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A failure to capitalist incentives

Michael Dial

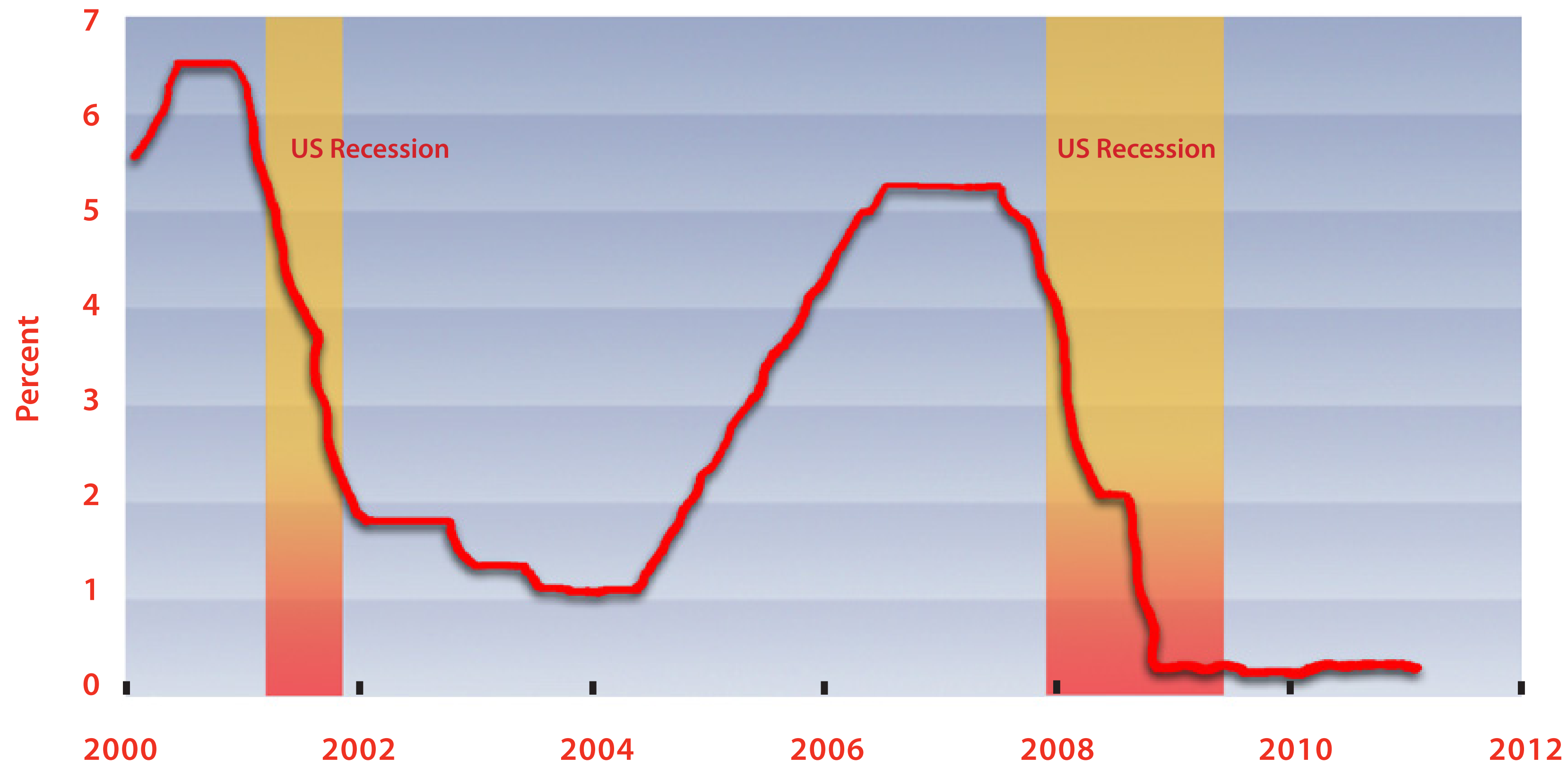
"Economic progress, in a capitalist society, means turmoil" (Schumpeter, 1949). For reasons similar to this, eminent leaders from government (Nicholas Sarkozy, France's president) to academia (Richard Posner, a University of Chicago law professor) have called for a retreat from capitalism and the advance of state regulation. According to the critics, the regulated economy is supposed to bring greater certainty and a safer environment for sustained economic growth. Is there reason to support the argument that increased regulation would create a less severe business cycle? Evidence indicates the heavy hand of government is responsible for the severity of the recent recession, not that the capitalist model fell apart under its own weight.

There is a general consensus that the cause of the financial crisis was a (housing) bubble. A bubble occurs when an asset class (residential property) grows in value much faster than the asset's economic fundamentals. The bubble can be self-inflating; investors will continue buying, essentially increasing demand faster than supply, driving up prices. Easily available credit, as was provided by the US government, facilitates the large increase in investment.

During the financial crisis, when prices finally stopped their meteoric rise, the housing bubble popped and prices fell as buyers disappeared, erasing savings and causing the sale of other mortgage securities to cover liabilities, which drove down prices and further erased wealth. Credit dried up as bank residential assets fell in value; constricting the ability of firms to operate and of entrepreneurs to function and make the necessary investments for job creation. Not only were new jobs not created, but the existing jobs were cut because demand fell with the lack of credit (Posner, 2009).

Agreement ends here; critics of laissez-faire capitalism point to excessive risk in

Effective federal funds rate (FEDFUNDS)



Sources: Board of Governors of the Federal Reserve System; 2011 <http://research.stlouisfed.org/>.

the financial sector in pursuit of profits and insufficient regulation of complex financial vehicles. However, this response leaves two important questions unanswered: where did the capital to fund the housing asset come from; and what encouraged continuing investment in the bubble? Critics point to excessive saving abroad that was able to fuel the mal-investments in America (Posner, 2009). This isn't supported by the numbers; net direct investment in 2007 was less than $70 billion. Net direct investment in prior years, particularly in the late 1990s and early 2000s, was at this level or higher (Federal Reserve Bank of St. Louis, 2011). This is a large sum of funds, but as a share of the US economy in 2007, it is less than 1 percent (GDP was over 14 trillion in 2007), not enough to fuel the housing bubble, even assuming that all foreign investment flowed into housing.

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Critics of free enterprise then point to irrational exuberance as the market mentality that continued to inflate the asset bubble. Investors will take risky loans and continue to increase leverage because greater leverage means greater returns (or losses). In a bubble, as asset prices rise, investors perceive more wealth so they continue to invest, or even keep savings in the form of assets, further driving prices (Posner, 2009).

Asset bubbles, recessions, and shifts in investment are all inherent parts of a free market economy and can arise on their own in the absence of government intervention; yet a recession of the magnitude of that in 2008 can only occur when aided by incentives and price mechanisms that are distorted by the government (Minksy, 2001). The Federal Reserve first distorted these price mechanisms and incentives by artificially manipulating interest rates, in effect sowing the seeds of the current crisis. In response to the recession that began in 2001, the Fed artificially lowered short term interest rates through open market operations, and kept rates down to encourage economic recovery (see graph on page 5). Investors see interest rates as a price mechanism to show the price of capital; when they are low, entrepreneurs take out more loans because it is cheaper to borrow

(Mahoney, 2001). In the current financial crisis, the low interest rates set by the Fed in the early and mid-2000s made buying houses cheap, and created the perception that the high demand for housing would continue, and that consumers would be able to pay their mortgages. As this illusion proved false, the housing bubble popped, and the financial system unraveled.

Interest rate manipulation explains where the funds and the initial impetus for the housing bubble came from; but why did savings continue to flow into mal-investments (misallocation of capital) even as it became apparent an enormous housing bubble was forming? Investors wouldn't continue to make investments in an increasingly risky market without proper incentives. Critics argue that the increased risk from greater leverage increases the profit potential (Posner, 2009). However, it also increases the loss potential; a fact not lost upon entrepreneurs. For investment to continue, there needs to be an attribute of the market that discounts the risk of failure while maintaining the opportunity of profit. The perils of principal-agent relations can be used to explain some of the rationale for the risky investments as mutual fund managers looked to gain higher returns with little danger of the losses being tracked back to them. However, the moral hazard of government bailouts played an important part in distorting capitalist incentives as firms embarked on risky investments because they were insured from financial failure (either implicitly or explicitly) through a government bailout. The best example of moral hazard, which also set the tone for the mal-investments leading up to the current financial crisis, is the bailout of Long Term Capital Management (LTCM) in 1998. LTCM was a very large hedge fund invested across the world, particularly in Russia. LTCM had leveraged its assets more than 30 times over to invest billions of dollars. When Russian debt began to default, LTCM had to call in assets to pay off its liabilities. The ensuing panic made LTCM insolvent, creating a possibility of billions in losses and a financial crisis. Fortunately for LTCM, the Federal Reserve stepped in, lowered interest rates and organized investors to recapitalize LTCM, effectively bailing it out (Posner, 2009).

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Incentive distortions by Freddie Mac and Fannie Mae helped drive the financial crisis

These events introduced a moral hazard and the concept of "too big to fail," which helped inflate the housing bubble. Fannie Mae and Freddie Mac guaranteed mortgage-backed securities with the full faith and credit of the US government (Fannie Mae, 2011), so investors subsequently had the incentive to continue to leverage their assets in the face of increasing risk. Firms had the expectation that if they became too big to fail, the government would bail them out, which distorted the benefits and costs of investing during the bubble. As the expected benefits exceeded costs, firms had a significant incentive to pursue riskier investments than they otherwise would have. These arguments bring us to the conclusion that it was government regulation, not a lack of government intervention, that created the incentives that drove the economy into a financial crisis. The incentive distortions created by artificially low interest rates and a moral hazard of government bailouts perverted the incentives to firms. Distorted interest rates and an implicit government bailout provide the rationale for firms to increase risk in search of greater returns. Since it is impossible to identify an asset bubble until the bubble begins to deflate (Posner, 2009), any firm that does not invest in an investment that is not part of an asset bubble will become uncompetitive. Government intervention forced out safe investors and firms which would have limited the effect of the financial crisis.

American history shows that periods of relatively undistorted incentive structures were able to deal with financial crises in a more effective manner. The US economy endured a period of deflation from 1870-1897. Instead of a period of low investment, high unemployment, and slow economic growth as economic theory would predict, it was a period of unprecedented economic growth when the US became the largest economy in the world both in terms of absolute and per capita output. The financial crisis of 1907, where total output fell as much as 10 percent in six months (a much deeper recession than the current one) (Walton and Rockoff, 2010), was met with no government intervention. Although the short-term hardship was intense, a strong recovery was well under way within a year of the crisis. The only long lasting recession of the period, from 1893-1896, was lengthened by government currency manipulations. The Congress and presidential candidates of the time were pursuing a policy to re-monetize silver that ended up causing steep and sudden inflation. The ensuing financial crisis had characteristics similar to the current financial debacle (Walton and Rockoff, 2010).

Capitalism is not dead; within the last 30 years, the application of capitalist principles has raised over 400 million Chinese out of poverty (Cukier and Klein, 2009). The financial crisis of 2008 is not a failure of free markets, but a failure of government and a stunning example of the unintended consequences of government economic intervention.

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Michael Dial attends Truman State University as an economics major and statistical methods minor. Michael also represents Truman State University in NCAA Division Two Cross Country as well as Track & Field.