The sub-prime mess, the huge risks taken by hedge funds, and the conflicts of interest that led to Enron are all the consequences of serial bouts of financial deregulation. Will we reverse field in time to prevent another 1929?

ROBERT KUTTNER | *September 24, 2007*

Illustration by Greg Mabley

We have all been here before. -- Crosby, Stills, Nash, and Young

The federal reserve is still struggling to contain what is already the most severe credit contraction since the Great Depression. Yet in all of the press coverage, commentators have scarcely acknowledged that this old-fashioned panic is a child of deregulation. During the past decade, the financial economy has repeated the excesses of the 1920s -- too much borrowing to underwrite too many speculative bets with other people's money, too far beyond the reach of regulators, setting up the entire economy for a crash.

The sub-prime mess, the huge risks taken by hedge funds, and the conflicts of interest that led to Enron and kindred scandals, are all the consequences of serial bouts of financial deregulation. Since the 1970s, in the name of free-market efficiency, Congress and presidents of both parties repealed key protections put in place by the New Deal. But the main effect has been to engineer windfall profits for financial insiders, replace real productive innovation with financial engineering, shift wealth from families to corporations, and put the entire American economy at ever greater risk.

As a result, the economy has increasingly come to depend on asset bubbles -- overvalued stocks, overpriced real estate, and dubious financial instruments like derivatives. The bubbles have been pumped up by speculative borrowing. The borrowing feeds on itself, as it did in the 1920s, since an inflated asset is handy collateral for still more borrowing. Alarmingly, these bubbles turn out to be interconnected -- hedge-fund profits reliant on high-yield sub-prime mortgages, and a soaring stock market bid up by risky private equity deals -- so if the air goes out of one bubble, it goes out of others. That's why the crisis is so hard to manage, even by a very aggressive Federal Reserve.

Supposedly, we can't have depressions anymore, for three reasons. First, the Fed has gotten far more sophisticated about containing financial panics. In recent weeks, the Fed's and the world's other central banks have poured hundreds of billions of dollars into credit markets so that risk-averse banks keep lending against shaky collateral. This in turn keeps the price of that collateral -- bonds, stocks, real estate -- from sinking still farther in a 1929-style meltdown. However, once a bubble bursts, low interest rates can't necessarily revive it; the Fed can cheapen money, but it can't make anxious creditors put it at risk.

The other story we all learn in Economics 101 is that ever since Franklin D. Roosevelt, the volatility of a market economy has been steadied both by regulations and by the ballast of "automatic stabilizers" -- unemployment insurance, public spending, Social Security, and so on. Meanwhile, the regulation contains financial bubbles before they start. But both the regulations and the automatic stabilizers have been seriously weakened, leaving only the Fed, to whose limitations we will return shortly.

Meanwhile, back in the real economy, most people are working longer hours for flat or declining incomes. Since 2000, productivity is up 19 percent, but median earnings are down. Ordinary people, and the larger economy, have come to depend on inflated prices of both real estate and stocks and on increasing debts against those assets as a substitute for rising incomes. Household savings rates are currently negative, meaning that new debt exceeds new savings. Home equity as a percentage of the value of the house is at a record low as people borrow against their homes for living expenses, while credit-card and tuition debt are at record highs. In short, the increasing financial insecurity and inequality for ordinary people, and the increasing risk of collapse now afflicting financial markets, are two sides of the same coin. And that coin is the willful dismantling of managed capitalism.

Deregulating Our Way to Depression

The current crisis was triggered by the sub-prime mortgage panic, but it might as easily have been sparked by a hedge-fund collapse or a run on the dollar. The vulnerabilities are system-wide. Since it began with sub-prime, let's start there.

For decades, real-estate prices have appreciated faster than incomes. This could not go on forever, because a house is worth only what some buyer can afford to pay for it. Lately, housing prices got an extra nudge from artificially cheap mortgages extended to people who didn't really qualify for credit. Mortgage companies could make these sketchy loans because some other speculator was willing to take the loans off their books, and because they expected housing prices to keep rising, adding a cushion of equity. Thanks to deregulation, the entire game operated largely beyond the purview of bank examiners.

When the housing market turned soft, mortgages started going bad, and investors headed for the exits. The stocks of mortgage companies plummeted; the banks that lent them money took hits; hedge funds that invested in their bonds lost money, too -- a chain of events rather like the poem about the war lost for lack of a horseshoe nail ("For want of a nail, the shoe was lost, for want of a shoe, the horse was lost, for want of a horse, the rider was lost …"). This variant on The House That Jack Built was a house of cards.

Thanks to deregulation, these several realms are interconnected. Inflated assets in real estate, the bond market, hedge funds, and private equity feed on each other. And the most important bubble is the stock market itself. The ratio of stock prices to corporate earnings is not quite as high as it was in 1929 or 2000, but it is still very high by historic standards. Takeover deals executed by hedge funds and private equity companies use borrowed money to pay a premium for companies they take over. That inflates the stock price. They hope that by selling off pieces of the company after cutting costs (mainly wages), they can make a quick bundle. But this whole business strategy is based on stock prices continuing to rise. If the cycle goes into reverse, and the deal makers have no buyers at their desired price, or if their financiers stop advancing them credit, the game stops and the stock market sags. Today, the game has certainly slowed: According to research firm Dealogic, the value of takeover deals fell from $695 billion in April and $579 billion in July to $222 billion in August.

Each of these bubbles grew thanks to a very lax regulatory environment combined with very low interest rates. Like every such bubble, our current ones could continue only as long as investors had confidence that prices would go still higher -- just as they did in 1929.

Hedged In

The hedge-fund story has close parallels to the sub-prime mess. A hedge fund is a nominally private investment fund designed to make very risky financial bets and reap unusually high returns. Hedge funds are free from the disclosures required of ordinary investment companies, thanks to a loophole that exempts narrowly-held funds that serve very wealthy people, no matter how large the fund or how risky its strategies.

As long as hedge funds were small players, some very smart strategists could reap very large returns by exploiting obscure pricing anomalies in financial markets, with little risk to the larger system. But in the booming 1990s, hedge funds exploded. By 2006, hedge funds and their unregulated cousins, private equity companies, were generating a third to a half of the business executed on Wall Street, and hedge funds held an estimated $1.5 trillion in assets.

In the low-yield environment of the post-2000 crash, everyone was hungry for higher returns. Pension funds, university endowments, and other traditionally prudent investors began to pour their money into hedge funds to get higher yields, driving the funds to make ever more dubious deals, or deals that involved improper insider trades or conflicts of interest, to satisfy investors and keep the money coming in.

Not surprisingly, hedge funds ran into a Lake Wobegon problem: Everybody can't be above average. By 2003, some hedge funds were still producing outsized returns, but the typical fund was no longer even beating the market averages. As the markets discovered in the collapse of August 2007, a lot of hedge funds using sophisticated computer models were making very similar bets. Rather than offsetting each other's risks, they were reinforcing them.

Today, hedge funds are being squeezed from both sides. Many of their investors want out, and a lot of their banks have stopped advancing them credit. The only thing stopping a hemorrhage of investor withdrawals are rules limiting how quickly investors can take their money and run. As their balance sheets worsen, hedge funds are forced to sell off assets, often for big losses. Several have taken big hits. A few smaller ones have gone bust. But a big hedge-fund collapse is the other shoe that hasn't yet dropped.

What would that be like? When Long Term Capital Management, a leading hedge fund of the roaring 1990s, collapsed in 1998, the Federal Reserve went to extraordinary lengths to prevent an economy-wide credit panic. Hedge funds use so-called derivatives to leverage their own capital at ratios unthinkable to ordinary investors -- 20 or even 50 to one. When LTCM suddenly found that its computer models had guessed wrong, so many banks were owed so much money by LTCM that if the fund simply ceased operations, the losses would have wiped out the capital of New York's major banks. So the Fed, technically exceeding its statutory authority, leaned on the big banks to simply buy the fund outright, liquidate its positions in orderly fashion, and eat about $4 billion in losses. Because hedge funds are unregulated, and LTCM was doing business with so many different banks, neither the Fed nor the other regulatory agencies had any idea of the degree of risk LTCM posed until the fund blew up and the Fed had to contain the damage.

In the nine years since LTCM collapsed, the industry has become hydra-headed. More than 9,000 hedge funds have opened up shop, and the kind of rescue that the Fed mounted in 1998 would not be possible today, according to one former senior official of the Fed, because the risks are now so diffuse. In principle, the authorities can monitor hedge funds by keeping tabs on the books of the so-called "counterparties" -- the banks that underwrite their activities. But bank examiners have not been able to keep up with hedge-fund innovations. The industry is a financial black box.

Repealing Roosevelt

Hedge funds, private equity companies, and the sub-prime mortgage industry have two big things in common. First, each represents financial middlemen unproductively extracting wealth from the real economy. Second, each exploits loopholes in what remains of financial regulation.

The Roosevelt schema of financial regulation was built around two principles -- disclosure and outright prohibition of inherent conflicts of interest. All publicly listed and traded companies were required to disclose to the Securities and Exchange Commission and to the public all financial information deemed "material" to investor decisions. The New Deal also prohibited stock trading based on insider information, and it created structural barriers against the kinds of temptations that ruined the economy in the 1920s. The most notable of these was the 1933 Glass-Steagall Act, which prohibited the same financial company from being both a commercial bank and an investment bank.

The Glass-Steagall wall was devised to prevent a repeat of the 1920s' scams, in which banks made speculative investments, turned the debts into securities, and sold them off to unsuspecting investors with the blessing of the bank. With Glass-Steagall, commercial banks were tightly supervised and given access to federal deposit insurance, to keep savings secure and prevent runs on banks. Investment banks, meanwhile, were not government-guaranteed and were free to do more speculative transactions for consenting adult customers. But Roosevelt's newly created SEC subjected securities markets to much tighter structures against self-dealing and insider conflicts of interest.

The New Deal also acted on the home mortgage front. Millions of people were losing their homes and farms to foreclosures, both creating human tragedies and deepening the Depression. In response, the Roosevelt administration literally invented the modern system of home finance. Pre–New Deal mortgages had typically been short-term notes, where most of the principal was due and payable at the end of a brief term, often just three to five years. The New Deal devised the modern long-term, fixed-rate, self-amortizing mortgage. Congress created the Federal Housing Administration to insure these mortgages and win their acceptance among lenders. It also created the Federal National Mortgage Association to sell bonds and buy mortgages, and thus replenish the funds of local lenders. And the New Deal devised a system of federal home loan banks to supervise and advance capital to savings and loan institutions. Deposit insurance was extended to government-supervised mortgage lenders.

The system worked like a watch, combining sound lending standards with expanded opportunity. The rate of home ownership rose from 44 percent in the late 1930s to 64 percent by the mid-1960s. Savings and loan associations almost always ran in the black, there were no serious scandals, and the government deposit-insurance funds regularly returned a profit.

Look Ma, No Hands

If you fast forward to 2000, much of this protective apparatus has been repealed. Regulators who didn't believe in regulation and a compliant Congress have allowed financial engineers to evade what remains. In the 1980s, regulators began allowing exceptions to Glass-Steagall. In 1999, Congress finally repealed it outright, permitting financial supermarkets like Citigroup to operate any kind of financial business they desired, and profit from multiple conflicts of interest. The scandals that pumped up the dot-com bubble of the late 1990s, as well as the most flagrant cases like Enron, and the crash that followed, were the result of the SEC and the bank regulators ceasing to police conflicts of interest. In the scandals of the 1990s, corporate CEOs, their accountants, and stock analysts working for their bankers, all conspired to puff up corporate balance sheets and pump up stock prices on which executive bonuses depended. This is a little harder today, thanks to the honest accounting requirements of the 2002 Sarbanes-Oxley Act (which the Bush administration hopes to water down). But the same kinds of conflicts and potentials for abuse exist when a mega-bank underwrites a leveraged buyout by an affiliated hedge fund, and then hypes the sale of securities when the fund is ready to sell the company back to the public.

Meanwhile, the once staid and socially directed system of providing home mortgages was seized by financial wise guys and turned into another casino. In the early 1980s, exploiting the Reaganite theme of government-bashing, the savings and loan industry persuaded Congress to substantially deregulate S&Ls -- which then speculated with government-insured money and lost many hundreds of billions, costing taxpayers upward of $350 billion in less than a decade.

In 1989 when Congress reregulated S&Ls, the financial engineers just did another end run. Mortgage companies that were exempt from federal regulation came to dominate the mortgage lending business. This loop of the story begins in 1968 with the privatization of Roosevelt's Federal National Mortgage Association. In the wake of that move, investment bankers invented a daisy chain known as "securitization" of mortgage credit. Through securitization, a mortgage broker could originate a loan, sell it to a mortgage banker, who would then sell it to an investment bank like Salomon Brothers, who in turn would package the mortgages into securities. These were then evaluated and coded (for a fee) by private bond-rating agencies according to their supposed risk, and sold off to hedge funds or pension funds. Each of these worthies took their little cut, raising the cost of credit to the borrower. Rather than diffusing risks (a course that economic theory urges on a prudent capitalist nation), however, securitization concentrated them, because everyone was making the same bet on real-estate inflation.

In the sub-prime sector, you could get a loan without a full credit check, or even without income verification. The initial "teaser" rate would be low, but after a few years the monthly payment would rise to unaffordable levels. Both borrower and lender were betting on rising real-estate prices to bail them out, by allowing an early refinancing. But when a soft housing market dashed those hopes, the whole sub-prime sector crashed, and the damage spilled over into other financial sectors.

The Great Enabler

Ever since late July when the credit crunch in sub-prime mortgages became an economy-wide problem, all eyes have been on the Federal Reserve. None other than Milton Friedman, no friend of government meddling in the economy, blamed the Great Depression on the failure of the Fed in the 1930s to intervene aggressively enough. Financial writers have taken to quoting Walter Bagehot, the great financial journalist and commentator of the Victorian era, who correctly counseled that in a financial panic, the job of the lender of last resort is to flood the system with liquidity. This is what the Fed, somewhat belatedly, has been contriving to do.

At first, Chairman Ben Bernanke was reluctant to move too quickly, lest he signal that irresponsible speculators would be bailed out. Then, after pleas from Wall Street became urgent, and credit markets began freezing up in an old-fashioned panic, Bernanke moved.

In mid-August, the Fed flooded the financial markets with cheap money, in order to induce panicky creditors to keep lending and prevent an asset meltdown. Though the Fed's target rate on overnight inter-bank loans (the "federal funds" rate) was kept at 5.25 percent to avoid a sense of desperation, the actual rate fluctuated between 4.5 and 5 percent for several days, thanks to the tens of billions that the central bank poured into the markets.

Then, when that move failed to calm the markets, the Fed took the additional step of reducing the discount rate, the interest rate charged on money that banks borrow directly from the Fed itself. At this writing, the Fed is universally expected to cut the federal funds rate at its next scheduled meeting Sept. 18. The only question is how much.

How aggressively the Fed should move has been the subject of extensive commentary. If the Fed moves too slowly or doesn't cut enough, it ends up playing catch-up behind an advancing panic. If it moves too quickly or too generously, it just invites the next round of speculation with cheap money, and in passing might erode confidence in the none-too-robust dollar. But all of this commentary misses the larger point: If monetary policy is the only tool the government has at its disposal, the Fed can't possibly solve the larger crisis (or prevent the next one) by using interest rates alone.

Indeed, until Congress dismantled financial regulation, the Fed was not called upon to mount these heroic rescues, which have become so common in recent years. Until the 1960s, the central bank could keep interest rates low, confident that they would underwrite the growth of the real economy rather than risky financial speculation, for the simple reason that entire categories of speculation did not exist.

But during the past quarter-century, as deregulation has turned the economy into a casino, the Federal Reserve has had to mount major rescues at least six times. In the early 1980s, it bailed out the big New York banks, some of which lost more than the total amount of their capital in failed speculative third world loans; the money-center banks would have been adjudged insolvent if the Fed hadn't bent its usual capital-adequacy rules. Next, the Fed poured huge quantities of liquidity into financial markets after the stock market crash of 1987, in which the market lost more than 20 percent of its value in a single day. The Fed intervened again on several occasions after speculators destabilized several third world currencies and economies from Mexico to Malaysia. The Fed cleaned up after the aforementioned Long Term Capital Management collapse. It flooded markets with money after the dot-com crash and the attacks of September 11, and most recently in the credit crunch of summer 2007.

Indeed, markets have become so reliant on the Fed's bailouts that they even have a term for it -- "the Greenspan put." A put is a financial term meaning a right to sell a financial security at a predetermined price. The knowledge that the Fed would cheapen money in a crisis reassured speculators that they could always unload their paper. That awareness also influenced financial insiders to behave more recklessly.

The point is not that the Fed should turn its back when financial markets are on the verge of replicating the Great Crash. The point is that the Fed has become the chief enabler of a dangerously speculative economy. It is simply not possible to get the right balance of financial prudence and financial liquidity using monetary policy alone. That's why we once had a more carefully regulated economy.

The Fed, as the designated lender of last resort, does have more arrows in its quiver than monetary policy. It has certain regulatory powers -- but has been loath to use them. For example, the Fed has residual powers to crack down on the credit terms of sub-prime lenders who sell mortgages in financial markets (virtually all of them). For the better part of a decade, the late Federal Reserve Governor Ned Gramlich, who was the Board of Governors' most expert member on housing and mortgage markets, warned Chairman Alan Greenspan about lowered credit standards and the risks of a housing bubble.

Greenspan, however, figured markets could police themselves and declined to act. The Fed could also have weighed in on the side of tighter regulation and disclosure standards for highly complex and risky over-the-counter derivatives, which are often the basis for hedge-fund strategies, and which have very shallow markets in the event of a credit crunch. But Greenspan repeatedly testified that he believed derivatives improved market liquidity and needed no regulation.

As we go to press, the current crisis is far from resolved. The nation's largest mortgage lender, Countrywide Financial, is tottering and has just laid off 12,000 employees. Foreclosures will mount as some two million more adjustable-rate mortgages are scheduled for rate hikes this year. All but the most blue-chip users of credit are finding money more expensive and harder to come by, even with the Fed easing the nation's overall monetary policy. And job generation has shuddered to a halt.

As markets reprice dubious assets, the interconnection of the several asset bubbles is becoming more painfully evident. The volume of takeover deals, which had pumped up hedge-fund profits and the larger stock market, is shrinking. Bank profits, like those of their hedge-fund and mortgage company customers, are taking big hits. Many exotic and unregulated financial products, with shallow trading markets, are difficult to value. Some collateralized debt obligations are selling at 7 cents on the dollar, and others are not selling at all. This broad financial unwinding incurs losses for investment banks, hedge funds, private equity firms, and those who invested in them. It creates a downward drag on share prices and eventually on the broader economy. Regulators are hesitant to press banks to mark down their assets to their current trading value lest honest bookkeeping trigger a deeper crisis of confidence.

In the economic tricycle of monetary, regulatory, and fiscal policy, the government today is trying to run on one wheel. Not only is regulation moribund but the use of fiscal policy to stimulate the economy through government spending in the event of a downturn has also become moot, because we are in an era of permanent deficits. In the aftermath of 9-11, the Bush administration promoted tax cuts for the rich, both as an end in itself and for the sake of economic stimulus. Then, with the Iraq War, big budget deficits became the norm. It took chronic deficits coupled with cheap money to achieve even a tolerable rate of growth. Now, with the risk of a recession looming, neither party is talking about serious public outlay to complement the spending of tapped-out workers and consumers, leaving the highly risky course of cheap money and asset inflation as the only strategy for stimulating the economy.

How Low Is Down?

Watching the turmoil in the financial markets, a worried friend recently asked me to define the difference between a recession and a depression. Probably the classic explanation of a depression is the economist Irving Fisher's celebrated 1933 article, "The Debt-Deflation Theory of Great Depressions," which was updated, interestingly enough, in 1983 by a young Princeton economist named Ben Bernanke.

An ordinary recession is a cycle of economic contraction that either cures itself when prices drop and buying resumes, or is cured by government acting to stimulate the economy through lower interest rates or increased public deficit-spending, or both. But in a great depression, as Fisher explained, the value of assets sinks below the value of the debt on those assets. A debt is fixed unless the debtor can find relief, while the value of assets varies according to the market's confidence. If you paid $400,000 for a house with a $350,000 mortgage, and the value of the house drops to $300,000, you are in big trouble -- particularly if you stretched to buy the house and were hoping to refinance, even more so if you need to sell the house. Same problem if you borrowed money to buy shares of a stock, and its value sinks instead of rises. In a capitalist economy, an asset is worth only what someone is willing to pay for it. If no buyer materializes, the asset is literally worthless.

In a debt-deflation, a financial chain reaction sets off a general depression. Owners of assets -- stock shares, bonds, houses, farms -- either conclude that prices have peaked and it's time to bail, or they are caught by falling prices, asked to produce collateral, and are forced to sell into a declining market. Sellers overwhelm buyers, reducing the value of assets overall and intensifying the collapse. It's as if the entire economy faces a margin call and goes into fire-sale mode.

The whole credit system can seize up because suddenly markets are short of buyers even for blue-chip securities that are ordinarily considered sound. Low interest rates can't fix that problem when too few people have the confidence to lend, borrow, or buy. In the 1930s, economists analogized the problem to "pushing on a string."

By the time the dust settles, demand has taken a huge hit, and the credit crisis has spilled over, causing businesses to go bust, banks to fail, workers to lose their jobs, and consumers to tighten their belts, further shrinking demand and deepening the depression. In the 1930s, even Roosevelt's heroic measures got the economy only partway into recovery. It took the massive government borrowing and public spending of World War II to finally repair the wreckage of 1929.

Typically, this debt-deflation syndrome is set off when excessive euphoria and speculative borrowing bid up prices to unsustainably high levels -- creating a bubble. When some random event leads the market to doubt whether those prices can be sustained, the psychology goes into reverse, and panic-selling ensues.

Fisher's description is as chillingly fresh as today's financial pages. The epic example, of course, was the speculative frenzy of the 1920s, stimulated by conflicts of interest on the part of Wall Street insiders. In more recent cases where a bubble burst, such as the LTCM affair or the dot-com bust, the Fed was able to contain the wider damage. But if the entire economy is an asset bubble, it remains to be seen whether the current crisis is more like those other containable panics, or more like 1929.

The Political Economy

Politically, this credit crunch is one more blot on the Bush administration, and the broader corporate ideology for which it stands.

Senate Banking Committee Chairman Chris Dodd has been meeting with top officials of the Fed and the Treasury, urging hands-on action to contain the crisis, but crisis management is only part of any policy. The Democrats are also pressing the administration to allow the Federal National Mortgage Association to refinance some at-risk mortgages, both to prevent the personal tragedy of foreclosures, as Roosevelt did in the 1930s, and to stabilize the mortgage sector and, by extension, credit markets generally.

Too few politicians are connecting the dots to the wider failure of deregulation, because too many were complicit in its enactment. House Financial Services Chairman Barney Frank, to his credit, plans hearings through the fall on the crunch's wider implications. The Republicans, meanwhile, are still calling for more deregulation, on the grounds that the Sarbanes-Oxley Act enacted in the wake of Enron and other scandals is onerous to corporations. America should be having a great debate on the need to restore managed capitalism, and so far we have just the barest beginnings of one.

It is possible that we will dodge this bullet (as it is possible that the Red Sox will win the World Series again). In the rosiest scenario, the Fed will do its job just right. Interest rates will be set low enough to restore confidence, but not so low as to trigger a run on the dollar or to invite still more speculation; the stock market will find a sustainable bottom of, say, the Dow at 12,000; the mortgage industry will get a well deserved haircut, but the wave of foreclosures will be contained, and the great game will continue. But this assumes that you can let a little air out of a bubble, and bubbles have an unfortunate habit of popping. If the broader economy does avoid catastrophic damage this time, the worst outcome of all would be if Congress just ignored the escalating systemic risk.

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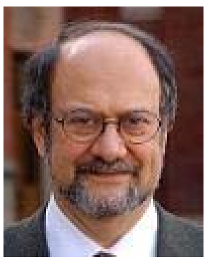

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