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Good Times Breed Bad Times

By [Robert Samuelson](#)

WASHINGTON -- A dozen years ago, James Grant -- one of the wisest commentators on Wall Street -- wrote a book called "The Trouble With Prosperity." Grant's survey of financial history captured his crusty theory of economic predestination. If things seem splendid, they will get worse. Success inspires overconfidence and excess. If things seem dismal, they will get better. Crisis spawns opportunities and progress. Our triumphs and follies follow a rhythm that, though it can be influenced, cannot be repealed.

Good times breed bad, and vice versa. Bear that in mind. It provides context for today's turmoil and recriminations. The recent astounding events -- the government's takeover of Fannie Mae and Freddie Mac, the Treasury's investments in private banks, the stock market's wild swings -- have thrust us into fierce debate. Has enough been done to protect the economy? Who or what caused this mess?

We Americans want instant solutions to problems. We crave a world of crisp moral certitudes, when the real world is awash with murky ambiguities. So it is now. Start with the immediate question: Has enough been done? Well, enough for what? If the goal is to prevent a calamitous collapse of bank lending, the answer is probably "yes."

Last week, the government guaranteed most interbank loans (loans among banks) and pressured nine major banks to accept \$125 billion of added capital from the Treasury. Together, these steps make it easier for banks to borrow and lend. There's less need to hoard cash. But if the goal is to inoculate us against recession and more financial turmoil, the answer is "no."

We're probably already in recession. In September, retail sales dropped 1.2 percent. The housing collapse, higher oil prices (now receding), job losses and sagging stocks have battered confidence. Consumer spending may have dropped in the third quarter for the first time since 1991. Loans are harder to get, because lax lending standards have been tightened. Unemployment, now 6.1 percent, may reach 7.5 percent or higher by year-end 2009.

Similar qualifications apply to financial perils. "The United States has an enormous financial system outside the banks," says economist Raghuram Rajan of the University of Chicago. Consider hedge funds. They manage perhaps \$2 trillion and rely heavily on borrowed money. They've suffered heavy redemptions (\$43 billion in September, reports the Financial Times). Selling pressures could destabilize the markets. There's also a global spillover. Brazil's market has lost about half its value since the spring.

In this fluid situation, one thing is predictable: The crisis will produce a cottage industry of academics, journalists, pundits, politicians and bloggers to assess blame. Is former Fed Chairman Alan Greenspan

responsible for holding interest rates too low and for not imposing tougher regulations on mortgage lending? Would Clinton Treasury Secretary Robert Rubin have spotted the crisis sooner? Did Republican free-market ideologues leave greedy Wall Street types too unregulated?

Some stories are make-believe. After leaving government, Rubin landed at Citigroup as a top executive. He failed to identify toxic mortgage securities as a big problem in the bank's own portfolio. It's implausible to think he'd have done so in Washington. As recent investigative stories in The New York Times and The Washington Post show, the Clinton administration broadly supported the financial deregulation that Democrats are now so loudly denouncing.

Greenspan is a harder case. His resistance to tougher regulation of mortgage lending is legitimately criticized, but the story of his low-interest-rate policies is more complicated. True, the overnight fed funds rate dropped to 1 percent in 2003 to offset the effects of the burst tech bubble and 9/11. Still, the Fed started raising rates in mid-2004. Unfortunately and surprisingly, long-term interest rates on mortgages (which are set by the market) didn't follow. That undercut the Fed and is often attributed to a surge of cheap capital from China and other Asian countries.

There's a broader lesson. When things go well, everyone wants to get on the bandwagon. Skeptics are regarded as fools. It's hard for government -- or anyone -- to say: "Whoa, cowboys; this won't last."

As the housing boom strengthened, existing home prices rose 50 percent from 2000 to 2006. Investment bankers packaged dubious loans in opaque securities. To their eventual regret, bankers kept many bad loans. Almost everyone assumed that home prices would rise forever, so risks were minimal. Congress allowed Fannie and Freddie to operate with meager capital. Congress also increased the share of their mortgages that had to go to low- and moderate-income buyers, from 40 percent in 1996 to 52 percent in 2005. This promoted subprime mortgage lending.

So Grant's thesis is confirmed. We go through cycles of self-delusion, sometimes too giddy and sometimes too glum. The only consolation is that the genesis of the next recovery usually lies in the ruins of the last recession.

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