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Dec 3, 2008

Economic Commentary

Mark-to-Market Mayhem II

Following the announcement by the National Bureau of Economic Research that a recession in the US began last September, both Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke gave speeches.

Mr. Paulson said, "We are actively engaged in developing additional programs to strengthen our financial system so that lending flows into our economy." Chairman Bernanke laid out additional steps the Fed could take to lift economic activity, including the purchase of Treasury bonds to boost the money supply.

As has been typical in the past year, every time the government comes out to explain what it will do to save the day, the markets stumble. The Dow Jones Industrial Average fell 670 points and financial stocks had one of their worst days ever.

What is most amazing about this crisis is that the government is unwilling to address one of the root causes of investor fears – mark-to-market accounting. For some reason, normally stalwart free market thinkers are willing to support trillions of dollars of government intervention, but are unwilling to support a suspension of mark-to-market accounting. They trust government solutions more than private sector solutions.

This has happened before. In the 1970s, when inflationary pressures were rising because of excessively easy monetary policy, the government tried everything but tightening money to fix the problem. A partial list includes, wage and price controls, windfall profits taxes, tax hikes, credit controls, WIN buttons, and price caps on energy products.

None of this worked because inflation was a monetary phenomenon. But every convoluted attempt at fighting inflation that did not address the real problem created even more problems elsewhere. The end result of all of this was stagflation as government interference in free markets undermined growth.

Milton Friedman, who understood the problem, and proposed the solution that was eventually put in place by Paul Volcker, was considered too narrow-minded. Many thought that inflation was intractable and something we would have to live with.

Sadly, it seems that the US government is repeating a similar error all over again. Conventional wisdom argues that the problems we face are fundamental in nature. That this is a classic case of an economy gone awry, and that the only way out is for government to bail us out.

But every new government bailout or injection of liquidity is designed to offset the pain caused by Sarbanes-Oxley, FASB 157 and mark-to-market accounting. And even more sadly, it is these convoluted attempts at bailing out the economy that pushed the economy into recession.

The decision to let Lehman Brothers fail caused the financial system to freeze up. Money under mattresses appeared safer than money in the bank. For the first time in roughly 100 years the velocity of money (the rate at which money changes hands) collapsed in September. As a result, real GDP in the fourth quarter of 2008 could well fall 4%.

This reality led the Treasury to propose a huge $700 billion facility to purchase troubled assets. The idea was to encourage more lending. Purchasing troubled assets would set a floor under their prices, provide liquidity and protect capital at financial institutions. It was the first real acknowledgement that the downward spiral of asset prices, and fair value accounting, were harming the financial system.

The plan never got off the ground. Instead, the Treasury invested directly in banks. But this has not encouraged any more lending because the vicious cycle of illiquid markets, fire sale prices, a weak economy, and fair value accounting is impairing, or threatening to further impair, capital. In fact, Citigroup, who received $25 billion from Treasury back in October, came back for more because the falling value of assets threatened its capital ratios.

So last week, the Treasury announced another investment in Citigroup, and also insured $306 billion of its troubled assets. This arrangement is designed to limit the possibility that falling asset values (and fair value accounting) could push Citi into bankruptcy.

To understand this process, imagine that a forest fire one mile to the east of your home in Montecito, CA. was being blown your way by the Santa Ana winds. How much would your home be worth at that moment? How about the loan on the books of your lender? Then imagine that the wind shifts to come from the ocean, your house is saved, and its value is unimpaired once again. Which set of books is right?

The only difference between this example and today's economic crisis is that no matter what price we place on the house, it will not affect the direction of the wind or power of the fire. But because marking-to-market impairs capital and therefore the financial system as a whole, it is causing the fire to burn hotter and the wind to blow harder. Marking to what might happen forces the system to accommodate losses that may not occur in reality.

Subprime loan problems, which started out as a $300 billion problem, have morphed into a $1.5 trillion dollar problem affecting many different markets and types of institutions. Even if the wind shifted, and the fire moved the other way, the damage would have already been done. In other words, it would not matter if the house had actually survived because the bankruptcy would have already occurred.

Suspending mark-to-market accounting will not keep institutions that took excessive risk from failing. Bad loans are still bad loans and there is no way to avoid the pain that they cause. It will, however, end the negative feedback loop, which drags everyone down. It allows time to see if the wind shifts and keeps the flames from spreading.

In the 1980s, loan problems took down thousands of banks, but because we did not force fair value accounting, the economy and stock market actually thrived. Every money center bank would have been insolvent in the early 1980s if they were forced to write down Latin American debt to 10 cents on the dollar. Add in bad oil loans which took down Penn Square and Continental and bad S&L loans, and it is easy to see that the bank problems in the early 1980s were much more severe than those of the 2000s. But the rules were not as inflexible then as they are today. Problems did not spread, many banks eventually recovered their principal on Latin American debt and the economy grew.

In contrast, today's problems are expanding, and have now caused the government to put almost $4 trillion of taxpayer funds at risk to support the financial system. This is an amazing sum of money, equaling 28% of GDP, or 42% of total US stock market capitalization, or more than a quarter of all household debt outstanding, or nearly 40% of all private household mortgage debt, or three times the amount of subprime loans outstanding at their peak.

The government has tried multiple strategies. The only thing they all have in common is that they are designed to offset or stop the damage caused by mark-to-market accounting.

For example, banks have increased their excess reserves from virtually zero to over $630 billion because the Fed now pays interest on those reserves. The Fed uses these funds to buy commercial paper and other debt instruments. So banks are pushing off credit risk to the Fed to avoid any chance of further markdowns or losses. As long as there is a threat to the economy, the Fed will not be able to extract itself from this arrangement, and unless the Fed can extract itself there will be a threat to the economy.

In addition, the Fed has decided to buy Fannie Mae and Freddie Mac debt in order to bring mortgage rates down. One of the key reasons that mortgage rates have remained elevated in recent months is that lenders have become more risk averse, not less. And much of that is due to the erosion in asset values and the interplay with fair value accounting rules. Forcing interest rates down may encourage more home buying, but it does not change the underlying threat.

At some point the government will have thrown so much money at this problem that it could overwhelm the negative feedback loop of mark-to-market accounting. But, in the process, the government will grow larger and the free market will suffer. Moreover, every step on this path the government takes makes it harder to reverse course.

After all, when Chairman Volcker finally put the brakes on the money supply, inflation finally came to an end just like Milton Friedman predicted. But by that time, the government had done incredible damage to the economy as a whole and unemployment had climbed to almost 11%.

Some think we have passed the point where changes in accounting rules will help, but since the rules have now affected the economy as a whole, the problem is spreading to a wider set of institutions and markets. Suspending mark-to-market accounting would still be the single most powerful tool in the government's tool kit if it really wants to end the problems we face today.

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