

ISSUES IN PERSPECTIVE

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PERSPECTIVE NUMBER ONE

THE FINANCIAL CRISIS IN AMERICA

As everyone now well knows, the United States is facing its greatest financial crisis since the Great Depression of the 1930s. In terms of the global nature of its implications, it is perhaps worse. In this *Perspective*, I hope to place it in historical perspective, give an overview of the crisis and close with some thoughts about how American capitalism will be fundamentally changed by the crisis.

- First, a broad overview of the crisis. The United States is in the midst of its most serious banking crisis in 70 years, stirring terrible memories of panics, bank failures, bankruptcies and mass unemployment. First Bear Stearns was rescued by the federal government. Then the national government took over Fannie Mae and Freddie Mac, the two largest US mortgage providers, holding over \$5 trillion in mortgage debt. Now it has rescued Lehman Brothers and last weekend announced the creation of a trust to buy up the “bad debt” of finance companies and banks. The estimated total of that last action alone exceeds \$700 billion. The amount of money involved in all these transactions is absolutely staggering and, quite frankly, unimaginable. It makes peanuts out of the rescue of Chrysler in the 1980s (\$1.2 billion) and other actions since then by the US government. The analysis of how we as a nation got into this mess will be ongoing, but there are a few things we do know with some certainty:
 1. The facts are that financial firms (e.g., Lehman Brothers, Merrill Lynch, Bear Stearns, Goldman Sachs, etc.) fundamentally changed how they did business in the 1990s and into the early 21st century. Historically, they were financial advisers and intermediaries, working mainly for their clients. They traded stocks and bonds for major institutional investors (e.g., insurance companies, pension funds, natural funds, etc.). They also helped raise capital for corporations by selling new stocks and bonds. Of course, they also provided advice and counsel for their clients on mergers, acquisitions and other financial transactions. And they were paid fees for this counsel. But recently, these firms began to invest for themselves. They used partners’ or shareholders’ money to place “bets” on stocks, bonds and other securities (what Robert Samuelson refers to as “principal transactions”). Many ventured into investment banking. The result is that these historic financial firms were significantly exposed when it came to the cycles of the economy. As long as the economy was expanding, their exposure was protected, so to speak. However, when the housing industry began its radical decline, that exposure became potentially lethal.
 2. These financial firms changed the method of compensation. The annual bonus became central and reflected the profits traders and managers earned for that year. Not only were

salaries lavish, but bonuses began to drive the industry. Some managers with only 10 to 15 years experience could earn bonuses 5 to 10 times their annual salary.

3. Perhaps most seriously, the investment banks began to rely heavily on borrowed money (called “leverage”). Listen to Samuelson’s example: “Lehman [Brothers] was typical. In late 2007, it held almost \$700 billion in stocks, bonds and other securities. Meanwhile, its shareholders’ investment (equity) was about \$23 billion. All the rest was supported by borrowings. The ‘leverage ratio’ was 30 to 1. Leverage can create huge windfalls. Suppose you buy stock for \$100. It goes to \$110. You made 10 percent, a decent return. Now suppose you borrowed \$90 of the \$100. If the price rises to \$101, you’ve made 10 percent on your \$10 investment. . . If it goes to \$110, you’ve doubled your money. Wow.” The problem of course is that this “Leverage” method created a maniacal passion for nothing less than gambling. Traders and money managers had huge incentives, therefore, to do whatever they could to increase short-term profits. Samuelson writes that “dubious mortgages were packaged into bonds, sold and traded. Investment houses had huge incentives to increase leverage. While the boom continued, government remain aloof. Congress resisted tougher regulation for Fannie and Freddie and permitted them to run leverage ratios that, by plausible calculations, exceeded 60 to 1.” The short-term profits blinded these bright people from consideration of the long-term risks. As mortgages began to go bad, the powerful logic of high leverage went into reverse. Losses eroded firms’ tiny capital bases, raising doubts about their survival. This year, Lehman, for example, lost \$8 billion in “principal transactions.” The downward spiral has begun and its effects are still unknown. Will the government’s plans stop the spiral downward? Will those plans still the sense of fear and panic that was evident only last week throughout the world’s financial community? Will there be significant unemployment because of this financial collapse? Will there be more failures of financial firms and commercial banks? Will the lending pipeline of regular banks dry up and thereby stifle recovery? None of these questions can be answered with certainty. In one very real sense, the US government had little choice to do what it did over the last two weeks. Whether these actions will stabilize the situation remains an unknown.

- Second, a comment about the three most powerful men in America right now—Treasury Secretary Henry M. Paulson, Jr., Federal Reserve Chairman Ben S. Bernanke and Timothy F. Geitner, president of the Federal Reserve Bank of New York. These three men are collaborating to tame the economic downturn and orchestrate the restructuring of Wall Street while avoiding an economic catastrophe. If they do not succeed, the toll in terms of unemployment, trillions of dollars of lost wealth and a critical crisis of confidence within global capitalism will result. In a sense, these men are running the “war room” when it comes to the economy. It is not President Bush or the Congress that make the decisions. These three men are negotiating among themselves, setting the strategic direction and consulting together to effect the most fundamental restructuring of the financial markets in history. There is probably no other mechanism that is possible in this crisis, but the fate of the US economy in effect rests in the hands of these three men.
- Third, American capitalism (indeed global capitalism) will be forever changed because of this crisis. Gone is the idea that government’s role is merely to get out of the way and let the free markets reign. Gone is the idea that the federal government sets the rules of the financial game, steps back and only intervenes to cushion the economy from shocks. Consider what the US government, the keeper of the flame of free markets and private enterprise, has done:

1. It nationalized the two engines of the US mortgage industry—Fannie Mae and Freddie Mac—and flooded the mortgage market with taxpayer funds to keep it going.
2. It crafted a deal to seize the nation's largest insurer, American International Group, fired its CEO and moved to sell off its pieces.
3. It banned, for 799 financial stocks, a practice at the heart of stock trading, the short-selling in which investors seek to profit from falling stock prices.
4. It allowed or encouraged the collapse of two of the four remaining banks—Lehman Brothers and Merrill Lynch.
5. It asked Congress by the end of the week of 22 September, to agree to assume control of illiquid assets from financial institutions so those institutions can raise capital and resume lending. The price tag is a staggering \$700 billion.

There is little question that the US government must craft regulatory legislation in the very near future to protect the economy from the string of bad decisions that brought on this crisis. Investment banks, mortgage companies and even insurance companies will come under much more severe regulation by the US government. American capitalism will never be the same!

- Fourth, the US government has acted before in dealing with serious financial crises. Consider these:
 1. The Panic of 1792: The US government assumed the debts of the states from the Revolutionary War. When the US government floated bonds to do this, speculators swarmed to buy them and the speculative bubble burst. Treasury Secretary Alexander Hamilton borrowed money from the banks to buy the troubled bonds, boosting the market price.
 2. The Panic of 1907: Amid a run on the banks and trusts which had made loans for a failed attempt to corner the market on copper stock, confidence in all financial institutions was threatened. Therefore, banking magnate JP Morgan organized other bankers to form a joint pool of capital to pay depositors at banks under duress. It worked.
 3. The Great Depression: The US government formed the Home Owners' Loan Corporation to buy defaulted mortgages from banks and refinancing them for fixed, 15-year mortgages. About 1 million Americans were affected.
 4. The Savings and Loan Crisis: From 1986 to 1995, about half of the nations Savings and Loan institutions (3234) folded. The US government then created the Resolution Trust Corporation to take over failed properties and clean up the industry. The cost was \$124 billion.

Despite these actions by the US government throughout US history, there has never been anything like what the US government is currently doing. American capitalism is fundamentally changing—and no one really knows the degree to which this change will prevent another crisis from occurring. We are entering a new era of federal activism and control over the US economy. But as David Brooks argues: “. . . this supposed new era of federal activism is going to confront the same old problems: the lack of information available to government planners, the inability to keep up with or control complex economic systems, the fact that political considerations invariably distort the best laid plans.” There is a huge difference between dreaming of an ideal regulatory regime and actually putting one in place. The US government must somehow police that fine line between the necessary risk-taking that drives an innovation economy and crazy

gambling with other peoples' savings in ways that threaten us all. That will take the wisdom of God to effect. The job of the current government is to somehow restore confidence and trust to the markets and to the financial institutions. If it cannot do that, there is little hope a crisis of catastrophic proportions can be averted.

See Thomas Friedman in the *New York Times* (17 September 2008); Robert Samuelson in the *Washington Post* (17 September and 22 September 2008); David Brooks in the *New York Times* (19 September 2008); Michael M. Phillips in the *Wall Street Journal* (20-21 September 2008); *Wall Street Journal* news article on the restructuring of US capitalism (20-21 September 2008); and David Cho and Neil Irwin in the *Washington Post* (19 September 2008).

PERSPECTIVE NUMBER TWO

ATHEISM AND IRRATIONAL SILLINESS

A comprehensive new study entitled “What Americans Really Believe” was recently released by Baylor University. It challenges to the core the conviction that the new atheism will lead to a smarter, more scientifically literate and civilized populace in America. In the words of Mollie Ziegler Hemingway, who has summarized the report, “[the study] shows that traditional Christian religion greatly decreases belief in everything from the efficacy of palm readers to the usefulness of astrology. It also shows that the irreligious and the members of more liberal Protestant denominations, far from being resistant to superstition, tend to be much more likely to believe in the paranormal and in pseudoscience than evangelical Christians.” The Gallup Organization, under contract to Baylor’s Institute for Studies of Religion, asked American adults a series of questions: Do dreams foretell the future? Did ancient advanced civilizations such as Atlantis exist? Can places be haunted? Is it possible to communicate with the dead? Will creatures like Bigfoot and the Loch Ness Monster someday be discovered by science? The answers were added up to create an index of belief in occult and the paranormal. While 31% of people who never worship expressed strong belief in these things, only 8% of people who attend a house of worship more than once a week did.

Furthermore, Hemingway reports, “. . . while increased church attendance and membership in a conservative denomination has a powerful negative effect on paranormal beliefs, higher education doesn’t. Two years ago two professors published another study in *Skeptical Inquirer* showing that, while less than one-quarter of college freshman surveyed expressed a general belief in such superstitions as ghosts, psychic healing, haunted houses, demonic possession, clairvoyance and witches, the figure jumped to 31% for college seniors and 34% for graduate students.” GK Chesterton once wrote that “It’s the first effect of not believing in God that you lose your common sense, and can’t see things as they are.” The recent Gallup study for Baylor validates that very point. Perhaps the new atheism evident in the best seller lists of this past spring and summer will foster a whole new interest in the paranormal and the superstitious—and that is sad and tragic. It is also a mark of foolishness. For that reason the Bible (Psalm 53:1) declares that “the fool has said in his heart that there is no God.”

See Hemingway’s summary of the Gallup and Baylor study in the *Wall Street Journal* (19 September 2008).