

RECESSION BLAME GAME

TOM HOSKING (RGGP)

"But I would suggest the first thing that would make me feel a little bit better toward them if they'd follow the Japanese example and come before the American people and take that deep bow and say, I'm sorry, and then either do one of two things: resign or go commit suicide."

Senator Charles Grassley, Iowa



Searching for a scapegoat

Should the senior executives of the fallen US insurance giant AIG fall on their swords to atone for the excessive greed that caused them to award \$165 million in bonuses after taking billions in Federal bailout money? The climate of public opinion towards executives with their turbo-charged salaries and bonuses has turned very nasty indeed but is this hatred warranted or a case of unfair scapegoating?

Bankers were behind the explosion of sub-prime lending that took place - risky lending that provided the spark which ignited the financial crisis that has engulfed the world economy. The problem is that bankers' bonuses have had a direct connection to how much money they make. Banks earn most of their revenue from commissions on loans they have initiated and sold. Therefore bankers are going to issue as many loans as they possibly can - they are simply responding to incentives even if this means taking their eye off the risks. Like any normal good, if you lower the price, you will sell more. So what happened was that bankers deliberately under-priced loans, bringing people into the market for mortgages whose credit-worthiness made them unsuitable. The **NINJA loan** became a notable feature of the credit markets - a borrower with no income, no job and no assets. But when interest rates started rising in 2007 and sub-prime debtors began defaulting on their loans on unexpectedly high scale, the genesis for the credit crunch was well and truly in place.

To understand better this mismanagement in loans, we need to go back to an earlier development in banking - the arrival of **securitization** which permitted a lender to issue a loan and then sell it to another bank or company as a mortgage-backed security (MBS). This encouraged bankers to under-price further because it separated ownership of loans from their instigation. Indeed, the former chief executive of Barclays, Martin Taylor, once said that the difference between banks and other businesses was that when banks sell you their product (money), they also

want it back! It was this discipline that traditionally encouraged bankers to price loans sensibly. Securitization meant that a credit crisis in one country could easily be transferred globally. For example, a bank in the Far East may have bought the MBS, which had become effectively worthless or **'toxic'**, from a bank in the UK. Bad assets can be transferred to firms who think they are just innocently buying securities with a decent credit rating when quite the reverse was true.

But weren't the bankers and the traders just doing what they are supposed to - simply strive to make a decent profit? Adam Smith once spoke of an 'invisible hand' which guides society to the social good by means of a nation of 'self-seeking agents'. It is not the job of the banks to regulate themselves - that is the government's job. In the 1987 film "Wall Street" Gordon Gecko (played by Michael Douglas) advocates the notion that **'greed is good'**, for greed is what makes capitalism tick. So in this recession we must also look at who was meant to be regulating the banks - for example the UK government through the Financial Services Authority. And who was assessing the quality of the securities, the so called "credit rating" agencies such as Moody's and Standard and Poors.

Problems also arose through assessing the value of securities. For this we can assign some responsibility to the accountants because of their use of **mark to market accounting** in valuing asset backed securities. The problem with using the last traded price for an asset is that it isn't always an accurate measure of value. For example, a mortgage security may have been valued at £1 million at instigation, but because a similar security traded at £900 000, mark to market accounting makes it seem as though that security has now dropped in value. Which it hasn't, because you have no reason to believe that the original £1 million won't be paid back fully. Therefore banks aren't losing the money that accountants are making out that they are. This is so relevant because once savers think that the bank is losing money, they will

withdraw their money- which will bankrupt the bank! Or the bank will have to replace "lost" capital which will cause its share price to fall. And that's exactly what we've seen happen. Northern Rock suffered a run from worried depositors, whilst several banks have come under attack from **short selling**. This isn't the first time that it has occurred: In 1938, President Roosevelt had to abolish market value accounting because it had impeded bank lending during the Great Depression.

During the 1930s, **Keynes** urged the government of the day to use fiscal spending counter-cyclically. In other words, the government could spend less and tax more during a boom and then do the reverse in a downturn, which is exactly what the British government is trying to do right now. However UK state expenditure has already risen from 38% of GDP in 2000 to 48% of GDP in 2009. Spending so much in the past decade



means that an increased fiscal stimulus is less affordable and has much less impact.

Many have suggested that the media are to blame, because speculating about a recession can be self-fulfilling. News of a likely slump may cause people to act as if there will definitely be one. They will increase their savings because job security is lower. A possible conclusion may be a Soviet style censoring of all media by the government, but I don't think it is possible to blame anyone for not

implementing such an absurd task in a capitalist and democratic society.

And what of those people who took out what became such toxic loans? If you smoke, it is generally perceived that the person who bought the cigarettes is the one who is responsible, not the seller of the cigarettes. Couldn't the same be said of mortgages and big loans for a new car? If the consumer knows that he or she doesn't really have the finances to pay the loan back in the long-term-why take out the loan in the first place? Surely it is too risky to take out a 125% mortgage when your own income and savings aren't strong enough to pay for it and you are relying instead on house prices soaring?

A Minsky Moment

That is the danger of enjoying the good times over a number of years. We tend to extrapolate the recent past into the future and when there have been several years of steady economic growth, our confidence increases. The mid-20th century economist, **Hyman Minsky** argued that 'stable economies sow the seeds of their own destruction' because investors would bet that rising asset values going forward would cover their debts. Small changes in price could then pop the bubble, because even a small downward blip could cause frightened investors to default on their loans and try to panic-sell their investments - which would cause further falls in price and further selling.

The recent UK housing boom is a classic example of Minsky's ideas. If there had not been such a bullish property market over the past decade, people wouldn't have taken out those mortgages in excess of 100% of the value of their house. However that raises the question over how to control asset prices. The best way to do this would be through a stricter form of monetarism where the Bank of England could manipulate interest rates in accordance with the asset markets and less with the inflation rate. That way, the property bubble might be pricked before it burst with such damaging force. So we should also blame the lack of regulation of asset prices for the recession. We cannot purely blame The Bank of England perhaps, because

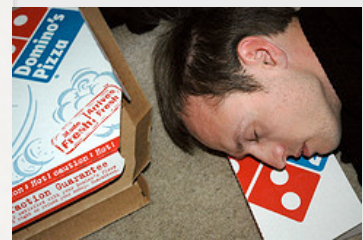
the crisis would probably have leaked into the system from abroad in the form of mortgage-backed securities.

A golden age of low inflation and money-for-nothing increases in property wealth served only to blind most of us to the excessive risks that bankers were taking. The reckoning may last for a generation.

Tom Hosking

Recession Watch

Since the summer of 2008....



- ◆ House prices are down by 20%
- ◆ Domino's Pizza profits are up by 25%
- ◆ Computer games sales are up by 20%
- ◆ Sales of Argos' cheapest sewing machines are up by 500%
- ◆ Sales of turnips are up by 75%
- ◆ Lunch box sales are up 75%
- ◆ Demand for rented TVs is up 10%
- ◆ The average amount left under the pillow by the tooth fairy has gone down by 30%
- ◆ Sales of vitamin pills and nutritional supplements have soared - so too has the demand for chocolate bars!

Pants to the Recession!

According to leading department store retailer Debenhams, sales of Y-fronts have increased by 35% since the recession began. The rise in demand for Y-fronts, which are being substituted for boxer shorts and slimline trunks, is attributed to the Y-front design offering men a greater sense of security in these troubled times. Leading Y-front brand Jockey reported that sales of coloured Y-fronts have risen by an average 60% over the last six months and baby pink pants in particular have risen by 62%. This is a classic case of a substitution effect in a consumer market. The fallout from the recession has driven men to reassess their underwear needs. But I won't be making a thong and dance about it.

Geoff Riley