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First Trust

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Monday Morning Outlook

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Financial Reform – Let's Do the Right Thing

Last week, President Obama announced a new set of policies designed to deal with financial institutions that are "Too Big Too Fail" – TBTF. While we agree that a debate about TBTF institutions and policy are important, a more critical set of issues is being left ignored and undone.

First, if the Federal Reserve would have followed our rule (using nominal GDP growth to guide short-term interest rates), or a gold standard, the Taylor Rule, or other rule-based monetary policies, the federal funds rate would never have been reduced to 1% in 2003, and housing over-investment would have been either non-existent or much less damaging.

Second, if mark-to-market accounting rules had not been re-instituted in late 2007, loan problems would have never spread as far or as fast as they eventually did in 2008. Mark-to-market accounting rules are pro-cyclical in the extreme. There is a reason FDR got rid of them in 1938. These accounting rules – that require banks to price assets to illiquid market bids, even when cash-flows are unimpeded – is the equivalent of throwing gasoline on a fire. They turn a problem in the financial system into a catastrophe.

The banking crisis of the early 1980s – also largely created by easy Fed policy, had more loan losses than existed at the beginning of the crisis of 2007-2008. Adding the early 80s bad debts in agriculture, oil, and Latin America to those of the Savings & Loan Industry, created bank losses of roughly 6% of GDP. Sub-prime and Alt-A loan losses in 2007 were roughly 4% of GDP. But once mark-to-market accounting started to accelerate, even those smaller losses, undermined confidence and created a vicious feedback loop which put the system in jeopardy. While some argue that it is TBTF institutions that create systemic risk, in reality it is misapplied government action and policy which creates this risk.

Government action and reaction is why a large (but non-lethal) set of banking losses, spread so rapidly and turned into the Panic of 2008.

Instead of suspending mark-to-market accounting rules in 2008, the Fed, Treasury, SEC, and FDIC arbitrarily saved certain firms while allowing others to fail. The crisis accelerated after Lehman Brothers failed, which then led to more government bailouts. Instead of allowing banks to value loans using cash-flow, the government forced these loans to be priced to illiquid market prices. When this put institutions in technical violation of arbitrary capital requirements, Treasury Secretary Hank Paulson forced these banks to swallow TARP money and accept government ownership.

Many conservatives, who profess to believe in free markets, supported these government actions. In a *de facto* sense, this support for government bailouts created a vacuum in Washington. People say, "If conservative Republicans supported emergency bank bailouts, then John Maynard Keynes must have been right. The free market system is inherently unstable. We need the government to save us from the animal spirit of greed." There are few left to defend free markets.

But Keynes wasn't right. It was government that caused the Panic of 2008, not the private financial system. If government had not artificially boosted housing in the first place, had run a stable monetary policy, and did not enforce a dumb accounting rule, the Panic of 2008 would not have happened. Unfortunately, many leading conservatives do not see the world this way. They panicked in 2008 and supported government bailouts. This leaves them with little firm ground to stand on when debating the merits of more government action against banks.

Hopefully, creative politicians can figure out how to circumvent this political stumbling block and focus on fixing the real problems of the financial crisis. Following a price rule for monetary policy would minimize the potential for bubbles, while suspending mark-to-market accounting would end the potential of a crisis spinning completely out of control.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-25 / 9:00 am	Existing Home Sales - Dec	5.900 Mil	**6.060 Mil**	5.450 Mil	6.540 Mil
1-26 / 9:00 am	Consumer Confidence - Jan	53.5	**53.0**		52.9
1-27 / 9:00 am	New Home Sales - Dec	0.370 Mil	**0.372 Mil**		0.355 Mil
1-28 / 7:30 am	Durable Goods - Dec	+2.0%	**+1.2%**		+0.2%
7:30 am	Durable Goods (Ex-Trans) - Dec	+0.5%	**+0.5%**		+2.0%
7:30 am	Initial Claims - Jan 23	450K	**458K**		482K
1-29 / 7:30 am	Q4 GDP Advance	+4.6%	**+5.2%**		+2.2%
7:30 am	Q4 GDP Chain Price Index	+1.3%	**+1.0%**		+0.4%
8:45 am	U. Mich. Consumer Sentiment	73.0	**73.5**		72.8
9:00 am	Chicago PMI - Jan	57.0	**59.0**		58.7