Greenspan and the Economic Crisis: "Moral Hazard" and Financial Fraud are the Main Problems

By Washington's Blog
Global Research, November 07, 2010
Washington's Blog 7 November 2010

Region: USA
Theme: Global Economy

Even Alan Greenspan is confirming what William Black, James Galbraith, Joseph Stiglitz, George Akerlof and many other economists and financial experts have been saying for a long time: the economy cannot recover if fraud is not prosecuted and if the big banks know that government will bail them out every time they get in trouble.

Specifically, Greenspan said today in a panel discussion at a Fed conference in Jekyll Island, Georgia (where the plans to form the Fed were originally hatched):

> Banks operated with less capital because of an assumption they would be rescued by the government, he said. Lehman Brothers Holdings Inc. wouldn't have failed with adequate capital, he said. "Rampant fraud" was also an issue, he said.
>
> Lack of Trust
>
> "Fraud creates very considerable instability in competitive markets," Greenspan said. "If you cannot trust your counterparties, it would not work."

Greenspan is right.

As leading economist Anna Schwartz, co-author of the leading book on the Great Depression with Milton Friedman, told the Wall Street journal in 2008:

> "The Fed ... has gone about as if the problem is a shortage of liquidity. That is not the basic problem. The basic problem for the markets is that [uncertainty] that the balance sheets of financial firms are credible."
>
> So even though the Fed has flooded the credit markets with cash, spreads haven't budged because banks don't know who is still solvent and who is not. This uncertainty, says Ms. Schwartz, is "the basic problem in the credit market. Lending freezes up when lenders are uncertain that would-be borrowers have the resources to repay them. So to assume that the whole problem is inadequate liquidity bypasses the real issue."
>
> ***
>
> Today, the banks have a problem on the asset side of their ledgers — "all these exotic securities that the market does not know how to value."
>
> "Why are they 'toxic'?" Ms. Schwartz asks. "They're toxic because you cannot sell them, you don't know what they're worth, your balance sheet is not

> credible and the whole market freezes up. We don't know whom to lend to because we don't know who is sound. So if you could get rid of them, that would be an improvement."

Similarly, Robert Reich wrote in 2008:

> The underlying problem isn't a liquidity problem. As I've noted elsewhere, the problem is that lenders and investors don't trust they'll get their money back because no one trusts that the numbers that purport to value securities are anything but wishful thinking. The trouble, in a nutshell, is that the financial entrepreneurship of recent years — the derivatives, credit default swaps, collateralized debt instruments, and so on — has undermined all notion of true value.
>
> Many of these fancy instruments became popular over recent years precisely because they circumvented financial regulations, especially rules on banks' capital adequacy. Big banks created all these off-balance-sheet vehicles because they allowed the big banks to carry less capital.

Nothing has changed since 2008 … the problem is still exactly the same.

The fraud committed by the giant banks – including mortgage fraud, encouraging appraisal fraud, fraud in representing the soundness of mortgages packaged together into mortgage backed securities, the rating of financial instruments, the numerous types of accounting fraud (repo 105s being just one example) – have continued. No big fish have been prosecuted.

No wonder no one trusts anyone else.

And the government has rewarded the looting by bailing out the bad actors again and again, either directly or through various backdoor schemes. (And many economic writers believe that quantitative easing itself is just another bailout).

Even Alan Greenspan is calling out fraud and moral hazard. As I noted in April, Greenspan has been a a die-hard neoclassical or "free market" economist:

> Alan Greenspan didn't think regulators should even pay any attention to fraud:
>
> > He didn't believe that fraud was something that needed to be enforced or was something that regulators should worry about, and he assumed she [Brooksley Born] probably did. And of course she did. I've never met a financial regulator who didn't feel that fraud was part of their mission, but that was her introduction to Alan Greenspan."
>
> Indeed, as Born pointed out last year, Greenspan told her:
>
> > I don't think there is any need for a law against fraud.

However, Greenspan started changing his tune somewhat in April, and his remarks today reinforce his apparent change of philosophy (a change which is as dramatic as the recantation by Judge Richard Posner – one of the leading proponents over the course of many decades for removing the reach of the law from the economy – of his anti-regulatory stance).

Admittedly, talk is cheap, and I'm not sure how much influence former Fed chairs like Greenspan and Volcker have on Bernanke or other sitting officials.

As I asked in April: "Fraud [is] finally being discussed in polite company … now where are the prosecutions?"

Articles by: Washington's Blog