

PERSONALLY SPEAKING

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FROM MAIN STREET TO WALL STREET TO CAPITOL HILL AND BACK

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Who's responsible for the current crisis besetting financial markets? The simple answer: Main Street, Wall Street, Capitol Hill.

Main Street

For signing mortgages without sufficient financial resources to meet the obligations inherent in those mortgages -- to make monthly payments as set forth in the terms of those mortgage documents.

For writing mortgages without evaluating the applicant's financial resources, without requiring the usual 20 percent down payment, because the institutions writing those mortgages eliminated their risk by selling them to other financial institutions.

For bundling those mortgages and selling them to other financial institutions with an appetite for the high return promised but a blind eye for due diligence.

Who benefited? Low-income families, loan originators, building contractors, realtors, title companies, appliance, hardware, lawn and garden, furniture, and carpet stores, insurance and telecommunications companies, commercial banks ... the entire local economy.

Wall Street

For selling insurance to the financial institutions holding those bundles of securitized assets in order to cover any defaults in the underlying mortgages.

For embracing the accounting practice of "mark to market" which requires financial institutions to re-value their assets according to their current market value, even as the market for those assets deteriorates precipitously, rather than valuing them according to the discounted value of the future cash flows of those assets.

For paying generous bonuses to Wall Street regulars on the basis of the short-term performance of their working units thereby reinforcing an incentive to boost performance by buying and selling risky financial instruments.

Who benefited? Investment banks, hedge funds, companies selling credit default insurance, directors of aggressive financial institutions, anyone especially senior managers of financial institutions whose salaries depend largely on year-end bonuses, sellers of luxury goods, expensive housing and furnishings, exotic leisure activities.

Capitol Hill

For encouraging Fannie Mae and Freddie Mac to buy, hold, and re-sell sub-prime mortgages as a way of extending home ownership to families at the margin of the mortgage market who were drawn in by assurances that their homes would increase in value over time.

For allowing Fannie Mae and Freddie Mac to lobby members of Congress, contribute to their re-election war chests, offer assurance that all was well, and thereby turn aside any further efforts to examine their practices more carefully and exercise their oversight role more diligently.

Who benefited? Fannie and Freddie shareholders and lobbyists, Congressional Republicans and Democrats.

This enormous financial house of cards began tumbling down when sub-prime mortgage holders on Main Street could not continue to make their monthly payments as their mortgages rates were adjusted upward and at the same time some were losing their jobs.

The Crisis.

Defaults, foreclosures, surplus housing stock, decline in the demand for new housing and the construction jobs tied to that housing, loss of business for building suppliers, realtors, title search, mortgage, and property insurers. Decline in property values for those who own their homes free of any mortgage and those who continue to pay their mortgages on time. Loss of tax revenues to local, state, and federal governments.

Financial institutions use mark-to-market rules to write down the value of the mortgage-backed securities they hold on their balance sheets, and sustain operating losses because the anticipated flow of income from those toxic assets has not materialized. The market capitalization of those institutions begins to fall as traders sell shares in those institutions, and buy and drive up the prices of more attractive holdings such as gold, or oil, or government securities.

Given the extent to which these mortgage-backed securities are held by financial institutions large and small, banks are reluctant to lend money to other banks even as the Federal Reserve drops the rate of interest (the federal funds rate) one bank can charge for inter-bank borrowings. To get the cash they need to continue operating on a daily basis and serve their customer base, banks turn to the Federal Reserve to borrow money through the discount window. Private loans including loans to Main Street businesses made under the condition that they are payable on demand are called in by banks which are short of cash on hand. As banks with large holdings of toxic, mark-to-market mortgage-backed securities are forced to report their financial losses to the public, some of their depositors become restless and decide to withdraw funds from their accounts. Banks with insufficient cash on hand to cover those withdrawals are forced to close their doors and declare bankruptcy.

The problem is that there is no ready market for the toxic mortgage-backed securities which originated on Main Street, and therefore no way to trade them for cash on Wall Street. With the rescue plan recommended by Treasury Secretary Paulson and modified by Congress, the federal government would purchase those securities from Wall Street by selling additional Treasury bonds in order to raise the cash necessary for the deal.

The crisis is linear, systemic, with a downside feedback loop to match the earlier upside loop that fueled the bubble. The crisis is so massive that only the federal government has access to the financial resources necessary to deal with it. For that reason the current economic hard times cannot be resolved without Capitol Hill bailing out Wall Street and in turn rescuing Main Street.

Doing nothing, as some have recommended, is as badly advised as letting a deadly drug-resistant virus just run its course. Without massive federal intervention to cut through the downside feedback loop and quite irrespective of where a person works -- Wall Street or Main Street – and lives, this crisis in financial markets will destroy not only those whose aggressive and risky decision-making precipitated the crisis but also those who always conducted their financial affairs above reproach.

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