From Chapter 5: The Past and the Future

A historian once said: “Bad ages to live through are good ages to learn from.” The current economic crisis has certainly been a bad time to live through, so we can at least try to learn from it. Indeed, there are many things to unlearn from it.

Perhaps the first thing to question is the conclusion that many seem to be deriving from today’s economic debacle—namely, that more government regulation of the housing and financial markets could have prevented the housing boom and bust, with its dire repercussions, and more government regulation is the way to prevent a recurrence of today’s crisis. We have seen, however, that government regulations and interventions are precisely what pushed lending institutions to reduce the standards which they had traditionally required of prospective borrowers before making mortgage loans to them. This lowering of mortgage loan standards, and the riskier loans that resulted, were crucial to the creation of a whole financial house of cards, whose collapse sent shock waves throughout the American economy, and whose repercussions have been felt internationally.

Those who are saying today that better regulation could lead to better results are voicing an attractive truism that is very misleading in the real world. No doubt perfect government regulation could have solved the housing market problems. But a perfect operation of the free market could have solved those problems as well. And perfect human beings could have prevented the problems from arising in the first place. But any serious attempt to deal with serious problems must begin with human beings, and human institutions, as they are—not as we wish or hope they are.

In a complex story about intricate financial arrangements, it is possible to lose sight of a plain and fundamental fact—that behind all the esoteric securities and sophisticated financial dealings are simple, monthly mortgage payments from millions of home buyers across the country. When many of those payments stop coming, no amount of financial expertise in Wall Street or government regulatory intervention from Washington can save the whole investment structure built up on the foundation of those mortgage payments.

The bedrock question then is: Why did so many monthly mortgage payments stop coming? And the bedrock answer is: Because mortgage loans were made to more people whose prospects of repaying them were less than in the past. Nor was this simply a matter of misjudgment by banks and other lenders. The political pressures to meet arbitrary lending quotas, set by officials with the power of economic life and death over banks and over Fannie Mae and Freddie Mac, led to riskier lending practices than in the past.
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Human beings make mistakes in both markets and government, despite the widespread notion that, when things go wrong in the market, that automatically means that the government should intervene—as if government makes no mistakes.* But neither sainthood nor infallibility is the norm in Washington or in Wall Street. Any realistic assessment of the decision-making process in the market or in government must examine the incentives and constraints facing those who operate in these two venues. Above all, such an examination must be based on the hard facts about the actual consequences of decisions, regardless of the goals, hopes or rhetoric of those decisions.

POLITICAL INTERVENTIONS

Government actions cannot be discussed as if government is simply the public interest personified. Government actions are political actions, and nowhere more so than in a democracy. The time horizon of elected officials is all too often bounded by the next election. Quick fixes are one result. Nor is this something new or peculiar to American politics. Writing in Britain back in 1776, Adam Smith referred to “that insidious and crafty animal, vulgarly called a statesman or politician, whose councils are directed by the momentary fluctuations of affairs.” Many of the “problems” which politicians set out to “solve,” are bad consequences of previous quick-fix “solutions” created by the same politicians or by other politicians. These include housing prices in some places that take half a family’s income just to put a roof over their heads. Dealing with this problem by launching nationwide housing crusades to create “affordable housing” through

*When a starting quarterback throws an interception, the coach does not immediately take him out of the game and send in a backup quarterback. Decisions in sports are often more rational than decisions in politics because the consequences are immediate and direct, in lost games and fired coaches. No amount of rhetoric or spin can trump what the won and lost columns say.
mortgage lending quotas and riskier lending practices tries to solve one problem by creating another. The collapse of this “solution” now confronts the country with a still bigger problem for which yet a new “solution” is being proposed, with the prospect of still bigger problems for this generation and for generations to come, who will have to pay off a national debt created by politicians who throw around the word “trillion” to the point where it has become familiar enough that its magnitude and dangers no longer evoke the alarm that they once would have.

However easy it may be for politicians to ignore the economic repercussions of their decisions, the costs of such repercussions are virtually inescapable in the marketplace, for they are reflected in prices, even if the individual decision maker has no clue as to why those prices are what they are. For example, a photographer who wants to buy a telephoto lens, and is choosing between two lenses of the same quality and magnification, may prefer the one that lets in more light. While the photographer may have no idea what additional optical problems are created when a lens is built wider to let in more light, or the more complex lenses made of more expensive glass that may be needed to handle those additional problems, nevertheless the huge price difference between the two lenses conveys all the information needed for decision-making. It is then up to the photographer to decide how much more light is worth how many hundreds more dollars, given the kinds of photographs that the particular photographer takes.

Facts have no such coercive power in politics as they have in markets. While a photographer who knows nothing about optical science is nevertheless forced to confront the fact that a particular lens that lets in more light can cost twice as much as a similar lens without this feature, the situation is completely different in politics, where what most voters believe, or can be induced to believe, is the ultimate reality for elected officials.

Ironically, two economists in the Soviet Union saw a key fact about market economies that so many who live in market economies have missed: “Everything is interconnected in the world of prices, so that the smallest change in one element is passed along the chain to millions of others.” In politics, however, “good things” can be advocated or enacted into law on the basis of the beneficial consequences anticipated, with little or no consideration of the many other repercussions that spread in all directions.

Setting an interest-rate ceiling, for example, may be intended to benefit borrowers but it creates incentives for lenders to lend only to people whose
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prospects of repayment are sufficiently high to make lending profitable at that imposed interest rate. Loan applicants are not “qualified” or “unqualified” absolutely. People whom it would be too risky to lend to at an interest rate of 5 percent may be worth lending to at an interest rate of 10 percent, with the extra interest covering higher rates of default. If an interest rate ceiling imposed by government is lowered enough, it would pay to lend only to millionaires—and, at a still lower interest rate ceiling, it would pay to lend only to billionaires. However politically attractive interest rate ceilings might be, they make it less likely that lower income people will get loans. And if different racial or ethnic groups are disproportionately represented in lower income brackets, then interest rate ceilings virtually guarantee that they will be disproportionately represented among those turned down for loans, including mortgage loans. For politicians, however, this differential in mortgage loan approvals can then become simply another isolated “problem” in the market for them to “solve”—with no awareness of how previous political “solutions” helped create this situation, much less any consideration ofhow the repercussions of their own new “solution” will spread in all directions. Those with a taste for moral melodrama are all too willing to attribute different prices, differing interest rates or other differences to “greed,” “racism” or other moral failings of other people. The flaws and shortcomings of human beings virtually guarantee that there will be examples. But examples do not provide an over-all explanation. Moreover, wrong explanations are not just an intellectual problem, when they lead to laws and policies geared to a different situation from that actually existing in the real world.

Another crucial difference between markets and politics is that markets usually leave no choice between changing mistaken notions or paying big-time in lost money or even outright bankruptcy. Under the pressure of such alternatives, the market has already responded quickly to the housing crisis, with a drastic reduction in interest-only loans, no-down-payment loans and other such “creative” financing. But there is no such renunciation of pet notions in Washington. On the contrary, politicians who have played a major role in ruining the housing market are now eager to try their luck intervening in the automobile industry and other sectors of the economy.

Survival in the market often requires recognizing mistakes and changing course, while survival in politics often requires denying mistakes, continuing the current policies and blaming the bad consequences on others. We have already seen in Chapter 4 how impervious to experience government decision-making can be, when the notion of improved housing’s beneficial influence on social behavior has persisted for more than a century—and counting—despite such widespread and devastating evidence to the contrary
as the degeneration of brand new public housing projects across the country into cesspools of crime, violence and vandalism when slum dwellers moved into these new homes and created new slums.

Despite such massive evidence, Section 8 housing vouchers continue the same notion in a different form, sending dysfunctional people to plague neighborhoods to which many other people have moved, often at some financial sacrifice over a period of years, precisely in order to escape such dysfunctional people. But those who make such government decisions, and those who applaud them from the sidelines, pay no price for persisting in empirically discredited assumptions. Perhaps if Section 8 vouchers were increased in value to the point where they would pay for living in Hollywood, or on Cape Cod, or in affluent gated communities where so many self-congratulatory believers in such social engineering live, then first-hand experience might have some hope of overcoming fashionable notions. More generally, what is called a “solution” in politics is often simply a patch put over problems caused by previous political “solutions,” which in turn were patches put over other political “solutions” before that. What never seems to get through to many politicians, or to supporters of political interventions in markets, is that policies have repercussions far beyond the particular goals of those policies.

In 2000, for example, Hillary Clinton called for tripling the number of Section 8 housing vouchers and building more public housing. In 2007, after the housing bubble burst, Senator Clinton proposed a plan “to preserve the American dream of home ownership” that would “curb unfair lending practices and hold brokers and lenders accountable, give families the support they need to avoid foreclosure and increase the supply of affordable housing.” This was the same approach that had led to the housing crisis in the first place, now spiced up with depictions of victims and villains.

To single out home ownership or any other goal as the crusade of the day—as a “good thing”—ignores the fact that virtually nothing is a good thing categorically. We must have food to live but, beyond some point, an increasing intake of food makes us overweight and shortens our lives. Home ownership has undoubted benefits but it also has costs and risks, however much those costs and risks were ignored, downplayed or dismissed by politicians and social crusaders during the housing crusades that led to the boom and bust. As of 2006, a larger proportion of homeowners than of renters were paying more than 50 percent of their incomes for housing.
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The disasters into which the heedless political pursuit of ever larger statistics on home ownership has led should at least make us aware of the dangers created by such heady and heedless adventures in the housing markets. An optimist might even hope that it would make us aware of the dangers of heady and heedless adventures in general. The financial markets that are at the center of our current economic problems have, over the generations, seen one government patch after another put on problems created by previous government patches. Perhaps the crown jewel of those who believe in government intervention in financial markets has been the Federal Deposit Insurance Corporation, which guarantees bank accounts and thus has effectively put an end to runs on banks. There is no question that FDIC, by removing the incentives to start a run on a bank by those fearful of losing the money in their accounts, has reduced bank failures.

But why was such a law necessary in the first place? Because of massive bank failures during the Great Depression of the 1930s. Yet what has seldom been mentioned is that a wholly disproportionate share of those banks that failed then were in states with laws preventing a bank from having more than one location. Whatever the rationale for preventing banks from having multiple branches, the economic consequence was increased risk. A bank located solely in a wheat-growing community is exposed to all the risks of a fluctuating wheat market, since both its depositors and those to whom it lends money are likely to include many people dependent on the price of wheat, which fluctuates in a world market beyond their control. But a bank with branches not only in wheatgrowing areas, but also in steel-producing areas, furnituremaking areas, etc., has more diversified risks, and therefore lower risks overall, since all these markets are unlikely to fluctuate the same way at the same time. It was precisely in states with laws forbidding multiple branches of banks that state deposit insurance arose, years before federal deposit insurance. In short, politicians were trying to solve a problem which politicians had created—namely, heightened risks of bank failures. Eventually, Washington politicians put a bigger patch over the patches of state politicians. That it was a good patch is undeniable. But it was solving a problem disproportionately created by other politicians, rather than by the market.

Even during the depths of the Great Depression, when thousands of American banks failed, larger banks with diversified risks, located in places where they were not constrained by state laws against multiple branches, had very low rates of failure. Ninety percent of the failing banks were in small communities and almost all were in states with laws against branch banking. Meanwhile, in Canada, which went through the same depression as
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In the United States, there was not one bank failure during the years when thousands of American banks failed—and the Canadian government did not provide deposit insurance. Canada had 10 banks, with 3,000 branches across the country. The market can work—but only when politicians allow it to work.

No doubt there are things that federal regulatory agencies could have done to keep financial institutions in Wall Street and elsewhere from adding to the risks in an already risky situation by the way they marketed securities based on mortgages. But these are things downstream from the fundamental source of risk, the lowering of standards for making mortgage loans and the resulting delinquencies, defaults and foreclosures.

What an ideal regulatory agency could do is no clue whatever to what actual regulatory agencies are likely to do, especially with members of Congress like Barney Frank and Christopher Dodd breathing down their necks. What banks could have done ideally in the past or can do ideally in the future is no clue to what they have done or will do when government agencies from the Federal Reserve System to the Justice Department are telling banks that they had better meet arbitrary quotas in their lending if they want to avoid big trouble from the government.

In housing markets, there have been an abundance of theories and of fervently believed doctrines, but not nearly such an abundance of willingness to subject those theories and doctrines to the test of evidence. Politicians would be gambling their entire careers on a roll of the dice, if they were to publicly subject the policies and programs that they have been advocating for years to empirical tests of their consequences. For others outside of politics, their only stake might be ego or ideology, but some people have been known to risk their lives for such things.

Most members of the general public have no such vested interests at risk when deciding whether belief A proves to be more consistent with the facts than belief B. That is one of the few hopeful aspects of the financial crisis we are in—that there are many people who just want to know what the truth is, so that we can all avoid a repetition of the disaster that has overtaken us, regardless of what theory, doctrine, political party or editorial position is vindicated or discredited in the process.
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Consequences

Let us go back to square one to consider the empirical consequences of policies in the housing market. Politicians in Washington set out to solve a national problem that did not exist—a nationwide shortage of “affordable housing”—and have now left us with a problem whose existence is as undeniable as it is painful. When the political crusade for affordable housing took off and built up steam during the 1990s, the share of their incomes that Americans were spending on housing in 1998 was 17 percent, compared to 30 percent in the early 1980s. Even during the housing boom of 2005, the median home took just 22 percent of the median American income.

What created the illusion of a nationwide problem was that, in particular localities around the country, housing prices had skyrocketed to the point where people had to pay half their income to buy a modest-sized home and often resorted to very risky ways of financing the purchase. In Tucson, for example, “roughly 60% of first-time home buyers make no down payment and instead now use 100% financing to get into the market,” according to the Wall Street Journal. Almost invariably, these locally extreme housing prices have been a result of local political crusades in the name of locally attractive slogans about the environment, open space, “smart growth” or whatever other phrases had political resonance at the particular time and place.

Where housing markets have been more or less left alone—in places like Houston or Dallas, for example—housing did not take even half as big a share of family incomes as did comparable housing in places like the San Francisco Bay Area, where heavily hyped political crusades had led to severe restrictions on building. It was in precisely these extremely high housing cost enclaves that the kind of people for whom the national housing crusade expressed much concern—minorities, low-income people and families with children—were forced out disproportionately. Few things blind human beings to the actual consequences of what they are doing like a heady feeling of selfrighteousness during a crusade to smite the wicked and rescue the downtrodden. Statistical studies about disparities between blacks and whites in mortgage loan approval rates might be said to have “jump-started” the housing crusades that began in the 1990s. Politicians and the media led this crusade, with many community activists following in their wake, much like scavengers, able to extract large sums of money from banks and other institutions by raising claims of discrimination, whose power to delay government approval of bank mergers and other business decisions made pay-offs to these activists the only prudent course for those accused.
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Even where loudly proclaimed concern for the poor and minorities gave impetus to the drive for over-riding traditional mortgage lending standards, this is not to say that the poor and minorities were the sole beneficiaries or even the main beneficiaries. When you open the floodgates, you cannot tell the water where to go. Housing speculators—“flippers”—found the new and looser home mortgage rules a bonanza. So did many others. It is by no means clear that the poor or minorities came out ahead at all, after the housing boom turned to bust and many were left with mortgage payments they couldn’t meet on homes they couldn’t afford.

With rich rewards available—politically, ideologically and financially—from the “affordable housing” crusade, there were ample incentives to keep this crusade going for years. Meanwhile, various special interests found ways to benefit themselves from all this, whether as home builders, real estate investors or others, and therefore added their voices in support of the open-ended goal of more home ownership through various ways of achieving, or seeming to achieve, affordable housing. Supporters of such policies and programs easily drowned out the voices of those economists and others who increasingly warned of the risky financial arrangements that were behind the statistics on the growing numbers of home buyers that were so triumphantly being paraded as fruits of the crusade for affordable housing and the stamping out of mortgage lending discrimination. In short, this was a crusade that was feeding on its own successes by its own criteria, and was not likely to stop unless it got stopped.

The housing market collapse dealt a blow to some of the devices that fed the crusade—“creative” financing and lax lending standards, for example—but even the ensuing national crisis did nothing to end the political attractiveness of the goal of making housing affordable by government fiat, rather than by individuals buying or renting housing that was within their own income range. Just as the utter discrediting of public housing projects did not discredit the underlying beliefs that caused such projects to be built, so in this case even the more widely disastrous consequences of the affordable housing crusade have led only to seeking other ways of carrying on that same crusade, based on the same discredited assumptions and the same disregard of repercussions. While some Congressional Democrats have proposed a moratorium on mortgage foreclosures or allowing judges to change the terms of mortgage contracts, Senate Republicans have proposed “providing government-backed, 4% fixed mortgages to any credit-worthy borrower.” What these proposals from politicians of both parties all have in common is an utter absence of any serious consideration of the repercussions in multiple directions of arbitrary government fiats.
Anyone who expected any such consideration of repercussions by most members of either political party would have little chance of avoiding painful disappointments. Certainly few politicians of either party have questioned whether the track record of politicians in the housing market justified more of the same in other markets. Many are in fact eager to extend political intervention into other industries receiving the government “stimulus” or bailout money.