

Running head: DEPARTURE FROM FREE MARKETS

How a Departure From Free-market Principles
Contributed to the Current Economic Downturn

Sean Philpott

A Senior Thesis submitted in partial fulfillment
of the requirements for graduation
in the Honors Program
Liberty University
Spring 2009

Acceptance of Senior Honors Thesis

This Senior Honors Thesis is accepted in partial fulfillment of the requirements for graduation from the Honors Program of Liberty University.

Edward Moore, Ph.D.
Thesis Chair

Andrew Light, Ph.D.
Committee Member

Mrs. Stephanie Blankenship, M.A.
Committee Member

Brenda Ayres, Ph.D.
Honors Director

Date

Abstract

What should the role of government be in regulating the economy? Through this paper the reader will gain an understanding of the impact of government intervention, when intervention is justified, and what happens when the government over regulates. The research will also reveal some major similarities between today's economic downturn and the financial debacle of the Great Depression. Finally, analysis will show that, as a result of this unnecessary government intervention, that there is a crisis that is not solely American, but one that has become a major contributor to the global downturn.

Introduction

The idea of free-markets has been near the heart of economic debates for hundreds of years. How much should the government attempt to control the economy, if at all? Should the economies of countries be completely free to operate under the controls of the individual businesses? What sort of a balance would be best for economic growth and stability? These are all questions that have been hotly debated. Through the remainder of this paper, the researcher will explain where the idea of free-markets came from and how it has evolved since. The researcher will also attempt to make a case that the government should not intervene unnecessarily in business with the understanding that there are certain times, however, when the government must step in to help the free market. This paper will provide specific examples about where the government stepped in effectively and where it should not have. There will be comparisons between the economic philosophies of President Theodore Roosevelt and President Herbert Hoover, because they were both centered upon heavy government involvement. Then the paper will compare the Great Depression to our current economic downturn, giving glaring similarities. Finally, the discussion will focus on the developments that preceded this giant economic hole that we are now almost completely submerged in. America is not the only country reeling from this debacle; the crisis has become global. Why did this happen, and could it have been prevented?

Background

Laissez-faire is an idea that has been around for centuries, despite its controversial origin. Ironically, the words “laissez faire,” which are extremely common today, are actually only part

of the original term "laissez-faire, laissez-passer," which translated, means "to let do." Shortly after Vincent de Gournay (1712-1759) coined this phrase, the idea was explored more thoroughly by a group known as the Physiocrats. Later, "[l]aissez faire became part of classical economics primarily because of Adam Smith's extensive study of the Physiocrats[,] and his close relationship with Francois Quesnay (1694-1774) and Anne Robert Jacques Turgot (1727-1781)" (McConnell and Brue, 2007, para. 2.)

Classical economics was a departure from the traditional mercantilist views which were previously practiced primarily during the 17th and 18th centuries in Europe. Mercantilism was dominated by the belief that

(g)overnmental control was exercised over industry and trade in accordance with the theory that national strength is increased by a preponderance of exports over imports.

Mercantilism was characterized not so much by a consistent or formal doctrine as by a set of generally held beliefs. (MSN Encarta: Mercantilism, 2008, para. 1.)

Mercantilism held to the views that "a country's economic strength is directly related to the maintenance of a positive balance of trade. That is, in order to remain economically and politically viable, a country must export more than it imports" (Sarich, 2007, para. 1.) These beliefs were widely accepted in Europe from the 16th through the 18th century.

Classical economics would seriously challenge traditionally accepted views of mercantilism by focusing on foreign concepts such as laissez-faire and free competition. The idea of classical economics proposes that government should neither interfere nor pamper business as the business owner seeks to earn a living. This idea assumes that business people

most likely act in their own self interest and produce the goods most beneficial. They, in turn, sell these goods for a profit and then purchase the goods most needed. One more major difference between what Smith proposed and the prevailing ideas of mercantilism is that

[m]ercantilism states that all the world's people must compete for the world's limited wealth. Adam Smith believed that wealth and trade was a non-zero-sum gain, which essentially means two parties involved in a transaction could each actually gain, because the exchanged items were more valuable to their new owners. Bullionism dictated that gold was gold — period. Thus, what one party gained, the other party had to give up (i.e., the zero-sum gain assumption). (Economicexpert.com, para. 9.)

All the ingredients are in place for the simplest economy. Free markets is an idea that had been known previously, but was made famous by Scottish economist Adam Smith in his book “The Wealth of Nations” first published in 1776 during the Age of Enlightenment. Free markets are simply defined as “An economic system in which businesses operate without government control in matters such as pricing and wage levels”. (MSN Encarta: Free Markets, 2009, para. 1.)

This is not to say that there should be no regulation. That would be as unhealthy as over regulation. Rather there has to be a certain amount of regulation – a minimal amount in to maintain order in the marketplace. Contrary to popular belief, markets can and sometimes do fail.

Potential Reasons for Free market Failure

According to research there are four main reasons why free markets can and sometimes do fail. One reason can be due to monopolies driving out competition and then charging

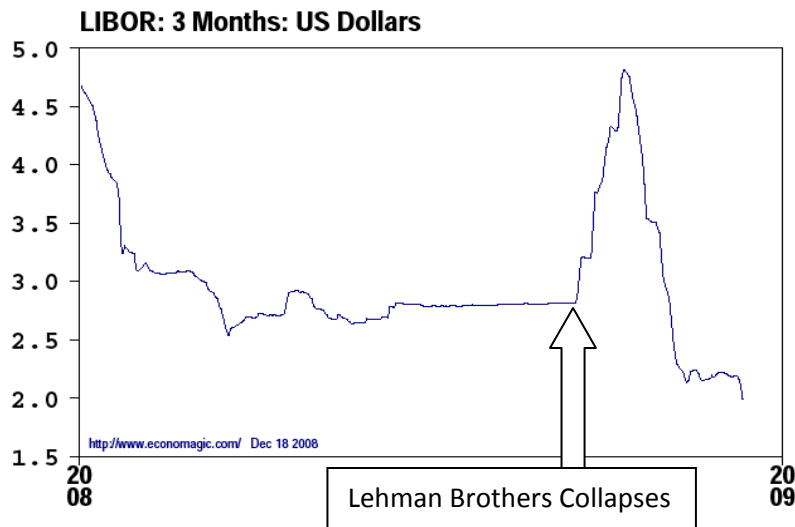
consumers whatever prices they decide. One example of this occurred on May 18, 1998. The United States government filed an anti-trust lawsuit against Microsoft Corporation alleging “the company had abused its monopoly position in the desktop computer operating system market to destroy and prevent competition. The states and the Department of Justice asserted that Microsoft had used a variety of unlawful tactics in order to maintain its monopoly” (Microsoft antitrust case documents, 2006, para. 1.). On April 3, 2000, District Court Judge Thomas Penfield Jackson ruled that Microsoft business practices were in violation of the Sherman Antitrust Act. As a result of this ruling, two months later on June 7, 2000, Jackson ordered Microsoft to break into two smaller companies. Ultimately, Microsoft reached a settlement with the government that avoided the dismantling of Microsoft. This came with a price as Microsoft was forced to sell off parts of the company.

A second possibility that could lead to free market failure is external conditions. These external conditions might have been an influencing factor in the banking calamity we are currently experiencing. Banks act as anchors for one another in that they balance each others net inflow/outflow once a week. If one bank (Bank 1) has more deposits than withdrawals, the bank will be holding excess cash. However, if another bank, (Bank 2) experiences excessive withdrawals in relation to its deposits leaving it with decreased cash levels, Bank 1 can then lend Bank 2 the amount that it is short in order to meet the desired levels of Bank 2. Bank 1 can charge Bank 2 a certain rate (measured in LIBOR[usually for 3 months]). Then if Bank 2 goes completely bankrupt, Bank 1 then has no way to recover the money that it loaned to Bank 2. At this point, fear takes over and Bank 1 no longer wishes to lend to other banks to help them

balance their books in case the other bank might default. In the event that banks are willing to lend to other banks, other banks will have to pay a higher LIBOR rate in order to compensate Bank 1 for the additional risk.

This is precisely what happened in 2008. When Bear Stearns & Co. appeared to be going into bankruptcy, the government was forced to step in and find a suitable acquirer for Bear Stearns. This came in the form of JP Morgan & Co. who purchased Bear Stearns at a drastically reduced price. The government was forced to do so to avoid potentially disastrous consequences and was left to hope that no additional companies would be forced to the brink of extinction. However, this was not to be, for fewer than six months later, Lehman Brothers appeared to be heading for inevitable bankruptcy. The government realized that they could not bail out all the banks and Lehman Brothers shortly thereafter filed for bankruptcy. All the banks that had loaned money to Lehman now had essentially lost their funds and had limited or no legal recourse to recover their lost assets. In so far as Lehman had been viewed to be “too big to fail,” this bankruptcy scared other major banks. If Lehman Brothers (158 years in existence) collapsed, might they be next? This caused major banks to no longer trust their mega counterparts, and loans between banks essentially ceased. In the rare event that money was available, a radically higher interest rate was charged. The sudden spike in three-month LIBOR rates immediately following the collapse of Lehman proved this.

Figure 1



Another example of outside factors causing a potential free market failure would be natural disaster. Millions of people along the Gulf Coast and in neighboring states are at tremendous risk for natural disaster. Unfortunately, coverage is not available for those who need it most or premiums are too expensive for many families to afford: “[H]urricane insurance here in Florida; it's either very difficult, and almost impossible to get or it's outrageously expensive.” (Respond, 1996, para. 11.) Florida is just one example of a state where insurance companies are not willing to give insurance to those most at risk. The entire southeast coast was devastated when Hurricane Katrina slammed into the mainland. Experts estimated that Katrina caused 110 billion dollars in damages. Insurance payouts however were estimated at roughly 25 billion dollars, less than 25% of the total cost (Hurricane Katrina, 2005, para. 4.) The government contributed an additional 81.6 billion dollars to relief efforts (Bea, 2006, p. 1.) The government

had to use this money in what was essentially a “bailout” without the term. This is another example of external conditions causing a free market to collapse.

A third cause of potential free market failure is corporation corruption within the company. Enron Corporation is probably the best known example of this. Enron filed for Chapter 11 Bankruptcy protection on July 11, 2003. Ultimately, there were “approximately 30 former Enron executives who have pleaded guilty or been convicted of various crimes” (Advice for Enron Litigants, 2006, para. 6.) These convictions ranged from conspiracy to fraud and insider trading to perjury. The executives at Enron successfully wove a web of deception that failed to accurately account for the debt that Enron was liable for, as well as improperly recording revenue which was not actually earned by the company. Between these two contributing factors, many financial ratios gave the appearance of consistency and stability that Enron in reality did not have. These accounting practices originated in the middle of the 1990s and lasted into 2001, (Clayton et. al., 2002, p. 1.). At its peak, Enron had a market capitalization of approximately 80 billion dollars and was ranked seventh on the Fortune 500 list (Glassman, 2001, para. 1.).

A fourth possibility of failure from the free market is excessive risk taking or poor management of a company. In recent days more and more companies have been using debt as a means to finance their daily operations. This is most commonly known as leveraging. When a company leverages its earnings, it borrows money to finance daily operations rather than using its own money. When a company continues to borrow for long periods of time without making significant debt payments, it runs the risk of becoming overleveraged. Leveraging works

extremely well when financial times are good for the company because it is able to use other people's money to grow. However, when market conditions begin to deteriorate, companies must come up with the monthly payments regardless of current economic circumstances.

Lehman Brothers was extremely overleveraged when it was forced to file for bankruptcy.

Lehman, at the end of their fiscal year 2007, was leveraged at 30.7:1. A look at its books for previous years tells us that it leveraged more and more from 2005-2007 (Sunshine, 2008, para. 27.) Overleveraging was the fatal flaw of Lehman Brothers and is the primary reason it failed.

As a comparison, First Capital Bank, also in the same global banking business as Lehman Brothers, had a leverage ratio of 3:1 when Lehman was carrying almost a 31:1 ratio.

These reasons for free market failure are by no means exhaustive but do give a starting point to discuss and debate. The ultimate question is when should the government step in, if at all, in free-market economics? The overwhelming consensus is that there must be a certain amount of regulation, but do any, some, or all of the above-mentioned failures deserve government intervention?

When Government Intervention is Necessary

In the example of a monopoly forming as a result of free-market trade, the government must step in. One of the prevailing arguments against splitting up the company is that Microsoft earned a competitive advantage through aggressive business practices, and now that they are in a powerful position within the industry, they should not be penalized. This sounds logical, but the reason the government must step in is to prevent Microsoft from eliminating competition by using their sheer size and abundant financial resources to drive competitors out of the

marketplace. Without healthy competition, there is no balance between goods received and price paid. The price could be unfairly inflated due to the lack of competition.

In the second example, external circumstances possibility contributed to free market failure. This is another example that does warrant some form of government intervention. However, not all extenuating external situations deserve unquestioned intervention. Businesses must take “appropriate actions” to protect themselves from “unforeseen difficulties.” When Lehman Brothers declared bankruptcy, it shocked the world. Beggars and brokers alike were astounded that a brokerage firm that had been around since before the Civil War and had survived the Great Depression would simply go out of business in such an unforeseeable manner. Other banks, who had lent money in confidence that they would receive their principal back plus interest, were now left to mourn their financial losses to which they had no legal recourse. Had this been a company that had been teetering on the brink of extinction for years, it would be understood that the company might be going out of business, and an atmosphere of “lender beware” would exist. Regulation, although technically in place, was not there in reality. As long as banks have not extremely overleveraged themselves as Lehman Brothers did, the government should recoup at least a percentage if not all of losses that other financial institutions experienced as a result of the bankruptcy.

In the example of a natural catastrophe, as long as the corporation or individuals had taken the previously mentioned “appropriate actions” to protect themselves from “unforeseen difficulties,” they may have been entitled to some compensation – if circumstances are extenuating. Hurricane Katrina is the perfect example. There were millions of people who

ended up losing everything and had no insurance policy, not because they elected not to be without, but because they lived in a “high-risk” area, and insurance companies would not draft policies for them. It must be understood, however, that for people who live in a high-risk area and are able to get insurance, they must pay the much higher premiums. Any sort of federal aid should not go to those who were able to get policies but elected not to pay their premiums. However, those who could not possibly get insurance should be entitled to the compensation that a typical insurance policy affords.

When Government Intervention is Unnecessary

The third instance of free market failure results from corporate corruption. The advocates for a bailout would likely hold the position that “people unwittingly invested in a company where they had no ability to control management and that they had no reason to suspect anything suspicious about the company.” This also sounds reasonable except for the lack of accountability of the executives of the company. If the government is always there to clean up everybody else’s mess, then there is absolutely no reason for big corporations to act in an honest and ethical manner. This would encourage investors to dig beneath the surface and to ask the hard questions before a hedge fund, mutual fund, or even a company earns their trust and their money.

A fourth reason why free markets can and sometimes do fail is due to excessive risk taking and poor management decisions. America has seen a wave of companies undergoing drastic change in recent days because of these very practices. Lehman Brothers leveraged at nearly a 31:1 ratio. Overleveraging to that degree was not merely an unwise business decision

but can be accurately described as stupid and greedy. However, all this data was documented in the company's balance sheet, and the public had access to this information. (This is different from Enron, whose public financial statements were intentionally falsified.) Therefore, the investors who lost their life savings in Lehman Brothers have only themselves to blame. If the government were to step in and bail out a company such as Lehman would justify and even condone these foolhardy business practices.

Government intervention is a necessity at times, but what happens when the government begins to unnecessarily involve itself in the affairs of the free market? The concept of government intervention sounds noble enough. Its purpose "is ideally designed to address perceived market failures in a way that maximiz[es] net community benefits" (What is an Unnecessary Regulatory Burden?, 2008, p. 1.).

Government Under Hoover and Roosevelt

Improper intervention can and does have negative impacts on the economy. The first examples of unnecessary government intervention occurred with Herbert Hoover (The New Era) and Franklin Delano Roosevelt (The New Deal). Although Roosevelt is credited with bringing us out of the Great Depression, many of his policies implemented under the New Deal actually helped deepen the depression. Also, upon closer inspection, research shows that many of Roosevelt's programs included in the New Deal were not entirely original.

Most people are quick to draw stark differences in the time frames of the new era (Hoover) versus the new deal (Roosevelt): "The former is thought to have been governed by a decentralized polity at the mercy of the free market, while the latter was run by a bold federal

government managing social and economic change” (Beck & Squire, 2001, p. 2.) This is not actually the case. Although President Hoover is portrayed by historians as an individual who believed in the power of laissez-faire, he was actively involved in government programs during the beginning of the economic downturn. In fact in his presidential campaign in 1932, Hoover summed up his actions:

We might have done nothing. That would have been utter ruin. Instead we met the situation with proposals to private business and to Congress of the most gigantic program of economic defense and counterattack ever evolved in the history of the Republic. We put it into action.... No government in Washington has hitherto considered that it held so broad a responsibility for leadership in such times.... For the first time in the history of depression, dividends, profits, and the cost of living, have been reduced before wages have suffered.... They were maintained until the cost of living had decreased and the profits had practically vanished. They are now the highest real wages in the world. Creating new jobs and giving to the whole system a new breath of life; nothing has ever been devised in our history which has done more for ... the common run of men and women. Some of the reactionary economists urged that we should allow the liquidation to take its course until we had found bottom.... We determined that we would not follow the advice of the bitter-end liquidationists and see the whole body of debtors of the United States brought to bankruptcy and the savings of our people brought to destruction (Rothbard, 2008, para. 8.)

Similarly it was believed that the New Deal originated with President Roosevelt, but it was actually Herbert Hoover who initiated and researched many of the programs we would later see in Roosevelt's New Deal. Roosevelt, for the most part, merely built upon programs that Hoover started. Beck and Squire (2001) noted that "Roosevelt brainster Rexford Tugwell confessed [w]e didn't admit it at the time, but practically the whole New Deal was extrapolated from programs that Hoover started." (p.3.) Examples of that would include the "Federal Emergency Relief Administration (FERA) of Roosevelt had as its precursor, direct unemployment relief through the Reconstruction Finance Corporation (RFC)" (p.3.). This was not the only example: "Before the Agricultural Adjustment Administration (AAA), Hoover had initiated commodity price supports by means of national government purchases" (p.3.).

President Roosevelt also made mistakes. He invoked the Trading with the Enemy Act of 1917, and in doing so declared that all banking transactions be suspended. As a result "[b]anks were permitted to reopen only after case-by-case inspection and approval by the government, a procedure that dragged on for months" (Higgs, 1995, para. 5.) This unprecedented move alarmed an already uneasy public. His biggest blunder, however, was one that set his fiscal policy. Roosevelt and his policymakers made one critical mistake: "They did not recognize that prices had fallen because of the Depression. They believed that the Depression prevailed because prices had fallen" (para. 6.) Most people believe that although the recession would not have been a light one, the policies Roosevelt implemented contributed to the downturn. Roger W. Garrison cites from Herbert Stein in his article "Reflections on Reflections: A Consensus about

the Great Depression?" "[W]e were having an ordinary recession which was converted into the Great Depression by the mistakes of monetary policy" (Garrison, 2003, para. 6.) One of the most drastic areas that critics question is Roosevelt's decision to cut food production in a time when millions of Americans were forced to go without. The best example of this was the Agricultural Adjustment Act of 1933:

It provided for acreage and production controls, restrictive marketing agreements, and regulatory licensing of processors and dealers to eliminate unfair practices and charges. It authorized new lending, taxed processors of agricultural commodities, and rewarded farmers who cut back production. (Higgs, para. 9.)

Although not exactly identical, there are definite comparisons between this and socialism; its policy is to share equally among all. It gives no incentive for workers in a government-controlled economy, and no reason to place limits on acreage usage, nor to reward farmers who cut back production. The result of farmers being paid to produce less was that many smaller farmers and sharecroppers found themselves unemployed because their employers were being paid by the government to produce less (The Great Depression and New Deal, 1929-1940s, para. 15.) Whether or not one agrees with government intervention, it is hard to disagree that this was a foolish decision.

Similarities Between 1920s and Today

Certainly, there are some parallels between the Great Depression and the economy of today. Both President Franklin Delano Roosevelt and Barack Obama inherited an economy that

was in shambles. Because their predecessors overregulated business (in Obama's case it was Presidents Bill Clinton and George W. Bush, and in Roosevelt's case it was Herbert Hoover), this caused potentially average recessions to become extremely deep recessions (although this is nearly impossible to prove). In both cases, bank failure was a major contributor to the crises. During the 1920s, America was just coming out of World War 1 and was feeling invincible. Prosperity abounded as the stock market continued to make record highs. Everyone was buying stocks, and the banks began making foolish decisions regarding their loan policies. People were allowed for the first time to use the stocks in their portfolio to act as collateral for the loans they requested from banks:

If the stocks dropped in value, and investors could not repay the banks, the banks would be left holding near-worthless collateral. Banks would then go broke, pulling productive businesses down with them as they called in loans and foreclosed mortgages in a desperate attempt to stay afloat. (The Great Depression and New Deal, 1929-1940s, para. 3.)

However, this idea was scoffed at by people when greed clouded their judgment. By the time people realized what was happening, it was too late. Although not the originator of the downturn, the stock market crash of 1929 certainly contributed to the length and severity of the Great Depression primarily because thousands of banks ultimately went bankrupt as a result.

The importance of banks in the financial system is brilliantly summed up in the following paragraph:

Banks are the pumping stations or hearts of the capitalist organism. Not only do banks circulate money, they create new money through the making of loans. Bank-created credit represents the most elastic element in the supply of money. As hundreds then thousands of banks failed between 1929 and 1933, the economy's credit (and, thus, money) supply began to dry up. Also, as banks went down, they often took local businesses with them as they called in business loans in a desperate effort to stay afloat. All of this rippled outward in ever-widening circles of bankruptcies, job lay-offs and curtailed consumption. (The Great Depression and New Deal, 1929-1940s, para. 5.)

Personal consumption expenditure is one of the biggest drivers of the United States economy. This is because consumption is the single largest component of GDP (70.5%) (Suranovic, 2005, figure 1.). When consumers reduce their expenditures, it is time to brace for an economic slowdown.

Modern Example of Unnecessary Government Intervention

The 1990s was a time of great economic prosperity with few short and relatively mild corrections. The economy was expanding, as evidenced by GDP, and there were widely accepted low unemployment levels, with only moderate inflation. During this expansionary economic time, the “American Dream” was being realized by millions. Home ownership levels were on the rise, and prosperity abounded. Similar to the 1920s, thoughts of a recession were essentially nonexistent. However, with rampant prosperity, carelessness set in and people stopped looking at the fundamental inherent value of a company. Also the fundamental values of free-market enterprise with minimal government interference were abandoned. At this time:

Fannie Mae, the nation's biggest underwriter of home mortgages, ha[d] been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people... In July (of 1999), the Department of Housing and Urban Development proposed that by the year 2001, 50% of Fannie Mae's and Freddie Mac's portfolio be made up of loans to low and moderate income borrowers. (Holmes, 1999, p. 1.)

In order to achieve these higher percentages, Fannie Mae and Freddie Mac were forced to reduce their underwriting standards to include low-income people who would not qualify for a normal loan either because of lack of income or bad credit. Subprime adjustable-rate mortgages were the vehicles that were used in order to meet these increased requirements from the government. A subprime adjustable-rate mortgage is a mortgage that initiates with a rate below prime. The Prime Rate is extremely important because it "is a commonly used, short-term interest rate in the banking system of the United States" (The U.S Prime Rate, 2008, para. 1.) A subprime mortgage is a mortgage that is offered to a potential homebuyer at below the prime rate. However, a bank could not make enough money to compensate for its risk by offering subprime mortgages for the entire life of the loan. Therefore, banks instituted subprime adjustable-rate mortgages. These are loans that have "teaser rates" that are subprime, but then the rates get readjusted after a certain amount of time. Simply stated:

[o]n an adjustable rate mortgage (ARM), the adjustment period is the time allotted between interest rate recalculation. The most common adjustment period for convention

ARMs is 1 year. So the adjustment period is 12 months meaning every 12 months the rate changes thereby changing the payment as well. The borrower will make those new payments based on the new rate for 12 months when it then repeat(s) the process. (Blake, 2008a)

This next fact is astounding but true: “10% of mortgages are adjustable rate, but they account for 60% of foreclosures” (Blake, 2008b). Unfortunately, when these readjustments occurred, they were often much higher than the original payments. Those people with less than stellar credit, or those who were coming close to overextending themselves with their original payments, found that they were now unable to make the new higher payments. Also with the prices of houses dropping as severely as they did, people were unable to refinance. People began to become delinquent on their payments and ultimately were forced into foreclosure. Once into foreclosure, the economic impacts became far reaching very quickly. Some experts would argue that this was a major decision that greatly contributed to the current economic debacle.

Modern Effects of Government Intervention

While foreclosure may be rock bottom for the families that were forced out of their homes, it is only the tip of the iceberg for the rest of the economy. Instead of receiving steady monthly payments for the outstanding loan that the bank issued, the bank now owns the house. Shortly afterwards, taxes and property upkeep charges start accruing. Cash flow quickly moves from positive to negative. Immediately, the bank begins to look for alternative solutions, which usually start with liquidating the assets it now owns (i.e., the house). However, it often must reduce the price of the asset in order to attract a buyer. This produces a net loss for the bank if it

is fortunate enough to find a buyer for the asset. In the event that no buyer is either available or willing, the bank is forced to hold an asset which is producing a negative cash flow and may even be losing value.

The asset may be losing value because the more properties in foreclosure, the more supply on the market. If supply outweighs demand, then prices fall. Foreclosure rates have increased 25% over last year to a nationwide average of just over 2.2% (RealtyTrac, 2008, para. 2.) This has put dramatic downward pressure on home prices overall. According to a recent Case-Shiller-Home-Price-Index Report, prices over the top 20 cities nationwide have fallen over 20% from their high, and have fallen over 17% in the last 12 months (S&P/Case-Shiller Home Price Indices, 2008, October, Figure 1.). Prices have not fallen this much in a given time period since prices began to be recorded in 1987. The drastic fall in housing value has taken a toll on the average homeowner as well. Many homebuyers who have purchased property within the last two years are finding out that despite making consistent mortgage payments, the value of their house has dropped so much that they actually owe more on their mortgage than their house is currently appraised at. This is known as being upside down on a mortgage. Katie Couric, anchor of CBS Nightly News, reported in 2008, “In fact almost two out [*sic*]¹⁰ who bought their homes in the last two years are already upside down.” At this point, homeowners have little reason to continue to make payments, and some have decided to simply walk away from their current mortgage and stop making payments, thus forcing bank foreclosure.

With all of these houses for sale on the market, there is very little demand for new construction of residential properties. According to the latest government release, U.S. housing starts were an incredibly low 580,000 units in February 2009. This was a decline of almost 75% versus the peak level in January 2006 of 2.273 million units. This has had a tremendous impact on employment because 30% of all jobs within the United States deal with housing. This has caused tremendous layoffs in the overall economy but particularly in the manufacturing and construction areas. As a result the number of people filing for unemployment has nearly doubled in the last nine months. In July of 2008, approximately 350,000 people filed for unemployment. This compares to 652,000 people filing for unemployment in March 2009 (Gledhill, 2009, Figure 1.) The unemployment rate is currently at 8.1% and is expected by analysts to continue to rise.

The culmination of everything previously mentioned has forced consumers to cut back on expenditures, which spells trouble for the economy. As of March 1, GDP was negative by 6.3% in the fourth quarter: a sharp decline from the -0.5% reading in the third quarter of 2008. Most financial analysts expect GDP to continue to decline even further in the coming months.

Unfortunately, the problem is not confined to America. This is because many risky subprime investments were being bundled into packages and sold to the highest bidder on the open market. Known as securitization, it essentially allowed illiquid assets to be transformed into securities, thus allowing them to be traded. During the economically prosperous times of the late 1990s, investors around the world had insatiable appetites for up securities because they promised large returns over a long period of time. The result is not only foreign individual

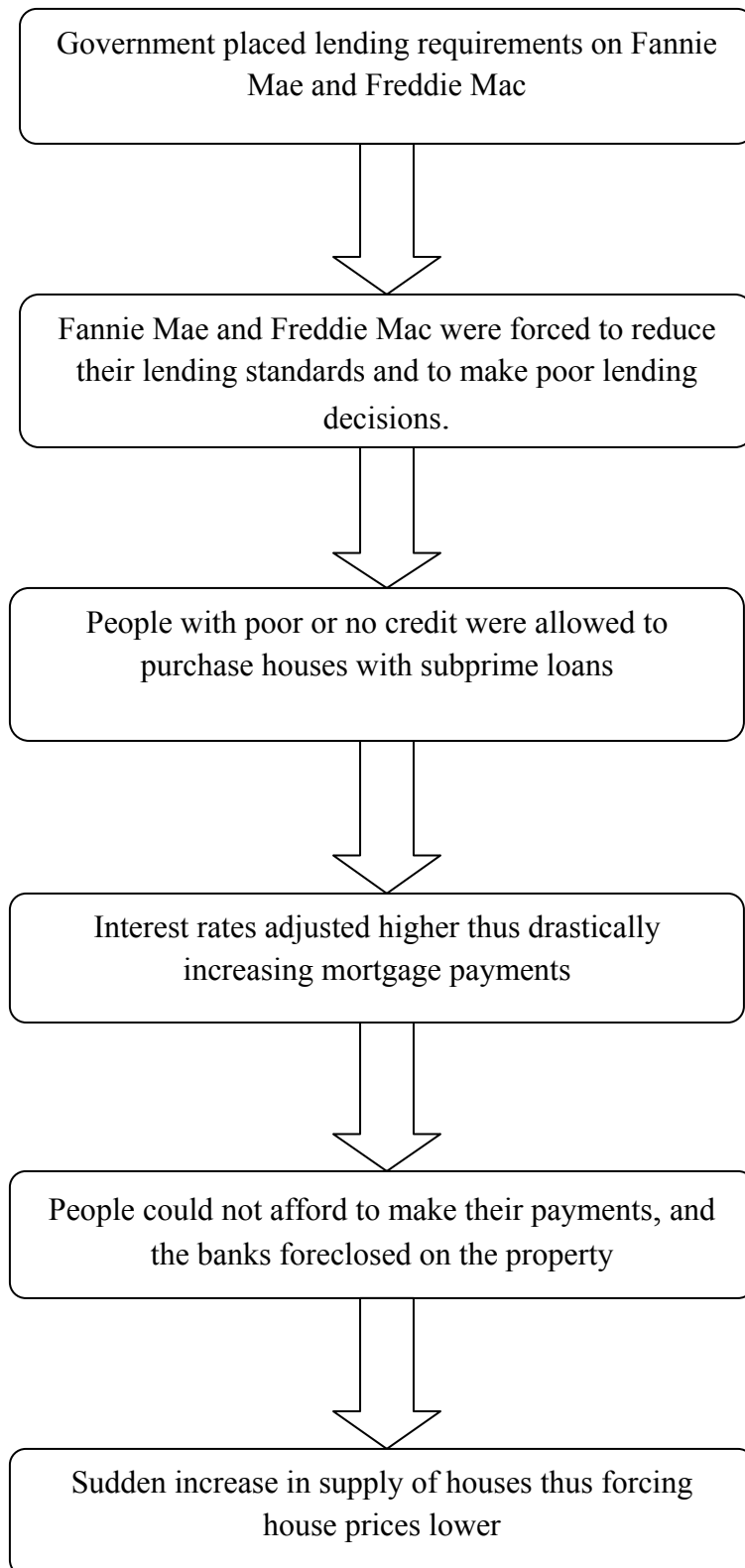
investors, but also foreign nations are holding large amounts of toxic debt that American banks are desperately trying to remove from their balance sheets. What would lead to people overloading their portfolios with these seemingly risky investments? The answer is simple: Credit agencies gave risk ratings much higher than the investments deserved. In fact, most mortgages subprime or not, were given AAA ratings – the highest possible rating. Credit agencies are blamed with three main areas of fault. The first is assigning ratings that were too high initially as most mortgages were assigned AAA ratings. The second is that they failed to adjust the ratings sooner, as the underlying assets began to deteriorate rapidly (Cox, 2007, para. 4.) Had this actually happened, investors would not have been deceived with the assurance that these assets had not fundamentally changed. The reality is that the underlying fundamentals had radically shifted. As a result, the owners of the AAA rated subprime packages were holding assets that no one could place a value on. Finally, and probably most importantly, credit rating agencies are blamed for “not maintaining appropriate independence from the issuers and underwriters of those securities” (Cox, para. 4.) One of the most obvious conflicts of interest is addressed here:

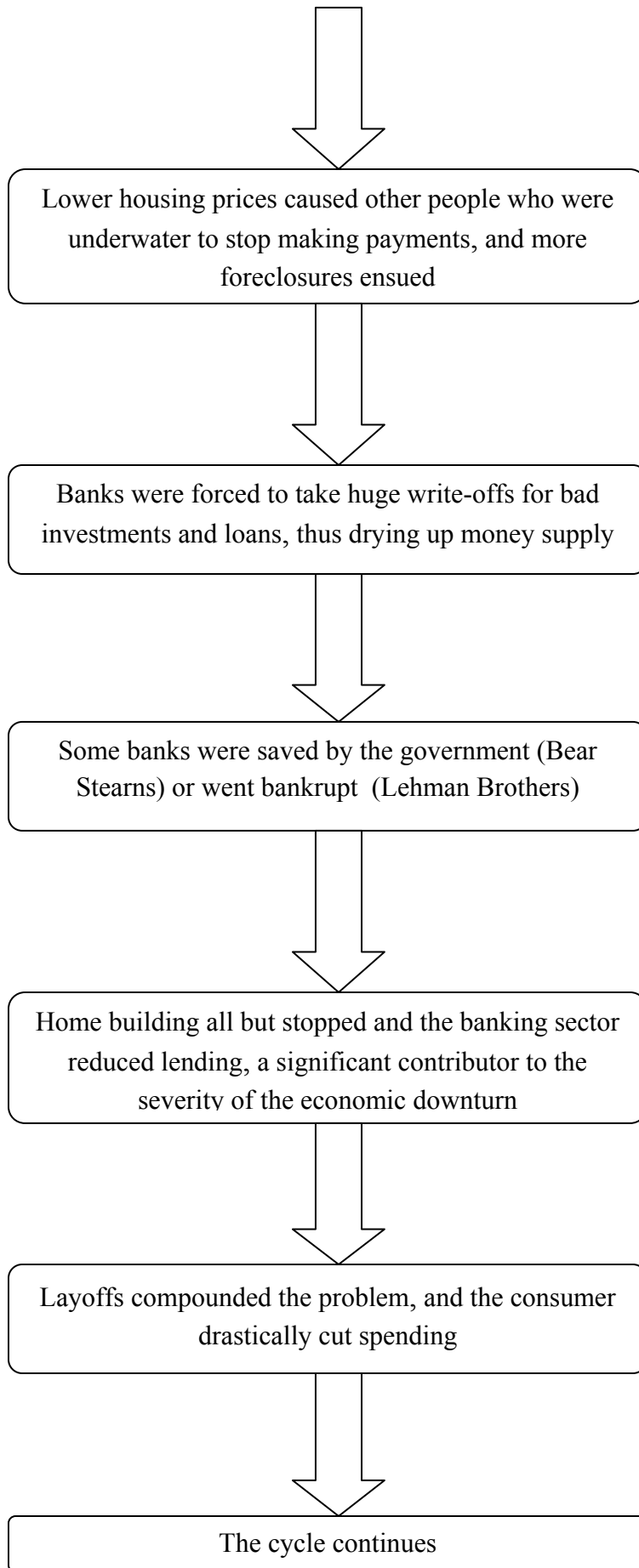
One of the conflicts in this category is receiving compensation for determining a credit rating where the person paying for the credit rating provided the NRSRO (Nationally Recognized Statistical Rating Organizations) with net revenue in the most recently ended fiscal year that equaled or exceeded 10% of the NRSRO's total net revenue. (Cox, para. 14.)

One more thing that has been looked into recently is:

[t]he handling of material non-public information by an NRSRO and prohibit certain unfair, coercive, or abusive practices by the NRSROs — including modifying or threatening to modify a credit rating or otherwise departing from systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases the credit rating or any other service or product of the NRSRO or any person associated with the NRSRO. (Cox, para. 15.)

Figure 2





Conclusion

America certainly did not seem to understand the implications of departing from free-market business practices even after the catastrophic downturn of the Great Depression. Seventy years or so later one finds government interference again – this time with the required distribution of assets to certain income groupings. If the companies themselves believed that this was the best business practice, they would have already been acting on those ideas. Since they were not, they obviously did not believe that this was the best investment on their part.

Unfortunately for the companies which are now under government control, and for the economy and nation as a whole, they were not allowed to invest their money as they saw fit. The government got involved with companies like Fannie Mae and Freddie Mac, and because of this, tremendous pressure was put on the United States financial system once mortgage rates began to adjust higher.

Although it is nearly impossible and very unfair to attribute the entire downturn to one event, a departure from free-market principles is certainly a significant factor that led to our present crisis. As Winston Churchill so eloquently put it “[t]hose who fail to learn from history are doomed to repeat it.”

References

- Advice for Enron litigants: keep it simple. (2006, March, 1). *Knowledge @ Wharton*. Retrieved December 23, 2008, from <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1389>
- Bea, K. (2006, August 22). Emergency supplemental appropriations for hurricane Katrina relief. Retrieved December 23, 2008, from CRS Report for Congress Web site, <http://fpc.state.gov/documents/organization/71874.pdf>
- Beck & Squire, M. P. (2001). The transformation of the American state: The new era-new deal test. *Business Source*. Retrieved January 28, 2009, from <http://web.ebscohost.com/bsi/pdf?vid=7&hid=6&sid=9e679e9a-3c98-45b5-bd32-2b31bd666910%40sessionmgr8>
- Blake, R (2008a, July 24). Adjustment period defined. Retrieved December 1, 2008, from Adjustment Period Web site, <http://themortgageinsider.net/glossary/adjustment-period/>
- Blake, R. (2008b, September 11). Adjustment period defined. Retrieved December 1, 2008, from Subprime ARM Mortgage Resets Ending Soon Web site, <http://themortgageinsider.net/mortgage/subprime-arm-mortgage-resets-ending-soon/>
- Clayton et. al., R. (2002). Enron: Market exploitation and correction. *Financial Decisions*, *Article 1*, Retrieved December 24, 2008, from <http://www.financialdecisionsonline.org/current/clayton.pdf>

Couric, K. (2008, January 24). When a mortgage turns upside down. Retrieved December 1, 2008, from CBS Evening News with Katie Couric Web site,

<http://www.cbsnews.com/stories/2008/01/24/eveningnews/main3750569.shtml>

Cox, C. (2007, September 26). Testimony: The role and impact of credit rating agencies on the subprime credit markets. Retrieved February 16, 2009, from U.S Securities and

Exchange Commission Web site: <http://sec.gov/news/testimony/2007/ts092607cc.htm>

Economicexpert: Mercantilism. Retrieved February 20, 2009, from Economicexpert.com Web

site: <http://www.economicexpert.com/a/Mercantilism.html>

Garrison, R. (2003). Reflections on reflections: A consensus about the great depression?.

Business Source Complete, 8, Retrieved January 30, 2009, from

<http://web.ebscohost.com/bsi/detail?vid=3&hid=113&sid=4c0fe5ad-0a73-4248-87e3-bf68326c127c%40sessionmgr108&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=10112485>

Glassman, J. (2001, December, 12). Investing lessons from the collapse of Enron. *Capitalism*

Magazine, Retrieved December 24, 2008, from

<http://www.capmag.com/articlePrint.asp?ID=1268>

Gledhill, A. (2009, March 26). United States: Jobless claims. Retrieved March 29, 2009, from

Dismal Scientist Web site:

http://www.economy.com/dismal/pro/release.asp?r=usa_claims

Higgs, R. (1995, February). How FDR made the depression worse. Retrieved January 28, 2009, from The Free-market Web site,

http://www.mises.org/freemarket_detail.aspx?control=258

Holmes, S (1999, September 30). Fannie Mae to ease mortgage credit lending. *New York Times* p.1.

Hurricane Katrina. (2005). Retrieved December 23, 2008, from GlobalSecurity.org Web site,

<http://www.globalsecurity.org/security/ops/hurricane-katrina.htm>

McConnell and Brue, (2007). Origin of the idea. Retrieved December 21, 2008, from

McConnell and Brue Macroeconomics Web site, <http://highered.mcgraw->

[hill.com/sites/0073273082/student_view0/chapter2/origin_of_the_idea.html](http://highered.mcgraw-hill.com/sites/0073273082/student_view0/chapter2/origin_of_the_idea.html)

Microsoft antitrust case documents. (2006). Retrieved December 23, 2008, from National Association of Attorneys General Web site,

http://www.naag.org/microsoft_antitrust_case_documents.php

MSN Encarta: Free Markets. (2009). In *MSN Encarta* [Web]. Retrieved November 24, 2008,

from http://encarta.msn.com/dictionary_1861690765/free_market.html

MSN Encarta: Mercantilism. (2008). In *MSN Encarta* [Web]. Microsoft. Retrieved December

21, 2008, from http://encarta.msn.com/encyclopedia_761564630/Mercantilism.html

RealtyTrac: (2008). Retrieved December 1, 2008, from The Latest Updated Foreclosure Rates

Web site, <http://www.realtytrac.com/foreclosure/foreclosure-rates.html>

- Respond, K. (1996). Insurance... do you have what it takes?. Retrieved December 23, 2008, from Disaster-Resource.com Web site, http://www.disaster-resource.com/articles/insurance_what_takes_respond.shtml
- Rothbard, M. (2008, April 12). Hoover's attack on laissez-faire. *Ludwig Von Mises Institute*. Retrieved January 30, 2009, from <http://www.mises.org/story/2902>
- S&P/Case-Shiller home price indices. (October 2008). Retrieved December 1, 2008, from Standard & Poor's Indices Web site, http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,1,1,0,0,0,0,0.html
- Sarich, J. (2007). Mercantilism. Retrieved February 12, 2009, from Reference for Business Web site, <http://www.referenceforbusiness.com/encyclopedia/Man-Mix/Mercantilism.html>
- Sunshine, M. (2008, May, 19). Minimum standards for CEO's of global banks - What they should know about leverage. *Sunshine Notes*. Retrieved December 24, 2008, from http://www.firstcapital.com/blogs/mark_sunshine/?tag=lehman-brothers
- Suranovic, S. (2005). The US national income statistics (2002-2003). Retrieved January 30, 2009, from International Finance Theory and Policy Web site, <http://internationalecon.com/Finance/Fch5/F5-4-0203.php>
- The Great Depression and New Deal, 1929-1940s. *HIST 1302 Online United States History, 1877-Present*. Retrieved January 29, 2009, from

<http://iws.ccccd.edu/kwilkison/Online1302home/20th%20Century/DepressionNewDeal.html>

The U.S prime rate. (2008). Retrieved December 1, 2008, Web site,

<http://www.wsjprimerate.us/>

Why regulate the upstream petroleum sector?. (2008). *What is an unnecessary regulatory burden?* Retrieved January 28, 2009, from

http://www.pc.gov.au/_data/assets/pdf_file/0004/84595/06-chapter3.pdf