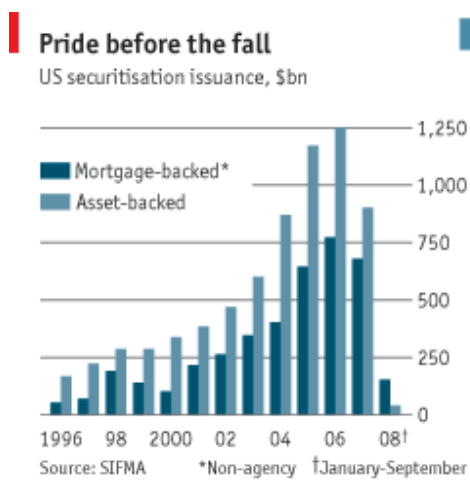
In financial economics price of any asset is determined by marginal costs of replicating it via portfolio of other assets. Any mispricings then would be eliminated by market via arbitrage. Task to replicate risk-free asset and get a higher return is tough, but creating assets with only systematic risk and getting more than Federal Reserve rate (one percent it was) did not seemed that of a challenge. Mortgage market, with backup of government, and derivatives market also offered a strong help here.

Why would anyone keep his investment for 1 percent in treasury bills if she can get few times more by investing in structured asse-backed securities as highest seniority tranche of collateralized debt obligation on restructured mortgage portfolio, which was rated triple A by Moody's and "friends" (which had their interest here as well). Even if individuals would have defaulted on their mortgages, the housing was gaining value.

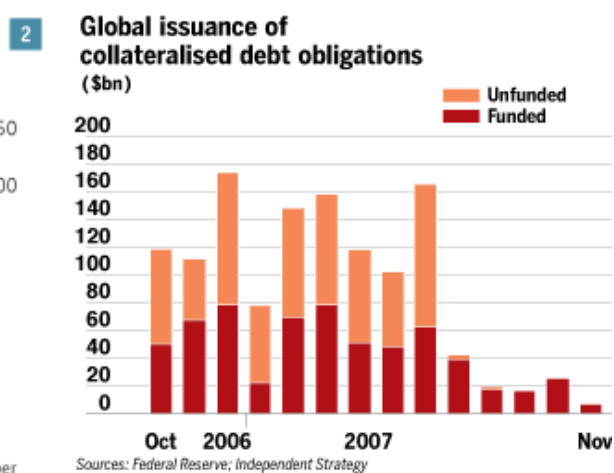
Essentially no risk seemed to be involved. Even if housing would stop gaining value, the loss would be covered by owners of lower seniority tranches. Only in the impossible case such investor would lose...

...impossible is nothing... This is what Adidas slogan says. And this is what turned to be true. The demand for such “risk-free” asset with such a low Federal Reserve rate was enormous. You borrow \$100 at 1%, invest it at 4% in your exotic “risk-free” derivative and you get 3\$ in profit after one year. The arbitrage it is called. One could argue about that it is not that risk-free, but keeping in mind the large probability of government intervention (“too big to fail” again), you can be more or less relaxed. You do not get much richer by 3\$, try borrowing \$100m. And you have just saved for your retirement. This is the core reason why the financial sector experienced enormous and incomparable growth in the period before credit crunch.

Everyone wanted to get their slice here. Demand was not saturated, but all those who were supposed to, already had a mortgage. Hm... Why not to give mortgage to those who are not supposed to have it. To those who anyway will not be able to repay – the ninjas (No Income, No Job or Assets people). Of course they will default. But who cares if housing gains value anyway?



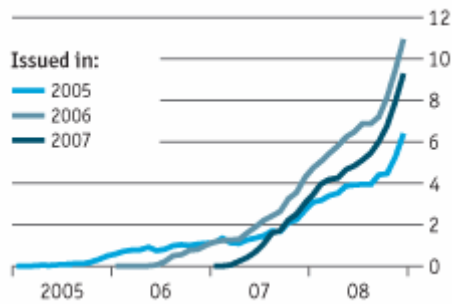
(Economist, 2009)



(Financial Times, 2007)

If in individual cases owners defaulted, growth of real estate market took care of it. However, individual cases started happening slightly too often. More and more houses were put on sale. Prices collapsed. When one’s house is worth less than the value of

mortgage payments, she as a rational person would choose to default on such mortgage and leave issuer of mortgage with a house. Even more defaults followed. Suddenly it did not felt that much risk-free...



### Hitting 60

Delinquent (more than 60 days) mortgages in Alt-A Residential Mortgage Backed Securities as a % of remaining mortgage balance

(Economist, 2009)

On financial system people started losing money. As everything was very complex and interrelated there was no way how to readjust towards changed essence of the risks involved. Bear Stearns was saved from collapse (“too big to fail” again). And Bear Stearns was not even considered as very large as compared to other players in the financial market. Paying Bear Stearns shareholders caused even larger moral hazard, because owners of other, bigger, companies now received their indirect government guarantees. And anyway it failed to prevent Lehman Brothers and AIG from collapse (Roberts, 2009).

Mortgage market fell, financial system fell, consequently and everything else associated with it... The economy followed...

### Moral hazard argument

First of all already mentioned “too big to fail” argument. The government saved Long Term Capital Management hedge fund. In general, everyone felt that financial system is too important to fail. If any other industry fails i.e. there could be a slightly higher unemployment, some products would not be available for consumption, etc. If the financial industry fails the credit for all other industries is halted. This causes serious implications for the rest of the economy.

Investors, especially risk takers, were happy to know that this is what government thinks. Now even if some derivative was bearing only the risk that system would collapse, the government indirectly assured that this risk is no longer relevant. This is another reason why a-little-more-risky derivatives were treated as if they were risk-free. Appetite for such derivatives was rising. Overall level of risk as well.

Deposit guarantee insurance was another invention. As banks may take excessive risks the government felt it is OK to protect individuals in case the banks would default. But as with any other regulation there is external effect. Things which seemed logical at the first side enhanced even larger problems.

When individuals know that their deposit is safe, they do not need to follow the excess risks the banks take. And banks knew it. You do not need to be safe anymore if you want have consumers. Vice versa it is. If you are safe you get lower returns. Meaning you are loosing profits for your “excessive want of safety”. So the risks taken by the banks increased. No speculations. Rational decisions given a certain endowment. If you take too little risk you will be out competed.

This excess feeling of direct or indirect safety provided by government also distorted the financial system. In financial economics laws everything is clear. No risk, no return. But it turned into essentially no risk with enormous returns. It meant that the price of risk was paid by taxpayers. So the government essentially was collecting tax payers money to pump a huge bubble...

### **Credit crunch. Who is guilty?**

Financial sector was blamed for creativity. The derivatives were blamed for being too complex. But can you blame investors? They did what was rational at a given endowment. Federal Reserve rate was not high enough for investors to keep their risk-free parts of portfolios. Can you blame customers that they're not buying expensive bread in your shop and looking for cheaper substitutes (and they believe that there are)? And in mortgages case, what if bread elsewhere is even subsidized (i.e. tax deductible as a mortgage) by the government. Who cares that there is tiny possibility that bread bought elsewhere can be a bit less tasty (i.e. a bit less risk-free...). If difference in prices is large enough, you are willing to take this extra risk. A rational choice it is called.

How can authority expect this not to turn into bubble if they take away from investors the most important signal in the market – the interest rate. As in any other case price of shifting opportunities over time must be determined by the demand and supply for it. Then any mispricing with interest is corrected by the market, by the arbitrageurs who immediately borrow or lend millions and leave no chances for the one which are few seconds late. But if the rate is set from outside, it is impossible to eliminate such at first

glance risk-free profit possibilities each and every time. Consequently, such possibilities would always lead to a bubble. Even if investor at some point realizes, that it bubble is likely to burst, quite often it is still beneficial to “ride on a wave for some time” as long as you get profits.

Financial markets are the ones with the highest volatilities. Each second exchange rates, interest rates and prices of securities change. Even discrepancies of a third digit after a comma can cause millions in arbitrage profits. It is by no means possible to regulate prices without having serious consequences of that. But this is exactly what central banks do.

Efficient capital allocation is the core reason why we need financial markets. Each dollar goes where it can give the largest marginal benefit. Efficient financial system not only injects capital where it is most required, but also takes it out, where it is not giving required benefits. Stock markets give signals for each investor, entrepreneur or any other person what the actual price of anything can be. It is one of the most important factors in everyday decision making. Government and central bank by interfering here and setting own prices eliminate this essential information and resources are misallocated.

Determination of interest rate should be left for the banks. Currently there is a system where central banks set the rate according to their “perception” of what it could be and keeping in mind what would be “beneficial” to the economy. But as I said previously, even slightest mispricing in financial markets can cause system creating its own suboptimal equilibriums. But individual banks cannot operate with fiduciary mediums of exchanges. This is how Ludwig von Mises expressed banknotes which are not backed by gold reserves. Ability to print as much as you can at the end of the day gives you only inflation. Banknotes need to be backed by assets, for example gold. Gold standard proved itself to be a powerful tool for combating inflation.

In the system where banks would be the ones who can issue gold-backed money, there would be no need for central bank. Finally market would be the one which sets interest rates, which would be real and informative signal for the rest of the economy.

## **Economic implications of interest rate regulation**

### **Interest rate as a signal for economy**

Interest rate is a crucial signal for enterprises (Rothbard, 1969). Ideally it is the equilibrium point of savings and lending. If people suddenly start to save more, the interest rate goes down. This signals for the producers that people are willing to wait for consumption goods. So they start to invest into longer way of production, the way which takes more time to make, but is more cost efficient. Keeping in mind the low interest rate it makes sense, since the capital can be borrowed cheaply and present value of the future sales is much higher than it would be with higher interest rate.

So the amount of goods to be consumed today is much lower. But it is exactly offset by the people's willingness to save. People are just not willing to consume today. Everything is in equilibrium. No unnecessary inflation.

### **Intervention in market determination of interest rates**

Now we have Federal Reserve setting interest rates as low as 1 percent. Federal Reserve does so in order to stimulate the growth of the economy. But it sends false signal to enterprises, since now people are not willing to save more and consume in the next periods. People still want to consume now, but the enterprises would provide them with too little goods for a few reasons.

Firstly, because this is the signal which the enterprises received. Even if it can be seen by some as artificial, it is still expected to be an approximation of the true one. Information is the crucial part in order to have efficient markets. And Federal Reserve eliminates this opportunity. Decisions of enterprises are distorted.

Secondly, with such a low interest rate the individuals will start borrowing more. It is irrational to save if you know that consuming today is much cheaper. So the demand for consuming the goods today boosts up. Everything what is made is bought (Horwitz, 2009).

And there is no need to explain what happens if you have lower supply and at the same time higher demand for goods. It boosts prices. And inflation is not the thing what one would be willing to have in his economy. It is well known that it seriously damages

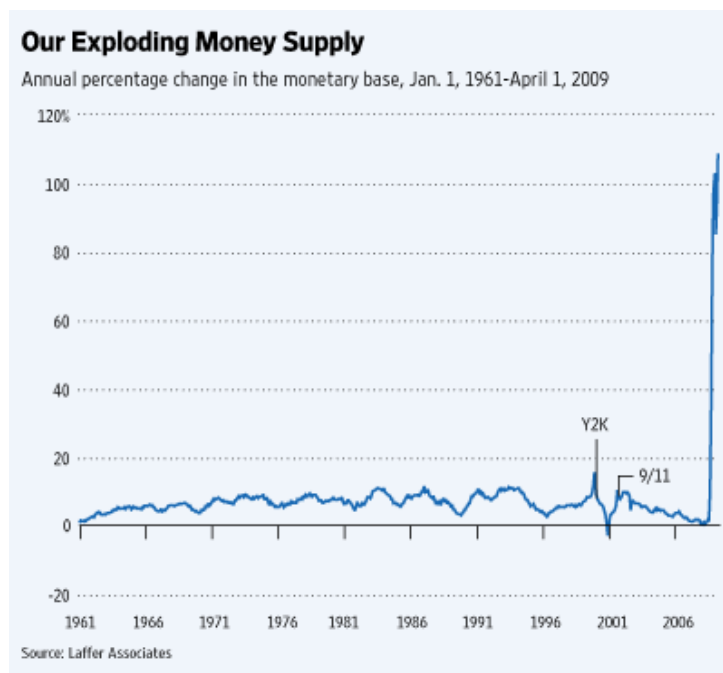
any perspectives of the country to have substantial growth in the future and has many other hazards for citizens as well.

### **And what has changed? If changed....**

President Barack Obama and his administration obviously did not learn the lesson of implications regulation has caused. Interest rates are record low. Government 700-billion-plan for bailouts would create even more and larger moral hazards in the future.

Moreover, the spending i.e. seems much more like a reform, not a recovery package. But governments are happy because on recessions their Keynesian policies are very welcomed by the society. Being popular and having power are the personal needs of politicians. Giving work for unemployed seems a right thing. One important fact is forgotten. Saying giving work is not the same as saying giving work in construction, financial or healthcare industry. If the labour (as any other resource) is misallocated – a correction would have to follow. And with such volumes of intervention, it can be even deeper and wider...

I would like to conclude with this graph by Arthur B. Laffer. It is more than evident why interest rates currently are so low and what implications it will have in the future.



*For me the issue is how to protect assets for my grandchildren.*

Arthur B. Laffer

(Laffer, 2009)

Lesson obviously not taken...

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