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OP-ED CONTRIBUTOR

The Fed's Subprime Solution

By JAMES GRANT

THE subprime mortgage crisis of 2007 is, in fact, a credit crisis — a worldwide disruption in lending and borrowing. It is only the latest in a long succession of such disturbances. Who's to blame? The human race, first and foremost. Well-intended public policy, second. And Wall Street, third — if only for taking what generations of policy makers have so unwisely handed it.

Possibly, one lender and one borrower could do business together without harm to themselves or to the economy around them. But masses of lenders and borrowers invariably seem to come to grief, as they have today — not only in mortgages but also in a variety of other debt instruments. First, they overdo it until the signs of excess become too obvious to ignore. Then, with contrite and fearful hearts, they proceed to underdo it. Such is the “credit cycle,” the eternal migration of lenders and borrowers between the extreme points of accommodation and stringency.

Significantly, such cycles have occurred in every institutional, monetary and regulatory setting. No need for a central bank, or for newfangled mortgage securities, or for the proliferation of hedge funds to foment a panic — there have been plenty of dislocations without any of the modern-day improvements.

Late in the 1880s, long before the institution of the Federal Reserve, Eastern savers and Western borrowers teamed up to inflate the value of cropland in the Great Plains. Gimmicky mortgages — pay interest and only interest for the first two years! — and loose talk of a new era in rainfall beguiled the borrowers. High yields on Western mortgages enticed the lenders. But the climate of Kansas and Nebraska reverted to parched, and the drought-stricken debtors trudged back East or to the West Coast in wagons emblazoned, “In God we trusted, in Kansas we busted.” To the creditors went the farms.

Every crackup is the same, yet every one is different. Today's troubles are unusual not because the losses have been felt so far from the corner of Broad and Wall, or because our lenders are unprecedentedly reckless. The panics of the second half of the 19th century were trans-Atlantic affairs, while the debt abuses of the 1920s anticipated the most dubious lending practices of 2006. Our crisis will go down in history for different reasons.

One is the sheer size of the debt in which people have belatedly lost faith. The issuance of one kind of mortgage-backed structure — collateralized debt obligations — alone runs to \$1 trillion. The shocking fragility of recently issued debt is another singular feature of the 2007 downturn — alarming numbers of defaults despite high employment and reasonably strong economic growth. Hundreds of billions of dollars of mortgage-backed securities would, by now, have had to be recalled if Wall Street did business as Detroit does.

Benjamin Graham and David L. Dodd, in the 1940 edition of their seminal volume “Security Analysis,” held that the acid test of a bond or a mortgage issuer is its ability to discharge its financial obligations “under conditions of depression rather than prosperity.” Today’s mortgage market can’t seem to weather prosperity.

A third remarkable aspect of the summer’s troubles is the speed with which the world’s central banks have felt it necessary to intervene. Bear in mind that when the Federal Reserve cut its discount rate on Aug. 17 — a move intended to restore confidence and restart the machinery of lending and borrowing — the Dow Jones industrial average had fallen just 8.25 percent from its record high. The Fed has so far refused to reduce the federal funds rate, the main interest rate it fixes, but it has all but begged the banks to avail themselves of the dollars they need through the slightly unconventional means of borrowing at the discount window — that is, from the Fed itself.

What could account for the weakness of our credit markets? Why does the Fed feel the need to intervene at the drop of a market? The reasons have to do with an idea set firmly in place in the 1930s and expanded at every crisis up to the present. This is the notion that, while the risks inherent in the business of lending and borrowing should be finally borne by the public, the profits of that line of work should mainly accrue to the lenders and borrowers.

It has not been lost on our Wall Street titans that the government is the reliable first responder to scenes of financial distress, or that there will always be enough paper dollars to go around to assist the very largest financial institutions. In the aftermath of the failure of Long-Term Capital Management, the genius-directed hedge fund that came a cropper in 1998, the Fed — under Alan Greenspan — delivered three quick reductions in the federal funds rate. Thus fortified, lenders and borrowers, speculators and investors, resumed their manic buying of technology stocks. That bubble burst in March 2000.

Understandably, it’s only the selling kind of panic to which the government dispatches its rescue apparatus. Few object to riots on the upside. But bull markets, too, go to extremes. People get carried away, prices go too high and economic resources go where they shouldn’t. Bear markets are nature’s way of returning to the rule of reason.

But the regulatory history of the past decade is the story of governmental encroachment on the bears' habitat. Under Mr. Greenspan, the Fed set its face against falling prices everywhere. As it intervened to save the financial markets in 1998, so it printed money in 2002 and 2003 to rescue the economy. From what? From the peril of everyday lower prices — “deflation,” the economists styled it. In this mission, at least, the Fed succeeded. Prices, especially housing prices, soared. Knowing that the Fed would do its best to engineer rising prices, people responded rationally. They borrowed lots of money at the Fed's ultralow interest rates.

Now comes the bill for that binge and, with it, cries for even greater federal oversight and protection. Ben S. Bernanke, Mr. Greenspan's successor at the Fed (and his loyal supporter during the antideflation hysteria), is said to be resisting the demand for broadly lower interest rates. Maybe he is seeing the light that capitalism without financial failure is not capitalism at all, but a kind of socialism for the rich.

In any case, to all of us, rich and poor alike, the Fed owes a pledge that it will do what it can and not do what it can't. High on the list of things that no human agency can, or should, attempt is manipulating prices to achieve a more stable and prosperous economy. Jiggling its interest rate, the Fed can impose the appearance of stability today, but only at the cost of instability tomorrow. By the looks of things, tomorrow is upon us already.

A century ago, on the eve of the Panic of 1907, the president of the National City Bank of New York, James Stillman, prepared for the troubles he saw coming. “If by able and judicious management,” he briefed his staff, “we have money to help our dealers when trust companies have [failed], we will have all the business we want for many years.” The panic came and his bank, today called Citigroup, emerged more profitable than ever.

Last month, Stillman's corporate descendant, Chuck Prince, chief executive of Citigroup, dismissed fears about an early end to the postmillennial debt frolics. “When the music stops,” he told *The Financial Times*, “in terms of liquidity, things will get complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.”

What a difference a century makes.

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