Larry Kotlikoff on The Big Con

By John Mauldin | August 9, 2019

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I have a special treat for you. I'm at Camp Kotok, the annual economics/fishing retreat in Maine. Knowing internet connectivity would be scarce here, I asked good friend Larry Kotlikoff to be your guest writer this week.

For those who don't know, Larry is a Boston University economist whose work spans an amazing breadth of fields. You've probably seen some of his retirement planning research or maybe used MaxiFiPlanner, the software tool his company offers.

Today, though, Larry will share some provocative ideas on what caused the Great Recession. As you'll read, he demolishes the explanations Wall Street and Pennsylvania Avenue want us to believe. Instead, he argues that our financial system was built to fail, failed spectacularly, and was then rebuilt to die another day.

If, as Larry claims, another financial collapse is a matter of when, not if, we need to pay close attention to the *animal spirits*—the group psychology—that Larry, like Keynes, claims can flip the economy on a dime. We should also heed Larry's call for *Limited Purpose Banking*, which, as described in his book, *Jimmy Stewart Is Dead*, eliminates, as he puts it, "banking's twin O rings."

For most of you, the idea of no- or low-leverage banking is quite new. It is not what we have now. It has been around since Irving Fisher proposed a version of it in the 1930s, as he blamed bank leverage for the Great Depression. Milton Friedman had a similar idea.

It is hard to imagine in today's world, but limiting bank leverage has a growing number of high-profile supporters, including me, but will probably happen only after another Great Depression-like event. Kind of like shutting the barn door after the horse is already in the north 40. But read with an open mind.

This is important because you need to understand why what seems like no big deal (subprime is contained) becomes a crisis of confidence and then panic. It will be the same in the next crisis. But that is why we always get through it. Because it is a confidence issue. Just make sure you are hedged and ready.

Now to Larry. I'll be back afterward with a few brief comments.

The Big Con: Reassessing the "Great" Recession and its "Fix"

By Laurence Kotlikoff

Everyone knows what caused the Great Recession (GR). Bad banks issued bad mortgages. Bad bankers overleveraged. Bad shadow banks evaded regulators. Bad rating companies overrated securities. Bad regulators fell asleep at the wheel. Bad households drove up house prices. Bad derivatives expanded. Bad traders overtraded.

In sum, bad banks full of bad bankers did bad things.

Some degree of bad banking is a given. But this time was different. Virtually all outstanding mortgages were subprimes, and virtually all subprimes were no-doc, liar, NINJA, or other forms of fraudulent loans. Bank leverage reached record levels. Massively bribed rating companies gave triple-A ratings to securities that were triple-F. Regulators were totally outgunned, outnumbered, and out of touch. House prices soared forming an incredible bubble. Derivatives became "weapons of mass destruction." Trading grew exponentially. And well-greased politicians looked the other way. The Financial Crisis Inquiry Commission (FCIC) summed it all up in two words: "pervasive permissiveness."

There's just one problem with this narrative. It doesn't fit the facts. Worse, it diverts attention from the real problem. The real problem wasn't bad actors misusing a good banking system. It was mostly good actors using a bad banking system—a banking system built to fail.

Structural failures have structural causes. The Hindenburg had a short circuit. The Challenger had faulty O-rings. The Titanic had unsealed bulkheads. The I-35W Mississippi River Bridge had inadequate gusset plates. Our banking system had and has leverage and opacity.

Thanks to these structural problems, the banking system failed colossally. Then it was bailed out and rebuilt to original spec. Consequently, it will collapse again.

Leverage and opacity are the O-rings of the banking system. They can cause it to collapse overnight. Recall *It's a Wonderful Life*—the Christmas movie featuring honest banker George Bailey. The movie starts with a run on George's bank sparked by a rumor that there's a run on George's bank. Everyone runs because George's bank is opaque and leveraged (in debt), meaning no one knows whether George's bank has enough assets to cover what it owes.

Like all banks, George's bank has borrowed money, which it's promised to repay come hell or high water. If the bank misses repayment by even one dollar, it's game over and the bank fails. The bank's riskiest liabilities are demand deposits, which can be withdrawn *on demand*. This is why checking accounts are called demand deposits.

But as George tells the panicked crowd assembled in his bank's lobby, he's lent out most of what he took in. If everyone is patient, they'll get their money back with interest in due course. But if they all want it back immediately, the bank will fail... and so will Bedford Falls, the town whose economy depends on George's bank.

Thus, the movie presents two equilibria (two places the economy can land). The first is everyone panics, the bank fails, and Bedford Falls' economy falls apart. The second is no one panics, the bank survives, and the local economy continues to thrive.

Fortunately, George, played by Jimmy Stewart, is a good talker. His plea to the crowd narrowly averts the bad equilibrium. This lets the movie continue for another hour until, yet again, George's bank confronts a financial panic but is again saved, this time thanks to a Christmas Eve miracle—a rich buddy of George's who wires him a large deposit just as the bank regulator is about to shutter the doors.

In the Great Depression, one third of US banks went under in precisely the manner depicted in the movie. They experienced runs by depositors for their money. But in 1933, President Roosevelt established FDIC insurance to convince depositors their money was insured by Uncle Sam. Had everyone called Roosevelt's bluff and continued to run anyway, Uncle Sam would have had to print tons of money to "insure" the deposits... leading to hyperinflation, leading to everyone running to retrieve and spend their money before prices went out the roof.

So, government deposit insurance also introduces multiple equilibria. Everyone believes that no one will run due to deposit insurance is one equilibrium. And everyone believes everyone will run despite deposit insurance is another—a very bad one. So far, in our country, the former equilibrium has held the day. In countries like Argentina, the second applies. No one there puts any trust whatsoever in government deposit insurance.

The Great Recession, which saw the collapse of 27 major financial companies worldwide, didn't feature people running on banks. (The fabricated promise of FDIC insurance, at least in terms of insuring the real value of one's deposits, worked its magic.) Instead, the Great Recession featured banks running on banks. The banks ran on the banks because of rumors—some true, some fabricated—that other banks were running on banks.

In 2008, financial panic here at home took down, in succession, Countrywide Financial, Bear Stearns, Fannie Mae, Freddie Mac, Merrill Lynch, Lehman Brothers, AIG, and Washington Mutual. The collapse of these massive and in many cases venerable financial companies (banks for short), whether via shotgun weddings, nationalizations, or bankruptcy, spelled economic disaster on Main Street along with financial disaster on Wall Street.

The reason is that Wall Street's bank runs triggered Main Street's firing runs.

Firing runs reference firing someone else's customers (i.e., your workers) for fear others are firing your customers (i.e., their workers). If you're an employer on September 15, 2008, the day Lehman died, and everyone is screaming "Great Depression," you don't wait months to see what's going on. You start to fire to reduce your biggest debt—your need to make payroll at the end of the month.

The firing runs expanded as one financial goliath after another crashed. They exacerbated the bank runs, which exacerbated the firing runs, which exacerbated the bank runs, all of which produced a vicious downward economic spiral that culminated in the swift loss of 9 million jobs.

The Usual Suspects

Given all we've been told about the causes of the Great Recession, the notion that pure financial panic, cultivated by opacity and leverage, tanked the economy is hard to swallow. So, let's round up the usual suspects and make sure we can rule them out.

Subprimes: Subprime mortgages are the bête noire of the Great Recession (GR). But their losses were far too small to produce a recession, let alone a great one. Indeed, during the GR, the subprime foreclosure rate peaked at 15%. Since at most 14% of outstanding mortgages during the GR were subprime, at most 2.1% (0.15 x 0.14) of all mortgages during the GR represented foreclosed subprimes. This is simply not big enough to matter to our massive economy.

The Housing Price Bubble: Between 2003 and 2007, real housing prices (home prices adjusted for inflation) rose at a 2 percentage-point faster annual clip than did real GDP. But this is hardly evidence of a bubble. One can construct economic models in which the stock of housing grows together with the economy and the real price of housing stays fixed. And one can construct models in which the stock of housing stays fixed and the real price of housing grows together with the economy. Given the increasing urbanization of our country, the fixed supply of central city land, and the remarkable foreign demand for US housing, an irrational bubble isn't needed to explain the pre-GR real housing price rise.

Ratings Shopping: The FCIC's report states that failures of the Big Three rating agencies were "key enablers of the financial meltdown." But economists have now studied tens of thousands of complex mortgage-backed securities and found that the number and values of the securities that may have been misrated could, at most, have impacted less than 1% of the US bond market. Again, this is trivially small.

Bank Leverage: A stable fable related to the run-up to the GR is that banks dramatically increased their leverage. Not so. Fed data show bank leverage falling from 1988 through 2008. Equity rose from 6% of bank assets in Q1 1988 to 10% in Q1 2008. Leverage was also not particularly high in either Bear Stearns or Lehman. Indeed, according to Christopher Cox, former chair of the Securities and Exchange Commission, Bear Stearns was well capitalized when it failed, with a capital ratio over 13% and a debt-equity ratio of just 6 to 1, not the 33-to-1 figure bandied about at the time.

As Chairman Cox stated,

> *The fate of Bear Stearns was the result of a lack of confidence, not a lack of capital. … [At] all times until its agreement to be acquired by JPMorgan Chase … the firm had a capital cushion well above what is required to meet supervisory standards.*

In the event, Bear Stearns' actual capital ratio didn't matter. Multiple equilibrium mattered. Creditors past and prospective came to believe, based on innocent and guilty rumors, that other creditors were pulling the plug. They did likewise.

Lehman was also well capitalized prior to its demise. Its capital (equity) was 11% of its assets when creditors pulled the plug. An 11% capital ratio is very close to the current banking system's figure, according to the Fed's recent stress tests.

Hence, today's banking system is no safer than was Lehman Brothers on the day it was driven out of business.

Mortgage Debt: Another "smoking gun" is the pre-GR run-up of mortgage debt, which roughly doubled between 2002 and 2007. But the increase in borrowing to purchase homes wasn't associated with a rise in household consumption relative to GDP. Instead, Americans borrowed to invest. And although the ratio of mortgage debt to household net wealth rose, the rise was minor. So, too, was the rise in debt payments relative to personal income.

Derivatives: The reigning narrative—that derivatives were overrated, complex securities sold to naïve investors—also doesn't jibe with the facts. Economists have studied thousands of residential mortgage-backed securities that were issued between 2007 and 2013 and rated AAA. Three-quarters of these securities experienced essentially zero losses through 2013. Most striking, AAA-rated residential mortgage-backed securities outperformed the universe of AAA-rated securities.

No Skin in the Game: Economists have also now examined the pre-GR executive compensation contracts of 95 banks. The stock and option compensation in these contracts exceeded wages by a factor of eight. The authors of one study write,

> *Banks with higher option (and bonus) compensation … for their CEOs did not perform worse during the crisis. Bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis. Consequently, they suffered extremely large wealth losses in the wake of the crisis.*

Jimmy Cayne, Bear Stearns' CEO, is an example. He lost $1 billion. Dick Fuld, Lehman's CEO, lost some $80 million. In short, these and other big-bank bankers had plenty of skin in the game.

Regulatory Capture: The main job of bank regulators is overseeing bank leverage. Since bank leverage was not historically high and indeed fell in the run-up to the GR, regulators did their job. What they couldn't do is prevent our unstable economy from switching equilibria.

Democratization of Finance: Some claim that politicians forced Fanny Mae and Freddie Mac, the big government-sponsored mortgage entities, to permit too much risky lending to the poor. But for this to be a major cause of the GR, losses from subprime mortgage foreclosures would have had to be much larger.

Fed Interest Rate Policy: In the 1990s, the expected real 30-year mortgage rate averaged 7.91%. It averaged 6.27% between January 2000 and December 2007. This decline is too small to matter. Furthermore, the Fed doesn't directly control long-term nominal, let alone real mortgage rates. As for 5/1-year adjustable-rate mortgages, their real rate averaged 5–6% in the two years preceding the GR. Real rates of this magnitude are not low.

Unsafe at Any Speed

Bank runs, as indicated, are midwifed by opacity. Opacity permits misinformation to spread and be spread. Bear Stearns was among the first to be picked off by short sellers because it was viewed as particularly opaque.

According to business writer William Cohan, no one on the Street or inside the bank, knew what it actually owed or owned, let alone the true value of those liabilities and assets. The fact that Bear's stock was valued at $60 per share one week before it was sold for $2 per share says that its valuation was a matter of pure conjecture. Apparently, before it didn't, the market thought Bear's assets were worth something because everyone else thought its assets were worth something.

Such self-fulfilling prophecies are the stuff of multiple equilibria.

Lehman's CEO, Richard Fuld, certainly lays the blame for the GR on multiple equilibria. As he publicly stated, "what happened to Lehman Brothers could have happened to any financial institution."

The facts support his view. Bankers didn't destroy the banking system. The banking system destroyed the banking system. It operated in the dark, and it operated with leverage. That, plus rumors of rampant malfeasance, brought Wall Street's house of cards tumbling down.

The takeaway is that banking can't be fixed with cosmetic reforms, such as the US Dodd-Frank Act or the UK's Vickers Commission Report. What's needed is a system with zero leverage and full, government-supervised disclosure.

Why *zero* leverage and *full* disclosure? The answer is simple. You can't be a little bit pregnant. Any degree of leverage and opacity invites bank runs, which produces firing runs, which produces bank runs, which moves the economy from a good to a bad equilibrium.

Are we and our children stuck living with an economy that can instantly fall apart?

The answer, which I provided in my 2010 book, *Jimmy Stewart Is Dead*, is absolutely not.

The book lays out a very simple means, called Limited Purpose Banking (LPB), to fix banking for good. LPB would transform all financial corporations into 100% equity-financed mutual fund holding companies subject to full and real-time disclosure, done by private firms working exclusively for the government.

In considering LPB, it's important to note that not a single equity-financed mutual fund failed during the Great Recession. Yes, the Reserve Primary money market fund failed, but it and other money market funds were leveraged because they promised to back their deposits to the buck.

Limited Purpose Banking has been endorsed by a Who's Who of former top policymakers and economists. The list includes senior statesmen like George Shultz, Nobel laureates in economics, former chairs of the President's Council of Economic Advisers, and some of the top names in finance.

There is no reason to run our financial system and economy on a knife's edge. It's happening for one reason, and one reason only: It works for Wall Street, which pays our politicians to keep the current leveraged, opaque banking system in place.

Wall Street, as we saw in stark relief in 2008, takes the upside and forces taxpayers to bail it out when things go south. If and when this will change is anyone's guess. In the meantime, we each need to realize that the next collapse of our banking system, the stock market, and the economy can happen at any time.

Looking for Solutions

John here again. Larry Kotlikoff and I have had several late-night discussions on the ideas you just read. I think we agree (and you probably do, too) that the banking system isn't sustainable as presently structured. It has too many twisted incentives, is too cozy with governments and central banks, and is much too leveraged. And of those problems, leverage is by far the most serious.

Larry and I aren't the only ones who see this. Even some former central bankers like Mervyn King and Bill White recognize the threat and have offered similar solutions. There are ways we could have a rational, viable banking system that doesn't expose everyone to these periodic meltdowns. They don't happen often, but even one such crisis is too many when the damage takes generations to repair.

This banking system wouldn't look like the one we have today. You might not be able to deposit your cash and have 100% of it back on demand. Or, if that's a feature you want, you might have to pay for it with lower interest rates.

But the bottom line is the same, whether via Larry's "Limited Purpose Banking" or something else. Risky, overleveraged banks are an economic problem we really need to solve. I'm glad Larry and others are trying to find solutions.

Maine and Montana

I will have more to say about Maine next week. My flight to Bangor got canceled, so I'm flying Boston to Augusta and then a long drive, getting in late. Ah, the romance of travel. But the conversation will be worth it.

Currency moves are driving market vol. There will be so much to write about next week. Have a great week. It's going to be an exciting time for those who can keep their cool for the next decade.

Your going to be in economic heaven very late tonight analyst,

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