

By George Friedman

Classical economists like Adam Smith and David Ricardo referred to their discipline as "political economy." Smith's great work, "The Wealth of Nations," was written by the man who held the chair in moral philosophy at the University of Glasgow. This did not seem odd at the time and is not odd now. Economics is not a freestanding discipline, regardless of how it is regarded today. It is a discipline that can only be understood when linked to politics, since the wealth of a nation rests on both these foundations, and it can best be understood by someone who approaches it from a moral standpoint, since economics makes significant assumptions about both human nature and proper behavior.

The modern penchant to regard economics as a discrete science parallels the belief that economics is a distinct sphere of existence — at its best when it is divorced from political and even moral considerations. Our view has always been that the economy can only be understood and forecast in the context of politics, and that the desire to separate the two derives from a moral teaching that Smith would not embrace. Smith understood that the word "economy" without the adjective "political" did not describe reality. We need to bear Smith in mind when we try to understand the current crisis.

Societies have two sorts of financial crises. The first sort is so large it overwhelms a society's ability to overcome it, and the society sinks deeper into dysfunction and poverty. In the second sort, the society has the resources to manage the situation — albeit at a collective price. Societies that can manage the crisis have two broad strategies. The first strategy is to allow the market to solve the problem over time. The second strategy is to have the state organize the resources of society to speed up the resolution. The market solution is more efficient over time, producing better outcomes and disciplining financial decision-making in the long run. But the market solution can create massive collateral damage, such as high unemployment, on the way to the superior resolution. The state-organized resolution creates inequities by not sufficiently punishing poor economic decisions, and creates long-term inefficiencies that are costly. But it has the virtue of being quicker and mitigating collateral damage.

Three views of the financial crisis

There is a first group that argues the current financial crisis already has outstripped available social resources, so that there is no market or state solution. This group asserts that the imbalances created in the financial markets are so vast that the market solution must consist of an extended period of depression. Any attempt by the state to appropriate social resources to solve the financial imbalance not only will be ineffective, it will prolong the crisis even further, although perhaps buying some minor alleviation up front. The thinking goes that the financial crisis has been building for years and the economy can no longer be protected from it, and that therefore an extended period of discipline and austerity — beginning with severe economic dislocations — is inevitable. This is not a majority view, but it is widespread; it opposes

government action on the grounds that the government will make a terrible situation worse.

A second group argues that the financial crisis has not outstripped the ability of society — organized by the state — to manage, but that it has outstripped the market's ability to manage it. The financial markets have been the problem, according to this view, and have created a massive liquidity crisis. The economy — as distinct from the financial markets — is relatively sound, but if the liquidity crisis is left unsolved, it will begin to affect the economy as a whole. Since the financial markets are unable to solve the problem in a time frame that will not dramatically affect the economy, the state must mobilize resources to impose a solution on the financial markets, introducing liquidity as the preface to any further solutions. This group believes, like the first group, that the financial crisis could have profound economic ramifications. But the second group also believes it is possible to contain the consequences. This is the view of the Bush administration, the congressional leadership, the Federal Reserve Board and most economic leaders.

There is a third group that argues that the state mobilization of resources to save the financial system is in fact an attempt to save financial institutions, including many of those whose imprudence and avarice caused the current crisis. This group divides in two. The first subgroup agrees the current financial crisis could have profound economic consequences, but believes a solution exists that would bring liquidity to the financial markets without rescuing the culpable. The second subgroup argues that the threat to the economic system is overblown, and that the financial crisis will correct itself without major state intervention but with some limited implementation of new regulations.

The first group thus views the situation as beyond salvation, and certainly rejects any political solution as incapable of addressing the issues from the standpoint of magnitude or competence. This group is out of the political game by its own rules, since for it the situation is beyond the ability of politics to make a difference — except perhaps to make the situation worse.

The second group represents the establishment consensus, which is that the markets cannot solve the problem but the federal government can — provided it acts quickly and decisively enough.

The third group spoke Sept. 29, when a coalition of Democrats and Republicans defeated the establishment proposal. For a myriad of reasons, some contradictory, this group opposed the bailout. The reasons ranged from moral outrage at protecting the interests of the perpetrators of this crisis to distrust of a plan implemented by this presidential administration, from distrust of the amount of power ceded the Treasury Department of any administration to a feeling the problem could be managed. It was a diverse group that focused on one premise — namely, that delay would not lead to economic catastrophe.

From economic to political problem

The problem ceased to be an economic problem months ago. More precisely, the economic problem has transformed into a political problem. Ever since the collapse of Bear Stearns, the

primary actor in the drama has been the federal government and the Federal Reserve, with its powers increasing as the nature of potential market outcomes became more and more unsettling. At a certain point, the size of the problem outstripped the legislated resources of the Treasury and the Fed, so they went to Congress for more power and money. This time, they were blocked.

It is useful to reflect on the nature of the crisis. It is a tale that can be as complicated as you wish to make it, but it is in essence simple and elegant. As interest rates declined in recent years, investors — particularly conservative ones — sought to increase their return without giving up safety and liquidity. They wanted something for nothing, and the market obliged. They were given instruments ultimately based on mortgages on private homes. They therefore had a very real asset base — a house — and therefore had collateral. The value of homes historically had risen, and therefore the value of the assets appeared secured. Financial instruments of increasing complexity eventually were devised, which were bought by conservative investors. In due course, these instruments were bought by less conservative investors, who used them as collateral for borrowing money. They used this money to buy other instruments in a pyramiding scheme that rested on one premise: the existence of houses whose value remained stable or grew.

Unfortunately, housing prices declined. A period of uncertainty about the value of the paper based on home mortgages followed. People claimed to be confused as to what the real value of the paper was. In fact, they were not so much confused as deceptive. They didn't want to reveal that the value of the paper had declined dramatically. At a certain point, the facts could no longer be hidden, and vast amounts of value evaporated — taking with them not only the vast pyramids of those who first created the instruments and then borrowed heavily against them, but also the more conservative investors trying to put their money in a secure space while squeezing out a few extra points of interest. The decline in housing prices triggered massive losses of money in the financial markets, as well as reluctance to lend based on uncertainty of values. The result was a liquidity crisis, which simply meant that a lot of people had gone broke and that those who still had money weren't lending it — certainly not to financial institutions.

The S&L precedent

Such financial meltdowns based on shifts in real estate prices are not new. In the 1970s, regulations on savings and loans (S&Ls) had changed. Previously, S&Ls had been limited to lending in the consumer market, primarily in mortgages for homes. But the regulations shifted, and they became allowed to invest more broadly. The assets of these small banks, of which there were thousands, were attractive in that they were a pool of cash available for investment. The S&Ls subsequently went into commercial real estate, sometimes with their old management, sometimes with new management who had bought them, as their depositors no longer held them.

The infusion of money from the S&Ls drove up the price of commercial real estate, which the institutions regarded as stable and conservative investments, not unlike private homes. They did not take into account that their presence in the market was driving up the price of

commercial real estate irrationally, however, or that commercial real estate prices fluctuate dramatically. As commercial real estate values started to fall, the assets of the S&Ls contracted until most failed. An entire sector of the financial system simply imploded, crushing shareholders and threatening a massive liquidity crisis. By the late 1980s, the entire sector had melted down, and in 1989 the federal government intervened.

The federal government intervened in that crisis as it had in several crises large and small since 1929. Using the resources at its disposal, the federal government took over failed S&Ls and their real estate investments, creating the Resolution Trust Corp. (RTC). The amount of assets acquired was about \$394 billion dollars in 1989 — or 6.7 percent of gross domestic product (GDP) — making it larger than the \$700 billion dollars — or 5 percent of GDP — being discussed now. Rather than flooding the markets with foreclosed commercial property, creating havoc in the market and further destroying assets, the RTC held the commercial properties off the market, maintaining their price artificially. They then sold off the foreclosed properties in a multiyear sequence that recovered much of what had been spent acquiring the properties. More important, it prevented the decline in commercial real estate from accelerating and creating liquidity crises throughout the entire economy.

Many of those involved in S&Ls were ruined. Others managed to use the RTC system to recover real estate and to profit. Still others came in from the outside and used the RTC system to build fortunes. The RTC is not something to use as moral lesson for your children. But the RTC managed to prevent the transformation of a financial crisis into an economic meltdown. It disrupted market operations by introducing large amounts of federal money to bring liquidity to the system, then used the ability of the federal government — not shared by individuals — to hold on to properties. The disruption of the market's normal operations was designed to avoid a market outcome. By holding on to the assets, the federal government was able to create an artificial market in real estate, one in which supply was constrained by the government to manage the value of commercial real estate. It did not work perfectly — far from it. But it managed to avoid the most feared outcome, which was a depression.

There have been many other federal interventions in the markets, such as the bailout of Chrysler in the 1970s or the intervention into failed Third World bonds in the 1980s. Political interventions in the American (or global) marketplace are hardly novel. They are used to control the consequences of bad decisions in the marketplace. Though they introduce inefficiencies and frequently reward foolish decisions, they achieve a single end: limiting the economic consequences of these decisions on the economy as a whole. Good idea or not, these interventions are institutionalized in American economic life and culture. The ability of Americans to be shocked at the thought of bailouts is interesting, since they are not all that rare, as judged historically.

The RTC showed the ability of federal resources — using taxpayer dollars — to control financial processes. In the end, the S&L story was simply one of bad decisions resulting in a shortage of dollars. On top of a vast economy, the U.S. government can mobilize large amounts of dollars as needed. It therefore can redefine the market for money. It did so in 1989 during the S&L crisis, and there was a general acceptance it would do so again Sept. 29.

The RTC model and the road ahead

As discussed above, the first group argues the current crisis is so large that it is beyond the federal government's ability to redefine. More precisely, it would argue that the attempt at intervention would unleash other consequences — such as weakening dollars and inflation — meaning the cure would be worse than the disease. That may be the case this time, but it is difficult to see why the consequences of this bailout would be profoundly different from the RTC bailout — namely, a normal recession that would probably happen anyway.

The debate between the political leadership and those opposing its plan is more interesting. The fundamental difference between the RTC and the current bailout was institutional. Congress created a semi-independent agency operating under guidelines to administer the S&L bailout. The proposal that was defeated Sept. 29 would have given the secretary of the Treasury extraordinary personal powers to dispense the money. Some also argued that the return on the federal investment was unclear, whereas in the RTC case it was fairly clear. In the end, all of this turned on the question of urgency. The establishment group argued that time was running out and the financial crisis was about to morph into an economic crisis. Those voting against the proposal argued there was enough time to have a more defined solution.

There was obviously a more direct political dimension to all this. Elections are just more than a month away, and the seat of every U.S. representative is in contest. The public is deeply distrustful of the establishment, and particularly of the idea that the people who caused the crisis might benefit from the bailout. The congressional opponents of the plan needed to demonstrate sensitivity to public opinion. Having done so, if they force a redefinition of the bailout plan, an additional 13 votes can likely be found to pass the measure.

But the key issue is this: Are the resources of the United States sufficient to redefine financial markets in such a way as to manage the outcome of this crisis, or has the crisis become so large that even the resources of a \$14 trillion economy mobilized by the state can't do the job? If the latter is true, then all other discussions are irrelevant. Events will take their course, and nothing can be done. But if that is not true, that means that politics defines the crisis, as it has other crisis. In that case, the federal government can marshal the resources needed to redefine the markets and the key decision-makers are not on Wall Street, but in Washington. Thus, when the chips are down, the state trumps the markets.

All of this may not be desirable, efficient or wise, but as an empirical fact, it is the way American society works and has worked for a long time. We are seeing a case study in it — including the possibility the state will refuse to act, creating an interesting and profound situation. This would allow the market alone to define the outcome of the crisis. This has not been allowed in extreme crises in 75 years, and we suspect this tradition of intervention will not be broken now. The federal government will act in due course, and an institutional resolution taking power from the Treasury and placing it in the equivalent of the RTC will emerge. The question is how much time remains before massive damage is done to the economy.

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