Economic Bubbles and Financial Crises, Past and Present

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> "It is well enough that people … do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning." Henry Ford, American industrialist

> "It seems to me that Europe, especially with the addition of more countries, is becoming ever-more susceptible to any asymmetric shock. Sooner or later, when the global economy hits a real bump, Europe's internal contradictions will tear it apart." Milton Friedman, American economist

> "The normal functioning of our economy leads to financial trauma and crises, inflation, currency depreciations, unemployment and poverty in the middle of what could be virtually universal affluence-in short … financially complex capitalism is inherently flawed." Hyman Minsky, American economist

I have spent some fifty years studying economic cycles and teaching international finance, but I had never seen the likes of what we witnessed and experienced over the last three years. That's because such financial crises seem to happen 60 to 75 years apart.

—It is a fact that the outbreak of this severe worldwide financial crisis two years ago was a surprise to many people. For instance, it was widely thought that financial crises, and the severe economic recessions and sometimes depressions they provoked, were really a thing of the past thanks to the protective net of financial regulations that was designed in the 1930s to prevent a repeat of such financial collapses.

—But here we are again, mired in the most severe economic crisis since the 1930s. We may ask why?

The main reason is that the U.S economy, but also most of the world economy, has been subjected to a financial experiment, over the last some 10 years, which has turned sour. In fact, it has turned into a financial fiasco.

Indeed, it must be understood that a completely new type of banking finance was invented; but all the risks involved had not been properly assessed. For a while, the debt pyramid was allowed to grow, but it collapsed when its shaky and unsound foundation disintegrated.

—Of course, there have been similar financial collapses in the past, (notably in 1873, in 1907 and in 1931) and the overall cause is always the same: the financial sector takes too much risk and becomes overextended, creating in the process a debt load for the economy that is unsustainable.

Let's consider a striking fact of today financial situation: The debt load imposed on the economy is even higher today than it was in the 1930s when total total debt reached the level of some 300% of the annual production or GDP.

Well, today, the ratio of total debt to the U.S. Gross Domestic Product (GDP) is close to 400 percent.

Keep in mind that it took nearly 20 years to bring this ratio down to about 140, in 1952.

What this means is that today it takes about $4.00 of debt to create one dollar of economic activity while it took only $1.40 of debt in the early 1950s to create one dollar of GDP activity. This shows how complex the financial system has become. The question that remains to be answered is whether it will take 20 years to lower the debt ratio from 400% to, say, 200%!

This all shows how this can be devastating for the real economy when financial flows are disrupted and when credit becomes difficult to obtain.

—Sadly, this is our situation today: Investors and producers have a lot of problems financing their new investment projects. This is a big monkey on the back of the economy and it is an important cause of current, and possibly future, economic stagnation.

But before looking into the future, let's review quickly the main reasons why financial crises arise. Why, in other words, the financial tail is sometime allowed to wag the economic dog.

1. First, the question of deregulation. Too much optimism, overconfidence or simple naiveté sometimes allow the development of some form of risky Ponzi-scheme finance. And, this is pretty much what we have seen over the last 10 years.

—Under the old traditional financial rules, a bank or a credit union would collect deposits or borrow in the open market, lend this money to investors, keep reserves for contingencies, and would hold onto the loans until maturity.

For big banks, at least, this is no longer the model. With the merging of investment banking and commercial banking after 1999, traditional financial rules were pushed aside and they were replaced with the rules of asset securitization through which large banks ceased being banks to become brokers, that is they ceased being lenders to become sellers of sophisticated new securities. More about that later.

Under these new rules, a bank still accepts deposits or borrows in the open market, but it does not hold on to the loans it makes. Rather, it takes a bunch of heterogeneous loans made by itself or by others, repackages and slices them up, and sells them as investment vehicles to third parties. That's what is called the "securitization" process; it is a sort of sausage machine that takes one type of securities at one end and transforms it into another type of securities, a more risky one, at the other end. —Large Banks have become large financial sausage makers!

In other words, the financial chain has been made longer, much longer; but, as with all chains, its overall strength is not better than the strength of its weakest link. And the new financial products turned out to be the weakest links. They were toxic financial products.

2. Why were such new banking rules adopted? Why were they so risky and dangerous? And

how did they lead to the near complete collapse of the credit system in the fall of 2008? These are fundamental questions.

And, as for most questions, there are short answers and there are long answers.

I have four short answers:

-First, they were very profitable to the mega-banks for a while because the banks raked in large fees on the new financial products.

-Second, the politicians were persuaded to let them "innovate" with the new leverage finance by removing most regulation that would have prevented the banks from doing what they were doing.

-Third, it led to irresponsible lending because the lenders were no longer risking their own money but the money of far away investors.

-And, fourth, the moral dimension cannot be neglected. Indeed, it took a lot of corruption and a lot of greed to create such a mammoth crisis. —[Greed was even glorified in the 1987 movie "Wall St." in which Michael Douglas—playing the character of financier Gordon Gekko—says: "Greed is good, Greed is right. Greed Works." This was the prevailing ideology at the time.]

(This is an issue that I explain more fully in my new book The Code for Global Ethics.)

For a financial crisis of this magnitude to occur, it takes two kinds of corruption or fraud. —(I don't delve here into the kind of intellectual corruption that supported the ideology that markets can do no wrong or that they are always "efficient". In fact, markets are very imperfect; they are often under the control of monopolies or cartels, and sometimes, they do not function at all.)

In the first place, politicians have either to make mistakes or worse, to be in the banks' pockets and do what people with money (who want more money) tell them what to do.

For instance, as far back as 1977, the Carter administration and the U.S. Congress prepared the ground for the future crisis: It passed the Community Reinvestment Act, by which the Federal Housing Administration loosened down-payment standards for marginal borrowers. —Twenty-five years later, in 2003, President George W. Bush also signed "The American Dream Downpayment Act" into law. This reinforced the pressure on large banks to provide subprime mortgages to needy borrowers incapable of making down payments.

The public financial deregulation stampede that took place between 1999 and 2007 was therefore an extension of this philosophy that special lending rules could and should apply to housing finance.

The string of specific financial deregulation steps taken by the politicians that have paved the way for the current era of irresponsible Ponzi-scheme finance and casino-like leverage banking practices is very long, and I don't want to burden you with too many details.

As a reminder, however, here are the most important ones:

1. In 1999, the Clinton administration and the Republican-dominated U. S. Congress

passed the Gramm-Leach-Bliley Act (GLBA) that, in effect, abolished most of the 1933 Glass-Steagall Act. — In the past, that law had prevented the unregulated investment banking from merging with the regulated and government-insured commercial banking sector.

2. Then, in 2000, the U. S. reintroduced legalized gambling into the financial sector, a prohibition that had been in place since after the 1907 financial crisis, when President Theodore Roosevelt (1858 –1919) was in office. It adopted the Commodity Futures Modernization Act of 2000, which specifically exempted financial gambling from state gaming laws. This move paved the way for inventing new risky financial instruments.

3. In 2004, the Securities and Exchange Commission (SEC) removed the ceiling on the level of risk that the largest American investment banks (Goldman Sachs, Morgan Stanley, Lehman Brothers, Merrill Lynch, Bear Stearns) could take on so-called securitized loans and their hedge fund operations.

4. In 2005, bankruptcy laws were changed in the United States at the request of the banking industry. This made it more difficult for federal bankruptcy judges to restructure mortgages before resorting to foreclosures, under Chapter 7 of the U.S. bankruptcy code. [N.B.: According to the Center for Responsive Politics, the banking industry spent over $100 million in lobbying efforts to have bill S-256 passed].

5. Finally, in July 2007, only weeks before the subprime financial crisis went into full gear the SEC removed the "uptick" rule for short selling stocks in a panic. (The President of CITI Group, Mr. Vikram Pandit, testified before the Congressional Oversight Committee that short-sellers played a big role in bringing his bank, the largest in the world, close to bankruptcy.)

3. The second type of irresponsibility, and even of fraud, was the one that bankers themselves committed.

-First, they embraced subprime lending, by selling adjustable-rate (ARMs), or interest-only or even negative-amortization subprime mortgages, with minimal or no down payments, to borrowers they knew could not pay them back if anything went wrong.

Today, about eight million foreclosures have already taken place. And it is expected that in 2010-11, the number of foreclosure filings could rise to another 3.5 to 4 million.

Why were banks irresponsible in their lending? Essentially, besides willing to please the politicians, it's because they thought they were not at risk for their own irresponsibility. Indeed, with the new practice of financial securitization, banks were not worried by the possible insolvency of borrowers, because they knew they could sell those risky subprime mortgages to other banks which ultimately sold them down-stream as some commercial-like paper to unaware investors. It was a form of "pass-the-buck" lending.

In the end, many of the primary and secondary mortgage lenders such as Countrywide Financial, Washington Mutual, IndyMac, and ultimately Bear Stearns and even Wachovia, collapsed. And the two largest players in the U. S. mortgage market Fannie Mae and Freddie Mac, as insurers and secondary mortgage lenders, came very near to total collapse before the U.S government came to their rescue and invested $400 billion in them.

4. A few more words about the main culprit products in this fiasco, the famous or rather

infamous so-called “credit derivatives”, that disintegrated in the fall of 2008. Those were the weak links in the financial chain. And that’s where I will limit my comments.

Credit derivatives come in acronyms like an alphabet soup, but the most basic ones are:

-The synthetic subprime collateralized debt obligations (CDOs), (or slices or tranches of amalgamated pools of subprime loans based on mostly interest-only second-handed mortgages, but also on other types of debts, such as credit card debts). CDOs are basically illiquid financial products because they usually can be bought or sold only through the entity that created them.

-And, the Credit Default Swaps. CDSs are insurance credit protection contracts offering protection against default on the interest or principal payments of a loan.

More than one trillion and a half dollars ($1 500 000 000 000) of these asset-backed financial products were sold, not only in the U.S., but all over the world.

The problem was those who sold this type of financial insurance—large investment banks and above all the largest insurance company in the world, American International Group (AIG) —were not regulated and kept very little reserves behind it.

Creating CDOs (i.e. packaging different debts together) was very profitable for banks, for some insurance companies that insured them by issuing CDSs, while holding very little reserves, and for the credit agencies (Moody’s, Standard & Poor’s and Fitch) that rated them.

But CDSs are very dangerous products.

-First, although they are really insurance contracts, they are not typically written by insurance companies but by financial firms or subsidiaries. This means that they are not regulated under insurance laws, state or federal.

-Second, one does not need to have an insurable interest to purchase CDS insurance. (For example, it is not allowed to buy life insurance on a person with whom the buyer is not closely related. The same for a fire insurance policy on a home; one must be an owner to qualify).

But with CDSs, one may be an outsider, that is a speculator or a hedger, who has nothing to insure but is only interested in holding the CDS contract for financial gain. As a consequence, the total amount of CDS contracts issued can be much larger than the value of the insured security, four or five times larger. At that point, CDSs become casino chips whose ultimate value is only backed only by the issuer.—And this has consequences. In fact, the invention of CDSs has made the debt default crisis much worse by artificially maintaining the value of debts at a high level, thus creating bankruptcies all around. It is as if a system of fire insurance had resulted in increasing the insidence of fire. This is an example of a very dangerous and bad financial innovation.

Essentially, the CDS (credit default swap) market is an opaque and thinly traded over-the-counter market that is easily open to manipulation. At any moment in time, nobody really knows who owns or owes what to everybody else. Speculators buy those CDSs as if they were put options on the underlying bonds. When their prices go up, the price of the underlying bonds goes down, and a financial crisis ensues for the bond-issuing company or government. Together, CDOs and CDSs can make for a very toxic cocktail. —This is a clear case where the speculative financial tail moves everything else. Speculators are in control.

In fact, let me say that this is what drove General Motors into bankruptcy. Speculators killed General Motors, not the recession and low car sales. GM could have survived the recession as it had in the past. But this time, there were the CDSs.

—Why is this so? —Essentially because banks had transformed normal GM bonds into collateralized debt obligations (CDOs) by merging them with other debts, and because these bonds had been insured against default with CDSs issued mainly by the Financial Products unit of the large insurance company American International Group (AIG). Speculators bought these CDSs on the hope that the underlying CDOs that incorporated GM bonds would fall if GM were to fail. In essence, the speculators were betting that GM would fail and they were helping it to fail at the same time by selling short the very CDOs that incorporated GM debt while buying on leverage the CDSs on those CDOs.

When GM ran into financial troubles due to the recession and a drop in car sales, the value of GM bonds should have declined, allowing GM to buy them back at a lowered discount and enabling it to reduce its debt load and survive. But this time, thanks to the new securitization finance, more appropriately called “Ponzi-scheme finance”, an imprudent and possibly criminal type of finance in my opinion, things did not work out that way. GM’s debts had been placed in packaged CDOs that were impossible to untangled, just as individual housing mortgages had been merged and packaged in sausage-like mortgage CDOs that could not be untangled if something were to go wrong.

CDS holders against CDO- GM bonds, both legitimate and gambling speculators, were insured against losses by AIG. And, as I will explain later, the Bush-Paulson administration guaranteed the value of all CDSs issued by AIG against CDO bonds, so the value of those bonds could not decline as they should have, and as they have in the past during an economic downturn. Besides, there are no open market for those CDOs, so nobody could know their real value.

—This is what forced General Motors to file for bankruptcy. This is the same cause that provoked eight million plus home foreclosures in the U.S. while there are much fewer foreclosures in Canada. [For example, in the first quarter of 2008, 1.6 per cent of mortgages issued by Canada’s top three sub-prime lenders were behind by at least three months. The equivalent rate was about 16 per cent in the U.S. As a consequence, house prices in Canada have been stable or rising.] —In this light, the GM bankruptcy was less a normal bankruptcy than a financial assassination.

—Please note that by salvaging General Motors, the U.S. government paid twice: It paid in full the banks and the speculators who held CDSs on CDO-GM bonds; and it later paid to keep GM operating.

Mind you, the same thing that the new securitization finance did to U.S. homeowners and to GM is being done these days to Greece. Greece’s government debt has been transformed into derivative products, insured with CDSs. Speculators are buying those Greek CDSs in the hope that the government of Greece will default on its debt.—This is the main reason behind the drop in the euro and of pound sterling in the last few weeks. There is a fear of a domino effect, with many European countries to default if speculators begin attacking one country after another. This could even bring down the euro monetary union.

—This is a crazy and immoral system. The plot thickens even more with the rumor that AIG has been a major issuer of Greek CDSs. If this were true, this would mean that the U.S. taxpayers are paying for AIG's losses on Greek CDSs with U.S. bail-out funds, thus financing the possible collapse of the euro monetary zone! —This cannot be allowed to go on. There should be an international conference to stop that madness.

-This the reason I wrote here on my international blog (www.TheNewAmericanEmpire.com/blog) that the international financial system has been transformed nowadays into a gigantic unregulated Casino that allows all types of Ponzi schemes to go on.

5. You all know that the U. S. government, following the ideology of "too-big-to-fail" for the large banks or the large insurers, has rescued the biggest among them.

It poured trillions of dollars into AIG, Fannie Mae and Freddie Mac and the five or six largest Wall St. Banks, essentially by buying their toxic assets at full price and by underwriting their gambling losses. With this massive recapitalization of the large banks through government subsidy, the crisis has somewhat subdued, for the time being.

In the meantime, however, the larger banks have become even larger, the bonuses received by their CEOs are still in the tens of millions, their huge pensions are intact, but bank loans to the economy have declined. The biggest winners of the financial crisis are precisely those who created it. —This is truly something that historians will have to explain to future generations.

(Without a doubt, the single bank that profited the most from the overall public rescue program was Lloyd Blankfein's Goldman Sachs, a bank that Secretary Henry (Hank) Paulson led until he became Treasury Secretary in 2006. —It can also be said that Treasury Secretary Henry Paulson and his deputy, investment banker Neel Kashkari, were in a mammoth financial conflict of interest when they engineered the banking bailout program, especially as $180 billion was pumped into AIG in order to pay out in full the gambling bets made by Goldman Sachs, their previous employer, and other speculators. It was a bailout of Wall Street by Wall Street while in control of the U.S. government.)

Meanwhile, and because of this bailout money, the largest American banks are getting larger. For example, in 2006, the combined assets of the U.S. six biggest banks (Citigroup, JPMorgan Chase, Bank of America, Wells Fargo, Goldman Sachs, and JP Morgan) totaled 55 percent of U.S. GDP. In 2010, this ratio stands at 63 percent (it was only 17 percent of GDP in 1995).

Consider also another measure: In 2007, the four largest U.S. banks — (Citigroup, JPMorgan Chase, Bank of America and Wells Fargo) — held 32 percent of all deposits in FDIC-insured institutions. As of June 30, 2009, it was 39 percent.

Therefore, since the banking structural problems have not been solved but rather made worse, the crisis could flare up again anytime, either here, as a lot of commercial loans (office buildings, malls, hotels…etc) are on the brink of default and will likely default in the coming years, or elsewhere, with many European governments having their own subprime crisis and being attacked by CDS gamblers.

I want to be clear here. —It would have been better if the problem had been avoided with more prudent government policies and banking practices. However, in the fall of 2008, the U.S. government had a responsibility, especially after the failure of Lehman Brothers on September 15, 2008, to stabilize the financial system and to avoid a deeper and wider financial crisis. After all, it was a series of government policies and deregulation steps that paved the way to the housing bubble and to the meltdown, to the emergence of risky financial products and to the resulting financial crisis.

—It is how this was done that borders on the scandalous, if it was not outright fraud in some cases, not the goal itself of averting the financial crisis from spiraling out of control. —For example, there was no need to pay billions of dollars to banks and speculators at 100 cents on the dollar for toxic and illiquid securities that were worth much, much less.

Presently, I think that we are in the eye of the hurricane regarding financial problems. I see five additional economic threats for the near and not so near future:

• A major sovereign debt crisis in many parts of the world, especially in southern Europe;

• A major commercial debt crisis and small bank crisis in the United States;

• The historical high level of income inequality in the United States and elsewhere;

• The aging of the population in the United States and elsewhere and a concomittent slowdown in private consumption.

• The over-heating Chinese economy, its undervalued currency and a possible financial crisis in that country.

These factors and the ongoing difficulty in obtaining credit for investment will exert a drag on the economy over the coming years.

Indeed, history teaches us that a serious structural worldwide financial crisis sooner or later results in sovereign debt defaults by some countries. This has happened in 1833-37, 1870-90, 1932-1945, and it is to be expected that the number of countries that will renege on their foreign debt will increase in the coming years. A global debt bomb is hanging over Europe and other parts of the world. The euro zone itself may not survive the coming crisis. And, I would not exclude some U. S. states from this default scenario, not even the U. S. federal government, with its trillion + dollar deficits, fiscal deficits for as long as we can see, even though it has the power to print dollars which are still accepted around the world. That is the reason why I expect the other financial shoe to drop in 2011-13. —A major financial crisis, a major U.S dollar crisis (and the concommittent rise in the price of gold) and major bond and stock market crashes have a good chance to unfold in that time period.

6. Conclusions

It seems to me that the U.S. financial system, and even the world financial system, have to be profoundly reformed, if they are to serve the real economy, rather than the contrary. If such a reform does not come about, however, I am afraid that we have entered a period of economic difficulties that may last many, many years. In fact, I think that the world economy stands today at the hedge of a large precipice.

What type of reform? First and for all, the packaging of different debts in impossible to untangle CDOs should be outlawed. These products are financial time-bombs waiting to explode for the real economy, not only in the United States, but around the world. Second, CDS insurance products should be issued only against insurable securities and not issued as casino chips in values much larger than the value of the insured securities (i.e. no so-called naked CDSs). In order words, the entire innovation of securitization finance has to be reviewed and reigned in before it does further damage. These two reforms could be implemented immediately if politicians really understood the problems or if they were not in the banks' pockets.

However, if the U.S. Congress feels that this is too big a problem to tackle on its own, for different reasons, my third recommendation would be for the Obama administration and the EU to call for an international finance conference, preferably a G-20 conference, to have coordinated actions and have legislation implemented to that effect.

So far, the steps taken to study the problem and to reform the system have been slow in coming and very timid. For example, House Speaker Nancy Pelosi intends to create a congressional panel (rather than an outside commission of inquiry) to investigate the causes of the US 2007-09 financial crisis. This would seem to me to be an inadequate and insufficient response to a crisis of this magnitude and severity.

Fourth, for the longer run, and regarding the toxic financial products that precipitated the crisis, one wonders why new medication pills or drugs have to be approved by the U.S. Food and Drug Administration (FDA) in order to make sure that they do not hurt the human body, while no similar requirements of the sort exist for new financial products to make sure that they are not going to be very harmful to the real economy.

There seems to be two different standards applied here. I personally think that there is a need for a Financial Products Administration (FPA) in order to make sure that possibly toxic financial products are not made available to the public before having been fully tested for their absence of toxicity. It should be mandatory that risky financial products be tested and approved before being sold to the public.

And fifth and last, as to deposit-taking banks and investment banks, I happen to believe that the Glass-Steagall act should be brought back in full. It was a wise and prudent law that stabilized financial markets for three quarters of a century. Its near complete elimination in 1999 opened the floodgates of irresponsible financial gambling that nearly brought down the demise of the entire U.S. economy. I do not think the contemplated "Volcker rule" to prevent banks from operating their own hedge funds goes far enough, considering the magnitude of the problem.

—I was amazed when the Glass-Steagal act was de facto repealed in 1999, and I am still amazed that the very economist who was most instrumental in that repeal is currently President Obama's principal economic adviser (Larry Summers).

—As a general principle, it should be reaffirmed that finance is there to serve the needs of the real economy, and not the reverse.

—Finally, I would say that in economics, as in medicine, it is never too late to do the right thing. But if you don't, the disease may become progressively worse and it may become irreversible. I think that is where we stand today regarding the necessity to reform the financial system.

** Drawn from notes for a conference by Dr. Rodrigue Tremblay at the Renaissance Academy (Florida Gulf Coast University FGCU), Florida, Friday, March 19, 2010*

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