"Financial Market Woes"

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It would be a gross understatement to comment that there is a great deal of worry about financial markets lately, with the "assisted" bailout of Bear Stearns, the bankruptcy of Lehman Brothers, the problems of Merrill Lynch, and the government bailouts of Fannie Mae, Freddie Mac, and AIG. And, as of this writing, there is the prospect of the U.S. government purchasing up to $700 billion of poorly performing mortgages.

Though the details of this most recent plan are not yet worked out, all of this government involvement in financial markets gives many people (including me) a lot of worry . . . as well it should. Government bailout of failing firms is decidedly unwise long-term policy. Firms that know they will be bailed out of their bad investments have much less incentive to make good ones. And when governments take over firms, further investment decisions becomes politicized, with money going into politically correct projects, not value creating ones. We will see short-term run ups in stock prices when the bailouts are anticipated, led by the stocks of those firms being bailed out. However, if the bailout policy is expected to continue, the long-term effect on the stock market is negative because incentives shift away from making sound, value-creating investment.

Many have suggested that financial markets need a greater degree of regulation to avoid the problems we have now. To me, this rings hollow. One of the most regulated financial markets, with heavy government participation, is the one causing the most trouble! That market is, of course, home mortgage lending. As anyone who has a mortgage knows, there is inch-thick stack of papers to sign, many of which are a series of regulation-induced warnings. No one reads these things at closing and adding another inch of paperwork is not going to help. Furthermore, two government sponsored entities directly involved in this market, Fannie Mae and Freddie Mac, did nothing to discourage the high-risk loans that are a key part of the problem. In fact, it's probably safe to say that they jumped wholeheartedly into these types of loans (with the encouragement of the U.S. Congress), which persuaded others to jump in, too.

More draconian lending regulations may diminish the number high-risk loans but at the expense of reducing financial market innovation and the overall availability of credit. A recent *New York Times* article (http://www.nytimes.com/2008/09/19/business/economy/19econ.html?_r=1&th&emc=th&oref=slogin) bemoans the fact that, "Lenders of all types had already been raising the bar for borrowers, turning away all but the best customers." But this is precisely what tighter lending regulation entails . . . only the best credit risks get credit. One cannot simultaneously reduce overall credit market risk and continue to extend more credit to marginal borrowers.

Like it or not, financial markets rely a lot on the reputation of the parties involved. Lenders, to some extent, rely on the reputation of borrowers to repay the loans. Buyers of securities rely on banks and credit rating agencies such as Standard and Poor's to effectively the evaluate risks associated with those securities. The failure to appropriately rate many mortgage-backed securities caused the reputations of many financial institutions to be tarred. This makes funds hard to raise . . . who will buy securities without some confidence in the level of risk undertaken. And now the value of mortgage-backed securities seems to be a great unknown, leading to few willing buyers.

We are told by top administration officials, many leaders in Congress, and other "experts" that this uncertainty is freezing up credits markets. Removal of these assets off financial institutions' books can restore confidence in those firms and get credit flowing again. We are warned by the same group that failure to do so will cause a great financial market collapse.

A financial market collapse is most assuredly something to be avoided. However, the credibility of government in making such proclamations is questionable. I am fully aware that governments do important things, but we are frequently told of the crucial nature of many pieces of legislation and government actions, be it an "essential" energy bill, "vital" health care legislation, an "indispensible" school funding initiative, or "critical" defense spending. I don't know about you, but I've heard the cry of "wolf" too often to simply swallow the next claim without considerable reservation.

To top it off, though the present economic situation is serious, it is nowhere near calamitous. The Dow Jones Industrial Average (DJIA) is off by about 14% over the past four and a half months. This is unfortunate, but not outside the norm for a sluggish economy. During the mild recession of 2002, the DJIA fell 23% over the four months of June to October. The recession months of June 1990 to October 1990 saw the DJIA fall 15%. Unemployment is growing, but is still at the relatively low level of 6.1%. Employment has fallen by 771,000 jobs this year, but that's just ½ of one percent of the total. Real GDP shrank in the 4th quarter of 2007 by 0.2 percent; the first decline in several years. For the 1st quarter of 2008, real GDP grew by 0.9 percent and in the 2nd quarter by 3.3 percent. Collectively, these are signs of a slowing economy . . . but they surely do not portend the utter disaster we are warned of.

What sort of government action is appropriate? When the Fed is doing its job well, it acts in times of economic stress to provide liquidity to the market through purchasing Treasury securities, not by acquiring bad mortgages. Other government agencies have helped facilitate and organize bankruptcy proceedings, such as the Resolution Trust Corporation during the savings and loan crisis of the 1980s. These actions are fitting. They facilitate market transactions, but do not supplant them. Most importantly, they do not bail out failing firms from their bad investments.

Facilitating bankruptcy proceedings has a lot of advantages relative to a bail out. The first, as just noted, is that it retains incentives. Firms that made bad investments bear the consequences of doing so. Stockholders lose and management changes. Debtholders,

in the interest of salvaging something, have reason to work out payment plans with mortgage holders. Second, there already is a well-established process in place to handle bankruptcy. Third, credit markets need not shut down during this time since bankrupt firms can (and do) continue basic operations during the process of bankruptcy and management transition. Though not a pleasant task, this approach is much preferred to making taxpayers liable for all the bad investment decisions made over the last several years in the mortgage market.