Don’t Nationalize; Suspend Mark-to-Market

We have been accused of beating a dead horse when it comes to our support for either suspension of, or targeted relief from, market-to-market accounting.

And we suppose after writing thousands of words, producing videos and giving speeches about the issue, some might be tempted to let it go. But, we can’t do that, especially when the government continues to spend trillions of dollars and is coming very close to bank nationalization.

This is a real shame. Suspending mark-to-market accounting could fix major problems at no cost. Unfortunately, many people dismiss this issue without really understanding its impact on the economy.

The history seems clear. Mark-to-market accounting existed in the Great Depression and according to Milton Friedman, who wrote about it just 30 years after the fact, it was responsible for the failure of many banks.

Franklin Roosevelt suspended it in 1938, and between then and 2007 there were no panics or depressions. But, when FASB 157 went into effect in 2007, reintroducing mark-to-market accounting, look what happened.

Two things are absolutely essential when fixing financial market problems – Time and Growth. Time to work things out and growth to make working those things out easier. Mark-to-market accounting takes both of these away.

Because these accounting rules force banks to write-off losses before they even happen, we lose time. This happens because markets are forward looking. For example, the price of many securitized mortgage pools is well below their value based on cash flows. In other words, the market is pricing in more losses than have actually, or may ever, occur. The accounting rules force banks to take artificial hits to capital without reference to the actual performance of loans.

And this affects growth. By wiping out capital, fair value accounting rules undermine the banking system, increase the odds of asset fire sales and make markets even less liquid. As this happened in 2008, investment banks failed and the government proposed bailouts. This drove prices down even further, which hurt the economy. And now as growth suffers, bad loans multiply. It’s a vicious downward spiral.

In the 1980s and 1990s, there were at least as many, and probably more, bad loans in the banking system as a share of the economy. The difference was that there was no mark-to-market accounting. This gave banks time to work through the problems. At the same time, the US cut marginal tax rates and raised interest rates, which helped lift economic growth. Time and growth allowed those major banking problems to be absorbed (even though roughly 3000 banks failed); without creating an economic catastrophe.

In Japan, during the 1990s, the government allowed banks to operate without ever even recognizing bad loans, which certainly bought time. However, Japan increased taxes, which undermined growth, creating an economic catastrophe. The real problem with Japan was not zombie banks, it was that there was no growth. After all, foreign banks were allowed to lend in Japan, but stayed away because the economy was not vibrant.

Suspending mark-to-market accounting is a cost free way to buy time. It does not allow banks to sweep bad loans under the rug. Bad loans are still bad loans and banks cannot hide from them. Not suspending it, while at the same time interfering in the economy with massive stimulus bills and bank nationalization, is a recipe to undermine both time and growth and therefore hurt the economy even more.

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