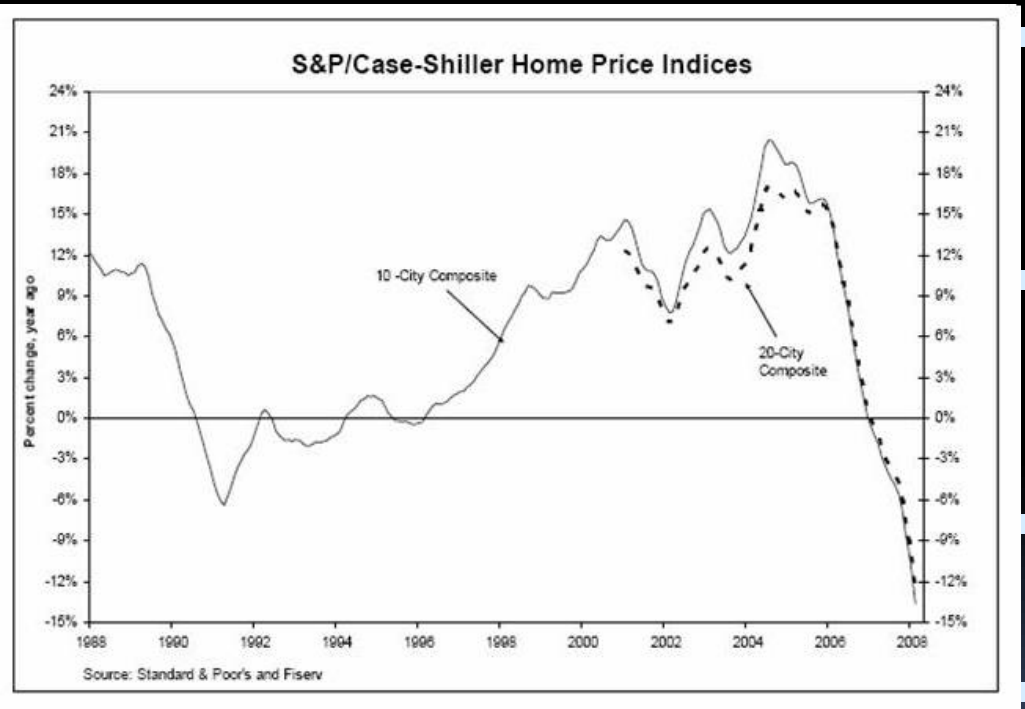
The Panic of 2007-2008: Not the Market's Fault

BY GEORGE BRAGUES
UNIVERSITY OF GUELPH-HUMBER

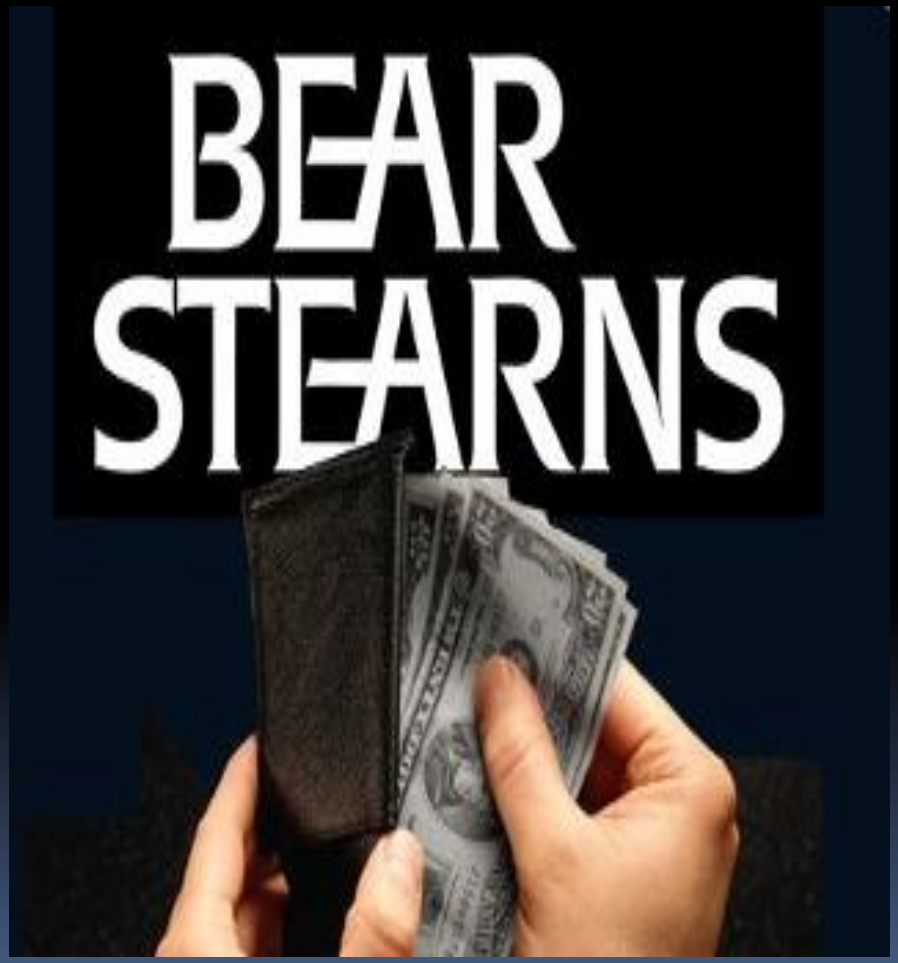
Background and beginning of crisis



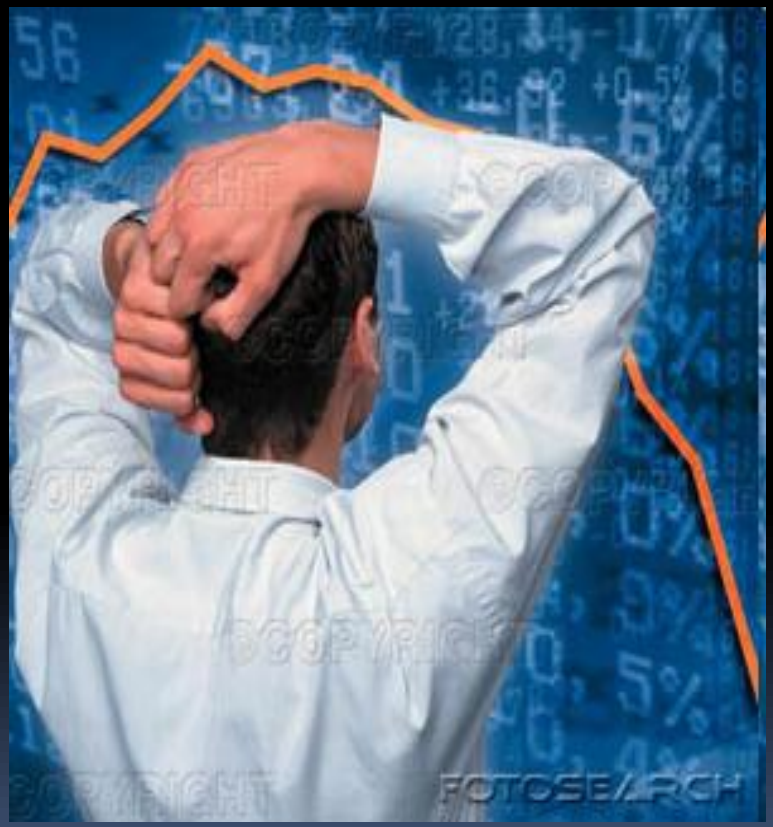
- Housing boom from late 90's to mid-2006
- Boom featured rise in sub-prime mortgage lending
- Securitization of these mortgages fueled lending
- Then foreclosures rose noticeably in late 2006
- First rumblings in markets in early 2007

The Crisis Heightens

- In August 2007, BNP Paribas closes three sub-prime mortgage related funds to withdrawals
- Markets dive globally
- US Fed begins dramatic lowering of rates
- Calm restored in fall 2007
- But downturn resumes in early 2008, culminating in March collapse of Bear Sterns



The Crisis spills into the Economy



- Markets go into free fall beginning in Sep. 2008
- Credit spreads skyrocket
- US government passes $700 billion bailout package
- Governments around the world inject funds into banks
- Economic conditions deteriorate suddenly and sharply

The Dominant Narrative

- Widely conceded that Greenspan left interest rates too low
- Yet conventional wisdom is that free capital markets are at fault
- Lack of regulation allowed greedy sub-prime mortgage lenders to exploit lower income borrowers and then these deals were packaged by investment banks
- Conflicts of interest drove rating agencies to certify dubious mortgage securities
- Lax supervision allowed financial institutions to take on too much leverage
- The upshot of this narrative: capitalism in finance has failed and its activities must be brought under the control of society through government intervention

The False premise

- Dominant narrative assumes that financial markets were free prior to crisis
- Though there was some deregulation, government presence in the markets was significant
- And it is this presence that lies at the roots of the panic of 2007-2008

Politics and Finance

- Politics made felt in financial markets in various ways:
  - 1. Central Banking
  - 2. Currency price controls
  - 3. Mortgage securitizatio
  - 4. Bank lending mandate
  - 5. Oversight of rating agencies

Central Banking goes awry – Greenspan

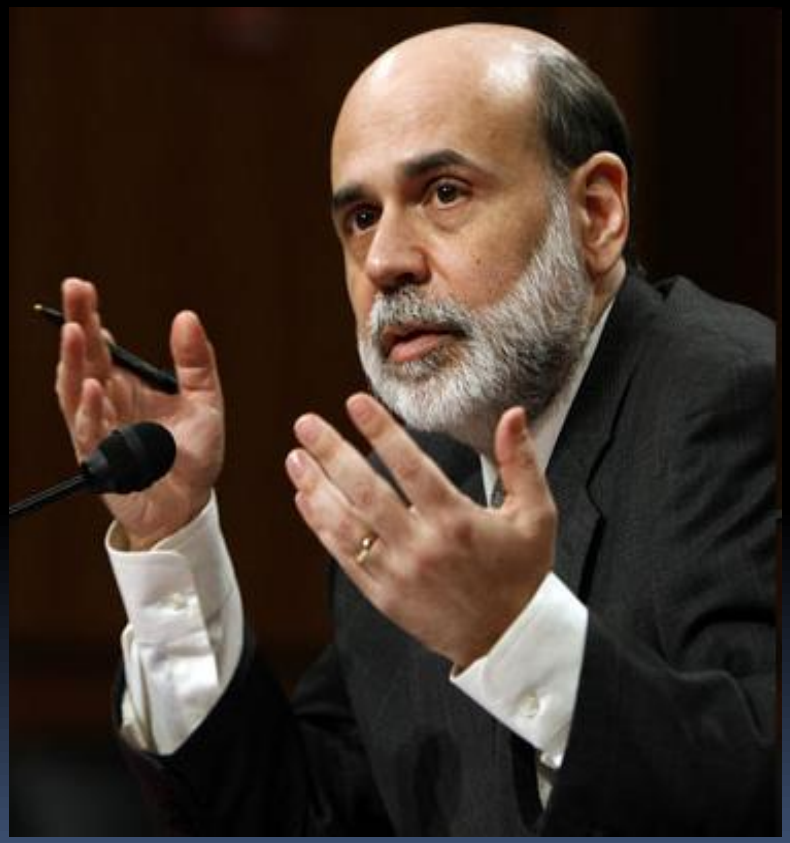
- Once referred to as the "Maestro", Alan Greenspan's record now coming under scrutiny
- He recently blamed lack of regulation for crisis
- But the foundation for everything that went wrong lies with his monetary policy

Austrian Theory of Business Cycles

- Greenspan's error best understood in light of Austrian school of economics
- Correct interest rate reflects preferences for future (capital) vs. present (consumption) goods
- If rate set too low, excess investment occurs in capital goods
- Greenspan kept rates too low for too long after dot. com collapse
- Sparked misallocation of investment towards housing

Ludwig von Mises – Economist of Austrian school

Central Banking goes awry – Bernanke

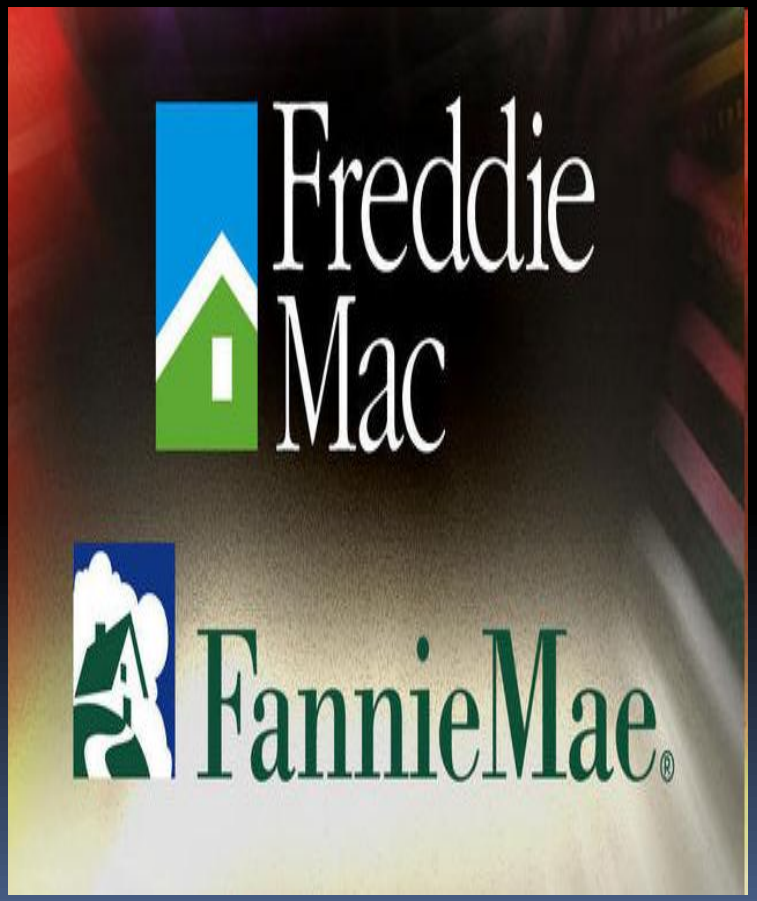


- According to Austrian theory, when the crisis arrives, savings need to rise
- But Bernanke's move to slash rates impeded this necessary adjustment
- Following M. Friedman interpretation of Great Depression
- Rate cuts caused US$ to fall precipitously
- This, in turn, put the commodity price boom into overdrive – thereby creating further investment misallocations

The Asia factor

- Greenspan insists he tried to raise rates after 2004
- But a savings glut in Asia, he says, found its way into US treasuries – causing long-term rates to go down
- But this buying of US treasuries largely a result of Chinese government's attempt to keep its currency down

Politicized Mortgage Banking



- Fannie Mae and Freddie Mac buy and insure mortgages
- Were private, but treated as having a public guarantee
- Effectively, a government subsidy to housing
- Banks pressured by government to extend loans to lower income borrowers

Government Protected Rating Agencies

- Three major rating agencies:
  - S&P
  - Moody's
  - Fitch's
- Hold enormous clout
- Gave overly high ratings to mortgage securities
- But they've been protected from competition by government

The Challenge Ahead

- Support for free market/classical liberal ideas is eroding
- Disaster socialism
- Urgent that the dominant narrative surrounding the crisis be challenged