"Immoral Hazard" : Financial Instability, "Free Markets" and the Fed

A review of Jeremy Grantham's book

By Stephen Lendman
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So says Jeremy Grantham, co-founder of Boston-based investment firm Grantham, Mayo and Van Otterloo, now known as GMO. Some call him the philosopher king of Wall Street because of his highly insightful views on markets and the economy, usually with a longer-term perspective. In a profession of touts, fast-buck and scam artists, Grantham's commentaries are notably refreshing. They're detailed, scholarly, sober, clear and especially important at a time of unparalleled excesses, great economic uncertainty, voices ranging from gloom and doom to blue skies and all clear ahead, so who knows what to believe. Few people sort things out better than he, and whether right or wrong, he makes consummate sense and should be taken seriously.

He calls his latest commentary "Immoral Hazard" and takes straight aim at the perpetrators. It's not the first time, and with good reason. Bad policy yields bad results with former Fed Chairman Greenspan Exhibit A.

Grantham notes: "It's not that the former Fed boss…was incompetent that is remarkable. (It's that even now) so many people (still) don't seem to get it." Do they "just believe high-quality, self-justifying blarney?" Or do they think top jobs ipso facto "attract great talent by divine right?" Often, the most important jobs get "mediocrities" like Greenspan and the current White House occupant. Even worse, Washington is infested with them.

Grantham first learned of Greenspan in the late 1960s when he headed economic consulting firm Townsend-Greenspan & Co. Even then, his assessment was unsparing: "To be brutally honest, he was considered run of the mill by anyone I knew then or have met later who knew" of his work. Consider his "famous" January 1973 call that "it is rare that you can be as unqualifiedly bullish as you now can." It was right at the start of a punishing recession and 60% two-year market decline in real terms, second only at the time to the 1929 crash.

Never one to equivocate, Grantham cuts to the chase and draws blood: Greenspan's call "was one of the first of a long line of terrible prognostications for which he has remarkably 'not' been remembered," except by a few historians and analysts like Grantham. He seemed to pop out of nowhere to become Fed Chairman in 1987, not for his professional skills but for plenty of political ones. The Greenspan years and what's so far followed haven't been "our finest hour in the US."

A smattering of skilled leaders handled things way back compared to the "rudderless" kind under Greenspan and today. Moments (far too few) showed "vision, leadership and backbone." They then gave way to political opportunism and "easy paths taken" for short-term gains – most notably since the Reagan era. Referring to when Greenspan became Fed Chairman, Grantham continued saying we're "get(ting) ready to celebrate the 20th anniversary of the Great Moral Hazard." Asset bubbles are tolerated because of who wins and loses. If managed well, speculators and Wall Street profit hugely, bail out at tops (the old pump and dump scheme), then let the public take the pain. No problem though if they miscalculate. Fed Chairmen like Greenspan and the current maestro step in with bailouts.

It's called "moral hazard," and the term goes way back – to the 1600s. English insurance companies then used it in the late 17th century. In the modern era, it got more study in the 1960s, but at the time didn't imply fraud, immoral behavior or outsized excess. Economists used the term to describe market inefficiencies when risks are displaced. It was before what became known as the "Greenspan put," or the idea that Fed Chairmen provide insurance – to bail out investors who take imprudent risks, so take even greater ones since winning is always guaranteed. But only for high-rollers.

Moral Hazard 101 – A Brief Case Study

Take Long Term Capital Management (LTCM), for example, and its dream team management:

— a former highly respected Salomon Brothers fixed income chief who became tainted by the firm's auction-rigging scandal; no matter, he remained highly regarded by Wall Street;

— a former Fed Vice-Chairman; and

— two economics Nobel laureates.

They played high-stakes poker with little regulatory oversight and used their good names to do very risky things – like putting on interest rate swaps at market rates for no initial margin; borrowing 100% of value of top-grade collateral held; using that cash to buy more securities, then using them as collateral for more borrowing. In other words, it was a scheme to theoretically leverage to infinity, LTCM practically did it, and for a while it worked.

Things began unravelling in 1998. It started in July when Salomon Smith Barney announced it was liquidating its dollar interest arbitrage positions. LTCM took a hit, then things got worse when in August Russia declared a moratorium on its rouble and domestic dollar debt. Panic ensued, it spread to other markets, risky investments fled to high quality ones, then they were sold to raise cash.

LTCM was one of many large investors affected. By September, it dropped 52% in value and needed new capital to avoid a dilemma that could impact all of Wall Street if not addressed. LTCM's balance sheet assets were leverage thirtyfold to $125 billion, then tenfold more by off-balance sheet transactions for a total valuation of around $1 trillion – or too big to fail. If they folded, a financial panic could ensue, so the situation was critical. Enter the Fed after some initial high-stakes maneuvering failed. It engineered a multi-billion dollar bailout to avoid a greater financial market collapse.

It worked, but it's no way to run an economy. Bad examples keep getting repeated and each time show up worse. That's precisely today's dilemma. The stakes are enormous. No one for sure knows to what degree, and there's even less assurance how things will play out.

Minsky on Markets

He’s passed but surely smiling and saying I warned you. His economic writings were mostly ignored in the prosperous 1980s and 1990s, but current market turbulence proved him right. He constructed a “financial instability hypothesis” building on the work of John Maynard Keynes. It showed how speculative bubbles grow out of outsized greed. Finally, asset values collapse in the end-game part of a seven-stage up-then-reverse journey downward. It’s a “Minsky Moment” when euphoria turns to panic, investors bail out, and meltdown ensues.

That’s how markets reacted to the Greenspan-caused tech bubble. They sold off hugely, then reinflated from outsized monetary and fiscal stimulus. Last summer, they peaked, dropped sharply, stabilized in April after a lesser Minsky reversal, but there’s no way to know if it’s over. Grantham doesn’t think so. Neither do others. More on that below.

Economist Michael Hudson Cuts Through the Clutter

Hudson is an economist and President of The Institute for the Study of Long-Term Economic Trends (ISLET). He’s also a Distinguished Research Professor of Economics, a former Wall Street financial analyst, and a no-nonsense critic of the current economic environment. He notes how recent events show that “economic royalists” and “money changers” run things and have “mismanage(d) our economy into dire straights of unprecendented risk – (a combination of reckless) debt creation, euphemized as ‘leveraging’ and ‘wealth creation.’ “

Few regulatory checks remain, and anything goes “under the guise of ‘saving the system.’ ” If money manipulators hadn’t endangered it, no fix would be needed. Now with systemic trouble of undetermined proportions, trillions of dollars are being misdirected. They’re going for wars and bailouts instead of helping beleaguered homeowners who were manipulated for profit, face possible foreclosure, job loss, and likely hard times ahead.

Hudson says what’s going on is “an economy-wide Ponzi scheme (for) creditors to lend debtors enough money (for their) interest costs so as to keep current on their loans.” The idea was for various asset prices (stocks, bonds, real estate) to be inflated enough so debtors could pledge them as collateral at higher market valuations for more loans.

It worked as long as valuations rose. When they fell, all bets were off, and here’s how trouble started and spread:

— cracks in the multi-trillion dollar US securitization markets showed up last summer; they created liquidity crises for two Bear Stearns hedge funds; they were heavily into sub-prime mortgages; Bear Stearns was a Wall Street outlier; it was much unloved on the street, notorious for taking outsized risks, and that made it very vulnerable for a run on its assets when the opportunity came; it happened in March and forced the firm to sell out for pennies on the dollar after 85 years in business;

— the initial damage spread to a little-known German bank, IKB; it forced the European Central Bank (ECB) to provide large amounts of liquidity to stem the damage;

— it became apparent that trouble was systemic; it could touch down anywhere and likely hardest where greatest risks were taken – in America; and

— intervention wasn’t working; panic didn’t stop; reserve hoarding took hold instead; and a run on commercial paper began – the kinds international banks issued in Structured

Investment Vehicles (SIVs).

The bottom began to fall out, and the problem was how to stop a growing debacle from becoming catastrophic. The solution, of course, was "immoral hazard" by bailing out transgressors, and the bigger they are, the greater the bailout amounts. Hudson calls it a "trillion-dollar bailout of bad mortgage debt" while homeowners go begging.

It began in March with heaps of hyperbole selling it. Multi-billions poured out. Money supply growth exploded. It now averages a near-monthly 18%. Deficits are mounting, and fiscal spending is just as outsized, but not much of it reaches households even with the so-called "rebate." In the meantime, real wages keep falling. Oil and food prices are skyrocketing. Real unemployment tops 12%. Consumer inflation is nearly as high, and real GDP (not the phony official number) hovers around -2%. Most other economic numbers are just as worrisome, so manipulating magic fixes them.

We're in uncharted territory, problems are huge, they're systemic and structural, and Hudson says "the Fed and Treasury officials seem to be making up new rules on a daily basis – that receive only….perfunctory" congressional oversight. Speculation is being rewarded, anything goes, and bailing out Wall Street and big banks takes top priority.

It gets worse. It costs trillions. No one knows where it will end or if it will work, and there's nothing left over for Social Security, Medicare, Medicaid, and all other essential social and national infrastructure needs.

Hudson puts it this way: "The historic road to serfdom is that of debt peonage to a financial oligarchy concentrating wealth in its own hands….The problem for society….is that finance finds its major gains to lie not in raising living standards, but in promoting a free lunch for its customers — while turning corporate profits, monopoly rent-seeking and real estate price gains into a flow of interest to itself, by advancing the credit to finance the purchase of these assets and privileges."

The only way out is to "scale back existing mortgages (especially ones with negative equity) to reflect the plunge in property values today." Once principal is "reduced to realistic levels," fixed rate mortgages would replace ARMs.

Financial institutions won't accept this or whatever other ways it costs them, and therein lies the problem. Blaming victims is much simpler along with bailing out culprits – when they're too big to fail. Hudson calls for some high-octane populism to change things. Unfortunately, not a hint of it is in sight, and debt levels are so high they "cannot be paid….given the nation's heavy military and trade deficits." It's hammered the dollar and "rais(ed) dollarized prices for oil and other raw materials."

It gets worse. Foreign central banks and investors keep funding our excesses, and US spending, of course, depends on them. The more they lend us, the more we need in a never-ending dependency cycle. It bankrupted Medici bankers in the Renaissance era and got Adam Smith to conclude that governments don't repay outsized debts. They either default, declare a moratorium, or repudiate them. Not fit subjects for discussion, but you can bet foreign debt holders weigh them as they debate whether to keep the daisy chain going.

It's got plenty of US investors concerned as well, and a notable one is bond guru Bill Gross. In an April commentary he wrote: In his judgment, "the private credit markets have forfeited their privileged right to operate relatively autonomously because of incompetence, excessive greed, and (at times) fraudulent activities."

In an earlier Financial Times interview he also criticized government quick fix schemes. He further blasted hedge funds as "unregulated bank(s)" and a "con" and said complicated financial instruments "exacerbated" credit problems, and over-leveraging "lead(s) to an implosion at the edges....of this new financial marketplace."

He's also very worried about declining home prices that many on Wall Street publicly pooh-pooh. He calls a 20% valuation decline "much more" of an economic shock than falling equities "because the amount of homeowner leverage is so much greater. A 20% negative adjustment not only wipes out all ownership equity for millions of Americans, it turns their homes 'upside down' – incentivizing them to let their gardens grow weeds instead of lettuce." He believes systemic crisis is possible if the decline isn't stopped. He's not alone in that judgment, but few agreeing get heard.

Consider damage already done. The current Case-Schiller Index shows home prices declining at a 32% annual rate. A year ago, it was 8%. The risk is a huge 4.6 million home inventory or nearly double the 2.6 million past 20 year average. Even more worrisome is that 2.27 million homes sit empty and that's besides all the others banks own from foreclosures. It's double the year ago number.

If these properties keep deflating and hit the dangerous 20% level Gross mentions, millions will lose their equity, consumption and credit will be hit, and banks will keep writing-off greater amounts no one wants to contemplate. Robert Shiller believes home prices may equal or exceed the 30% drop of the 1930s. That's $6 trillion in today's dollars, or $80,000 for every US homeowner. The Fed can keep injecting liquidity but only for so long, and it may not work. If bank losses are great enough, they'll need all they can get to stay afloat, but for some it may not be enough. Not a pretty picture and no way to know how bad things may get.

Placing Blame Where It's Due According to Grantham

Grantham looks back at 2007 and awarded three prizes for "odd prognostications." They're named in Greenspan's honor. First prize went to Citicorp's CEO Chuck Prince for enthusiastically taking on more credit at a time markets were over-extended and peaking. He subsequently wrote off billions of worthless assets, $17 billion in first quarter 2008 alone, risked the bank's solvency, and got himself replaced by a new CEO.

Current Fed Chairman Ben Bernanke took second prize for "incomprehensible misreading of obvious data by an apparently well-informed source." In late 2006, he said what he now regrets (or should) – that "US housing prices merely reflect a strong US economy." His cohort at Treasury, Hank Paulson, got third prize for his spring 2007 comment that subprime problems were "contained."

Not if you own one or too many of those junk assets written down to a fraction of their original value. Grantham calls the crisis the most important one since World War II. It's more global than others. Its tentacles are everywhere. Speculative greed and broad asset overpricing caused it. Loose regulatory and irresponsible Fed policies allowed it. Perpetrators point fingers elsewhere, and no one's got backbone enough to fess up to their to their own mistakes and transgressions.

Before this ends, according to Grantham, it's "likely to make the S & L crisis look contained." As a per cent of GDP, write-downs this time are on the order of two to three times greater now than then. But there's no precise way to know their full impact or to what degree monetary and fiscal stimulus will contain the damage or delay its final resolution. They won't be papered over, and writer/economist William Engdahl puts it this way:

Greenspan was a tool of the monied interests who gave him his job. He "knew who buttered his bread" and returned their favors manyfold. He engineered many crises and used them all to "advance and consolidate the influence of US-centered finance over the global economy, almost always to the severe detriment of the economy and broad general welfare of the population." His 18 year tenure was undistinguished to say the least. "It can be described as rolling the financial markets from successive crises into ever larger ones…"

It remains to be seen if his "securitization revolution was a 'bridge too far,' " spelling the beginning of the end of US dominance as an economic power. The "true significance" of today's crisis (nowhere near resolved) lies right in his lap. Engdahl lists his menu of malpractice in serving the "Money Trust," meaning Wall Street and big banks. In each case, it yielded big short-term gains, greater long-term losses, and successively greater crises. A new Fed Chairmen has to solve them. Bailout is his strategy. It may help in the short-term. The jury is still out. The policy is flawed. It assures greater crises ahead, and at some point the music stops.

Bernanke may end up being too smart by half. We're awash in problems that one analyst calls three simultaneous imploding bubbles:

— a property, mainly housing, price one;

— a mortgage finance one; and

— an alphabet soup of CDOs, SIVs, SPVs, and a whole menu of levered-up, high-risk securitized assets amounting to financial alchemy.

Grantham also takes aim at them and sees lots more write-downs and defaults ahead before it ends. He cites a longer-term problem as well – "that all debt standards fell so that losses will accumulate right across the entire credit system." Even worse, it came at a time equities were overpriced, still are, and particularly higher-risk ones. Further, "profit margins are spectacularly above average" in some sectors, margins are being squeezed, and markets finally caught on that "all risk is dangerous."

Grantham's research shows that all markets eventually revert to their means and for months have been "well into a massive repricing of both risk and asset prices" to get there. Before it started last July, we reached "the lowest risk premium, by far, ever recorded." It needs lots of heaving lifting to return it to more normal levels. And, of course, it's a painful process, a drag on the economy, and will likely take years to fix. In Grantham's judgment, through 2010 "to clean house completely," and when it ends "the amount of write-downs (may likely) start with a 'T.' "

Blame it on a Fed Chairman whose name starts with "G," and Grantham has been unsparing on him before. Referring to the 1990s dot.com and tech excess, he blamed him for engineering the largest ever stock market bubble and bust in history through incompetence, timidity, dereliction of duty or a combination of all three. It didn't matter because Wall

Street types made fortunes, then got plenty of early warning to exit to let small investors take the pain.

Undeterred, Greenspan was at it again in the current cycle that's now being unwound. But this time, multiple bubbles were created, with housing and mortgage ones most affecting households. Grantham (like Gross) calls them "much rarer and more dangerous than stock bubbles" because they affect so many people. Even worse, with over half of all housing wealth borrowed and "on much less credit-worthy terms," it's very much "more dangerous than normal."

It's the Fed's job to watch over:

— mortgage quality;

— the soundness of repackaging mortgages; and

— off balance sheet commercial banking that should have been stopped or curtailed.

"And what did Alan Greenspan do this time? Absolutely nothing" except whine about a little excess in housing when it was already out of hand. Even then he implied not to worry because "the housing boom will soon simmer down." And Bernanke is even more feckless with comments like "The housing market merely reflects a strong US economy." Grantham portrays him as a Greenspan clone, just as incompetent, and someone having "extraordinary faith in efficiency to the point of denial." Above all, like Greenspan, he's there to serve the "Money Trust" that appointed him.

And he's done it since taking over. First, by "stimulat(ing) at all costs" and repeating the same mistakes as his predecessor. Grantham calls 2008 "the year of Santayana: we ignored history and (are) condemned to repeat it." Housing price deflation is its most notable feature. It's what affects households most, and that, in turn, reverberates through the economy. Greenspan and Bernanke paid it no heed. Each now accepts no blame, and Grantham calls it "shameful." It's far worse than that at a time people are suffering, and the current Fed Chairman gets accolades for bailing out bankers while paying only lip service to homeowners.

By creating asset bubbles, Fed policy caused their dilemma, and Grantham believes their deflating may be the greatest of all threats to financial and economic stability. It stands to reason that efforts must be made to avoid the worst possible outcome. That means curbing speculation is key. Minsky was right that short of that financial crises are inevitable and excess is always the cause.

Grantham sums it up saying: it's important or even vital "to our financial well-being that the Fed recognizes a responsibility to move against" this behavior that comes with a huge price. Greenspan's response: "I have no regrets on any of the Federal Reserve's policies that we initiated...." Grantham calls that "chutzpah that even Paul Bremer would have to admire."

Engdahl calls it a "financial tsunami." It triggered a "crisis of confidence." High-risk securities were most affected. So were sub-prime mortgages. Then the whole "edifice of securitized debt" began unravelling, triggered by its weakest link collapse. Its effect is global and "a crisis not even comparable to the 1930s Great Depression."

High-quality municipal debt got hit. Interest rates on them "rose to the highest ever relative to Treasuries." It makes financing unaffordable and caused states and local agencies to "pull out of the $330 billion floating (auction-rate) market where costs have doubled since January." New York and London bond fund managers say it's the worst they ever saw. High interest rates aggravate fiscal crises even with the Fed cutting fed funds and discount rates. Some call it pushing on a string. Time will tell if it'll work. Engdahl is dubious. He sees depression spreading. It creates "a self-reinforcing downward spiral. The process is in its early stages…."

With market turbulence somewhat quieted after a sharp April rebound after months of declines, unanswered questions remain. Is it a lull, a turnaround, or the eye of the storm before its harshest side hits? Grantham and Engdahl see trouble. Bernanke's fingers are crossed. European central bankers as well, while Americans fear losing their homes and jobs the longer the crisis goes on and deeper it gets.

Direst forecasts have it in its early innings with the worst of things ahead. Only in the fullness of time will we know, but some things are clear. None of this happened by chance. Nor should it have in the first place. A combination of financial malpractice, outright fraud, and greed are to blame. The same mistakes keep getting repeated. The costs keep going higher. Sooner or later they matter, and some day it'll be too late to fix them. Some day may be closer than smart money folks think. Stay tuned, be cautious, and ignore Fed Chairmen and politicians promising miracles. If things were sound and improving, they wouldn't have to keep reminding us.

Global Research Associate Stephen Lendman lives in Chicago and can be reached at lendmanstephen@sbcglobal.net.

Also visit his blog site at sjlendman.blogspot.com and listen to The Global Research News Hour on RepublicBroadcasting.org Mondays from 11AM to 1PM US Central time for cutting-edge discussions with distinguished guests. Programs are also archived for easy listening.

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Articles by: **Stephen Lendman**

About the author:

Stephen Lendman lives in Chicago. He can be reached at lendmanstephen@sbcglobal.net. His new book as editor and contributor is titled "Flashpoint in Ukraine: US Drive for Hegemony Risks WW III." http://www.claritypress.com/LendmanIII.html Visit his

blog site at sjlendman.blogspot.com. Listen to cutting-edge discussions with distinguished guests on the Progressive Radio News Hour on the Progressive Radio Network. It airs three times weekly: live on Sundays at 1PM Central time plus two prerecorded archived programs.