The Rule of Law and the Wealth of Nations

Reuven Brenner

Fundamentals seem to cluster in foursomes. Classical alchemy had four elements, and classical medicine had four humors. Though it's neither alchemy nor medicine, economics, too, turns out to have four elements that are helpful to think of when discussing remedies for restoring a country to health. In essence, it comes down to this: Restoration of economic health requires that risk capital and talent move from yesterday's industries to tomorrow's industries, and that someone must match them accountably.

There are four key terms that emerge from that statement: *talent*, *capital*, *matchmakers*, and *accountability*. Under normal conditions, venture-capital firms, banks, investment banks, leveraged-buyout firms, and asset-management firms make matches, offer risk capital, and bet on entrepreneurs or managers. The suppliers of capital also decide whether to terminate their investments or continue them when it takes longer than expected to bring such visions to life or when these visions turn out to be erroneous.

Capital markets thus both finance experimentation and, by holding the players accountable, prevent mistakes from persisting. The innovation on which prosperity depends stems from the experimentation of countless players—most of whom will fail. Out of the mass of failure and the occasional success, society somehow manages to thrive.

So what allows dynamic order to arise out of the seeming chaotic bets that drive economic growth? Although innovators change people's patterns of behavior—using cell phones instead of watches, for example, or googling rather than searching through papers—the rules that govern commercial life in general have grown stable over the years in the prospering countries. Who gets into existing markets and creates new ones (licensing and regulation) and who gets out (bankruptcy laws) came to be well understood and anticipated. Relative risks such as the rights of different investors became clear and protected by law. And, for investors to bet on risky ventures, there was access to low-risk assets for portfolio balance, insurance against falling behind.

There are thus preconditions for commercial matchmaking, and they all relate to the responsibilities of government. *Guarding the entrance* to the market is the first: Not just anyone can start a bank, for example. And just as there must be criteria for startups, so someone must be *guarding the exits*, through the criteria for bankruptcy, for example. Likewise, creditors and equity holders must be able to assert their claims on profits and assets, if necessary in courts of law. And, finally, there must be provision for *risk-free assets*—typically from the government (Treasury debt, for example, and guarantees on bank deposits that promise no default), which has been a sine qua non of American finance since the first Treasury secretary, Alexander Hamilton, funded the public debt—built on a solid, non-defaulting currency.

Private factors thus provide the four elements of talent, capital, matchmaking, and accountability, and government sets these four basic rules for entry into and exit from certain activities, rights of investors, and the provision of a risk-free asset, the latter anchoring prices and negotiations. With these preconditions in place, many independent sources finance many independent players betting on a wide range of ideas, some

Reuven Brenner *holds the Repap Chair at McGill University's Desautels Faculty of Management and is the author of* Force of Finance *and* World of Chance.

ending up creating products and services people want, and others ending in failure.

Confusing the responsibilities of the private markets and the government leads to misguided policies. Some analysts draw the dangerously wrong conclusion that the crisis of 2008 simply was a failure of capitalism. Judge Richard Posner, for example, recently argued that "the key to understanding is that a capitalist economy, while immensely dynamic and productive, is not inherently stable." Whether a capitalist economy is stable or not might be a worthwhile topic for abstract speculation. But the events of 2008 shed no light on it, since what they actually tell is the story of what happens when governments neglect their responsibilities.

In a well-functioning market, the chances of all the players making the same mistake in the same direction is negligible. But systemic errors—errors in which a plurality of the players all err in the same direction—can and do occur when governments forget what makes a commercial society tick. This can occur suddenly, as in a communist revolution. Or it can occur imperceptibly over years, as during the past decade in the United States. Such governmental neglect of responsibilities prepared the ground for the present day, the worst American financial crisis since the Great Depression.

A review of what happened can help us see a path out of the present maze of confusion. The first responsibility of governments is to guard the entrance to the marketplace. During the past decade the Treasury and Federal Reserve let the equivalent of an alien entity take over the banking system.

Commercial banks were supposed to run leverage of about 12 to 1 on their credit books—that is, they were to put up $1 of shareholders' capital for every $12 of risk assets on their books. Yet regulators let the financial industry run arbitrarily high amounts of leverage on the false premise that derivatives protected credit books against prospective losses. Rather than guarding the entrance of the marketplace, the government let barbarians in, with devastating consequences.

The regulators told the banks that, if the rating agencies assigned high ratings to certain assets (meaning that they were nearly default proof), banks could drastically reduce the amount of capital held against them. The banks then structured assets with the greatest chance of defaulting—such as subprime mortgages, junk bonds, and so forth—into packages to which the ratings agencies obligingly assigned AAA ratings. In addition, the regulators allowed the banks to hold these assets in off-balance-sheet structures, using a fraction of the capital they normally required. A boom in bank profits ensued. Shareholders demanded that bank managers maximize leverage so as to replicate more of these highly profitable endeavors, and boards, management, and regulators all succumbed. Seemingly arcane bits of bank regulation running in the background of the economy, far from the scrutiny of financial journalists or even the majority of securities analysts, transformed the financial system.

To make matters worse, a rapidly aging Asia and Europe, following an export-driven growth model, sought a secure destination for their savings. They poured capital into the United States' capital markets, abetting the expansion of leverage to 6 percent of America's gross domestic product. Wall Street created seemingly low-risk assets to exploit the new capital rules, and foreigners bought a substantial share of these presumably low-risk assets. The AAA-rated securities backed by subprime home mortgages, commercial mortgages, or lowest-grade junk bonds could not have been in the trillions and spread around the world if not for such imbalances. Indeed, as Federal Reserve Chairman Ben Bernanke observed in 2003, capital inflows kept U.S. interest rates lower than they otherwise would have been, feeding the availability of cheap credit and supporting the housing bubble. Sustaining a solid currency could have mitigated this impact of the capital inflows, but the Federal Reserve has abandoned that responsibility for long stretches of time (the dollar losing more than 95 percent of its value since the Federal Reserve's creation in 1913).

It helps in this context to distinguish between two types of business. One type fulfills contractual agreements with the cash flows it generates. The second type digs for oil or searches for new technologies, and has no cash flows until it makes a discovery. The latter kind of company normally sells equity to investors willing to accept uncertainty about future outcomes in return for the possibility of excess returns. It also can sell debt paying a very high coupon, so-called *junk bonds*, which are really a special kind of equity, a financing instrument fitting certain types of uncertain projects.

The financial technology of the past decade created trillions of dollars' worth of structured bonds—in effect, attempting to do a magic trick by turning the inherently uncertain cash flows of junk bonds into the predictable cash flows of high-grade debt. Subprime mortgages, for example, are a kind of junk bond. Households with insufficient incomes, and often without prospects of securing good ones in the future, were not just granted entry into the market but were also helped (actively, though indirectly, by the mortgage agencies Fannie Mae and Freddie Mac) to speculate in housing on an unprecedented scale.

Home-mortgage debt relative to disposable personal income stood stable around 80 percent between

1957 and 2000 but jumped to 140 percent by 2007. The availability of adjustable-rate mortgages at very low interest rates prevailing in the early part of the decade allowed households to carry these much higher debt levels for a while. However, once the Federal Reserve raised the federal-funds rate from 0.5 percent in 2002 to 5.25 percent in 2007, households no longer could pay the higher debt burden. Meanwhile, financial institutions resold about 65 percent of the face value of the mortgages in the form of AAA-rated securities. This means that they sold the other 35 percent to investors who would absorb losses before any losses accrued to the AAA-rated securities.

Yet, since the Federal Reserve considers a AAA-rated security nearly default-proof, it let banks use the spurious AAAs for more than 60-to-1 leverage, rather than the standard 12-to-1 leverage for loans. Today, many of the AAA-rated mortgage-backed securities backed by subprime collateral issued in 2007 are trading at around 25 cents on the dollar. Lower-rated securities backed by the same collateral, including securities originally rated AA, are trading at close to zero, and loss rates on many mortgage pools backing these securities are likely to reach 80 percent.

By accepting the rating agencies' opinions as the criteria for the amount of leverage that banks could apply, the Federal Reserve turned the ratings agencies into a quasi-official monopoly. And by securitizing trillions of dollars of structured bonds on the strength of these ratings, the financial system put the ratings agencies into a pivotal position in the economy. The ratings agencies never grasped their new roles. On the contrary, they saw their monopoly position as a license to print money by issuing rubber-stamp opinions about structured product that they neither understood nor cared to understand. Meanwhile, in the case of the federally sponsored mortgage corporations Fannie Mae and Freddie Mac, the government made it cheaper for a while for anyone to speculate in the housing market.

That is how so much debt accumulated on U.S. balance sheets. The government abandoned its responsibilities. And the making of such mistakes has little to do with capitalism, with ingrained cycles, or some peculiar features of human nature. It has to do with amnesia about what constitutes the pillars of a commercial society.

This conclusion becomes even clearer when we examine how the government and the Federal Reserve managed to destroy other pillars as well. The next function to fail was the government's responsibility to act as gatekeeper at the exit to the marketplace. Accountability and responsibility require bankrupt companies to be closed, while fraud and incompetence are punished. That does not quite work, however, for financial institutions under our present banking system.

Individuals and firms thought money-market funds to be reliable substitutes for bank deposits: always available and invested heavily in structured securities as well as corporate commercial paper. Once it became clear that supposedly AAA-rated securities were in fact prone to default, money-market funds faced a run by fearful depositors, and the market for corporate commercial paper crashed as well.

The collapse of the structured securities market in July 2007 led to the collapse of Bear Stearns in March 2008, the failure of the government-sponsored mortgage guarantors Fannie Mae and Freddie Mac, and eventually the Lehman Brothers bankruptcy in September 2008, followed by the bailout of the nation's largest commercial banks and the reincarnation of the remaining investment banks and of GMAC as bank-like institutions, with access to funds from the Federal Reserve. Capital markets, as we knew them, shut down. And asset prices predictably then crashed. Too many mistakes, too much mispriced debt.

When this happened, there was no alternative but for the government and the Federal Reserve to step in and become a financial intermediary. The intervention was needed because the mistakes suddenly exposed the fragility of the financial institutions' funding mechanism. To restore it, the government had to insure the counterparty risks.

Whatever the reasons, at first the government did not, and it allowed Lehman Brothers to fail. Then the government suddenly did: Correcting this blunder of letting the edifice of counterparty claims collapse led then to the dramatic expansion of the Federal Reserve balance sheet and the Treasury's bailing out the banks.

In truth, the government had no choice: Depositors had to be convinced that they were secure. Otherwise, the government would have failed in its responsibility of providing the default-free assets that are the foundation of commercial banking. We would have had a massive run on the system, and the vanishing liquidity would have been much worse than what we experienced. By guaranteeing bank deposits as well as a great deal of bank debt, and by purchasing more than a trillion dollars' worth of securities, the government prevented a collapse of the financial system. That was not a matter of ideology or politics but of necessity.

Once government has the deciding vote in the financial system, however, one of two things can happen. Government can try to get out of the financial business and restore decision-making to the private sector. Or it can use its new power for political ends.

Public officials have more power when the access to capital markets decreases. People can access capital either through capital markets or the government. Except for resorting to crime and reliance on family and friends, there are no other sources.

Yet, relying on government and the Federal Reserve to access capital is not the same as relying on banks and other financial institutions. Bankers make decisions about who gets the loans, and on what terms, based on the ability of entrepreneurs and managements to carry on successfully. But a government's decision to finance ventures—as in the case of the auto industry—is based on political clout.

Of course, political clout sometimes passes under the name of *national interest*, a phrase that bankruptcy judge Arthur Gonzalez used in his opinion concerning the objection of investors challenging the administration's use of TARP money for Chrysler: He wrote that the U.S. government "made the determination" that it is in the "national interest to save the automobile industry, in the same way that the U.S. Treasury concluded that it was in the national interest to protect financial institutions."

Using national interest as a criterion for financing has allowed politicians at all times and in every country to usurp the responsibilities of the private sector. It is happening again in the United States, and without much resistance, since the public's attention has been focused on the failure of *private* financial institutions to correct their mistakes. This failure destroyed public trust in these institutions, especially since their mistakes were visible, whereas the mistakes of the government—without which the private sector could not have carried on with its own—were less visible.

Under these circumstances, it is not surprising that the public seems to put its trust in politicians, even though there is no historic precedent in which politicians successfully solved commercial problems. Even France's François Mitterand gave up on the experiment of nationalized banks three years after starting it.

It is one thing for the government to maintain the functioning of the financial system by guaranteeing deposits and providing liquidity for well-collateralized loans and quite another thing for the government to pick commercial winners. Judge Gonzales' inference was wrong: Protecting core financial institutions was in the national interest, but that does not imply that either the auto industry or any other industries qualify. The banking system is unique because the Federal Reserve can provide liquidity to the economy only through it. Deposit insurance and commercial banks' access to the central bank's lending windows give the banking system quasi-official status, even more so now that the Federal Reserve has increased its balance sheet by trillions of dollars, and the Treasury has provided trillions of dollars of equity in financing and loan guarantees as well.

The credit of the central government stands or falls with the credit of the banking system. That is why no Western government can allow the liquidation of commercial banks in deep recession, even one induced by an egregious accumulation of mistakes, even if the banks would be insolvent under regulatory capital requirements. That is why the big commercial banks had to be bailed out, while ordinary businesses (those that lacked the autoworkers' political clout in particular) had to suffer.

The spending and managing powers of the government have limits. If the government abuses its financial power to buy political support and does not restore the eroded responsibilities, it will eventually fail in its function of providing default-free assets. Without such assets, a commercial society cannot exist, no matter what the constitution of the country says. The words would lose their meaning, and the traditional institutions would be much weakened, becoming a mere façade.

To have such assets, the Federal Reserve must sustain the value of the dollar while it restores capital markets to health. Otherwise capital will flee the United States, the Treasury will not be able to finance its deficit, and risk capital will dry up for private business. And without risk capital, equity cannot be rebuilt, unless we stumble on new natural resources. That happened to neither the ill-fated Callaghan government in the United Kingdom nor the Carter administration in the United States during the 1970s.

For the time being, the United States is lucky that the world does not presently have a good alternative to the dollar. This gives the country a window of opportunity to make the necessary changes. Part of the world is committed to the politically motivated export model, and another part (Europe) is in the midst of the unique experiment of betting on a paper money that is not backed by any government, making the coordination between treasuries and a central bank during crisis hard to achieve. These experiments cannot be corrected fast.

The window of opportunity for the United States will not last long, however. That China, Russia, and Brazil are starting to experiment on a small scale with such alternatives to dollars as IMF-backed bonds should serve as a warning to the administration. Washington may have the power to intimidate the speculators who owned the senior debt of American auto companies, but it does not have the clout to do the same thing to the bondholders of the world. FT