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THE ECONOMIC CRISIS

Capitalist Fools

by Joseph E. Stiglitz
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ABSTRACT

In the January 2009 issue of *Vanity Fair* magazine, Joseph E. Stiglitz reminds us in his article, “Capitalist Fools”, that any debate about future policy direction necessarily involves a debate over the past, and that to successfully remedy what ails our economy will require an accurate assessment of what created the crisis. Stiglitz identifies five key decisions made between 1987 and 2008 by Presidents Reagan, Clinton, and Bush II that cascaded to create the inevitable “system failure” that led to today’s circumstances.

He explains the effects of each decision, both intended and unintended, illustrating how flawed incentive structures and inadequate regulation bent human behavior toward short-term self-interest, rather than towards Tocqueville’s “self interest rightly understood.” Even Alan Greenspan now agrees that to believe markets are self-adjusting and that the role of government should be minimal is “a flaw.”

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Behind the debate over remaking U.S. financial policy will be a debate over who's to blame. It's crucial to get the history right, writes a Nobel-laureate economist, identifying five key mistakes—under Reagan, Clinton, and Bush II—and one national delusion.

by JOSEPH E. STIGLITZ January 2009

Treasury Secretary Henry Paulson and former Federal Reserve Board chairman Alan Greenspan bookend two decades of economic missteps. *Photo illustration by Darrow.*

There will come a moment when the most urgent threats posed by the credit crisis have eased and the larger task before us will be to chart a direction for the economic steps ahead. This will be a dangerous moment. Behind the debates over future policy is a debate over history—a debate over the causes of our current situation. The battle for the past will determine the battle for the present. So it's crucial to get the history straight.

What were the critical decisions that led to the crisis? Mistakes were made at every fork in the road—we had what engineers call a "system failure," when not a single decision but a cascade of decisions produce a tragic result. Let's look at five key moments.

No. 1: Firing the Chairman

In 1987 the Reagan administration decided to remove Paul Volcker as chairman of the Federal Reserve Board and appoint Alan Greenspan in his place. Volcker had done what central bankers are supposed to do. On his watch, inflation had been brought down from more than 11 percent to under 4 percent. In the world of central banking, that should have earned him a grade of A+++ and assured his re-appointment. But Volcker also understood that financial markets need to be regulated. Reagan wanted someone who did not believe any such thing, and he found him in a devotee of the objectivist philosopher and free-market zealot Ayn Rand.

Greenspan played a double role. The Fed controls the money spigot, and in the early years of this decade, he turned it on full force. But the Fed is also a regulator. If you appoint an anti-regulator as your enforcer, you know what kind of enforcement you'll get. A flood of liquidity combined with the failed levees of regulation proved disastrous.

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Greenspan presided over not one but two financial bubbles. After the high-tech bubble popped, in 2000-2001, he helped inflate the housing bubble. The first responsibility of a central bank should be to maintain the stability of the financial system. If banks lend on the basis of artificially high asset prices, the result can be a meltdown—as we are seeing now, and as Greenspan should have known. He had many of the tools he needed to cope with the situation. To deal with the high-tech bubble, he could have increased margin requirements (the amount of cash people need to put down to buy stock). To deflate the housing bubble, he could have curbed predatory lending to low-income households and prohibited other insidious practices (the no-documentation—or "liar"—loans, the interest-only loans, and so on). This would have gone a long way toward protecting us. If he didn't have the tools, he could have gone to Congress and asked for them.

Of course, the current problems with our financial system are not solely the result of bad lending. The banks have made mega-bets with one another through complicated instruments such as derivatives, credit-default swaps, and so forth. With these, one party pays another if certain events happen—for instance, if Bear Stearns goes bankrupt, or if the dollar soars. These instruments were originally created to help manage risk—but they can also be used to gamble. Thus, if you felt confident that the dollar was going to fall, you could make a big bet accordingly, and if the dollar indeed fell, your profits would soar. The problem is that, with this complicated intertwining of bets of great magnitude, no one could be sure of the financial position of anyone else—or even of one's own position. Not surprisingly, the credit markets froze.

Here too Greenspan played a role. When I was chairman of the Council of Economic Advisers, during the Clinton administration, I served on a committee of all the major federal financial regulators, a group that included

Greenspan and Treasury Secretary Robert Rubin. Even then, it was clear that derivatives posed a danger. We didn't put it as memorably as Warren Buffett—who saw derivatives as "financial weapons of mass destruction"—but we took his point. And yet, for all the risk, the deregulators in charge of the financial system—at the Fed, at the Securities and Exchange Commission, and elsewhere—decided to do nothing, worried that any action might interfere with "innovation" in the financial system. But innovation, like "change," has no inherent value. It can be bad (the "liar" loans are a good example) as well as good.

No. 2: Tearing Down the Walls

The deregulation philosophy would pay unwelcome dividends for years to come. In November 1999, Congress repealed the Glass-Steagall Act—the culmination of a $300 million lobbying effort by the banking and financial-services industries, and spearheaded in Congress by Senator Phil Gramm. Glass-Steagall had long separated commercial banks (which lend money) and investment banks (which organize the sale of bonds and equities); it had been enacted in the aftermath of the Great Depression and was meant to curb the excesses of that era, including grave conflicts of interest. For instance, without separation, if a company whose shares had been issued by an investment bank, with its strong endorsement, got into trouble, wouldn't its commercial arm, if it had one, feel pressure to lend it money, perhaps unwisely? An ensuing spiral of bad judgment is not hard to foresee. I had opposed repeal of Glass-Steagall. The proponents said, in effect, Trust us: we will create Chinese walls to make sure that the problems of the past do not recur. As an economist, I certainly possessed a healthy degree of trust, trust in the power of economic incentives to bend human behavior toward self-interest—toward short-term self-interest, at any rate, rather than Tocqueville's "self interest rightly understood."

The most important consequence of the repeal of Glass-Steagall was indirect—it lay in the way repeal changed an entire culture. Commercial banks are not supposed to be high-risk ventures; they are supposed to manage other people's money very conservatively. It is with this understanding that the government agrees to pick up the tab should they fail. Investment banks, on the other hand, have traditionally managed rich people's money—people who can take bigger risks in order to get bigger returns. When repeal of Glass-Steagall brought investment and commercial banks together, the investment-bank culture came out on top. There was a demand for the kind of high returns that could be obtained only through high leverage and big risktaking.

There were other important steps down the deregulatory path. One was the decision in April 2004 by the Securities and Exchange Commission, at a meeting attended by virtually no one and largely overlooked at the time, to allow big investment banks to increase their debt-to-capital ratio (from 12:1 to 30:1, or higher) so that they could buy more mortgage-backed securities, inflating the housing bubble in the process. In agreeing to this measure, the S.E.C. argued for the virtues of self-regulation: the peculiar notion that banks can effectively police themselves. Self-regulation is preposterous, as even Alan Greenspan now concedes, and as a practical matter it can't, in any case, identify systemic risks—the kinds of risks that arise when, for instance, the models used by each of the banks to manage their portfolios tell all the banks to sell some security all at once.

As we stripped back the old regulations, we did nothing to address the new challenges posed by 21st-century markets. The most important challenge was that posed by derivatives. In 1998 the head of the Commodity Futures Trading Commission, Brooksley Born, had called for such regulation—a concern that took on urgency after the Fed, in that same year, engineered the bailout of Long-Term Capital Management, a hedge fund whose trillion-dollar-plus failure threatened global financial markets. But Secretary of the Treasury Robert Rubin, his deputy, Larry Summers, and Greenspan were adamant—and successful—in their opposition. Nothing was done.

No. 3: Applying the Leeches

Then along came the Bush tax cuts, enacted first on June 7, 2001, with a follow-on installment two years later. The president and his advisers seemed to believe that tax cuts, especially for upper-income Americans and corporations, were a cure-all for any economic disease—the modern-day equivalent of leeches. The tax cuts played a pivotal role in shaping the background conditions of the current crisis. Because they did very little to stimulate the economy, real stimulation was left to the Fed, which took up the task with unprecedented low-interest rates and liquidity. The war in Iraq made matters worse, because it led to soaring oil prices. With America so dependent on oil imports, we had to spend several hundred billion more to purchase oil—money that otherwise would have been spent on American goods. Normally this would have led to an economic slowdown, as it had in the 1970s. But the Fed met the challenge in the most myopic way imaginable. The flood of liquidity made money readily available in mortgage markets, even to those who would normally not be able to borrow. And, yes, this succeeded in forestalling an economic downturn; America's household saving rate plummeted to zero. But it should have been clear that we were living on borrowed money and borrowed time.

The cut in the tax rate on capital gains contributed to the crisis in another way. It was a decision that turned on values: those who speculated (read: gambled) and won were taxed more lightly than wage earners who simply worked hard. But more than that, the decision encouraged leveraging, because interest was tax-deductible. If, for instance, you borrowed a million to buy a home or took a $100,000 home-equity loan to buy stock, the interest would be fully deductible every year. Any capital gains you made were taxed lightly—and at some possibly remote day in the future. The Bush administration was providing an open invitation to excessive borrowing and lending—not that American consumers needed any more encouragement.

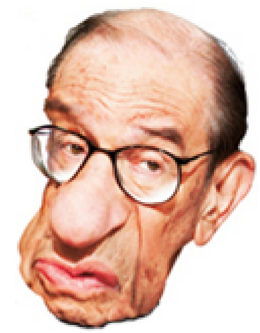
No. 4: Faking the Numbers

Meanwhile, on July 30, 2002, in the wake of a series of major scandals—notably the collapse of WorldCom and Enron—Congress passed the Sarbanes-Oxley Act. The scandals had involved every major American accounting firm, most of our banks, and some of our premier companies, and made it clear that we had serious problems with our accounting system. Accounting is a sleep-inducing topic for most people, but if you can't have faith in a company's numbers, then you can't have faith in anything about a company at all. Unfortunately, in the negotiations over what became Sarbanes-Oxley a decision was made not to deal with what many, including the respected former head of the S.E.C. Arthur Levitt, believed to be a fundamental underlying problem: stock options. Stock options have been defended as providing healthy incentives toward good management, but in fact they are "incentive pay" in name only. If a company does well, the C.E.O. gets great rewards in the form of stock options; if a company does poorly, the compensation is almost as substantial but is bestowed in other ways. This is bad enough. But a collateral problem with stock options is that they provide incentives for bad accounting: top management has every incentive to provide distorted information in order to pump up share prices.

The incentive structure of the rating agencies also proved perverse. Agencies such as Moody's and Standard & Poor's are paid by the very people they are supposed to grade. As a result, they've had every reason to give companies high ratings, in a financial version of what college professors know as grade inflation. The rating agencies, like the investment banks that were paying them, believed in financial alchemy—that F-rated toxic mortgages could be converted into products that were safe enough to be held by commercial banks and pension funds. We had seen this same failure of the rating agencies during the East Asia crisis of the 1990s: high ratings facilitated a rush of money into the region, and then a sudden reversal in the ratings brought devastation. But the financial overseers paid no attention.

No. 5: Letting It Bleed

The final turning point came with the passage of a bailout package on October 3, 2008—that is, with the administration's response to the crisis itself. We will be feeling the consequences for years to come. Both the administration and the Fed had long been driven by wishful thinking, hoping that the bad news was just a blip, and that a return to growth was just around the corner. As America's banks faced collapse, the administration veered from one course of action to another. Some institutions (Bear Stearns, A.I.G., Fannie Mae, Freddie Mac) were bailed out. Lehman Brothers was not. Some shareholders got something back. Others did not.



The original proposal by Treasury Secretary Henry Paulson, a three-page document that would have provided $700 billion for the secretary to spend at his sole discretion, without oversight or judicial review, was an act of extraordinary arrogance. He sold the program as necessary to restore confidence. But it didn't address the underlying reasons for the loss of confidence. The banks had made too many bad loans. There were big holes in their balance sheets. No one knew what was truth and what was fiction. The bailout package was like a massive transfusion to a patient suffering from internal bleeding—and nothing was being done about the source of the problem, namely all those foreclosures. Valuable time was wasted as Paulson pushed his own plan, "cash for trash," buying up the bad assets and putting the risk onto American taxpayers. When he finally abandoned it, providing banks with money they needed, he did it in a way that not only cheated America's taxpayers but failed to ensure that the banks would use the money to re-start lending. He even allowed the banks to pour out money to their shareholders as taxpayers were pouring money into the banks.

The other problem not addressed involved the looming weaknesses in the economy. The economy had been sustained by excessive borrowing. That game was up. As consumption contracted, exports kept the economy going, but with the dollar strengthening and Europe and the rest of the world declining, it was hard to see how that could continue. Meanwhile, states faced massive drop-offs in revenues—they would have to cut back on expenditures. Without quick action by government, the economy faced a downturn. And even if banks had lent wisely—which they hadn't—the downturn was sure to mean an increase in bad debts, further weakening the struggling financial sector.

The administration talked about confidence building, but what it delivered was actually a confidence trick. If the administration had really wanted to restore confidence in the financial system, it would have begun by addressing the underlying problems—the flawed incentive structures and the inadequate regulatory system.

Was there any single decision which, had it been reversed, would have changed the course of history? Every decision—including decisions not to do something, as many of our bad economic decisions have been—is a consequence of prior decisions, an interlinked web stretching from the distant past into the future. You'll hear some on the right point to certain actions by the government itself—such as the Community Reinvestment Act, which requires banks to make mortgage money available in low-income neighborhoods. (Defaults on C.R.A. lending were actually much lower than on other lending.) There has been much finger-pointing at Fannie Mae and Freddie Mac, the two huge mortgage lenders, which were originally government-owned. But in fact they came late to the subprime game, and their problem was similar to that of the private sector: their C.E.O.'s had the same perverse incentive to indulge in gambling.

The truth is most of the individual mistakes boil down to just one: a belief that markets are self-adjusting and that the role of government should be minimal. Looking back at that belief during hearings this fall on Capitol Hill, Alan Greenspan said out loud, "I have found a flaw." Congressman Henry Waxman pushed him, responding, "In other words, you found that your view of the world, your ideology, was not right; it was not working." "Absolutely, precisely," Greenspan said. The embrace by America—and much of the rest of the world—of this flawed economic philosophy made it inevitable that we would eventually arrive at the place we are today.

Joseph E. Stiglitz, a Nobel Prize–winning economist, is a professor at Columbia University.