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# Addressing the financial crisis

## Market forces, not government intervention

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MANY believe that deregulation and Wall Street greed are at the root of the financial crisis and that governments must now step in to clean up the mess. The reality, however, is much different. It wasn't greed or deregulation that fuelled the crisis; the main culprits were lax monetary policy and poor government policy attempting to increase home ownership amongst those least able to afford a home.

Now, with \$700 billion in "bailout" money at its disposal, the US government wants to solve a problem it had a significant hand in creating, likely making a bad situation even worse.

It is critical to understand the government's role in the financial crisis. First, the Federal Reserve (US equivalent to the Bank of Canada) promoted the conditions for a housing boom by keeping interest rates historically low for too long. The Federal Reserve decreased the federal funds rate (upon which commercial banks set their interest rates) 13 consecutive times from 6.5% in 2000 to 1% in 2003. The federal funds rate was not increased for a full year thereafter. Low interest rates fuelled the housing boom by encouraging individuals to borrow, increasing the demand for mortgages and driving house prices upward.

Second, US government-backed mortgage giants Fannie Mae and Freddie Mac, whose primary purpose is to expand residential mortgages, increased their purchases and securitization of mortgages issued to low-income earners,

thereby funding hundreds of billions of dollars in loans, many of which were sub-prime.

Yet another culprit is the Community Reinvestment Act (CRA), which further induced banks to make high-risk loans to low- and moderate-income families. According to Russell Roberts, professor of economics at George Mason University, the expansion of the CRA under President Clinton caused an 80% increase in the number of bank loans to low- and moderate-income families (Roberts, 2008, Oct. 3).

Of course, self-interested investors and banks also played a part in the current crisis by lending money to unqualified applicants, issuing unsound mortgages, and trading in risky mortgage-backed assets. Home owners also acted in their own self-interest in seeking out and taking these loans. However, the financial crisis isn't the result of greed or deregulation; rather banks, borrowers, and investors simply acted rationally, in their own self-interest, following a set of rules created by poor government policy.

This brings us back to the recent government bailout package. The problem now facing financial markets is that access to credit for individuals and businesses has been severally constrained. Banks are reluctant to lend because of deep concerns over counter-party risk: who owns the impaired mortgage-backed and other assets, and what are the odds of repayment in the inter-bank market for funds? It is a situation of great uncertainty, compounded by the reluctance of shell-shocked investors to buy into the market.

The root of the problem is that many banks are holding "assets" backed by mortgages that are now worthless. As a result, numerous banks are insolvent because their liabilities exceed their assets.

Initially, the US treasury was planning to buy these "toxic" assets but has instead chosen to use \$250 billion of the bailout money to directly purchase shares in US banks to "increase the confidence of our banks, so that they will deploy, not hoard, their capital," according to Treasury Secretary Henry Paulson (US Department of the Treasury, 2008). In fact, the government has compelled all of the major US commercial banks to take a piece of the action, whether they need funds or not, in order to avoid stigmatizing the weaker ones.

Many banks need the capital infusion to restore balance sheets and raise capital requirement ratios. This will keep weak and insolvent banks open longer and ultimately prolong the financial crisis. In addition, moral hazard will be created as the bailout will ultimately reward banks that are insolvent because of bad decisions.

The government was on the right track with Bear Stearns and other early victims of the crisis by destroying equity and removing management with (what should have been temporary) liquidity additions. Later, government erred with the Lehman Brothers bankruptcy by failing to move the solvent elements of that firm into stronger hands. Now we are seeing less discerning policies that fail to differentiate weak from strong and the illiquid from the insolvent.

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The harsh reality is that there is no painless quick fix for the financial crisis. Allowing banks that made bad decisions to fail or be bought up through mergers, while not painless, may be the quickest way out of the crisis. Ultimately, the market is still the best way to prevent and respond to government failure.

## References

Roberts, Russell (2008, October 3). How Government Stoked the Mania: Housing Prices Would Never Have Risen So High Without Multiple Washington Mistakes. *Wall Street Journal*.

US Department of the Treasury (2008). Statement by Secretary Henry M. Paulson, Jr. on Capital Purchase Program. <<http://www.ustreas.gov/press/releases/hp1223.htm>>. ■