

The Government Bubble

Contributed by Martin Hutchinson
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The causes of the 2007-08 downturn are now etched indelibly into popular memory: it all came about because of an infamous housing bubble, which policymakers inexplicably failed to spot. Readers of this column will know that I regard this explanation as simplistic, although housing was certainly an intermediate cause of the problem. However spotting the housing bubble at the time was difficult (though not impossible – this column did it a couple of times) which is why it is unsurprising that commentators have failed to identify that repetition in greater magnitude of the same policy mistake – excessively cheap money – has now produced another bubble. Not in gold and commodities, whose price rises are an entirely rational response to monetary conditions. Today the true and hugely damaging bubble is in government.

Very cheap money and relaxed credit standards are/were key drivers of both the housing and government bubbles. Traditionally, governments had been constrained to maintain deficits below about 5% of GDP and homeowners had been constrained to maintain home mortgage payments at below 30% of their incomes (or in Britain, mortgage principal at less than 2.5 or 3 times their incomes.) With easy money, these constraints were abandoned, and new frontiers of leverage and budget deficits were explored.

Political philosophies have underpinned both bubbles. In the housing case, there was a belief, fed by the absurd U.S. home mortgage guarantee system, that home ownership was in some sense a right, even for those who could not properly afford the mortgage payments. In the government case, the belief was the age-old Keynesian Bureaucrat Fallacy of government infallibility, that problems could best be solved by government intervention, and recessions cured by injections of government money.

These philosophical beliefs were combined with misguided beliefs about the market. In housing the core belief was that house prices never fell, except in local areas for short periods. The New England and Texas meltdowns of the late 1980s should have disabused the housing market of this theory, but memories are surprisingly short when there are financial advantages to oblivion. Thus a mere 15 years after those meltdowns the housing market embarked on a nationwide, nearly worldwide, adventure in leverage and overvaluation.

For governments, the equivalent belief was that governments can borrow more or less ad infinitum, rolling over their debt, without much danger of default or adverse economic consequences. There was somewhat more excuse for this belief; defaults within living memory had all been in places like Latin America which could be written off as poor and underdeveloped.

The Japanese counterexample, where debt rose steadily above 200% of GDP without visible adverse consequences (that could not be attributed to some other cause) gave the borrowers encouragement. So too did the distant historical experience of Britain, which had twice worked down debt levels of 250% of GDP. The second, after 1945, was eliminated through inflation and “repression” of its savers by forcing them to buy government bonds at below-inflation interest rates. (This tactic would be much less effective in a globalized system, where money can flow freely, than it was in Britain with its 1945-79 exchange controls.) The first work-down, after 1815, was achieved through a government austerity and management quality almost certainly impossible in a modern democracy.

Once the bubble got going, traditional metrics on house prices, borrowing ratios and budget deficits were rubbished. House prices rose by 107% between January 2000 (already a fairly buoyant period) and April 2006, according to the S&P-Case Shiller Index. The U.S. budget deficit, which had never in peacetime exceeded 6.3% of GDP or \$500 billion, was pushed up aggressively to 12% of GDP, and allowed to remain above \$1 trillion for four successive years (and counting – there’s no certainty at all that the deficit for the year to September 2013 will end up below that figure). As in all bubbles, participants convinced themselves “it’s different this time.”

As well as metrics being abandoned, traditional lending standards and budget constraints were trashed. However much Republicans may wish to blame President Obama for this, the reality is that subprime budget policies were adopted in 2008, nearly a year before Obama took office. The first trillion dollar deficit occurred in the year to September 2009, for which Obama had de facto responsibility for only the last 3-4 months. The equivalent of “liar loans” in which the borrower did not have to prove his income or ability to repay the mortgage was the 2009 “stimulus” in which government spending did not have to be shown to have any value.

Many have written of the bubble in U.S. Treasury bond markets, with the 10-year yield below 2% while inflation is at above 3%, and the Fed owning close to \$3 trillion of government guaranteed paper, mostly of long duration, but this is a symptom of the bubble, not the bubble itself. The collateralized debt obligation market was an efficient if flawed mechanism to distribute securitized home mortgages, but it was housing and the mortgages themselves, not the securitized market, that formed the bubble. If home mortgages had remained sound, mortgage bonds would equally have been sound. Similarly, it is government spending and borrowing that forms the current unsustainable bubble; the Treasury bond market is merely a financing mechanism.

Wall Street has been blamed for the housing finance debacle and will doubtless be blamed for the coming government bond debacle, but in reality it is merely an efficient testosterone-fueled distribution mechanism. Its risk managers, and those of many institutional investors, were in 2005-08 working on hopelessly flawed models, which made incorrect assumptions about the nature of markets. However in the housing case the true blame should fall on the rating agencies, which recklessly and unquestioningly took Wall Street’s models and used them to assign AAA ratings to bonds that were anything but.

In the government case, most of the blame should fall on bank regulators, who are even more culpable than the rating agencies of 2005-08. They have allowed banks to invest in government bonds without assigning capital to their holdings,

thereby effectively permitting infinite leverage. In addition, blame should fall on the designers of current monetary policies, which have encouraged banks to buy huge stocks of government bonds and finance them through short term borrowing and repurchase agreements, making an unlimited profit through unlimited leverage of the yield curve. Making this silly game more profitable than small business lending is a principal source of the economic sluggishness in the United States, and even more so in southern Europe.

The Enron example showed that jail sentences are felt to be appropriate after financial crashes. In this case they should fall on regulators, monetary policy designers and budget committee chairmen rather than on the relatively blameless bankers, who were simply responding to the misguided incentives they were given. Of course, in both the housing and government examples, some operators were worse than others. Countrywide's mortgage lending practices appear to have been significantly more feckless than most of their competitors' while among governments Greece, Italy, Illinois and California were notably less prudent than their brethren.

In the government bubble, central banks have played the exacerbating role that Fannie Mae and Freddie Mac played in the mortgage bubble. The Bernanke Fed's repeated purchases of government bonds, a practice believed devoutly to be thoroughly unsound before 2008, mirrors Fannie and Freddie's massive portfolio of mortgage bonds and their determination not to be left behind in market share however "subprime"; the mortgage market became. Similarly the European Central Bank's \$600 billion 3-year 1% bank funding in December 2011, and its promise to repeat the operation in February, have provided a massive subsidy to the government bubble in the same way as Fannie and Freddie's recklessly awarded guarantees, their dumbing down of approval criteria and their bloating of maximum mortgage limits subsidized the subprime mortgage bubble.

One interesting case study is China, which conflated the two bubbles. Having developed a real estate bubble of its own, based on reckless bank lending at below-inflation interest rates, it then engaged in "stimulus" that consisted of yet more feckless bank lending to needless construction projects. With a gigantic domestic pool of savings available to raid at any time, China may yet escape the yawning recession that would normally follow such redoubled folly, but someone in that country is going to lose truly gigantic amounts of money in the next few years, as the bad loans come due.

Both housing and government bubbles thus involve massive amounts of "malinvestment" in the Austrian economic sense — money flowing into assets and activities that are superfluous to the economy's requirements. The solution in both cases is a recession that writes down the malinvestment and begins the redeployment of resources to more economically viable areas. In the case of housing, that process is nearly finished — there are strong signs that house prices are nearing a bottom, having returned in most areas to below-average multiples of incomes. The next few years will see two further downdrafts, however, one caused by the inevitable (if artificially delayed) foreclosures and the other caused by a rise in real interest rates to historically appropriate levels. It may thus be 2018-2020 before the housing market is truly restored to health, in terms of new home building, etc.

In the government case, the first solution attempted will inevitably be a burst of inflation, with interest rates being kept artificially below the inflation rate, inflation statistics being falsified, and the Fed attempting to depress the real value of the government's obligations. This will not work, but the temptations to the Fed and the authorities are likely to be such that no Paul Volcker will appear as in 1979 while inflation is at the relatively benign 10-12% level. Instead, sloppy money will be perpetuated until hyperinflation of 100% per year or more has entered the American experience for the first time.

At that point, the international money and capital markets will refuse to accept the now worthless dollars (and, equivalently, euros) and will increasingly move to gold, with governments in the U.S. and elsewhere being powerless to prevent this development. Eventually the combination of a Gold Standard, a balanced budget amendment to the Constitution and a massive write-down of remaining U.S. and European obligations will restore order. Needless to say, a political crisis of some magnitude will accompany these developments, since current politicians are quite incapable of dealing with the rigors of Gold Standard government finance.

This column said as early as 2005 that the housing bubble would inevitably burst, and that it would cause a major economic disruption. The same is now equally obvious for the bubble, not merely in government bonds, but in government itself.

The S&P/Case-Shiller Home Price Index measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States.

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