# Why the Conventional Wisdom about the 2008 Financial Crisis is Still Wrong

# Why the Conventional Wisdom about the 2008 Financial Crisis is Still Wrong:

## *Ten Years Later*

By

Paul D. Mueller

Cambridge Scholars Publishing

Why the Conventional Wisdom about the 2008 Financial Crisis is Still Wrong: Ten Years Later

By Paul D. Mueller

This book first published 2019

Cambridge Scholars Publishing

Lady Stephenson Library, Newcastle upon Tyne, NE6 2PA, UK

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Copyright © 2019 by Paul D. Mueller

All rights for this book reserved. No part of this book may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the copyright owner.

ISBN (10): 1-5275-1923-6
ISBN (13): 978-1-5275-1923-7

# TABLE OF CONTENTS

Preface ........................................ vii

Introduction ........................................ 1
Ten Years Later

Chapter One ........................................ 8
The Current Landscape

**Part I - What Happened?**

Chapter Two ........................................ 22
How Ordinary Americans Experienced the Crisis

Chapter Three ........................................ 36
Chronology of the Financial Crisis

Chapter Four ........................................ 47
Financial Mechanics of the Crisis

Chapter Five ........................................ 73
Political Responses to the Crisis

**Part II - Why Did It Happen?**

Chapter Six ........................................ 90
Conventional Wisdom: The Free Market Failed

Chapter Seven ........................................ 101
Dissenting Views

Chapter Eight ........................................ 122
Assessment of Competing Explanations

## Part III - What Now?

Chapter Nine ........ 142
How Things Have Changed since the Crisis

Chapter Ten ........ 157
What We Have (Not) Learned

Conclusion ........ 170
What We Should Do

Glossary ........ 178

References ........ 184

Index ........ 188

# PREFACE

The book you are holding has been the result of a decade of thinking about the financial crisis of 2008. That event motivated much of my initial study in graduate school. I decided, after years of mulling over what happened, teaching multiple courses on the topic, and seeing many similar pre-crisis trends emerge, to write a book about the crisis from my perspective.

I've written *Why the Conventional Wisdom about the 2008 Financial Crisis is Still Wrong: Ten Years Later*, with the intelligent layman in mind. You don't have to be an expert in economics or finance to read this book. You don't have to be up to date on all the latest financial developments to understand what happened. My book is not as thorough and detailed as many of the works I cite. But it attempts to present the whole crisis, including its aftermath, in the way you might describe the crisis to friends and family at the dinner table or on an airplane.

I don't want to delay you from diving in any longer but I would be remiss if I didn't acknowledge several important contributions. A book may be written by one person, but that person's ideas have been shaped and developed in hundreds of ways through conversations and research. I wish I could acknowledge all the people who have affected my thinking on the crisis, but the list would run on for pages. Those of you who have talked with me about the crisis know who you are and I want to sincerely thank you for your thoughts and ideas that may have been worked into a chapter here and there.

I would like to explicitly thank my former students who took my class on the 2008 financial crisis last year. They sharpened my thinking with their questions and insights from the variety of materials we read. I would also like to thank conference participants who gave me helpful comments when I presented various elements of this book on panels at the Association for Private Enterprise Education and the Southern Economic Association Meetings. I have also had several student research assistants who looked up many details and references for me including: Kara Simmons, Rachel Cooley, Rachel Cline & Justin Cox.

I must also thank Linda Williams for giving extensive editorial comments. Her detailed comments, suggestions, and notes on every part of the book improved its quality. Any remaining shortcomings in grammar,

syntax, or clarity are certainly my own. I also owe an enormous debt of gratitude to my wife, Kathryn Mueller, for watching our two, now three, children under five years old. If it weren't for her efforts to care for them while I disappeared for hours at a time to finish this book, it would never have seen the light of day. And I thank God, without whom none of this would exist or have any meaning.

# Introduction

## Ten Years Later

2018 marked the tenth anniversary of the greatest financial crisis in recent history. Was the crisis caused by unfettered capitalism? Did market fundamentalism and deregulation open the door to excessive risk-taking? Did greedy people on Wall Street deliberately ignore warning signs? Were government bailouts during the crisis necessary? Has there been adequate regulatory reform to prevent future crises? Unfortunately, our society's answers to these important questions are basically wrong.

The 2008 financial crisis was not caused by free market capitalism run amok. The crisis was not created by deregulatory zeal. It wasn't primarily due to greed on Wall Street. The crisis was not simply created by people's "irrational exuberance" or "animal spirits." And perhaps, most importantly, it did not require bailouts and thousands of pages of new regulations to fix. If you are surprised by these claims, you're not alone. These misconceptions are all part of the commonly held "conventional wisdom."

The 2008 financial crisis is, and will remain, a pivotal event in our nation's history. Not only was it an economic catastrophe for the United States, the crisis caused the entire global economy to slow in 2008 and contract in 2009, causing financial hardship and suffering for millions of people who lost jobs, houses, or retirement savings. Because of its magnitude—and more importantly, because of the misdiagnosis of the conventional wisdom as to its cause—the crisis also generated significant regulatory changes affecting our lives today. Despite reforms by the Trump administration, the new regulatory framework ushered in by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) will persist for years to come. The crisis and the conventional wisdom about it have also had a profound effect on how people view markets, finance, and government—most noticeably fostering skepticism of free markets and free trade.

Unfortunately, the regulatory changes and heightened skepticism of free markets have made the country, and the world, less prosperous. For

the first several years following the crisis, we had a so-called "jobless recovery." The average 2% rate of annual economic growth during the past ten years was less than half the average annual economic growth following the ten previous recessions: 4.3%. The bailouts and the new financial regulations created by Dodd-Frank have also led to rapid consolidation in the banking industry. Costly regulations and barriers have also limited the number of new banks entering the industry. From 1997 to 2007, an average of 150 commercial banks were charted every year. According to the Federal Deposit Insurance Corporation (FDIC), from 2008 to 2015, only 36 new commercial banks were chartered, ***total***. Fewer new banks reduces financial innovation, competition, and thereby, growth in the economy.

The amount of assets held by the ten largest banks in the U. S. has increased by over 50% from 2007. The three largest U.S. banks, JP Morgan Chase, Wells Fargo, and Bank of America, are bigger than ever in terms of assets (~$5.5 trillion in 2007, ~$7.5 trillion in 2017) and market capitalization (~$400 billion in 2007, ~$966 billion in 2017). These three all acquired large parts of failing firms during the crisis. JP Morgan acquired most of Bear Stearns and most of Washington Mutual. Bank of America acquired Countrywide Financial and Merrill Lynch. Wells Fargo acquired Wachovia.

Furthermore, the unprecedented artificially-low interest rates promoted by the Federal Reserve and other central banks have fueled increasing consolidation in other industries by financing record amounts of mergers and acquisitions. From 2014-2017, global mergers and acquisitions averaged over $5 trillion a year according to Statista. The frequency of M&As over this period in the U.S. also increased approximately 25%, according to the Institute for Mergers, Acquisitions and Alliances. Instead of making us safer, policy makers relying on the conventional wisdom misdiagnosed the causes of the crisis and so implemented incorrect solutions which have slowed the economy, made it less competitive, and sowed the seeds for future financial crises.

The slow recovery and increasing consolidation within various industries are the result of markets that are less free, less dynamic, less efficient, and less productive than they could be. Thousands of new rules created by various regulatory agencies—especially financial regulators—have made larger companies more competitive relative to smaller ones because the costs of understanding and complying with regulations is much smaller as a percentage of their total expenses. Consolidation driven by regulatory change means fewer competitors, not because the larger

firms are more efficient and productive in serving the consumer, but because they can deal with government rules and bureaucrats more easily.

The second major reason markets are less productive and dynamic than they could be is because government responses during the 2008 financial crisis rewarded less productive firms with bailouts while taxing more productive firms to help pay for them. In a free market system, companies that use resources poorly lose money and go out of business while companies that use resources well have high profits and expand their business. This healthy check of profits and losses was upended in 2008. Leaders of the Federal Reserve and the Treasury argued that the whole financial system was collapsing and that some firms were "too big to fail." So the government didn't let them fail.

Another part of the conventional wisdom is that the 2008 crisis was caused by too little regulation and oversight. When Lehman Brothers failed because the Federal Reserve and the Treasury unexpectedly refused to bail them out, panic ensued. Lehman's failure began the financial crisis and credit markets collapsed. The entire western world was at risk of imploding. It was only because of the swift and dramatic government bailouts, especially TARP, that the U. S. didn't enter another Great Depression—or so conventional wisdom would have us believe.

But there is good reason to doubt that the conventional wisdom gets the story right. In fact, evidence suggests that haphazard government interventions may have made the crisis much worse than it needed to be—which means we would all be better off if the government had done less in the first place. If that is true, then the conventional wisdom is pernicious, both because it is wrong and because it has been used to justify unnecessary policies, regulations, and interventions in the economy that have made the economy less productive, have created even bigger banks, and have generated systemic risk in financial markets.

This book synthesizes and then challenges the conventional wisdom about the 2008 financial crisis. It explores alternative explanations for what caused the crisis, how the crisis played out, and what lessons we should have learned. To evaluate the competing explanations, we must have a good understanding of the timeline and the mechanics of the crisis. We will examine both in detail before moving into competing explanations of the crisis. You may also be helped by the glossary of financial terms and institutions at the back of this book.

I want to present both sides of the story as best I can so that you can weigh the different explanations against each other. The conventional wisdom is not monolithic, or even compelling, on many points. That means there are serious flaws or holes in the current leading explanations

of the 2008 financial crisis, even a decade later. Whether or not you find all of my arguments convincing, I hope you learn a great deal by reading this book and will at least take the conventional wisdom with a large grain of salt.

## Book Chapter Summaries

### *Part 1 – What Happened?*

The first part of the book outlines what happened before, during, and after the 2008 financial crisis.

Chapter 1 (The Current Landscape) talks about the legacy of financial crises in general, and of the legacy of the 2008 financial crisis today. Crises tend to generate significant social and political change, much of it negative. We are still dealing with the effects of the 2008 financial crisis in terms of lower labor force participation, lower productivity, slow economic growth, and increasing consolidation of corporate America. We are also living with the social consequences of political polarization and rising anti-market sentiments.

Chapter 2 (How Ordinary Americans Experienced the Crisis) delves more deeply into specific economic consequences of the 2008 crisis. It discusses the loss of trillions of dollars of wealth. It looks at changes in home ownership, employment, wages, rental markets, and other economic data. The goal is to show how the financial crisis affected ordinary people as well as the overall economy.

Chapter 3 (Chronology of the Financial Crisis) presents a detailed timeline of the major events leading up to, during, and following the stock market crash in the fall of 2008, including: the seeds of the crisis in the 1990s and early 2000s, the initial panic in credit markets in 2007, the widespread failure of loan origination companies, the declining value of stocks, the failure of Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Washington Mutual, and other financial institutions, the actions taken by the Federal Reserve and the U. S. Treasury, and Congressional laws, including the 2008 tax rebate, the Troubled Asset Relief Program (TARP), and the American Recovery and Reinvestment Act of 2009.

Chapter 4 (Financial Mechanics of the Crisis) explores what happened in financial markets during the crisis. It includes a brief explanation of the process by which individual mortgages are bundled into mortgage-backed securities (MBS) and other financial derivatives, traded, repacked into collateralized debt obligations (CDOs) and $CDO^2$, and then insured through Credit-Default Swaps (CDS) and other guarantees.

Chapter 5 (Political Responses to the Crisis) discusses the political interventions during the crisis in more detail. It includes the reasoning and actions of the Federal Reserve, the reasoning and actions of Secretary Paulson and the Treasury Department, and the other government interventions in late 2008. I also consider the political fallout of the financial crisis in terms of changed attitudes towards financial markets and globalization, as well as changes in regulatory and legal oversight—including the massive, 2300-page Dodd-Frank Wall Street Reform and Consumer Protection Act and the creation of the Consumer Financial Protection Bureau.

## *Part II – Why did it happen?*

The second part of the book assesses the conventional wisdom against competing explanations of the financial crisis.

Chapter 6 (Conventional Wisdom: The Free Market Failed) surveys several of the most popular explanations of the crisis—both among economists and among the general public. I argue that some combination of these explanations makes up the "conventional wisdom" about the crisis—namely that the crisis was caused by deregulation, market failure, and the Federal government not being aggressive enough in stopping it. Letting Lehman Brothers fail is generally seen as catastrophic and the point at which financial markets, if left to themselves, would certainly have collapsed.

Chapter 7 (Minority Reports) presents several competing alternative explanations and compares them to the conventional wisdom. Minority perspectives on the crisis emphasize the role of the federal reserve in stoking the housing bubble by keeping interest rates artificially low. They also explain the role of various government agencies and Congress in encouraging the deterioration of mortgage standards—and the housing mania more generally—through the Community Reinvestment Act and legal changes to Fannie Mae and Freddie Mac's standards for purchasing mortgages. Finally, most alternative explanations highlight how misregulation encouraged banks and the financial sector more broadly to build up risk in mortgage securities, thus creating systemic risk and error.

Chapter 8 (Assessment of Competing Explanations) presents my views on the debates between the conventional wisdom and the dissenters. I argue that, on the whole, the minority explanations do a better job identifying the causes of the 2008 financial crisis. I also present evidence showing why government-induced uncertainty and instability contributed to the severity of the financial crisis in the fall of 2008. Rather than

stabilizing markets, government interventions, like bailouts, extensive lending facilities, brokered mergers, and so on, actually destabilized markets. My arguments cast new light on the financial crisis and suggest that almost all of the government responses during and after the crisis, as well as subsequent changes in public opinion, have been harmful rather than helpful.

## *Part III – What Now?*

The third part of the book brings us to today. Given that the financial crisis occurred, and given that the conventional wisdom about what caused it seems deeply flawed, what kind of world do we live in today and how can we reverse the damage done by our political and social responses to the crisis over the past ten years?

Chapter 9 (How Things Have Changed Since the Crisis) examines the political, social, and cultural responses to the 2008 financial crisis, including the new laws and rules imposed on the financial sector, some of the common rhetoric used against banks and against Wall street by politicians, some of the long-run economic consequences, especially on labor and financial markets, and the changes in public opinion and economic orthodoxy—particularly the sharp turn away from free markets and trade liberalization to nostalgia for the more controlled and more "equitable" era of the 1950s and 1960s.

Chapter 10 (What We Have (Not) Learned) pulls together lessons we should have learned from the crisis. These lessons include recognizing the importance of mis-regulation, moral hazard, and market distortion through policy intervention. But since the conventional wisdom is flawed, this chapter also spends time discussing the *wrong* lessons most people have learned—namely that banks and financial institutions need to be more heavily regulated and more closely monitored; as well as the idea that people need to be protected from making unwise decisions.

Chapter 11 (What We Should Do) Given the mistaken interpretations of the crisis and the mistaken policy that flowed out of those interpretations, what can we do to mitigate the damage? This chapter focuses on broad guidelines and general approaches to improving our economic and social outlook rather than recommending specific policies. We need to understand the general principles that create a healthy (or unhealthy) financial system. This chapter emphasizes the distinction between free markets and regulated markets. It also points out that higher economic growth outweighs periodic crises – and that governments, however well-

intentioned, are much more likely to do harm than good when they intervene in heavy-handed or haphazard ways.

As you can see, we have a lot of ground to cover. But this book will give you a comprehensive overview of competing explanations regarding the conditions that created the crisis, what happened during the crisis, and what kinds of solutions will reduce the likelihood of future crises. The conventional wisdom that free markets or capitalism failed, and that greater regulation and restrictions are necessary, is mostly wrong. At the end of the day, government interventions created most of the conditions for the crisis and fostered uncertainty, panic, and inefficiency both during and after the crisis. Not only did these interventions make the crisis worse, they slowed economic growth and reduced prosperity for the entire decade that followed. This book attempts to set the record straight.

# CHAPTER ONE

# THE CURRENT LANDSCAPE

The 2008 Financial Crisis will be a pivotal event in financial market history for decades to come. Economist Mark Zandi says, "I'm confident that the subprime financial shock will be judged the most significant financial event in our nation's economic history."[1] What people believe caused the crisis has already influenced the decisions of legislators, regulators, investors, and "too big to fail" banks. Was the crisis caused by bankers' greed and unfettered capitalism? Was it a failure of regulators who fell asleep at the wheel? Or was it the unintended result of hundreds of regulations distorting financial and housing markets for decades? The reigning narrative, or conventional wisdom, of what happened during the crisis will shape financial and monetary policy for the foreseeable future.

The conventional wisdom has already had tremendous consequences. It justified thousands of pages of new legislation and tens of thousands of pages of new regulations. It greatly expanded the oversight and authority of the Federal Reserve and other financial regulators. The various regulations imposed on markets during and after the crisis have dramatically increased compliance costs, led to rapid consolidation within the financial industry, and generally slowed economic growth.

But the conventional wisdom that Lehman's failure triggered the worst part of the 2008 financial crisis and that government interventions stabilized the market rests on shaky ground. Instead, the evidence suggests that repeated government interventions in the market, especially the Troubled Asset Relief Program (TARP), contributed significantly to the largest declines in the stock market by creating uncertainty, fostering panic, and making markets less dynamic by thwarting market mechanisms like profits, losses, and price signals. This had the effect of both deepening the crisis in terms of falling asset prices and less lending, as well as making the market less dynamic after the crisis—the so-called "jobless recovery."

The conventional wisdom's narrative leaves out many important factors and places too much emphasis on the wrong ones. In fact, it gets the story almost entirely *backward.* If anything, government intervention

worsened the crisis, not lessened it. There were dozens of interventions in 2008 that created legal and regulatory uncertainty, fostered panic, and thwarted profit and loss signals.

The world changed after 2008 and so did the fortunes of many people. Although the vast majority of people saw their income and wealth decline, there are stark contrasts in how their wealth and income rebounded. People's beliefs about markets and public policy shifted as well. These changes in the wake of the 2008 financial crisis should not be surprising. There are clear precedents for significant social, political, and economic change following major financial crises in the U.S. in the early 20$^{th}$ century. The two most important examples of this shift are the banking crisis of 1907 and the banking crisis following the 1929 stock market crash.

The 1907 banking panic followed a long line of banking crises post-Civil War, in 1873, 1884, 1890, 1893, and 1896.[2] There had also been a series of banking crises before the Civil War too. In fact, in the 19$^{th}$ century, the U.S. had one of the most unstable banking systems in the world. Many people attribute this instability to free "wild cat" banking that had few barriers to entry, relatively little regulation, and no central bank. But banking in the U. S. during the 19th century was decidedly *not* free in several important ways.

First, and most importantly, there were significant legal restrictions preventing banks from branching across state lines, or even branching within the same state. One major part of the controversy surrounding the 1$^{st}$ and 2$^{nd}$ Banks of the United States was the fact that this national bank could create branches across states lines while other banks were not. Branching allows banks to diversify and spread two important forms of risk: liquidity risk (that is, running out of cash in the present even though you have significant assets and significant future cash income) and credit risk (the possibility that some of your loans or other assets will default or decline in value). These two forms of risk were relevant to the 2008 financial crisis too.

Branching allows banks to be larger, more stable, and more efficient. They can transfer funds between branches and make a greater variety of loans to a greater variety of customers. Lack of branching creates fragility and instability—which resulted in crisis after crisis in the 1800s. Instead of a branch banking system, the U. S. had a unit banking system, resulting in "27,399 banks in the United States" by the time the Federal Reserve was created in 1914![3] This differs markedly from the experience of other developed countries in the 19$^{th}$ century.

Other factors contributed to the instability of the U. S. banking system too. One was that states, and then the Federal government, required banks to buy their debt before they could issue more loans. This policy restricted their lending and note issue to how much government debt they held. A second contributing factor to instability in the 1800s was that state governments regularly allowed banks to suspend redemption of bank notes and deposits with minor penalties. Normally, when a company can't meet its obligations, say if it lent money too aggressively and ran out of reserves, it declares bankruptcy. These state policies, however, allowed most banks to avoid bankruptcy, which encouraged banks to issue riskier loans and increase their leverage. This behavior made the whole banking system far more susceptible to crises. Based on these factors, and the many U. S. banking crises in the 1800s, it seems like the banking system in the U.S. was practically *Fragile by Design.*[4]

The crisis of 1907 followed this long string of banking crises. Even though this crisis was not as bad as previous ones, it fomented significant change. There were several reasons why the 1907 crisis triggered changes in ways the previous crises had not. First, the antitrust movement was in full swing. The end of the 19th century had seen unprecedented increases in the size of corporations (or trusts) and the size of individual businessmen's fortunes. These trusts ranged from oil (Standard Oil) to steel (U.S. Steel) to railroads (Northern Securities Company). Wall Street, and the king of Wall Street at the time, J. P. Morgan, were involved in creating and financing many of these trusts. In the midst of growing skepticism and hostility towards large concentrations of wealth and influence in private banks, the 1907 crisis saw something else unusual—the federal government had to effectively be bailed out by J. P. Morgan. Ordinary citizens and politicians decided it was unacceptable to have the fate of the financial system, or even government solvency, depend on one man.

The National Monetary Commission was created to assess the problems of banking in the U.S. and propose a solution. They ultimately proposed creating a central bank in the United States—the Federal Reserve. The structure of the Federal Reserve System differs significantly from other central banks. It has twelve regional reserve banks based in Boston, New York City, Philadelphia, Richmond, Atlanta, Cleveland, St. Louis, Chicago, Minneapolis, Dallas, Kansas City, and San Francisco. The Board of Governors is based in Washington, D. C. Both the regional banks and the Board engage in regulating banks, but they tend to do so differently. The Board is much like any other political and bureaucratic regulatory agency, but the regional banks still have some element of competition and

market discipline in how they deal with the banks they regulate.[5] This is due in part to the fact that the member banks "own" the regional reserve banks and have input into their governance.

The creation of the Federal Reserve was one of the most important changes to the U.S. financial system. It eventually paved the way for suspending the gold standard, when paper currency could be redeemed for a fixed quantity of gold on demand, and introducing a currency without any backing (fiat currency), introducing increasing levels of bank regulation, and creating sustained inflation.[6] Besides the creation of the Federal Reserve System in 1913, which changed the U.S. banking system permanently, the 16th and 17th amendments to the Constitution, allowing the levying of federal income taxes and requiring the direct election of senators, were also ratified. Blaming these additional amendments on the 1907 banking crisis alone would be a stretch, though it's an open question as to whether there would have been enough political and popular support for the amendments if the 1907 crash hadn't taken place.

The next major banking crisis followed the 1929 stock market crash. The crisis lasted several years and "between 1930 and 1933 more than 9,100 banks (38 percent of all banks) suspended operations."[7] As economists Milton Friedman and Anna Schwartz point out, the result of this massive banking crisis was that the money supply declined by a third, resulting in significant price declines.[8] This also marked the beginning of the Great Depression, a period of perhaps the most significant changes to the Federal government in U.S. history. Again, not everything can be pinned on the banking crisis, but in this case, the banking crisis was clearly the most important economic cause of the Depression, among other contributing factors such as the Smoot-Hawley tariff and an alphabet soup of federal programs seemingly designed to hamstring the market and delay recovery. These included restrictions on output, restrictions on wages, and restrictions on prices. Many economists argue that lifting these restrictions after WWII, not the war itself, brought the Great Depression to an end.

For our purposes, I want to highlight the major changes in financial regulation during the Depression that would ultimately contribute to the housing bubble in the early 2000s and the financial crisis of 2008. These include the formation of national deposit insurance, the creation of the Federal Housing Administration, the creation of the precursor of Fannie Mae, and of course, the Glass-Steagall Act that divided investment banking activity from commercial banking activity. Now is not the place to describe the history and influence of each of these programs. I simply want to highlight again how a serious banking crisis fomented significant legal and regulatory change that had lasting effects.

The 2008 financial crisis had a similar influence on laws and regulations. In its wake followed the largest stimulus bill in U.S. history, the largest financial regulation bill in U.S. history, and the largest healthcare regulation in U.S. history. We'll spend more time on financial regulation later, but suffice it to say that thousands of new pages of regulations have changed how financial institutions do business, and not necessarily for the better. When historians look back on the Dodd-Frank Wall Street Reform and Consumer Protection Act, they will note the supreme irony of it being authored by two of the politicians most responsible for creating the Financial Crisis in the first place. Congressman Barney Frank and Senator Chris Dodd.

For example, in 2003, Barney Frank said, "I want to roll the dice a little bit more in this situation towards subsidized housing." And in 2008, only months before Fannie and Freddie were taken over by the government because they were bankrupt, Congressman Frank said, "I think this is a case where Fannie and Freddie are fundamentally sound, that they are not in danger of going under." Senator Dodd also said, in 2004, that "This [Government Sponsored Housing] is one of the great success stories of all time."[9] Yet somehow these two men have their names on the biggest overhaul of financial regulation in U. S. history.

The 2008 financial crisis had significant economic consequences. A few of the most important were a significant increase in unemployment from 4.4% to 10%, or an increase of about 2.5 million unemployed people, declines in the value of stocks and houses which reduced most people's wealth, and significantly lower growth rates in the economy compared to previous recoveries. All these factors combined to reduce the well-being of most Americans.

After the 2008 financial crisis ended, policy makers were concerned about preventing unemployment from rising. This was a significant part of the Obama administration's argument for the American Recovery and Reinvestment Act (ARRA). In a report from the President's Council of Economic Advisers, the administration warned that without the stimulus, unemployment could rise as high as 9%. The stimulus would put more people to work and keep unemployment from passing 8%. Unfortunately, such estimates were inaccurate and unemployment eventually reached 10%, exceeding the White House's worst-case scenario, even though the stimulus package was passed. Perhaps things would have been even worse without the stimulus package, but exceeding the worst-case scenario estimate (without a stimulus) should give advocates of stimulus some pause as to whether such programs contribute to economic growth and reduce unemployment.

Besides unemployment reaching double digits, there were two other related problems. One was that unemployment remained elevated for an unusually long period. This high persistent unemployment was partially due to increases and extensions of unemployment insurance and disabilities benefits.[10] But it was also the result of slower economic recovery and growth.

Another problem revealed in the aftermath of the crisis was a noticeable decline in the number of people, especially prime-age males, in the workforce. Not only did the number of people who were searching for a job while not having one increase (unemployment), but the number of people without a job who were *not* looking for a job increased (lower labor force participation). These problems also don't include the issue of "underemployment"—that is, people taking jobs requiring less skill and with less pay than their experience or education would normally warrant.

Employment problems, along with declines in the value of common assets, such as houses and stocks, have contributed to some measures of income and wealth inequality. It is no coincidence that Occupy Wall Street and the Bernie Sanders movement have attracted so many followers in a post-financial crisis world. It is also not a coincidence that Sanders appealed to young, left-wing people, who have lived much of their lives in a post-financial crisis, low-growth world, rather than with older, left-wing folk who were more likely to support Hillary Clinton.

## Who Was Harmed by the Crisis?

Elderly Americans nearing retirement with a large portion of their savings invested in stock portfolios saw the value of their investments fall by over 50% from the fall of 2007 to the spring of 2009. Let me illustrate the implications of this decline with a fictional character, Jim, who was nearing retirement in 2007. Jim's million-dollar nest egg, which he spent the last 30 years of his life building, could have declined in value to less than $500,000. That's not money most people nearing retirement can replace through savings.

But I should note that this loss was initially only a "paper loss." Jim still owned just as much stock as before—it was simply worth less after the financial crisis because stock prices declined. If Jim sold his stocks at these lower prices, then his paper losses were "realized." Unfortunately, many people did sell their investments as prices were falling or near the bottom. But if Jim had simply held on to his stock investments, by January 2013—less than five years later—he would have had a million dollars

again. By August of 2017, those investments would be worth more than one-and-a-half-million dollars.

But retirees, or those with large stock investments, were not the only ones harmed by the crisis. Ordinary homeowners were harmed too. In the decade leading up to 2007-2008, housing prices across the country rose at unprecedented rates. On average, a house worth $100,000 in 1999 would have sold for $200,000 in early 2006, adjusting for inflation. By mid-2008, that house would only have been worth something near $150,000. Interestingly enough, house prices have rebounded since the crisis and in 2017 surpassed the peak reached by the Case-Shiller index in 2005—meaning houses are more expensive today, on average, than at the peak of the housing bubble!

But in 2007-2009, a lot of ordinary Americans who borrowed money to buy a house found themselves with more debt than the house was worth. They were "underwater." Many people also had mortgages they couldn't afford. Defaults on mortgages, and subsequent foreclosures, spiked as people walked away from their house and their mortgage. But even those who didn't default on their mortgage were far less wealthy (just like those with stock investments) after the crisis than before it.

Which leads to the final group of people harmed by the 2008 financial crisis: American workers. As you would expect, people who had lost money in the stock market or in their house—regardless of whether they "realized" those losses by selling their stocks or defaulting on their mortgages—cut back on their spending. That meant a temporary, though sharp, decline in the demand for all kinds of goods: shoes, clothing, cars, TVs, furniture, computers, restaurants, and so on. This dramatic decline in demand and consumer spending meant fewer sales. Businesses had to tighten their belts—frequently by laying people off. As a result, unemployment rose sharply during and after the 2008 financial crisis.

But even more important than declines in consumer spending was the dramatic decline in bank lending. As the financial crisis unfolded, it crippled banks' willingness and ability to lend—leaving many companies without operating capital and making it difficult to start new ventures or to expand existing ones.

Although the crisis affected general groups of people, individuals had widely varying experiences. Someone nearing retirement with large stock investments that lost half of their value, who had borrowed money to buy an expensive house that also lost 20%-40% of its value, and who may have been laid off as people cut back on spending, would have been in a bad place. On the other hand, someone with little money in the stock market,

no house, and a stable job may have experienced hardly any negative impact from the crisis at all.

## Political Responses to the Crisis

There were many political responses to the crisis, both regulatory and legislative. Congress passed the Economic Stimulus Act of 2008, the Emergency Economic Stabilization Act of 2008 (which included the Troubled Asset Relief Program – TARP), the American Recovery and Reinvestment Act, the Dodd-Frank Wall Street Reform and Consumer Protection Act, and others. Regulatory responses included bailouts, lines of credit, lending programs, stress tests, guarantees, etc. Some of these responses will figure prominently in later chapters. But here I will address two specific legislative responses, the reasoning behind them, and what evidence we have of their effectiveness. As unemployment rose in late 2007 and throughout 2008 and 2009, politicians responded with stimulus policies to revive demand.

The two stimulus plans were supposed to stabilize the economy. Traditional Keynesian economic thinking argues that both economic expansions and contractions generate self-reinforcing mechanisms that amplify the booms and busts in the economy. With rising unemployment and slowing economic activity, many economists on the left and the right were concerned that the contraction, if nothing was done, could become far worse than it needed to be.

For almost a century, economists have described the operation of the economy by using the following equation of national income accounting: Annual GDP = Investments + Consumption + Government Spending + (Exports - Imports). John Maynard Keynes, in his book *The General Theory of Employment, Interest, and Money,* explains how the economy can move into disequilibrium for sustained periods of time. There are two mechanisms in Keynesian thought that generate self-reinforcing cycles: animal spirits in investing and the paradox of thrift in consumption. He argued that investors are often driven by animal spirits and herd behavior; bull and bear markets for example. Keynes argued that psychology was an important factor in investment. Investors don't trade solely or primarily on the long-term underlying fundamental value. Instead, they are concerned about short-term price movements, which are driven by what other people think and do. As some people become nervous and start selling their stock, prices begin to fall and their fear begins to spread and becomes amplified. In such a situation, investment can decline precipitously, more than may

be warranted by the initial negative shock to the economy. If investment declines, then GDP declines, assuming no other changes to the economy.

The second aspect of Keynes' theory that explains the self-reinforcing cycles of booms and busts is called the Paradox of Thrift. Stated simply, the paradox of thrift is that saving can be a good decision for an individual, but a bad decision for society. As people begin to save more of their income, whether because their net worth on paper has declined, they are concerned about losing their job, or they have lost their job, they spend less money on consumption. As spending on consumption declines, businesses see their revenue and profitability decline while their inventories increase. The rational response of business owners is to cut back on orders (meaning less revenue for other companies) or cut back on their own costs and production (usually by reducing hours or laying off workers). Either possibility reduces people's incomes, further increasing their desire to save, which results in less consumption spending and the cycle continuing. As consumption declines, GDP declines, again assuming no other changes.

To counteract the problems of animal spirits and the paradox of thrift, Keynes argued governments should increase their spending; hence the stimulus plans of 2008 and 2009. President Bush proposed and eventually signed the $168 billion Economic Stimulus Act of 2008. The idea was that sending millions of checks to Americans would cause them to increase their spending on goods and services, thereby reversing the paradox of thrift and reducing unemployment.

Unfortunately, it seems like none of the Bush advisors had studied economic theory written after the 1960s. If they had, they would have known about rational expectations and the permanent income hypothesis. People are unlikely to increase their consumption dramatically with a temporary boost in income when they expect to pay higher taxes in the future to offset their current benefit. People also tend to smooth consumption over time, distributing one-time windfalls over a long period.

President Obama proposed and signed the more than ***$800 billion*** American Recovery and Reinvestment Act of 2009. The goal was similar to the tax rebate program. But instead of giving citizens money to spend on goods and services for themselves, government agencies and officials decided how to spend the money. That overcomes the rational expectations and permanent income hypothesis issues, but it doesn't address the problems of crowding out and waste. Neither of these programs prevented unemployment from rising. And as I will discuss later, these programs likely made the problem worse, not better, by making the

economy less dynamic and less efficient because they diverted capital to less productive projects and encouraged cronyism.

But if nothing were done during the economic decline, how do we escape the trap of animal spirits and the paradox of thrift? How might the negative downward spiral of people getting poorer, then cutting back on consumption leading to more layoffs, which makes people poorer, naturally end? The short answer is that prices will adjust. It is true that companies are selling fewer goods and services, often at lower prices, and therefore are seeing their revenue fall. But revenue is only half the story. What about their costs? They are laying people off, which reduces their costs and their production to some extent. That may be enough to offset their decline in revenue and put them in the black again. But many of their other costs will decline too—rent, materials, etc. As overall production slows in the economy, the demand for resources from raw materials to capital goods to real estate also falls—lowering the price at an accelerating rate. Eventually falling resource prices will outpace falling sales—leading to higher profits and thereby greater demand for workers—which is when firms start hiring more people and unemployment declines. One major problem with policy interventions to stop the downward cycle is that they explicitly or implicitly prevent many input prices from falling.

## Changes in Public Opinion

The 2008 financial crisis caused major shifts in public opinion about the role of government and the role of financial institutions in society. Changes in public opinion can be seen in the rise of two countervailing groups: Occupy Wall Street and the Tea Party. These movements represented increasing hostility and disgust with the banking system and financial organizations from the left, and outrage over the massive growth in arbitrary government regulation, spending, and debt from the right. Looking back over the past decade, it is not hard to see how these two reactions to the financial crisis contributed to the highly partisan, highly divisive election of 2016.

Other changes included the rapid increases in the level of arbitrary discretion used by non-elected bureaucrats in handing out billions of dollars in subsidies and forcing companies to engage in certain practices. There was also an explosion in the number and intrusiveness of federal regulations in all industries—especially finance and banking.

But beyond these specific movements, the 2008 financial crisis sparked a crisis of faith and a period of soul-searching for economists, politicians, and ordinary Americans. What actually happened during the crisis? How

did we get there? What does Wall Street actually do for America? Do markets really promote our well-being or do they benefit a few people at the expense of everyone else? Are markets inherently unstable and prone to periodic catastrophes? And finally, what can, or should, we do through public policy to improve our circumstances and protect ourselves from Wall Street, globalization, and general market fluctuations?

This book addresses many of these questions. It focuses especially on answers given by prominent economists and public officials. These answers have given rise to what John Kenneth Galbraith mockingly called the "conventional wisdom" in his 1958 book *The Affluent Society*. He described conventional wisdom as the uncritical acceptance of explanations simply because they are the most popular or common views. Yet with regard to the 2008 financial crisis, the conventional wisdom is mistaken in several important ways and has justified bad policy responses and bad laws that exacerbated rather than relieved many of the underlying problems that gave rise to the crisis in the first place.

Popular backlash to the 2008 crisis includes much more than disillusionment with the financial system. Skepticism of global trade, of technology, and of business, in general, has risen. Again, the 2016 campaign rhetoric is instructive here. The main candidates moved away from the free trade consensus of the previous three decades. The phenomenon of Bernie Sanders' primary campaign revealed how deep the skepticism of a market-based economy runs, particularly with the concern that Wall Street seems to be calling the shots in Washington—a point amply demonstrated during the financial crisis—and that the current system arbitrarily awards billions of dollars to the top 1% at the expense of everyone else.

There is a great deal of hostility and fear toward Wall Street, even though banking and financial regulations are at an all-time high! The passage of Dodd-Frank in 2010 has led to an explosion in the number of financial regulations—many with criminal sanctions. In fact, the 2,300-page bill was still generating new rules and regulations six years after its passage. Besides the rules flowing out of the behemoth legislation, various regulating agencies have also continued adding new rules for financial institutions. Although there was some movement in early 2018 to roll back these regulations and which financial institutions had to comply with them, most remain in place.

## The Problem of Misdiagnosis

The 2008 financial crisis created a noticeable change in economic orthodoxy. There has been a resurgence of old economic dogmas about asset bubbles, panics, hysteria, animal spirits, irrational exuberance, market failure, and the inherent instability of unfettered market capitalism. These theories downplay human rationality as well as the power of market signals to check erratic behavior and correct mistakes. They mostly ignore the entrepreneurial reward for solving market failures privately. Such views naturally rely on laws and regulations to "fix" market problems and to "protect" consumers, investors, or workers.

But if the diagnosis of irrationality, animal spirits, and market failure as the root causes of the financial crisis is wrong, then we have very little reason to believe that our new laws and regulations fixed the problems or will prevent future crises. In fact, I argue that it was primarily bad rules and laws that created the conditions of the financial crisis in the first place *and* which contributed to its duration and severity. If that is true, then the recent prescriptions of many economists, and the recent actions of politicians and bureaucrats, have likely made our economic situation worse and made a future crisis more likely. But before we can evaluate the merits or demerits of the conventional wisdom, we need to get a good handle on what the 2008 financial crisis was, its mechanics, and how it affected people.

## Notes

[1] Zandi (2008), *Financial Shock* pg. 8.
[2] Calomiris & Haber (2014), *Fragile by Design* pg.183.
[3] Ibid, pg 184.
[4] Calomiris & Habor (2014), *Fragile By Design: The Political Origins of Banking Crises and Scarce Credit*; see also Vera Smith (1936), *The Rationale of Central Banking* and Lawrence H. White (1984) *Free Banking in Britain: Theory, Experience, and Debate, 1800-1845.*
[5] Mueller (2016), "Public and Private Institutions in the Federal Reserve."
[6] Selgin, Lastrapes, & White (2012), "Has the Fed been a failure?"
[7] Calomiris & Haber (2014), *Fragile by Design* pg. 189.
[8] Friedman & Schwartz (1967), *A Monetary History of the United States, 1867-1960.*
[9] Boettke & Horowitz (2009), T*he House that Uncle Sam Built.*
[10] Mulligan (2012), *The Redistribution Recession.*

# PART I -

# WHAT HAPPENED?

# CHAPTER TWO

# HOW ORDINARY AMERICANS EXPERIENCED THE CRISIS

The previous chapter summarized some of the general ways in which the crisis affected different groups of Americans. This chapter dives more deeply into the details. It provides a snapshot of what was happening in the stock market, housing market, and the labor market from 2007-2009. The changes over this period were bad for most people and catastrophic for many.

## Stock Markets

Most people participate in the stock market without fully understanding it or even realizing that they are participating in it. If you have any kind of retirement account, you most likely own stock. If you are part of a pension program, odds are good that some of your contributions go toward purchasing stock. If you own mutual funds or ETFs, you are invested in stocks. Shares of stock simply represent ownership of a company. Owning shares entitles you to a portion of the firm's future profits, which are often paid in dividends. But most companies choose to reinvest all their profits in the company rather than pay dividends. In that case, the shareholder benefits because the company is becoming more valuable—if the profits are reinvested well, that is—and so your piece of ownership of the company, your share, increases in value too. The primary gain from holding stock comes through the increase or appreciation of the stock price. Conversely, when the price of stock falls, people think they have lost money.

While it is true that the monetary value of people's stock portfolio changes as the price of their shares changes, they do not actually realize their gains or losses until they sell their shares. This means that gains and losses are only temporary until they are actually realized. Remember that having stock shares means owning a piece of a company. I don't own less of a company when the share price falls. Instead, a lower share price