EEI POLICY PAPERS

The Financial Crisis

A Gigantic Failure of Politics

Johnny Munkhammar och Nima Sanandaji

EEI POLICY PAPERS

The Financial Crisis

A Gigantic Failure of Politics

Johnny Munkhammar och Nima Sanandaji

About EEI Policy Papers

The European Enterprise Institute Policy Papers series aims to inform the European political debate with qualified opinionated arguments, promoting the ideas of free enterprise and free competition. Papers are commissioned as analytical papers written either directly by EEI staff or by external writers. Any conclusions or opinions expressed in these papers do not necessarily reflect the opinion of the EEI or of those affiliated with the EEI.

Editor-in-chief
Johnny Munkhammar

Design
picture element

Copyright European Enterprise Institute

Reproduction is nor authorized without permission in written from from the publisher.

Published by:
European Enterprise Institute
c/o Kellen Europe
Avenue Jules Bordetlaan 142
1140 Brussels

Tel: +32 (0) 2 761 16 75
E-mail: european-enterprise@kelleneurope.com
Web site: www.european-enterprise.org

EEI President and Co-President: Peter Jungen, Gunnar Hökmark

The European Enterprise Institute is a non-profit, non-party affiliated organization, registered in Belgium. It aims to promote entrepreneurship in the EU policy community and to provide a platform for the ideas and philosophy of entrepreneurship throughout Europe.

The EEI works to facilitate research and debate in all areas of policy with impact on the conditions for entrepreneurship, incentives for innovation, competitiveness and economic prosperity. The EEI does not take any institutional opinion on individual issues but actively encourages an opinionated dialogue among stakeholders.

Table of Contents

A Word From the Publisher......6

Introduction......8

From Risky Mortgages to Global Financial crisis......12

Tax-Financed Credit Institutions and Regulations Create the Crisis......15

Experts Predicted How Politics Created the Crisis......19

... But the Politicians Ignored the Warnings......24

The Crisis of Capitalism?......28

Free Financial Markets are Decisive For Wealth Creation......31

The U.S. is Trailing in Terms of Reform......35

Conclusions......40

Literature and References......42

A Word From the Publisher

During the last 25 years, the global economy has experienced an unprecedented growth and development. Poverty has been defeated in vast regions of the world. The significance of this is impressive and certainly not only something for economists to be happy about. Prosperity is not mainly an economical issue but an issue about dignity and social opportunities.

Millions of people have got new dignity and real opportunities in a way and to a magnitude that no one would have believed 1968 or even 1989. The world has changed and we do not any more talk about the third world because there exists not any more that sort of division of our globe, which was presumed by the categories of the third, the second and the first world. Modern and global financial markets have changed all that and given opportunities for investments and trade to peoples and regions that were formerly excluded from most of those possibilities.

This perspective is important when we discuss the financial crisis of today and its causes. Our conclusions must not get in the way of having just another successful 25 years. Because we need at least as successful years as we have seen thus far to meet challenges like the people still living in poverty, the societies that are under transformation, the climate policy, the challenge of climate change and the integration of nations and regions.

The results of the global growth we have experienced are astonishing. What we certainly see today is the importance of well functioning global financial markets. And we need to secure that they function well in the future, adapting to the reality of a global economy. If we today regulate

these markets in a way that would hinder vitality and innovations regarding trade, enterprising and investments, we would lose opportunities but not win stability.

The financial sector must be stable, credible and transparent but it can't balance the shortcomings of other parts of the economy. If monetary policy isn't stable, if public finances are unstable or if political interventions undermine the market, the market can't compensate for that. And no one can avoid the consequences of an economical downturn; we can only reduce them as much as possible.

That is why the discussion about the causes of the present crisis must be open and provide a road map for the future development of the financial markets. A lot has to be done in order to achieve better regulation, but that does certainly not mean more regulations – something that is commonly suggested in today's debate. Europe should take a leading role in securing free global financial markets with better regulation.

This publication from the European Enterprise Institute (EEI) provides valuable pieces of information about how government interventions actually caused much of the financial crisis, and therefore provides arguments for free financial markets in the future.

Gunnar Hökmark
Co-chairman of EEI and member of the European Parliament

Introduction

The financial crisis in the United States has shaken the global economy. Some of the world's largest banks have gone bankrupt or been taken over by government authorities. Stock markets have collapsed and small savers fear they will lose their capital when the situation of the banks is insecure.

Today, many observers see the crisis as a proof of the free market's weaknesses. They think the solution lies in greater use of regulations and government intervention in the financial markets. At the same time, there are many signs that the crisis was *created* by regulations and government meddling. This has not been a market failure, it has been a failure of politics.

The crisis originated in the US mortgage market, specifically in the so-called "subprime" loan market focusing on households with weak credit worthiness. The US government had initially given the task of making it easier for low-income households to become home-owners to the public institutions Fannie Mae and Freddie Mac.

Drawing on hefty subsidies, Fannie Mae and Freddie Mac guaranteed mortgages granted to those individuals who did not qualify for ordinary loans. At the same time, regulations had been introduced which in some cases forced banks to extend credit to borrowers with shaky assets.

As in the financial crisis in Sweden in the 1990s and during America's Great Depression, the current financial crisis also has its origins in government monetary policy. The US Federal

Reserve cut the federal funds rate to very low levels after 2001 in order to soften the economic slowdown, which created a mortgage bubble.

Finally, the banks were convinced that the government very probably would bail them out, should a crisis occur. In this context US credit institutions granted extensive high-risk loans to people with low credit worthiness. When the housing market turned around, many of these households could no longer redeem their loans, and the crisis ensued.

Numerous experts and commentators had warned about the current crisis. But during the period of healthy economic growth, the will to listen let alone act was limited, among Republicans and Democrats alike.

Free markets are characterized by creative destruction: old products, companies and jobs are replaced by new and better ones. Without government intervention in the US financial markets, the decline would have been more limited and the market actors borne the loss. Through government action the decline has evolved into a crisis which without continued intervention would have – and still may have – serious consequences for the entire economy. Thus government intrusion often breeds more intervention.

The crisis must be handled, and this may entail repeated interventions over a long period. This is not limited to the USA as financial institutions in other countries also have bought credits which can no longer be honoured. Today the European countries are acting separately, but concerted action within the EU is being discussed. Beyond the crisis management, there is every reason

to focus on a long-term reform perspective, where the government's role also in the financial markets should be to set the rules, and not to be a player.

The United States previously held an advantage through an economic policy of freedom and growth relative to other industrial countries. In recent years, the country has lost momentum in market reforms, public expenditure has increased and new regulations of industry have been introduced. This means that the US has lost somewhat in terms of economic freedom – and therefore in competitiveness – while this has increased in other countries. This applies to large parts of Europe and of course China, India and Brazil – to mention but the three fastest-growing economies.

Many predict that the crisis marks the end of an era of American prosperity and global dominance. The United States will of course surmount the crisis, but the question is in which form and when – and which will be the long-term economic conditions created by US politicians, in particular within the financial markets. To succeed, American politicians have to realize the main causes of the crisis and the value of continuing reform. The crisis is not a result of the US economy being too free, but comes from the various parts where it has not been free until now.

There will always be downturns in the economy and risks of bubbles being created in markets. But rushing into the ideas of Karl Marx or Jean-Baptiste Colbert, as seems very popular, is not the solution to any of that. Free markets are an unprecedented engine of prosperity, and freer financial markets have been essential in the global boom of the past decades. In fact, since this crisis is to such a large extent government-created, it provides a stronger case for further

liberalizing financial markets.

This knowledge is important also for the European debate, not least because the financial crisis is hitting us equally. We may learn a great deal of what has worked and what has worked less well in US economic policy. The objective of this paper is therefore to describe the origins and long-term solutions of the current crisis.

Johnny Munkhammar
Research Director, European Enterprise Institute

Nima Sanandaji
Managing Director, Captus, a think-tank

From Risky Mortgages to Global Financial Crisis

In recent years, the American economy has grown rapidly and foreign investments have flown into the country. At the same time, the Federal Reserve has for a long time kept a very low federal funds rate. In 2003, the interest rate for 3-month treasury bills were as low as one per cent.[1] Above all, from 2003 to 2005 the Fed maintained the interest rates below the expected inflation rate and thus strongly subsidized loaning. This created a housing bubble.[2]

Since the mid-1990s a market for subprime mortgages has evolved. This concerns loans granted to borrowers with insufficient credit worthiness to qualify for ordinary bank loans.

The development of these mortgages has been strongly encouraged on the political level through subsidies. There have even been regulations which in some cases forced banks to extend mortgages. The subprime mortgages have played an important role in pushing the share of US home-owning households from 65 to 69 per cent between 1995 and 2006.[3]

In total, more than seven million American households had subscribed to a subprime mortgage at the end of 2007. The value of these mortgages at that time amounted to $ 1,300 billion, four times more than in 2003.[4] In 2005 alone, subprime mortgage contracts were signed at a value of $ 600 billion.[5]

The high-risk subprime loans coincided with a general overheating of the market. The government created the crisis to a great extent, but excessive lending contributed to its contagion. US

politicians increased risk-taking on a market which was already highly prone to risk, and the crisis soon emerged. When the economy turned around and housing prices started stagnating, low-income households increasingly found it difficult to reimburse and renew their mortgages.

During the third quarter of 2007, subprime contracts represented 13 per cent of the US mortgage market, but also 55 per cent of the foreclosures initiated during this period.[6] A number of American credit institutions specializing in subprime mortgages were then in deep crisis. For instance, the shares of New Century Financial Corporations and Novastar Financial plunged by 90 per cent.[7]

The crisis then spread throughout the overheated financial sector and soon hit credit institutions outside the United States. In March 2008, Bloomberg reported that more than 34,000 jobs had been cut in various Wall Street quoted banks.[8]

In April 2008, the IMF warned repeatedly that the crisis could lead to a global recession. The organization even said that it could be "the greatest financial shock since the Great Depression".[9]

The US subprime mortgage crisis has become a global problem. Around the world, small and large savers and investors alike fear losing their assets. A number of the world's best-known banks have gone bankrupt, been bought by other banks, taken over by the government or saved by public credits. This ranges from Bear Sterns, Merrill Lynch and the 119-year old Washington Mutual in the United States, to Northern Rock, Bradford & Bing and HBOS in the UK.

Internationally there is great uncertainty on which banks are rife for bankruptcy, which is why banks are reticent to lend to each other. Since many banks are dependent both on lending and borrowing, even those surviving are in dire straits.

The US government has spent $ 700 billion on a rescue package to calm the markets and transfer funds to the banks, granting them a margin for renewed lending. The capital is to be used in part to buy back bad loans, for instance bank mortgages.

Around Europe, other methods – with the same purpose – have been applied. Governments have pledged guarantees for bank deposits in several countries. In the UK the government has swapped capital transfers to banks against equity, to facilitate a return of taxpayers' money in the future – as was the case in Sweden in 1992.

Perhaps the most remarkable feature of the crisis is that it was all but inevitable. In fact some experts foresaw this development as early as 1999, but their warnings were not heeded by governments.

Tax-Financed Credit Institutions and Regulations Create the Crisis

To understand the current economic turbulence in the United States, it is necessary to study the two credit institutions which played a decisive role in its creation: Fannie Mae and Freddie Mac. The Federal National Mortgage Association, a k a Fannie Mae, was founded by the US federal government after the Great Depression. Over time it evolved into a private credit institution which simultaneously had the status of a government entity.

The business of Fannie Mae mostly consists of underwriting loans granted by other credit agencies. The Federal Home Loan Mortgage Corporation, Freddie Mac for short, was created in 1970 with the same basic structure and purpose as Fannie Mae.

The two institutions were taken over by the federal authorities on 7 September 2008, as both of them were very badly hit by the crisis to which they had largely contributed. It should be mentioned that these institutions in the preceding months had been in charge of 70 per cent of the mortgages in the United States, which provides an indication of their decisive role in the market where the crisis first occurred.[10]

Prior to being taken over by the federal government, these institutions had a very peculiar design. Fannie Mae and Freddie Mac were on one hand government entities with political goals for which they received substantial subsidies; on the other hand, they were private businesses seeking to maximize shareholder value.

The political objective was to push down the cost of subprime mortgages, using public subsidies. The latter in effect served to directly disable market risk analysis by artificially deflating the mortgage costs. They focused on increasing the subprime mortgages whose beneficiaries triggered the crisis by defaulting on their payments.

One reason why Fannie Mae and Freddie Mac controlled such a large share of the market is that they also used the subsidies to expand their activities. A 1996 Congressional Budget Office study showed that Fannie Mae and Freddie Mac received some $ 6.5 billion in subsidies in 1995. They both retained more than 40 per cent of these funds, rather than using them to subsidize mortgages.[11]

Unsurprisingly, the companies thus enjoyed very large profit margins. A survey from the US Treasury Department from the same year confirms this impression.[12] Fannie Mae and Freddie Mac not only benefited from the government subsidies. The financial sector clearly perceived that the federal government backed these organizations and that it was very unlikely that it would let them fail – a hypothesis which proved accurate on 7 September 2008.

Thus, profits were privatized and losses socialized. The advantages granted by the politicians to Fannie Mae and Freddie Mac enabled them to grow rapidly and crowd out the ordinary credit institutions on the free market. In July 2008 the New York Times reported that the two institutions granted or underwrote approximately half of the mortgage market, representing $ 12,000 billion.[13]

Fannie Mae and Freddie Mac may be said to have increased risk-taking in the mortgage market in three ways:

- Tax money was channeled via Fannie Mae and Freddie Mac to encourage high-risk loans
- The implicit knowledge that the government would step in to save Fannie Mae and Freddie Mac in case of a crisis further stimulated the market's risk prone behaviour
- Ordinary credit institutions were crowded out by Fannie Mae and Freddie Mac, whose dominant role made their mistakes fatal

Beyond Fannie Mae and Freddie Mac, there are federal home loan banks in the United States. These were created after the Depression and, like Fannie Mae and Freddie Mac, they are tax-financed credit institutions. The federal home loan banks lend money to other banks which in turn provide mortgages to private individuals. They use tax subsidies to reduce the cost of mortgages and have thus also contributed to the excessive credits in the US mortgage market.[14]

The US financial markets are tightly regulated and these regulations have played an important role in creating the current crisis. Federal and state regulations have meant that only a few institutions exist to evaluate the risk-taking associated with loans in the market. This oligopolistic market was badly equipped to gauge risks compared to a freer market with more actors.[15]

The Community Reinvestment Act introduced in 1977 has also fuelled bad risks in the credit market. Public authorities are in charge of evaluating the number of branch offices of banks in low-income areas and how many loans are granted there. If these are considered to be too few,

banks run the risk of being sanctioned, via fines for instance. In other words, regulation induces extending credits to people who are unable to redeem them.[16] In 1995 the Clinton administration modified the Community Reinvestment Act to increase the pressure on banks to grant high-risk loans.[17]

Allegedly, the market took on these risks because greed gained the upper hand. But in a market with many competitors and without government intervention, the profit motive would never have led to extreme lending to people who cannot pay back their loans. Such behaviour and risk-taking could only be done by government – with other people's money.

Experts Predicted How Politics Created the Crisis ...

Numerous critics over the years have warned against the financial crisis which the government-backed companies Fannie Mae and Freddie Mac could create. An example is an article published in the New York Times already in 1999. It describes the early plans to use Fannie Mae to ease the credit restrictions for mortgages: *"By expanding the type of loans that it will buy, Fannie Mae is hoping to spur banks to make more loans to people with less-than-stellar credit ratings."* This was motivated by the wish to "help increase home ownership among minorities and low-income households" responding to pressure from the Clinton administration.

But there was also support for this policy within the private financial sector. Private banks saw the possibility of expanding their market to people with poor credit worthiness. Loans which ordinarily would be too risky became profitable once they were subsidized by tax money and underwritten by institutions backed by the government. However, already nine years ago it was recognized how dangerous this social policy was. The same article noted how Fannie Mae in its new role was creating a lot more risk in the financial sector, which could lead to serious problems in an economic downturn.

As in the 1980s, there was the danger that government be forced to rescue the financial sector. Peter J. Wallison of the American Enterprise Institute and a financial expert, warned the readers: "'If they fail [with the subprimes], the government will have to step up and bail them out".[18] Wallison continued to develop his insights about the crisis he foresaw. In 2001, he edited a book about the various problems created by Fannie Mae and Freddie Mac in the American financial

system.[19] Three years later he published a book, *Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks – Why and How*, co-authored with Thomas H. Stanton and Bert Ely.

The authors were very clear in their warnings to the reader that in particular Fannie Mae and Freddie Mac but also the federal home loan banks could trigger a future crisis: *"The government sponsored companies in the housing market contribute very little to the quality of the financial system for housing in the USA, but creates risks for the taxpayers and the economy as a whole which cannot be resolved by regulation."*[20]

As noted by the economist Thomas Sowell, N. Gregory Mankiw (chairman of the Council of Economic Advisors to the US President) warned in 2004 that the financial sector expected government to bail them out in case of a crisis. Mankiw realized that this created "incentives for companies to take risks and enjoy the concomitant increase in revenue". At the same time, the price of these risks decreased, as government would at least in part cushion the blow using the taxpayers' money.[21]

Among the critics was Alan Greenspan, then chairman of the US Federal Reserve. Testifying before the Senate Committee on Banking, Housing and Urban Affairs in April 2005, he issued explicit warnings on how social policy channeled through loan institutions could lead to a future crisis. Greenspan noted that "investors have reached the conclusion that the government will not let the subsidized corporations fail", which led to overvaluation of the security and that mortgage rates were significantly lower than they would have been on a free market.

Greenspan also noted that the government backing of Fannie Mae och Freddie Mac was an important reason explaining why they had come to dominate such a large share of the mortgage market. It was the federal government which had enabled them to expand their share of the mortgage market to households from 5.6 per cent in 1990 to 23 per cent in 2003. In his presentation, Greenspan explained the mechanisms which would trigger the financial crisis. In a market creditors and investors make sure that borrowers are on a sound economic footing. The actions of Fannie Mae and Freddie Mac however disabled the market mechanisms:

"[M]arket discipline with respect to the GSEs has been weak to nonexistent. Because the many counterparties in GSE transactions assess risk based almost wholly on the GSE's perceived special relationship to the government rather than on the underlying soundness of the institutions, regulators cannot rely on market discipline to contain systemic risk."

When Fannie Mae and Freddie Mac were small, the risk they presented to the stability of the financial system was limited. Since the institutions, thanks to taxpayers' money, had grown large, they required "extensive reinforcement" of the way in which the government-subsidized lending institutions were regulated, and a limitation of their role on the market. Greenspan warned that the existing situation could "threaten the stability of financial markets" and also explained that Fannie Mae and Freddie Mac created social advantages in the mortgage market through their subsidized activities to a lesser extent than commonly thought.

Finally he noted that Freddie Mac's CEO in 1989 had declared before Congress that there were risks associated with his company's activities becoming too extensive. This changed after

1989 when the company came under the ownership of private shareholders who used their close connection to the government to expand their activities.[22]

Perhaps the strongest criticism – against both the social policy which triggered the crisis and the financial policy (for which Greenspan is largely responsible) which provoked the credit bubble – has come from some of the most market-friendly observers. Former presidential candidate Ron Paul and free market think tanks like the Cato Institute and the Mises Institute have forcefully criticized the actions of Republicans and Democrats alike recently.

During 2005, LewRockwell.com (among the best-known webzines with a consistent libertarian profile and closely connected to the Mises Institute) published a speech by Ron Paul before Congress where he warned of the coming crisis:

"I hope that my colleagues join me in protecting taxpayers from having to bail out Fannie Mae and Freddie Mac when the housing bubble bursts."[23]

Scathing criticism has also hit the Bush administration and both Democrats and Republican members of Congress for having been too generous in spending taxpayers' money.

Well before the crisis had spread, the Chairman of the US Federal Reserve, the President's chief economic advisors and an expert on the mortgage market had thus carefully described how the government policy could lead to a financial crisis and identified how a combination of private profit and socialized losses had paved the way. An entire political movement has in reality shed

light on the problems which were being created by a monetary policy subsidizing loans combined with government intervention.

The political will to carry out the necessary reforms was however all but great.

... But the Politicians Ignored the Warnings

Within the White House, there were early insights that the behaviour of Fannie Mae and Freddie Mac entailed great risks. An article in the New York Post pointed out that already the 2002 budget bill notes that the government-subsidized loan institutions had already grown large enough that their financial problems could spawn great difficulties in the financial sector as a whole.[24]

In 2003 the Bush administration attempted to persuade Congress to create an authority to monitor and regulate Fannie Mae and Freddie Mac. The proposal aimed at more explicit regulation of the credit institutions. But their tax financing would remain, as would the implicit guarantee that government would step in if the institutions got into trouble.

Barney Frank, then Democrat chairman of the House Financial Committee, resisted these initiatives however. Frank believed that Fannie Mae and Freddie Mac were fundamentally financially sound and declared that he couldn't see a threat of serious losses. "These two entities – Fannie Mae and Freddie Mac – are not facing any kind of financial crisis", Frank explained. Further he argued:

"The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing."

Frank received support from Rep. Melvin L. Watt (D) who said:

'I don't see much other than a shell game going on here, moving something from one agency to another and in the process weakening the bargaining power of poorer families and their ability to get affordable housing."[25]

Already nine years ago there were clear warning signs of the coming crisis, but the measures taken by the Bush administration to restrict the destructive policy which was channeled through Fannie Mae and Freddie Mac were limited to the creation of a new regulatory authority.

The latter would neither fundamentally resolve the problem of pumping subsidies into the mortgage market which dangerously increased risk-taking, nor how the government's implicit role as guarantor of Fannie Mae and Freddie Mac further encouraged high-risk lending. Even a mild attempt at regulation was stopped by Congress as it went against the social objective of making it easier for low-income households to buy their own home.

An important reason explaining why Fannie Mae and Freddie Mac were able to carry on despite the danger that government intervention increased risks in the mortgage market was that these risks were not at all obvious to the politicians at a time when the US economy was growing rapidly. However well respected Alan Greenspan was among both Democrats and Republicans as an eminent economist and chairman of the Fed, even his words fell into deaf ears. As the economy was doing well, politicians were more interested in scoring short-term points in terms of social policy than in preventing a potential future crisis.

There may also have been a lack of understanding for the importance of not manipulating the

risk calculus of the market, especially if government intervention aims to strongly *increase* risk taking.

Finally, an important explanation is that Fannie Mae and Freddie Mac are organizations which have spent considerable resources on influencing political decisions in the United States – they are a leading donor to the Obama campaign for instance – which could possibly help explain that they were able to grow by way of special regulations and tax subsidies.

That the Bush administration tried to regulate Fannie Mae and Freddie Mac in 2003 should not be interpreted as proof of its prescience in terms of the crisis. The proposed reform was toothless and Bush himself was a driving force in channeling social policy through government intervention in the mortgage market. In a speech held in the summer of 2002, Bush declared:

"We want 5.5 million more homeowners by 2010 -- million more minority homeowners by 2010. (...) But it's going to mean we're going to have to work hard to achieve the goal, all of us. And by all of us, I mean not only the federal government, but the private sector, as well."[26]

The crisis spread, with the help of international financial markets, from the US mortgage sector to many other financial institutions. Another international government involvement also helped create the crisis. The enormous Chinese surpluses stemming from foreign trade was invested in government-owned sovereign wealth funds. In turn, they invested in US financial instruments, further boosting lending and blowing up the bubble.

French President Nicolas Sarkozy proposed on October 21st that Europe should create European wealth funds. That way, European governments would purchase European companies to avoid foreign ownership. It remains unclear what is negative with foreign ownership. But the main point is that government involvement – such as sovereign wealth funds – helped create the crisis, which means that more of that cannot be the solution. Before setting out on a protectionist path, one should remember how exactly those kinds of policies created a recession in the 1930s. And before initiating policies with which countries would start competing in socializing companies, one should remember that private owners have proven better at running companies that governments.

The Crisis of Capitalism?

Numerous are those today willing to interpret the current financial crisis as a result of economic freedom. French President Nicolas Sarkozy has for instance declared that the crisis comes from the world's economies not being sufficiently regulated, and that this era now is over.[27]

Numerous observers have claimed that the crisis means we should introduce more regulation, increased government intervention in the economy, tax hikes and generally abandon the idea of free markets.

According to an editorial in the largest daily newspaper in Scandinavia, Aftonbladet, the financial crisis may be entirely blamed on economic freedom, showing that free markets are ultimately unsustainable. The title is telling, demonstrating the ideological left-wing perspective to interpret the crisis: "Financial crisis by Marxist script."[28]

The fact that the US crisis was the result of precisely government intervention with social policy goals is most of the time not discussed by those who view it as a proof of the demise of capitalism. Rather, it is contended that the crisis was produced by greed: everything from US health care policy to education and the level of taxation are accused of being too free-market.

Peter J. Wallison, the expert who in 1999 already foresaw how government intervention in the mortgage market could trigger a future crisis as well as penning two books about the risk represented by the actions of Fannie Mae and Freddie Mac, notes with a colleague that it would

be entirely unjustified to blame the crisis on the lack of regulation.

The past three decades have seen substantial deregulation of the US economy, but not within the financial sector:

"Almost all financial legislation, such as the Federal Deposit Insurance Corp. Improvement Act of 1991, adopted after the savings and loans collapse in the late 1980s, significantly tightened the regulation of banks."[29]

The libertarian commentator Johan Norberg asks in the Swedish daily Expressen:

"Shouldn't we for a start study the tens of thousands of pages of regulation already existing and what the 12,190 individuals who spend all their time regulating the financial markets only on the federal level and what they did when this happened? And then we will see that, at least as eagerly as the rest, they helped to inflate the bubble. The only difference was that they had a bigger pump."[30]

Even during preceding financial crises, interpreted as proof of the failure of capitalism, regulations and government meddling are responsible for many problems. As Nobel Laureate Milton Friedman explained in a book co-authored with Anna J. Schwartz: by creating deflation through monetary policy, the economic downturn became a depression.[31]

The Swedish financial crisis during the 1990s showed some similarities with the one hitting

the United States today. Interest rates were low, meaning that loans were subsidized by the government. Many Swedes were willing to contract even high risk loans to buy housing, amongst other goods. As the real interest crisis occurred, real estate prices plummeted and the housing bubble burst. Thus banking credibility quickly sunk and the crisis ensued. The combination of a fixed exchange rate policy and a long-term inflationary economic policy, both politically created, led to a very serious recession.[32]

Although the crisis in the United States has also to a large extent been created by government intervention and regulation, these very instruments are currently viewed as the remedy. A more constructive policy would be to eliminate, or at the least to reduce, the way in which the US federal government has used credit institutions for social policy through the mortgage market, thereby provoking the crisis. In the same vein, regulations forcing banks in some cases to grant high-risk loans ought to be revised or indeed eliminated. A lesson is that it is hazardous to promote a policy whereby tax money and regulations are used to encourage banks to grant loans which they would otherwise have avoided.

Free Financial Markets are Decisive For Wealth Creation

Unlike what media and certain commentators tend to express, the world's financial markets are regulated in a variety of ways. Government institutions grant market entry and exit of financial institutions, they monitor their behaviour, influence the credit markets and govern the flow of monetary funds. On an international level, a series of organizations – such as the IMF, the World Bank and the Bank for International Settlements – regulate financial markets.

Some forms of regulation and government intervention in the financial market aim to reduce risk taking, whereas others (such as the US mortgage crisis) tend to increase risk taking.

It is easy to call for more regulation in times of crisis. However, few are those knowledgeable of the US mortgage crisis who would approve the wisdom of forcing banks by regulatory fiat to lend money to low-income households with low credit worthiness, or by subsidizing high-risk loans through interest rates or government backed credit institutions. Conversely – regulations which restrict financial markets' risk taking – today seem an attractive solution to many.

However, for a number of reasons, we should be cautious about over-regulating financial markets. For a start – and this is essential – free markets are the foundation of wealth creation worldwide. The relatively free financial markets have played a decisive role in making economic development possible throughout the world. Studies have established the link between the degree of competition and openness in the financial sector and the economic growth of a given country, which is also reinforced by the globalization effect in the financial sector.[33]

As free markets have spread to the former socialist states of Eastern Europe, as well as to China, Vietnam and India, financial markets have had a decisive role in lifting hundreds of millions of people out of poverty in recent years. When markets are regulated, they tend to work less well, a lesson that the US crisis clearly shows. Making markets devoid of risk means depriving them of their capacity to create wealth.

Failing the deregulation of financial markets carried out during the 1980s, we would not benefit from the same explicit globalization featuring high general economic growth and the concomitant reduction of world poverty. The greater liberty in financial markets rendered investments in poorer countries possible.

The private sector tends to find ways and means to circumvent regulations, thus making them ineffective in terms of the original purpose. At the same time, capital flows between countries and tend to shun nations where regulations are strict. This trend clearly illustrates that investors usually view increased regulation of financial markets as being harmful to long-term investments; otherwise, investments would have sought to enter more rather than less regulated financial markets.

For politicians, the cost of introducing additional regulations is rather low. Short term, decision makers may gain in popularity by "showing action" through increased government direction of financial markets. It is only in the long term that the actual impact of regulation may be observed, and experience tells us that finance – like other markets – is best developed where it remains free.

Thus, the public interest is not always the focus of political decision-making. Numerous examples demonstrating this have been presented within the theoretical framework of the Public Choice school of economics. In complex markets, politicians and bureaucrats cannot always determine the public interest, nor indeed how this may be favoured. The US Federal Reserve maintained its interest rate at a far too low rate, thereby subsidizing loans and contributing to an overheated economy. This illustrates a policy which civil servants thought reasonable, but which created a major crisis.

In fact, regulatory policy is not simply done on a rational basis. The politicians and civil servants in charge of conceiving regulations are conditioned by their own interests and ideological preferences. One motivation behind regulations and public interference in the economy is to increase the power of politicians and authorities; another is to satisfy the aspiration of various large lobbying organizations. It is one thing to posit the market as it works in reality against the theoretically perfect government regulation; it is another to ponder how political management actually tends to work.

Markets are not perfect, and overheating may sometimes occur, just as investors in other cases may be too prudent in placing their capital. However, this does not automatically imply that politicians should intervene to improve the market, since political management generally uses worse information and leads to greater problems than market-based management. There will always be ups and downs on free markets; but it takes political intervention to create enormous crises.

Politicians obviously have a role in the financial sector, by maintaining a well-functioning monetary system, creating the electronic systems through which transactions are made, regulating contract enforcement and so on. When financial crises develop, there are also arguments for dealing with this politically – since failures in financial markets may put the entire economy on hold. But at the same time, there is always the risk that the financial sector realize that government will provide a bail-out in the next crisis and therefore continues its exaggerated risk behaviour.

The analysis pertaining to the appropriate legislation of financial markets is complex, but it would be unreasonable to start out from an erroneous vision of the world – that is, ignoring that the United States already has a tightly regulated financial market and that regulation and government intervention triggered the current crisis – and thus call for additional regulation and government interference to solve it.

Overall, there is on the contrary reason to work towards freer financial markets – in the United States as well as in other countries and internationally – to stimulate wealth creation and avoid crises produced by political intervention.

The U.S. is Trailing in Terms of Reform

One reason why financial crises originating in the United States superficially may be interpreted as a crisis for the free economy is that the country enjoys a high degree of economic freedom. It is correct that the United States rates a superior position in the *Index of Economic Freedom* in terms of various aggregate indicators.[34] That said, there are naturally parts of the US economy which are not free. In terms of financial markets, the economic freedom in the US is on par with that of many European countries.

Economic freedom has continually risen in the world over the past 20 years. This is not the case everywhere and where the rate has improved, it has not been constant all the time – nevertheless, the trend is clear. In recent years however, the US has stagnated and even experienced a loss of economic freedom, resulting among other things from new regulations hitting industry, e.g. Sarbanes-Oxley, as well as increased public expenditure. Contrariwise, Europe has enjoyed greater economic freedom. The crisis has therefore occurred in the United States with regulated financial markets and in recent years decreasing economic freedom. It thus suddenly seems less reasonable to assume that widespread deregulation is the cause of the crisis.

How the American crisis is handled and how the conditions for the future growth of the country develop are decisive factors also for Europe and its citizens. The United States is not only our most important trading partner, but also a significant exporter of innovations and ideas. The US debate is currently dominated by accusations of greed and claims that deregulation has caused the crisis, that Wall Street has destroyed Main Street. This is influencing the political climate

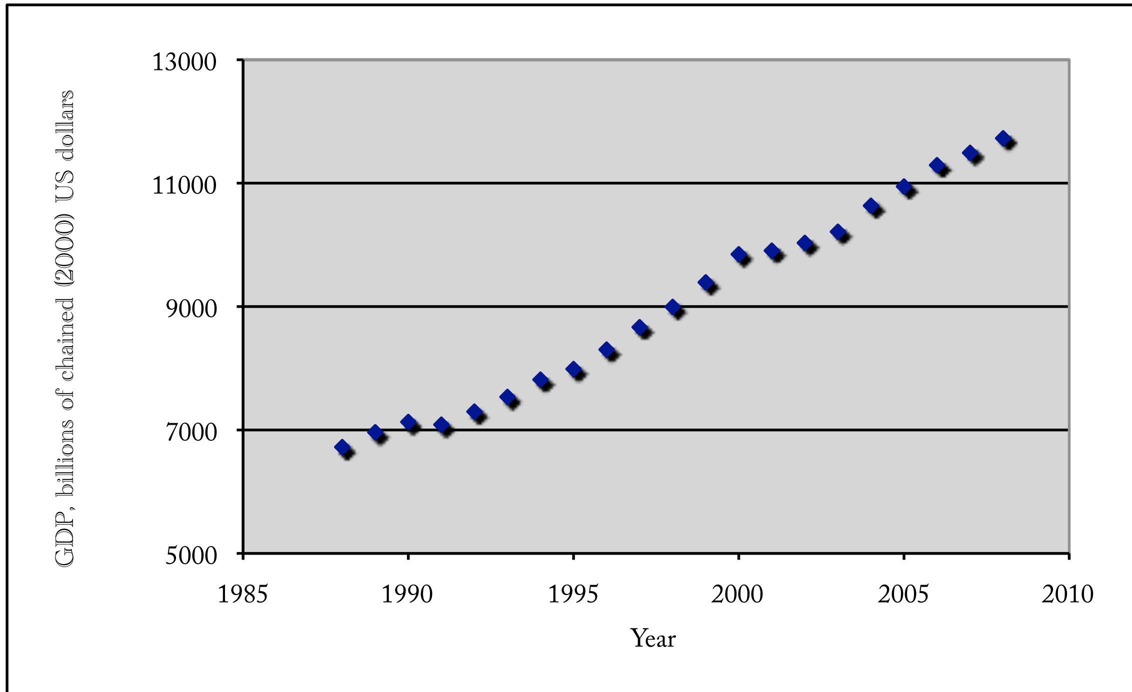
before the upcoming elections. It thus unfortunately seems probable that the new administration in Washington DC would continue to reduce economic freedom in the United States.

The ongoing fall in US stock markets must be viewed in the light of the strong rise in financial markets which has taken place in recent years. The net sum of household and non-profit organizations' savings and assets minus debts in the US economy amounted in the second quarter of 2008 to almost $ 56,000 billion.[35] This corresponds to approx.
$ 190,000 (or SEK 1.3 million) per capita. Between 2002 and 2007, savings and assets increased by almost 50 per cent.[36]

This amount may be compared to the approx. $ 700 billion which is the cost of the rescue package so far implemented in the United States to solve the crisis. $ 700 billion is of course a lot of money, but it is important to remember the increase in wealth in recent years, and which for the most part remains even after the current crisis.

The US economy continually enjoys productivity increases. The annual increase in productivity between 2002 and 2007 was on average 2.5 per cent. This is higher than the average annual increase of 2.1 per cent in the period 1988-2007.[37] Figure 1 shows real GDP growth in the United States from the second quarter of 1988 to the second quarter of 2008. In the past five years, average growth has been 2.8 per cent, i.e. the same as for the entire 20-year period.[38]

Figure 1 – GDP growth in the United States 1988-2008

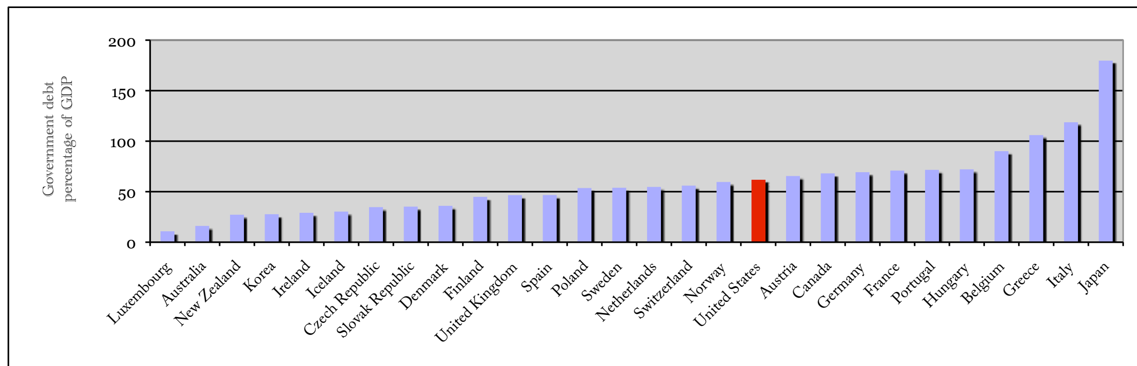


Source: Bureau of Economic Analysis

It is true that the US public sector has run a deficit since 2002 and it is important that decision makers limit public expenditure to eliminate the deficit. But this problem should not be exaggerated. From 2002 to 2007, the budget deficit was on average 2.4 per cent, and 1.3 per cent since 2000.[39] In the media, it is often claimed that the US economy is suffering from a very large public deficit, but again there is a tendency to exaggerate.

The OECD Factbook compares public debt in various countries until the year 2006. The figures show that the US public debt was 62 per cent of GDP. This is relatively high, but still lower than the corresponding figure for the period 1990-1998. An international comparison shows that the US public debt of 62 per cent was not exceptional in terms of GDP relative to other industrial countries.[40]

Figure 2 – Public debt in the OECD member countries 2006



Source: OECD Factbook 2008

In summary, the United States has enjoyed strong economic growth resulting from a series of reforms, chiefly during the 1980s, which increased economic freedom. The effects of this growth in prosperity will remain also after the present crisis. There are obvious problems in the US economy, but these should not be exaggerated. John McCain was heavily criticized for declaring that the fundamentals of the US economy are strong, but if we leave aside the alarmist media reports, there is much to confirm this picture.

As the United States benefited from strong growth as a result of market liberalization, the government should carry on in the same direction and certainly not reduce economic freedom. The ongoing crisis shows that there is substantial harmful government intervention in US markets, i.e. this is not the way to go. In any case, it is very important – also for Europe although there are other countries driving economic growth – that the United States choose a direction which strengthens the good economic fundamentals.

The financial crisis may be the signature event that pushes Europe ahead. For 30 years, Europe has lagged behind the United States in economic growth. This can largely be explained by the difference in economic freedom. But in recent years, economic freedom has continued to rise in most of Europe, and declined in the US. And now, Europe seems to have handled the financial crisis more efficiently. European policy agendas will most likely remain set on reform, but it is more unclear in the US.

Conclusions

A recurrent assertion in the analyses of the crisis, its origins and impact has been that the time has come to discuss what type of capitalism we need. This is a reasonable demand. A central conclusion is that we should have more freedom for capitalism, and less government intervention. The current global crisis is a result of government interference and heavily regulated markets. Once again: free markets lead to the disappearence of old companies and jobs, downturns do occur. But comprehensive government intervention often leads to major crises. Markets obviously need rules to function, but that is not the same as semi-public corporations, tax subsidies and excessive regulations. We need capitalism, not what in the 1970s was termed the mixed economy.

There is sometimes talk of market failures, which politicians supposedly must correct with various means. We may object to the concept, as failure must be related to a specific objective, something which a free market doesn't have by definition. More importantly however, we should realize that the financial crisis is not a market failure – if indeed there is such a thing – but a very serious failure of politics. Public Choice theory explains how politicians implement policies which seriously harm the general interest, and this is a case in point. The crisis occurred despite repeated warnings from experts. Hopefully the debate will in due time focus more on the origins of this failure, in order to avoid similar crises in the future.

Literature and References

[1] Selected U.S. Interest Rates and Bond Yields: 1965-2003 (percent per annum), Business Statistics of the United States and Federal Reserve Board http://eparc.missouri.edu/publication/SAM/D/D1.pdf . Last consulted by the authors 2008-10-02

[2] A Mortgage Fable, The Wall Street Journal, 2008-09-22

[3] Speech by Ben S. Bernanke, Federal Reserve Bank of Chicago, 43rd annual conference on the banking system and competition, Chicago, Illinois, USA, 2007-05-17

[4] A Snapshot of the Subprime Market, Center For Responsible Lending, 2007-11-28

[5] Subprime Time, The American, 2007-03-08

[6] Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey, press release from the Mortage Bankers Association, 2007-06-12

[7] Subprime Time, The American, 2007-03-08

[8] Wall Street Firms Cut 34,000 Jobs, Most Since 2001 Dot-Com Bust, Bloomberg, 2008-03-24

[9] IMF says US crisis is 'largest financial shock since Great Depression', The Guardian, 2008-04-09

[10] Treasury to Rescue Fannie and Freddie, Washington Post, 2008-09-07

[11] Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, U.S. Congressional Budget Office, 1996

[12] Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, U.S. Department of the Treasury, 1996

[13] Loan-Agency Woes Swell From a Trickle to a Torrent, The New York Times, 2008-07-11

[14] Peter J. Wallison, Thomas H. Stanton och Bert Ely, Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks - Why and How, AEI Press, 2004

[15] A Mortgage Fable, The Wall Street Journal, 2008-09-22

[16] George J. Benston, The Community Reinvestment Act - Looking for Discrimination That Isn't There, Cato Institute, 1999-10-06

[17] The Free Market's Not Dead, Forbes, 2008-10-03
[18] Fannie Mae Eases Credit To Aid Mortgage Lending, New York Times, 1999-09-30
[19] Peter J. Wallison, red., Serving Two Masters, Yet Out of Control Fannie Mae and Freddie Mac The AEI Press, AEI Press, 2001
[20] Peter J. Wallison, Thomas H. Stanton och Bert Ely, Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks - Why and How, AEI Press, 2004
[21] Bailout Politics, National Review, 2008-09-30
[22] Testimony of Chairman Alan Greenspan, Regulatory reform of the government-sponsored enterprises, before the Committee on Banking, Housing, and Urban Affairs, US Senate, 2005-04-06
http://www.federalreserve.gov/boarddocs/testimony/2005/20050406/default.htm
[23] The GSE Crisis, LewRockwell.com, 2005-10-27
http://www.lewrockwell.com/paul/paul282.html
[24] Alarms & denial, warnings on road to bailout – and refusals to listen, New York Post, 2008-09-26
[25] New Agency Proposed to Oversee Freddie Mac and Fannie Mae, The New York Times, 2003-09-11
http://query.nytimes.com/gst/fullpage.html?res=9E06E3D6123BF932A2575AC0A9659C8B63
[26] President Reiterates Goal on Homeownership, 2002-06-18
Speech available on the White House homepage:
http://www.whitehouse.gov/news/releases/2002/06/20020618-1.html
Last consulted by authors on 2008-10-04
[27] 'Laissez-faire' capitalism is finished, says France, EU-observer.com, 2008-09-26
[28] Finanskris efter manus av Marx, Aftonbladet, 2008-10-01
[29] Deregulation Not to Blame for Financial Woes, American Enterprise Institute, 2008-09-30
http://www.aei.org/publications/filter.all,pubID.28701/pub_detail.asp
[30] Tack och lov att Bush fick nobben, Expressen, 2008-10-01
[31] A Monetary History of the United States: 1867-1960, Milton Friedman och Anna Jacobson

Schwartz, 1963
[32] Se bl a Dennis, Bengt, 500 %, Norstedts 1998
[33] Cf. François, Joseph, F, Schuknecht, Ludger, Trade In Financial Services: Procompetitive Effects And Growth Performance, Centre for Economic Policy Research, Discussion Paper No 2144, December 1999, och Dilip, Das K, Globalisation in the World of Finance, Global Economy Journal, Vol 6, Issue 1, 2006
[34] Se http://www.heritage.org/index
[35] B.100 Balance Sheet of Households and Nonprofit Organizations (1) - Billions of dollars; amounts outstanding end of period, not seasonally adjusted, Federal Reserve Statistical Release, 2008-09-18
http://www.federalreserve.gov/releases/Z1/current/z1r-5.pdf
Last consulted by authors on 2008-10-04
[36] B.100 Balance Sheet of Households and Nonprofit Organizations (1) - Billions of dollars; amounts outstanding end of period, not seasonally adjusted, Federal Reserve Statistical Release, 2008-09-18
http://www.federalreserve.gov/releases/Z1/current/Z1/current/z1r-5.pdf
Last consulted by the authors on 2008-10-04
[37] Major Sector Productivity and Costs Index, Output per Hour, Nonfarm Businesses, Bureau of Labor Statistics, http://www.bls.gov/lpc/
[38] Bureau of Economic Analysis
http://www.bea.gov/national/nipaweb/index.asp
Last consulted by the authors on 2008-10-04
[39] Budget of the United States Government, Fiscal Year 2009, Office of Management and Budget, Table 1.2-Summary of Receipts, Outlays, and Surpluses or Deficits(-) as Percentages of GDP:1930-2013
[40] Public finance - Government deficits and debt - Government debt, OECD Factbook 2008: Economic, Environmental and Social Statistics, OECD, 2008

The financial crisis has shaken the global economy. Policymakers have had to focus on short-term crisis management. As time goes, it becomes increasingly important, however, to analyze the long-term picture.

Many have argued that this is a crisis of the free economy. Some hope that the liberalizations of the last 25 years will be rolled back and that governments will become more interventionist.

This publication provides the opposite analysis and message. The main conclusion is that the core of the crisis is rather a failure of governments and politicians. The US government required massive lending to people who could not afford to pay.

The publication is written by Johnny Munkhammar, EEI Research Director, and Nima Sanandaji, Managing Director for Captus. They describe how politicians, not free markets, created the crisis and argue that the world needs freer financial markets.