

**REMARKS BEFORE THE TUESDAY EVENING CLUB
NEWTON, MA JUNE 24, 2008**

**The Credit Crunch: What Happened and Why?
Or, The Etiology of a Recent Episode in Modern Political Economy**

When the capital development of a country becomes a by product
of the activities of a casino, the job is likely to be ill done.

--J.M Keynes

I. Globalization and Its Discontents (w/apologies. to S. Freud)

For those who favor the broadest sweep of history (and have a bent toward historicist “declinism”), the rise of the financial services sector in the first half of the decade was no cyclical phenomenon. These anti-Panglossians see it not as a successor to the stock market’s technology bubble in the late ‘90s or the energy sector’s in the ‘70s. To them it was, instead, part of the final phase of a long secular trend in the rise and fall of empire similar to that which befell Hapsburg Spain, the Dutch Republic and then the British Empire. All arguably ended in so-called “financialization,” which in simplistic terms characterizes that late stage in a nation’s development where much of the economy is devoted to creating and trading pieces of paper rather than things. Some of the more conspiratorially minded among them see a kind of cabal at work among conservative policy makers and other string-pullers to anoint financial services as the economy’s flagship after the long decline of manufacturing and the maturation of other portions of the services sector. The irony, of course, is that if true, these people would have been just those kinds of conservatives for whom a “national economic policy,” once a favorite of liberals who loved Japanese-style national planning, would be anathema.

Beyond the grander sweep of history, a major trend that helped bring us to our present pass can be labeled neo-mercantilism. After WWII America’s oil-based economy supplanted the U.K.’s coal-based as the foundation for hegemony in the non-Communist world. Then several decades ago, America made a Devil’s pact with the Saudis (“There will be blood!”). In exchange for U.S. protection and its indulgence for the Kingdom’s Wahabbist religious undergirdings, the Saudis agreed to assure a dependable supply of oil at affordable cost (always and everywhere priced in dollars). Other major oil producers in the Gulf followed suit.

Then, more recently as trade liberalization led to more open U.S. markets, an international system some have called Bretton Woods II arose.¹ After the collapse of the Soviet Union and the emergence of a market-based China, Bretton Woods II assured unimpeded access to the U.S. consumer market—the world’s biggest—for goods from the emerging markets countries in exchange for their implicit promise not to dump their

¹ Bretton Woods was the celebrated post-WWII conference (held in New Hampshire) where the victorious allies (other than the Soviets) created the system of rules and institutions that would govern currencies, trade and capital flows for more than a generation.

dollar earnings but instead to invest them in dollar-denominated securities, especially Treasury securities. The latter was convenient for a Federal government whose parlous finances the last Kings of France would have recognized. It also had the broader salutary impact of lowering interest rates on the margin. The unspoken bargain was that it would give U.S. consumers access to incredibly cheap goods and at the same time integrate hundreds of millions—if not billions—of peasants into the world economy, where in time they would become buyers of U.S. goods and services such as technology and media.

Bretton Woods II worked well for a number of years but at great cost. It could never exist in equilibrium. Factories closed, and living standards stagnated, though prices fell at Walmart. The current account deficit rose inexorably to an unimaginable 6.5% of GDP, and the dollar inevitably declined steadily against the U.S.'s major trading partners' currencies to banana republic levels. Indeed, some of those old banana republics like Brazil are now doing quite well, thank you. As for the U.S., the dollar's status as the world's sole reserve currency seems jeopardized as we lose the power of "seignourage"—the ability of one sovereign to dictate to others the economic terms of their relationship.

In the early part of this decade, after the tech stock bust, this "wall of money" from oil and goods exporters (which then-Professor Bernanke, now chairman of the Federal Reserve, called a "savings glut") swept across the U.S. available to invest in anything and everything, though often at several iterations away from its original source. At some point, in a presumed coincidence, the Federal Reserve, under Al "Easy Money" Greenspan, reacted in horror after the tech bust (but sat on their hands before) and, in the face of a wholly fanciful threat of a Japanese-style deflation, drove after-inflation short-term rates into negative territory and kept them there for an unconscionable 31 straight months—the ultimate "Greenspan put," i.e., the alleged implicit promise by Greenspan's Fed to protect Wall Street and the broader financial system against their own improvidence. Money (short-term, at least) was free! All of this occurred against the secular trend of disinflation inaugurated by Greenspan's predecessor, Paul Volcker—whom I call St. Paul—who slew the beast of near-hyperinflation starting in the late '70s. With inflation down, interest rates declined, and asset prices naturally rose. Long-term money was cheap!

The result was a decades-long massive rise in private debt and therefore financial leverage. It was a classic credit bubble, and they are always more dangerous than asset bubbles, for two reasons. One is that instead of acting vertically in one or more asset classes, they pervade the system horizontally and put much more at risk. The second is that recovery takes much longer just because they are systemic.

II. The Death of Keynesianism and the Triumph of the Chicago School

It can be argued—persuasively, I think—that in the yin and yang of history, we have reached the end of a conservative cycle not unlike the Gilded Age and the Roaring '20s. This one (nameless so far) began in the early 1980s with the collapse of the New Deal consensus and the near-hyperinflation of the 1970s. For some 25 years Friedmanite

glorification of free markets has reigned supreme, with its major corollary the demonization of regulation.

As a result, the regulated portion of the financial services sector has declined tremendously. What one observer has called the “shadow banking system” (i.e., all the institutions and private equity and hedge funds that extend credit but are not regulated banks) is now responsible for 80% of all lending versus 25% 20 years ago. And even the so-called regulated sources of credit have been much less constrained by regulatory oversight. One compelling example is what to me was the SEC’s gutting of the net capital rule in 2004.² The foxes were invited into the hen house and given their pick of the fryers.

Whatever the merits of deregulation in general (and do we really need the ICC setting railroad tariffs anymore?), Ayn Rand’s descendants in general and one acolyte in particular (i.e., Easy Al) have not given us truly free markets in the banking sector. Instead, we have asymmetrical libertarianism, in which reward in privatized and loss is socialized. As the Bear Stearns near-collapse and shot-gun marriage illustrates, even staunch conservatives recognize that banking is different and cannot be left to the vagaries of market fates. There is always—and increasingly—systemic risk, and when push comes to shove, it trumps moral hazard.

III. In Banking, Black Boxes Breed Black Swans

Perhaps the landmark event in the history of modern technology in the banking sector was the invention of the CMO (collateralized mortgage obligation) in 1983.³ That heralded the process of securitization and crucially, of course, depended on the power of modern computers to sort, sift and store mountains of data. Eventually, of course, securitization would take all manner of credit cats-and-dogs and magically turn them into something better and safer, so it was said.

Especially after the bursting of the tech bubble, with its baleful impact on investment banking fee revenues and commercial banking spread revenues, the financial sector naturally set its sights on the biggest asset class of them all, residential real estate, a \$20 trillion honey pot. Technology was the open-sesame, and the promise of securitization was that it would spread risk, raise efficiency and thus ultimately lower risk. In fact, it made risk fatefully more opaque, and in the end it fostered the illusion of omniscience and omnipotence.

In part because of partisan conviction that homeowners were likely to be more conservative voters than renters, there was an ideological commitment early in the decade to the “ownership society”. Combined with loose and unsupervised underwriting

² The net capital rule prescribes maximum ratios of assets to “capital” for broker-dealers and thus investment banks.

³ The potential dangers of technology in finance were revealed in the “portfolio insurance” debacle in 1987, in which computer model-driven selling on an epochal scale turned an ordinary bad day into a historic rout.

standards, it made a home mortgage available to anyone with a pay stub—and sometimes (have you heard of NINJA loans? liar loans?) that was not even necessary. The era of subprime and Alt A was upon us.

So by 2004, 60% of all bank loans were property-related compared to 25% in 1985. More specifically, between first quarter 2001 and first quarter 2007 home mortgage debt rose 102% while both the current account deficit and foreign holdings of U.S. debt rose 104%. House prices rose 50% in five years, far in excess of either nominal GDP or the CPI, the band within which they normally rise.

Banking gradually evolved from a cash-flow to an asset-value orientation, which made the role of technology all the more important. Armies of mathematics PhDs descended on Wall Street as well as on Greenwich, CT, and other leafy clusters of hedge funds. When changed accounting rules forced most market participants to report “fair market” values, those whose assets were illiquid and thus had no market had to resort to “mark-to-model” valuation, a phrase that should have sent us all screaming to the exits.

The whole phantasmagoria was based on the delusional premise that because house prices had not declined nationwide since the Great Depression, they would not do so again. Instead, they went straight up until, inevitably—a Black Swan⁴!—they headed straight down.

Technology also exacerbated the inherent “agency” problem in banking (and other arenas of commerce and life), where decisions are made by individuals who may profit from their success but not necessarily suffer from their failure—either absolutely or relative to their principals, the shareholders. The reason: technology allows the assumption of much greater risk.

One way in which greater risk was assumed was through leverage. Some was supplied by conventional lenders but the rest through the use of derivatives, most of which are over-the-counter and thus very opaque. The temptation to take more risk also grew as asset prices rose in the course of the credit bubble. It increased corporate ROEs (return on equity), raised bonuses, and fattened the product of the “carry” (the typical 20% performance fee earned by hedge fund managers known as a “carried interest”) and thus was “pro-cyclical” and self-reinforcing.

All the increased opacity afforded by technology (the fruits of “financial engineering” or what Boston-based money manager Jeremy Grantham calls “quantery”) also exacerbated counterparty risk. One may know one’s counterparty but not necessarily one’s

⁴ Popularized in his recent books by the philosopher-cum-hedgie, Nassim Nicholas Taleb, the black swan was David Hume’s metaphorical criticism of inductive reasoning in an age when empiricism had overtaken scholasticism and its reliance on deduction. Hume said, “No amount of observations of white swans can allow the inference that all swans are white, but the observation of a single black swan is sufficient to refute that conclusion.” To Taleb, a Black Swan is an event (or non-event) that i) is deemed, ab initio, highly unlikely if not impossible but after its occurrence (or non-occurrence) ii) has a tremendous impact and iii) eventually is regarded as having essentially been inevitable. Nine-eleven is a Black Swan. By the way, Hume was unaware that Australia is full of black swans.

counterparty's counterparty. There is reason to believe that it was the fear of a daisy-chain of counterparty failures that led the Fed to intervene in Bear Stearns's public hanging as the firm was known to be deeply and widely embedded in the interstices of Wall Street's and hedge funds' back office—it was everyone's counterparty.

Technology also led to the use of VAR (“value at risk”) in risk management. VAR may be a useful tool in some financial or other contexts, but here it was a disaster. Its gaze is only retrospective, typically over the past four or five years, but in the building of a bubble, the data by definition are damned good. Also, VAR tells you what is likely to happen 99% of the time, but in a bubble you need to know what might happen in that remaining 1%—the “long tail,” which every once in a while is tied to a Black Swan.

That vulnerability was compounded by the Basel capital adequacy rules for commercial banks and the (eviscerated) net capital rule for investment banks, both of which encouraged the “originate-to-distribute” business model, yet inconceivably—after Enron—permitted (with the connivance of loose accounting standards) both kinds of banks to establish off-balance sheet vehicles and stuff them with dodgy paper. Much of it, despite AAA ratings, proved to be toxic waste when stress-tested. Moreover, these banks-within-a-bank were all leveraged to their eyeballs through the commercial paper market—the classic bank model of lending long and borrowing short. All of this near-criminal activity led to the deadly alphabet soup or witches' brew of CDOs, CLOs, CDSs, SIVs, ABCP and so on—all divorced from economic reality and only waiting to explode (“blow up,” in Wall Street parlance). Starting in mid-2007, with the implosion of two Bear Stearns hedge funds, they began to explode and may yet continue.

IV. Lessons

We can perhaps find some wisdom in our experience so far (the future may teach us some further, perhaps more painful, lessons) in the form of the following:

1. Over the last several decades, financial services in general and banking in particular have become more prone to periodic crisis just as the macro-economy has become less so.
2. The “Great Unwind” of the current so-called credit crunch could take several more years and ultimately cost far more (as a percentage of GDP) than the S&L crisis, the Russia default and the implosion of Long Term Capital Management, a huge hedge fund, or any other financial crisis of the post-WWII period.
3. Though to some extent the result of large forces of history, it is largely a self-inflicted wound.
4. The business model of a publicly held investment bank is, or should be, broken, though like Japanese zombie-banks post 1989, most will plod on, and the hedge fund (just “leveraged longs,” according to Jeremy Grantham) is based on an inherently false business model—“heads I win, tails you lose.”

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Recommended reading:

1. Bad Money by Kevin Phillips
2. The Trillion Dollar Meltdown by Charles Morris
3. Fooled by Randomness by Nassim Nicholas Taleb
4. The Black Swan by Nassim Nicholas Taleb
5. Markets, Hedge Funds and the Perils of Financial Innovation: A Demon of our Own Design by Richard Bookstaber