The Big Debate – Markets Win!

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Leon Louw, director of the Free Market Foundation, says anti market ideologues have endured decades of misery, as freer markets out performed less free ones by every objectively measured criterion

Mindless anti market fundamentalism takes many forms: calls for nationalisation, extreme regulation, bailouts and debt moratoria.

Why do seemingly knowledgeable people blame free-market capitalism when they know that the US government manufactured the subprime mortgage market? Why is the crisis regarded as immediate and huge when there have been no substantial mortgage losses yet? Why is it seen as "market failure," rather than the triumph of free-market capitalism over anti market interventionism?

Answers lie in understanding the true nature and causes of the crisis. If the US government perpetuates antimarket causes and imposes ill-conceived "solutions," it will worsen and extend this crisis as the New Deal did with the Great Depression.

The crisis has three main elements.

The first is the dark socialist underbelly of American capitalism - all US administrations promoted subprime credit after the 1930s. Their complicitous guilt explains why both parties redefine symptoms (toxic credit, the land bubble, rising defaults, collapsing equities) as "fundamental causes". The most banal pseudo-explanation is "Wall Street greed".

Obviously greed precludes rather than encourages giving loans to "ninja" debtors (no income, jobs or assets). In free or nearly free markets, banks finance credit worthy people. But governments want them to finance credit-unworthy people, to which end the US government created elaborate interventions such as:

- Huge government-sponsored enterprises (GSEs);
- Draconian lending laws, the prohibition of "red-lining" and the mandating of "community reinvestment";
- Regulatory exemptions and tax breaks for sub prime investors; and
- Political pressure.

Needless to say, investors would buy obviously toxic loans only if they were government-backed, which they were officially until 1996, and unofficially thereafter as "implicitly government-backed". That was the sufficient and necessary cause of the crisis.

In a futile attempt to provide limitless funding and prevent the bu st, Fannie Mae and Freddie Mac raised trillions by "securitising" the mortgages they'd bought, with implicit government backing to investors worldwide in the secondary mortgage market.

This created the second core element of the crisis - the emergence of widely traded derivatives, sometimes so remote from underlying mortgages that investors cannot establish their probable value. Subprime borrowing grew from 5% in 1994 to 15% of all mortgages by 2006.

Our GSEs - SAA, SABC, Sasol and so on - are local examples of bodies with "implicit" government backing.

The third element explains why the crisis may be exaggerated. The Brookings Institution in the US observes that the crisis may be smaller than imagined, and constitutes a process rather than an event, because large-scale losses are speculative. The default rate rose from 2% in 2005 to about 10% of subprime mortgages now, which is below 1% of all mortgages by value. Actual losses occur only to the extent of foreclosures, and the houses sell for less than outstanding balances.

Another folly is that international accounting standards, from which GSEs are exempt, require assets to be reflected at minimal or zero value. That the market is precluded from valuing toxic mortgages realistically explains extreme market uncertainty.

Fannie and Freddie, exempt from the standards, overvalued their assets, deceiving markets into thinking it was too soon to panic.

Of greater danger than the crisis is denial that government caused it. Misconceived bailout plans entail recapitalising of banks by central banks buying their shares (partial nationalisation) and government purchases of dodgy mortgages with a view to recapitalising and reselling them - which means more of the same.

Denialism results in avoidance of the obvious solutions: abolition of GSEs and deregulation, so that the market can value assets realistically and recover expeditiously.