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The Unintended Consequences of Government Intrusion into the Economy

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Abstract

The government's intrusion into the private sector to save companies and stimulate the economy during hard times has played a major role in causing the next set of problems for the economy. Many think that the bank failures of 2008 were fueled by government actions beginning in 2001 when the Federal Reserve Bank began printing money as well as slashing its main interest rate to combat an economic slowdown resulting from the tech bubble popping. The Fed's intervention produced the housing bubble crash of 2008. The government responded to the housing crash by bailing out many of the failing institutions using taxpayer money. It also created a Quantitative Easing (QE) program to keep banks solvent and stimulate the economy through the Fed printing up trillions of dollars and buying treasury bonds and mortgage backed securities with it. This created liquidity for banks and reduced interest rates to near zero. The low rates and liquidity provided by the QE program have fueled a stock market bubble that may pop and cause numerous dislocations in the population that may surpass the Great Depression in severity. It appears that in this century when the government steps in to save companies and help revive the economy it ends up costing the tax-payers money and creates an environment to facilitate the next economic disaster.

Key words: bubble, Quantitative Easing, Federal Reserve Bank, bail out

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INTRODUCTION

Government intervention into the private sector to save favored companies and to stimulate the economy during down economic times has unintended consequences that result in causing more harm than good. A glaring example of it was the 2008 bail out from the real estate crash. The crash in 2008 was actually fueled by government actions that began in 2001 (1). Most of the borrowing from the money expansion from 2001 through 2005 went to individuals to buy homes. And with the quasi-government agencies, Fannie Mae and Freddie Mac, buying mortgage loans from banks and requiring no creditworthy standards, the real estate market collapsed. The government bailed out banks, investment banks and insurance companies with taxpayer money and then intervened at the end of 2008, with the initiation of the Quantitative Easing (QE) program that provided liquidity to the banking system to keep banks solvent and interest rates low. The liquidity, instead of being lent out, has stayed in banks as excess reserves and is used as margin money for intra-day trading by speculators to bid up stock prices. In addition, the very low savings rate produced through the QE program has forced risk-averse savers into the equity market in an attempt to receive reasonable investment returns and has encouraged firms to borrow and buy back their company stock. These reactions to government intervention in the economy have produced a stock market bubble that may pop and have devastating consequences.

BAIL OUT 2008

The rationale for the financial institutions bail out in 2008 promoted by government officials was that these institutions were too big to fail. Ironically many think that the bank failures were the result of government actions that began in 2001 as a reaction to the tech bubble bursting and the shock of the September 11th terrorist attacks. It was at that point that the Federal Reserve started printing money and slashed its main interest rate, the Federal Funds rate, to try to combat an economic slowdown. The rate plunged from 3.5 percent in August 2001 to one percent by the middle of 2003 and has stayed very low ever since. Never before in history have short-term rates been this low this long.

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During the time frame from 2001 to 2005 most of the borrowing from the money expansion went to individual families for mortgage loans. This happened for several reasons. For one, interest rates were low and attracted borrowers. Second, there was a movement by the government to encourage more families to own homes in the US so standards were lowered or eliminated on many mortgage loans. This was aided through two quasi-government agencies, Freddie Mac and Fannie Mae. These organizations were originally created to facilitate borrowing and lending by purchasing quality loans from banks. With government officials pushing for more home ownership by families, Fannie Mae and Freddie Mac began buying the loans from banks with no regard for the mortgagee's creditworthiness. And, third, there was a large market for residential loans because investment banks were profiting by packaging the home loans into mortgage backed securities (MBS) and selling them to the public. The rating agencies also played ball by giving nearly all mortgage backed securities ratings of AAA ratings even though many of the loans contained in the securities were of poor quality.

There was an even bigger market for an instrument called a credit default swap. A credit default swap is a type of contract that offers a guarantee against the non-payment of loans contained in mortgage backed securities. Investment banks and insurance companies sold these swaps and collected premiums from the buyer as long as the securities didn't default, but they were obligated to pay the face of the mortgage backed security if the loans inside the security defaulted. A path to disaster developed as investment banking firms wrote credit default swaps for 20 times the face value of the MBS in circulation. Then when the inevitable happened and defaults on loans exploded, several financial institutions were put in a position of having to pay off on the billions of dollars of credit default swaps they had written. It was then the federal government came to the rescue. The government enacted law, facilitated buyouts for investment banking firms, saved the Fannie and Freddie, and bailed out AIG. This was all at the expense of the taxpayer.

The investment bank, Bear Stearns, received a bailout deal after being unable to pay for the money owed on the billions of dollars of credit default swaps they had sold. On April of 2008, Bear was rescued by the U.S. government, through the Federal Reserve Bank of New York that lent $29 billion to JP Morgan Chase to buy the financially troubled firm. A few months later in the late summer of 2008, the federal government seized control of Fannie Mae and Freddie Mac and guaranteed $100 billion in cash credits to each of them to prevent their bankruptcies.

In September 2008, the U.S. government saved American International Group (AIG), one of the world's largest insurance companies, from failing. AIG had also written billions of dollars of credit default swaps on sub-prime mortgage securities and could not fund the payoff on them. Private lenders had declined to loan money to the financially troubled firm. This prompted the federal government to protect AIG and agreed to loan the insurance firm up to $85 billion.

On the other hand, government regulators chose not to bail out Lehman Brothers after the Bank of America abandoned an attempt to buy Lehman early in the crisis. This resulted in Lehman Brothers being forced into a Chapter 11 bankruptcy filing. It initially looked very grim for Lehman, but it actually enabled Barclays to buy the attractive parts of Lehman while leaving behind the toxic parts. This was the one instance during the crisis that capitalism was allowed to function without government interference and it produced an efficient outcome that cost taxpayers nothing.

The government also enacted a bill to buy bad loans from banks which of course was funded by taxpayers. It was officially called the Emergency Economic Stabilization Act of 2008 and it surpassed any previous government bailout. The legislation authorized the US Treasury to buy risky and nonperforming debt from various lending institutions. These debts included mortgages, auto loans, and college loans.

QUANTITATIVE EASING

In addition to bailouts the Federal Reserve Bank used three rounds of Quantitative Easing (QE) to try to revive a sluggish economy by buying treasury bonds and mortgage backed securities. This action, which began in late 2008, infused cash into the system in an effort to counter deflationary pressures. A major reason the Federal Reserve Chair, Ben Bernanke, employed such a strategy was from his understanding of the Great Depression. It appeared to him that the US was heading for the same deflationary cycle in 2008-2009.

Bernanke's thinking was in line with the work done by Nicolai Kondratiev on deflationary cycles. His analysis produced the Krondratiev Wave that modeled repeating cycles throughout history. The K Wave, according to Kondratiev, is a cycle that lasts 60-80 years and has internal phases that are referred to as seasons. The Spring season is characterized by good economic times and rising inflation. The Summer season occurs when the economy is saddled with double digit inflation while Autumn has falling inflation and a credit boom that creates a false prosperity, resulting in speculative financial bubbles. The Winter season is a deflationary time as enormous amounts of debt are liquidated and asset prices are severely reduced.(2) The Great Depression in the 1930s was the last winter season in the US and Bernanke and others thought the next winter season was eminent in 2008-2009 as the economy and stock market were crashing. Bernanke said he was willing to drop cash out of helicopters to stave off the deflationary pressures. Drop cash he did.

The first round of quantitative easing, now called QE 1, was initiated in November 2008. The Fed bought $100 billion of government agency debt and $500 billion of mortgage backed securities (MBS). And then QE 1was extended by printing up another $850 billion to purchase MBS as well as buying another $300 billion of longer maturity treasury bonds. In November 2010, the Fed announced QE 2 that involved buying $600 billion worth of treasuries securities. Then in September 2012, the Fed rolled out QE 3 and by December 2013, it began tapering by reducing the $85 billion spent per month by $10 billion. Finally, in October 2014 the Fed ended QE 3 program (3).

In all the Federal Reserve Bank spent almost $3.5 trillion on treasury securities and mortgage-back securities during the quantitative easing period. In 2007 before QE 1 began the Fed's balance sheet contained only $750 billion in assets but the balance sheet grew to over $4.2 trillion by October 2014.

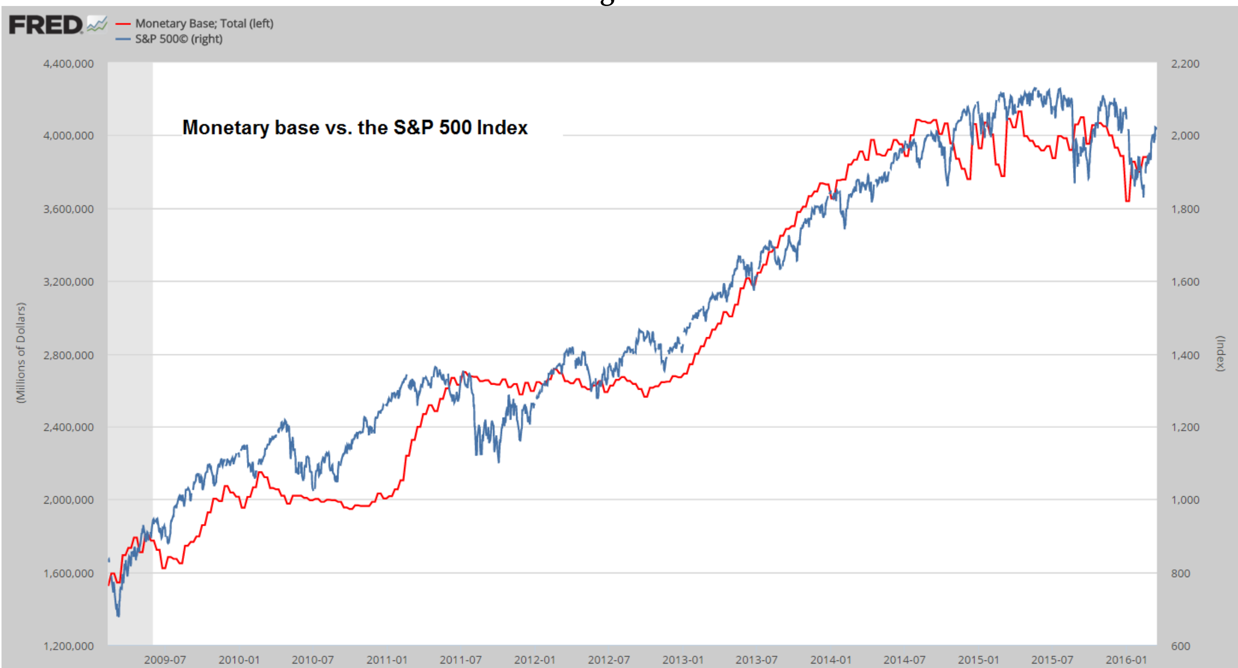
The QE program was designed to provide liquidity to banks that could be loaned to businesses and individuals to stimulate the economic. Or at least keep the economy and stock market afloat until the economy hits "escape velocity." The program may have delayed the US from a depression but the economy has shown tepid growth since the program began with the GDP averaging just slightly over two percent growth per year since 2009.

Surprising, even with the enormous infusion of cash by the Federal Reserve into the economic system the United States is not experiencing excessive inflation since it appears to be offset by deflationary pressures from debt liquidation and lower commodity prices, according to cycle expert Mike Maloney. The liquidity provided by the QE program has ended up in banks as excess reserves (cash in the bank not required to support loans). These excess reserves are being put to use, however, during the day as margin money, allowing traders to use funds priced at a zero interest rate to buy stocks. This activity along with companies borrowing money at near zero interest and buying their own stock and individual forced into the market to find reasonable rates of return on their savings has produced inflated prices for financial assets.(4)

STOCK MARKET BUBBLE

Figure 1 shows the movement of the stock market with the growth in base money in the US. Base money is defined as currency in circulation and excess reserves of banks. There appears to be a very close correlation between money creation and the movement of the stock market, indicating that the inflated price of stock market may be just a fabricated bubble. A view of the price to earnings ratio for stocks over time provides more evidence.

Figure 1



Economics Professor, Robert Shiller of Yale University, developed a stock price per share to earnings per share ratio (called the Shiller PE) to measure the stock market's valuation by using a 10 year average of earnings adjusted for inflation. The average Shiller PE ratio for stocks over time is 16.6 and is generally considered in bubble territory when the ratio is over 20 and undervalued when below10. The ratio has been over 28 in 2016 but has yet to return to undervalued territory which may indicate that the stock market is very overpriced and may crash to a much lower area, according to economist Harry Dent. He thinks the liquidity in the economic system is causing a bubble in asset prices and he points to history showing that bubbles always pop (5).

CONCLUSION

The United States Government's intrusion to save companies and stimulate the economy during downturns has played a major role in causing the next set of problems for the economy. Many think that the bank failures of 2008 were fueled by government actions which began in 2001 as a reaction to the tech bubble bursting and the shock of the September 11th terrorist attacks. It was then that the Federal Reserve started printing money and slashed the Federal Funds rate to try to combat an economic slowdown. During the time frame from 2001 to 2005 most of the borrowing from the money expansion went to individual families for mortgage loans because of low rates and the government's promotion of family home ownership. Fannie Mae and Freddie Mac help facilitate family home ownership by dropping all credit worthiness standards on the loans they purchased from banks.

Then after the real estate market collapsed in 2008, the government intruded into the market place again. This time to save banks and other institutions and, in addition, used Quantitative Easing in an attempt to stimulate the economy and keep the stock market afloat until reaching escape velocity. Saving the banks and other organizations have cost the taxpayers billions of dollars. And the intervention of the government in the economy through QE has disrupted the natural cycle of capitalism. According to the Kondratiev Wave the economy is due for a deflationary cycle and that will reset prices at lower levels. The reset will give our younger generation the opportunity to afford to buy homes, start businesses at reasonable prices and set US wages low enough to compete for manufacturing jobs that are now overseas. The effort by the government to keep markets elevated with zero interest rates and by printing money has created a bubble in financial assets and when it pops it may surpass the Great Depression in severity.

It appears that in this century when the government steps in to save companies and help revive the economy it ends up costing the tax-payers money and creates an environment to fuel the next economic disaster.

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