Can They Stop the Great Recession?

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By Jeff Madrick
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Freefall: America, Free Markets, and the Sinking of the World Economy
by Joseph E. Stiglitz

The Sellout: How Three Decades of Wall Street Greed and Government Mismanagement Destroyed the Global Financial System
by Charles Gasparino

Taking Stock: What Has the Troubled Asset Relief Program Achieved?
by the Congressional Oversight Panel

A year and a half after the bankruptcy of Lehman Brothers and the near collapse of the global financial system that followed, the US Congress still has adopted no new rules to reregulate financial institutions. Well over three years have passed since the housing market began to unravel after an unprecedented boom fed by Wall Street speculation. Some financial firms borrowed more than forty times their capital at the height of speculation in 2006 and 2007 to invest in mortgage and other securities. Yet today, there are still no significantly higher capital requirements for them. There are no restraints on multimillion-dollar banker compensation, except on the executives of companies that took and have not yet paid back bailout funds from the Bush administration's $700 billion Troubled Asset Relief Program (TARP). Most of the major firms, including Goldman Sachs and even struggling Citigroup, already have.

There are no adequate new restrictions on the private credit-rating agencies such as Moody's, which doled out AAA ratings in increasing numbers even as mortgage securities became far more risky in 2006 and mortgage defaults started to rise. There are no new requirements to trade derivatives openly and transparently, and they are still being traded in obscurity. The value of these highly leveraged and typically volatile instruments was based on other more stable securities, such as treasury bonds, which enabled investment firms to take on more risky investments while avoiding regulatory restrictions. And there are no new regulations to protect consumers from credit card or mortgage fraud, despite rampant deception and abuse of homeowners.

Meantime, financial institutions are thriving again. After many posted large losses in 2008, the banking firms earned record profits in 2009, and are set to pay as much as $145 billion in bonuses to their employees. The rest of the American economy is largely suffering. A congressional oversight panel headed by Harvard Law School professor Elizabeth Warren reported in December that lending to businesses and consumers by major banks was down from the previous year, especially by the twenty banks that received the biggest bailouts. The unemployment rate hovers around 10 percent. When those who have given up looking for jobs or are taking temporary jobs are included, about one in six Americans who want to work full-time cannot do so. Household incomes are suffering in general and because of high levels of debt, few experts see a strong economic recovery in the making. Three years after housing prices fell by an

average of one third, they are still not rising. As a result of the recession the federal deficit keeps increasing as tax receipts flounder, preventing the federal government from introducing programs to rebuild infrastructure, improve education, and provide health care for all Americans.

Joseph Stiglitz, the Nobel Prize– winning economist who also served in the Clinton administration, cannot suppress his dismay in a new book, *Freefall*, over how poorly Congress and the Obama administration, not to mention the Bush administration before it, have reacted to the nation's greatest modern economic test. His anger sometimes leads to inappropriately bold criticism. After all, Obama inherited from his predecessor some of the worst economic circumstances of any first-term president. But Stiglitz, a leading economic theoretician, with considerable public policy experience as well (he was the World Bank's chief economist), presents a substantial and disheartening case that the US is losing a battle to right the nation's course—and the world's. He has managed to clarify deftly and intelligently almost all the relevant and perplexing issues that have arisen from the crisis, and he proposes a comprehensive and sensible, if politically difficult, way forward as well.

For Stiglitz, the most important conclusion to be drawn is that the deep recession and financial collapse made hash of the long-standing claims of former Federal Reserve Chairman Alan Greenspan and the leading economist of the political right, the late Milton Friedman, and their countless disciples that unfettered competitive markets will lead to more stable economies and long-term prosperity. Competition itself, they alleged, checks excessive risks and minimizes market manipulation.

To the contrary, Stiglitz replies, markets very often fail, especially financial markets. Without large-scale government intervention, the financial system would have stopped working entirely. For a few days—after the demise of Lehman Brothers in September 2008—it essentially did. A depression, with soaring unemployment, shuttered factories and stores, and growing hunger and starvation around the world, would have very likely been the result. But Washington, Stiglitz fears, may not yet have learned from its errors.

Last December, the House of Representatives passed what I would consider a minimally acceptable financial reregulation plan, which was based on a Treasury Department white paper issued in the early summer that was hardly an example of rigorous analysis or adequate reform. But even its moderately strong proposals have been watered down in the House bill, while a Senate bill is now taking shape and is likely to be weaker. In particular demands to make trading of derivatives open and above board—the derivatives that would have brought down the giant insurance company AIG without a federal bailout—are now compromised. The House has exempted up to 30 percent, according to some analysts, of all such trading from having to go through an exchange or clearinghouse, opening loopholes that still more traders will probably learn how to exploit. Yet the exemptions were explicitly endorsed by Treasury Secretary Timothy Geithner last August in a sad retreat from his original proposal.

The other strong proposal of the Treasury white paper was the creation of a Consumer Finance Protection Agency (CFPA), to monitor and approve consumer products like credit cards, auto loans, payday loans, and mortgages. The deception of homeowners by mortgage brokers since the 1990s, especially with the surge in subprime mortgages in the 2000s, is one of the most

deplorable examples of regulatory failure in modern American history. Hundreds of billions of dollars' worth of low-rate and no-down-payment mortgages were made to Americans with poor credit who believed their brokers when they told them not to worry about the fine print.

It turned out that many of these brokers, who were regulated by no one (and still aren't), told the homeowners just about anything they wanted to hear. For many of these subprime mortgages—usually with an "adjustable rate"—interest payments would go up significantly in two years. The only way many mortgage holders could avoid default was if home prices kept rising, which would allow them to refinance into another temporarily cheap mortgage or sell their house. Some $650 billion worth of these mortgages were written in 2006. By 2007, defaults on subprime mortgages reached 15 to 20 percent and at the nation's largest mortgage broker, Countrywide Financial Services, nearly 30 percent.[1]

A well-managed independent Consumer Finance Protection Agency could have prevented this. The House bill provides for only a watered-down version of it. There will be no outright requirements to offer very simple, understandable credit card or mortgage products, for example. But it is increasingly unlikely that the Senate Banking Committee under Christopher Dodd will send even a mild version of it to the full Senate. Currently Dodd is proposing that oversight of consumer finance be given to a new bureau in the Treasury Department or be housed in the Federal Reserve. And though the Obama administration announced that it strongly backs an independent agency, it has not been able to mobilize support for it.

The financial lobbyists, according to law professor Michael Greenberger of the University of Maryland, have made killing this agency their primary goal. Those mortgages and other consumer debt products fed one of the largest sources of profit in Wall Street history, and they do not want it seriously tampered with. The Wall Street firms turned the mortgage, credit card, and auto debt into complex securities bought—for trillions of dollars—by pension funds, trust funds, hedge funds, mutual funds, and insurance companies in the US and around the world, funneling trillions of dollars into these markets, particularly housing. The Wall Street firms made substantial fees every step of the way from selling these asset-backed securities. There were $5.5 trillion worth of mortgages outstanding in America in 2001. By 2007, there were $11 trillion, made possible not by lending by the old-fashioned thrift institutions but through the conversion of good and bad debt into salable securities.

To control excessive lending and risk-taking, the Obama administration proposals and the House bill both largely depend instead on raising capital requirements on financial institutions, particularly those deemed so large that their failure can bring down the entire financial system, posing what is often called a "systemic risk." The Obama administration proposes that the Federal Reserve be the new "systemic risk regulator" with authority to set capital requirements (and also to set liquidity requirements, meaning that a sufficient volume of assets is held that can readily be sold), not only for commercial banks, which they now regulate, but for any and all financial institutions, including investment banks, whose excesses may jeopardize the financial system. The House endorses this proposal.

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[1] See *The People of the State of California* v. *Countrywide Financial Corporation*, available at ag.ca.gov/cms_attachments /press/pdfs/n1582_draft_cwide_com plaint2.pdf.

But Stiglitz is appalled that the administration and Congress are so eager to confer such ultimate power on the Fed after its recent performance. Federal Reserve Chairman Ben Bernanke, who took over from Alan Greenspan in 2006, asserted in a major speech in May 2007 that the growing mortgage defaults would not spread to the rest of the financial system. At the time, house prices had already been falling for a year, major mortgage brokers were going broke, and two Bear Stearns hedge funds, which invested aggressively in mortgage-backed securities, were near collapse. Well before Bernanke's inexplicable statement, according to journalistic accounts, prominent Wall Street traders and analysts were warning their bosses about the broad dangers of the system. The head of fixed-income trading at Bear Stearns, which the federal government essentially pushed into acquisition by JPMorgan Chase at a distressed price in March 2008, pleaded with his CEO and other executives that they stop investing in mortgage-backed securities back in 2005. Raking in huge sums, they chose to ignore him.[2]

Similarly, the head of mortgage research at Deutsche Bank, Karen Weaver, warned in 2005 that the value of mortgage securities was highly vulnerable to a downturn in housing prices. In 2006, heeding her advice, Deutsche Bank sharply shifted its policy and started selling the securities. So did Goldman Sachs. Lewis Ranieri, who founded mortgage securitization back at Salomon Brothers in the late 1970s, issued stern warnings about the vulnerability of the market by late 2006. And respected economists at the Bank for International Settlements in Basel warned a few weeks after Bernanke's remarks about the possibility of a depression-size collapse because of excessive securitizing of mortgage and other debt.[3]

Stiglitz points out that the Fed under both Greenspan and Bernanke had refused to try to mitigate the housing bubble, despite the unprecedentedly rapid run-up in prices in the 2000s. They could, for example, have raised down-payment requirements on mortgages or raised margin requirements on bank lending for securities. The Fed did not, as it is entitled to do, investigate the rampant mortgage deceptions or probable frauds committed by the mortgage brokers. Even the Federal Bureau of Investigation was issuing warnings about such fraud and deception by 2004. Stiglitz and others believe that any institution capable of creating systemic risk should, at the least, be subject to more rigorous regulation not just from the Fed but from other agencies as well. Originally Senator Dodd wanted to remove such oversight powers from the Fed but he has since backed off.

Stiglitz is especially disappointed that the Obama economics team did not seriously change the course set by the Bush administration, led by Treasury Secretary Henry Paulson. But they were, after all, mostly the same people. Timothy Geithner was an integral member of the Bush team, assigned to rescue the financial system when he was president of the New York Federal Reserve Bank, as was Bernanke, whom Obama strongly recommended for a second term at the Fed. The third member of the triumvirate now running the rescue is Lawrence Summers, Clinton's former Treasury secretary, who was a strong advocate of financial deregulation in the 1990s.

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[2] Lawrence G. McDonald, *A Colossal Failure of Common Sense* (Crow Business, 2009), pp. 135–138.

[3] On Weaver and Ranieri, see among others, Paul Muolo and Mathew Padilla, *Chain of Blame* (Wiley, 2008), pp. 223 and 216–225. On the BIS, see "BIS *Slams Central Banks, Warns of Worse Crunch to Come," The Daily Telegraph, June 30, 2008.*

Stiglitz does not believe that saving Lehman Brothers would have prevented the crisis. He calls that "sheer nonsense," and he is surely right. Wall Street was so overleveraged—i.e., its borrowings were so great in relation to its cash holdings—that far more radical action was ultimately required than keeping Lehman going on one cylinder. To his credit, Bernanke had been cutting interest rates sharply since August 2007, but the regulators were overconfident that that was sufficient. When markets did indeed fall apart after the Lehman announcement—bank lending dried up and the Dow Jones industrials fell five hundred points the next day—the regulators at last realized that they had to act more boldly. The next day, the Fed saved AIG with an $80 billion investment, and the Treasury guaranteed the liabilities of the $3.5 trillion money market industry. Later that week, Paulson, Geithner, and Bernanke put together the $700 billion request to Congress to set up TARP.

At first, the proposal did not pass Congress. But by October the Treasury was given authority to provide up to $250 billion to nine major banks (and later other banks) to shore up their capital in return for preferred shares paying a dividend of 5 percent a year and warrants, which are rights to buy common shares.

In retrospect, however, it is clear, as Stiglitz claims, that the government, in accepting these preferred shares and warrants, gave away the store. Earlier in 2009, the Congressional Oversight Panel boiled the numbers down: TARP, it concluded, overpaid for the package of securities by 34 cents for every dollar. Warren Buffett, as CEO of Berkshire Hathaway, and several Mideast investors got much better deals when they privately provided needed capital to firms like Goldman Sachs.

Although it was a bad deal, the TARP bailout, which was extended to General Motors and other such companies, and included still more injections of capital to especially troubled banks like Citigroup, stopped the extensive hemorrhaging, according to the Congressional Oversight Panel. Stiglitz does not give adequate credit to TARP. But he convincingly and clearly shows that the bailout and subsequent programs have not laid down a workable path to recovery. As the valuable Congressional Oversight Panel report, *Taking Stock*, makes clear, banks are still not lending adequately, and without an expansion of bank credit there will not be a strong economic recovery. If banks don't lend when they get bailed out, Stiglitz wants to know, what is the purpose of the bailout? Moreover, the banks still have an enormous volume of bad mortgage assets on their books, which means that there are high financial hurdles ahead. Proposals to mitigate mortgage obligations in order to help homeowners to retain their houses are also far from adequate.

Stiglitz would have placed the most troubled of the banks under a federal conservatorship—a legal entity to take financial control of them—which could have forced the bondholders of the banks to trade their fixed-income investment for less certain shares in the company. The effect would have been to wipe out the existing shareholders. In his view, the shareholders—the owners—should have rightly borne the risk of bad management decisions.

Such a policy, however, may have had its own deficiencies. It risked causing a panic among bank bondholders who would have sold bonds of *other* companies abruptly and forced yet another and perhaps more severe financial collapse. Still, without establishing a conservatorship,

the Treasury could have driven a much harder bargain for its capital injections, which would have reduced the cost of the bailouts and future federal budget deficits. It could have demanded guarantees that the recovering financial industry devote much of its rising revenue to relending to America, especially to small businesses and local communities. The failure to make such a demand has had particularly serious consequences. Banks and other beneficiaries of the taxpayers' money have refused to make adequate credit available to small businesses that need it to survive. The Treasury could also have been tougher on executive compensation and removed some of the more incompetent managers of the banks.

There are several orthodox explanations why financial markets fail frequently, writes Stiglitz. One of the major reasons for market failures that economists are generally aware of is known as agency risk. The financial incentives that motivate the executives who run the firms (the agents) differ from the interests of the longer-term investors, the shareholders (the principals). On Wall Street, executives, research analysts, and traders were allowed to maximize their own short-term earnings, with little responsibility for future losses to the shareholders. This inevitably encouraged risk-taking, not risk management.

Another inherent market problem for Wall Street was the prevalence of "asymmetric information," a theoretical idea for which Stiglitz and several others won the Nobel Prize. In this case, those who invested in mortgage-backed securities knew far less about the creditworthiness of the mortgage holders than those who wrote the mortgages, or the homeowners themselves. But in the new Wall Street, mortgage brokers immediately sold the mortgages to Wall Street packagers, and no one carefully examined the books to see if the mortgage payments were likely to be made.

Investors bought the securities on the basis of Wall Street recommendations and high ratings provided by private credit-rating agencies like Moody's and Standard & Poor's. These agencies themselves had conflicts of interest. They were paid by the institutions that wanted high ratings from them and they readily overlooked flaws in the computer models they used, which, they assured investors, compensated for lack of information about individual mortgage holders.

As Stiglitz makes clear, trading in derivatives—in particular, the credit default swaps sold as insurance against mortgage securities collapses—was not conducted openly. The same is true for the collateralized debt obligations, the securities backed by mortgages that were often falsely sold as almost riskless. Transparency and adequate information—two staples of free markets according to economists of every political stripe—were rarities in the mortgage markets.

Finally, Stiglitz writes, the fact that systemic risk itself is allowed to develop should be seen as a market failure. As the financial community became larger and more intertwined, further propelled by deregulation, it created risks for the entire system. Rather than dealing with market failures, as economic theory suggests they should, the regulators, including Greenspan and, until recently, Bernanke, took comfort in "efficient markets theory," which argues that markets usually set prices accurately. If so, the prices of mortgage-backed securities reflected the true risk. There was therefore no need to investigate much further, and they did not.

"The crisis was not something that just happened to the financial markets; it was man-made," Stiglitz writes. "It was something Wall Street did to itself and to the rest of our society." To him, the bankers were the chief cause of the catastrophe, pursuing self-interest to an irresponsible extreme and claiming that the market was rewarding them justly with millions of dollars in bonuses, while many of them claimed that securities based on shaky mortgages were virtually riskless. But regulators were surely equally to blame; I would argue, given their explicit responsibility, even more so.

Recent reports by journalists on how decisions were actually made on Wall Street shed needed light on these economic abstractions. The most comprehensive anecdotal account to date of the crisis is *The Sellout*, by Charles Gasparino, an enterprising former reporter for *The Wall Street Journal* who recently left the financial cable network CNBC to work for the Fox Business Network. Gasparino cuts his way through Wall Street rhetoric and in the process uncovers in considerable detail how blind profit-making ambition led to the destruction of the markets. He interviewed the men and women who were involved in the fall of Bear Stearns, which was sold for almost nothing by the pot-smoking and incompetent Jimmy Cayne, and the collapse of Lehman under the autocratic and absurdly aloof Richard Fuld.

Bear Stearns and Lehman had been at the forefront of the mortgage-writing business since the 1990s. Citigroup and Merrill Lynch, however, were the relative latecomers who pushed Wall Street over the edge. At Citigroup, CEO Sandy Weill, with the encouragement of Clinton's former Treasury Secretary Robert Rubin, according to Gasparino's account, authorized aggressive traders like Thomas Maheras to expand unimpeded into the mortgage-backed securities markets. With the Glass-Steagall Act repealed in 1999—the law had separated commercial and investment banks—Citigroup's ratio of debt-to-equity soared. After Weill retired in 2003, his chief lawyer, Charles Prince, succeeded him, but with Rubin's encouragement, let Maheras have his way. "Are you sure that's what Rubin said?" one incredulous high-level Citigroup executive told Gasparino when he heard how Rubin encouraged Maheras and others to take risks.

At Merrill Lynch, the star investment banker Stan O'Neal, named CEO in 2002, was determined to turn his staid company into a financial powerhouse comparable to Goldman Sachs. He saw the mortgage business as a vein of gold. He borrowed lavishly to support the new aggressive mortgage bond traders he hired and refused to listen to warnings from his underlings about the thin foundation of the mortgage-backed securities market. His personal glory was at stake. In only a few years, Citigroup and Merrill became the two largest underwriters of collateralized debt obligations on Wall Street, much of it comprised of subprime mortgages. Their financing contributed significantly to the final years of the housing price bubble. Both generated enormous losses. Merrill Lynch has now been sold to Bank of America and Citigroup is barely surviving after receiving more bailout money than any other bank.

No one could argue, after reading Gasparino's book, that compensation practices and regulatory neglect did not drive bad decisions. Cayne, Fuld, Prince, and O'Neal barely understood the mortgage securities market at all—nor did they try. But they each made a fortune despite their

ignorance.[4] Less well known to the public is that all these companies were aggressive participants in every stage of the market. Citigroup, through subsidiaries, sold almost as many subprime mortgages to unaware homeowners as did Countrywide Financial, the largest residential mortgage writer. At the same time, Countrywide built a securitization operation that sold as many collateralized debt obligations to pension funds and others as almost any Wall Street bank. These companies were rife with conflicts of interest.

Now the nation faces a spring in which Congress will debate how to reregulate a financial community with hundreds of millions of dollars to spend on lobbying and political campaigns. Stiglitz believes that risky banking activities should be separated from basic business lending and savers' deposits. President Obama took a step in this direction by supporting a suggestion of former Federal Reserve chairman Paul Volcker to restrain banks from engaging in some forms of speculative behavior. But even under the so-called "Volcker rule," a great deal of speculation will continue to be done on the banks' trading desks. At the time of this writing, some members of the Senate Banking Committee already opposed the Volcker rule. Among central questions are whether Congress and the administration will demand that large financial institutions come under rigorous regulation, including strong requirements for maintaining adequate capital, for transparency, and for control of derivatives. It is not too late to demand that institutions bailed out by the government should be obliged to extend loans to creditworthy homeowners.

Meanwhilte, Stiglitz, in his recent journalistic writing, is appropriately worried that fears of growing deficits will prevent the nation from developing another stimulus package that is necessary to avoid a second recession. The responsibility for ongoing economic recovery and adequate financial reregulation lies squarely with the President. It is not an easy task, given the size of the federal deficit Obama inherited from the Bush administration and the depth of the financial crisis he faced—and the wealth and vehemence of the political opposition. Regulatory reform was not passed in America until four years after the 1929 crash, when Franklin D. Roosevelt finally took office. But Roosevelt never took his eye off the need for regulation, a lesson that Obama, one hopes, is learning.

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[4] Cayne and Fuld did lose a lot of money when their companies collapsed, but according to a Harvard Law study, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman, 2000–2008," they had earned tens of millions of dollars in previous years.