NOVEMBER • 2010

LMR

BUILDING THE 10%

PULSE ON THE MARKET

Page 4

Fed Flat-Lining?
Insider Trades
Ireland Too?
TSA Grip
$igns

BUBBLE COURSE CORRECTIONS

Interview with
MISES INSTITUTE PRESIDENT
DOUG FRENCH

Page 20

QUANTITATIVE EASING ROUND II

Feature Story • Page 13

BANKRUPTCY?

THERE IS AN ALTERNATIVE. A NEW ROLE FOR

PRIVATIZED BANKING

Part One

Feature Story • Page 6

LARA-MURPHY REPORT

BUBBLE COURSE CORRECTIONS

AN INTERVIEW WITH MISES INSTITUTE PRESIDENT DOUG FRENCH

Douglas French is president of the Mises Institute. He is the author of ***Early Speculative Bubbles & Increases in the Money Supply*** *and his newest book* ***Walk Away: The Rise and Fall of the Home-Ownership Myth****. He received his masters degree in economics from the University of Nevada, Las Vegas, under Murray Rothbard with Professor Hans-Hermann Hoppe serving on his thesis committee.*

Lara-Murphy Report: You were in the belly of the beast during the housing bubble. Can you explain how things got so bad? Were there warning signs that people ignored, or was it literally the case that "no one could have predicted this"?

Doug French: Bubbles are much harder to detect from the inside looking out, rather than the outside looking in. In hot housing markets like Las Vegas, Phoenix and Atlanta demographers were making all kinds of rosy projections about population growth. The thought was America's aging population was heading south for the sunshine and (at least in the case of Las Vegas) lower taxes. When the numbers indicated that 200 people a day were moving to Las Vegas and double that for Phoenix, developers figured more housing and commercial real estate development was needed. Low interest rates fueled borrowing, raised home values and mobilized those seeking opportunity especially in the sun belt.

Bankers saw an opportunity to grow their businesses in an area that hadn't been taken over by the large money center banks--real estate finance. Like anyone else running a business, bankers wanted to grow their franchises: their shareholders and boards of directors demanded it. Real estate finance was a way to do it, and most small to regional-sized banks made that their focus.

With the benefit of hindsight the continued escalating prices of housing was out-stripping the median income earner's ability to pay and borrow, and was a warning sign. At the time this was considered, but comfort was gained looking at California home prices, which were double those in Phoenix and Las Vegas, with median incomes being not that much different. Mortgage lenders did their part with creative mortgage products. Also, investors began to be a larger portion of the market. Again, a warning signal. But, while a few bankers had some experience with the commercial property meltdown of the early 1990's, not many lenders had ever witnessed a housing crash that lasted very long or that was nation-wide.

Bankers in high-growth areas that didn't focus on real estate lending must have endured six to seven years of criticism as their banks under-performed the high-growth banks that did. That would have been incredibly hard to do, because of the opportunity cost for one thing and let's face it, nobody at the Rotary Club meeting or the country club praises bankers for not making loans, especially in a boom.

As near as anyone can tell very few people bet against the housing market and made big money. In his book *The Big Short: Inside The Doomsday Machine* Michael Lewis tells the stories of a few guys who took the other side of the housing bet and won. These guys were socially awkward, obsessive, and brilliant individuals.

However, when it comes down to it, fractionalized banking is the boom-and-bust machine.

So as far as 'no one could have predicted this,' a few did, bet real money and made fortunes. And there were a few other academics and financial commentators who called it. But, of course, no one predicted exactly *when* it would fall apart.

And the *when* is important if you're in business. More than a few bankers who sat on their hands and let the boom pass them by were likely fired for missing the opportunity, before they could be vindicated. This is what makes the Fed's actions so pernicious.

LMR: After the crash, there has been a huge battle over the official narrative. People on the left want to blame deregulation and greed, while people on the right want to blame various government intervention. What's your take?

DF: Anyone who throws out the "deregulation" canard hasn't ever worked at a bank or in the securities industry. Living with regulators and increased regulation is a fact of life in these industries. Banks are given on-site exams at least every year and in some cases more often. Large banks often have regulators in and out of their offices every week. There are state regulators and various federal regulators, so the overlap is tremendous. Every aspect of the operation is scrutinized continuously. Plus, banks have their financial statements audited by outside accounting firms and most banks are required to have outside firms reviewing loans and doing stress tests on their loan portfolios. Everything from the actions of the tellers to that of the president and board are reviewed.

From my experience the

Community Reinvestment Act (CRA) angle to the crash is overstated. Sure, banks by law have to lend some money in low-income areas. But, when people say, "banks were forced to lend to people who couldn't pay, and this caused the housing crash," I believe that's over doing it. CRA loans can be commercial loans for going concerns and if located in a low-income area, the bank is satisfying its CRA requirement with loans like this. Banks just didn't originate and hold that many mortgages, CRA or otherwise. By the way, banks are given CRA audits that are entirely separate from safety & soundness exams.

Federal Reserve money pumping combined with securitization aided by the government controlled secondary market of Fannie and Freddie with a dash of ratings agency neglect and that's the government intervention housing stew to point the finger at.

The federal government has been promoting and subsidizing all aspects of housing since the days of Herbert Hoover, which I write about in *Walk Away: The Rise and Fall of the Home-Ownership Myth*.

For instance, I don't think there would be such a thing as a 30 year mortgage in an unfettered free market. Who on earth has a crystal ball that clear?

However, when it comes down to it, fractionalized banking is the boom-and-bust machine. As long as banks can take deposits and lend them out, while the original depositor can come get his money any time and thus new money is created, there is no way to regulate this system into safety and soundness. It's impossible. Booms are made, and made bigger with increased lending and when the malinvestments that those loans funded are revealed, busts will constantly attempt to cleanse the market. I say 'attempt' because the government is constantly intervening to keep the bubbles afloat with bailouts and incentives. This time it was real estate, next time it will be something else. Who knows what it will be, but keep an eye on derivatives exposure.

> **The mainstream press has suddenly awakened to the ideas of Mises and Hayek.**

LMR: More recently, you have lectured about the precarious state of FDIC. Can you talk about that?

DF: Murray Rothbard pointed out that market events are inherently unique and heterogeneous; they are not random but influence each other; so they are not insurable and not subject to grouping into these homogeneous classes measurable in advance. It is for the entrepreneur to assume the uninsurable risks of the marketplace. This is as opposed (as your audience is especially aware) to insurable risks, such as death, accidents, or health emergencies which are homogeneous, replicable, random events that can therefore be grouped into homogeneous classes and predicted in large numbers.

When banks were making

record profits in the boom, the government agency that insures bank deposits--the Federal Deposit Insurance Corporation (FDIC)--did not add to its reserves because it was near its mandated reserve ratio of 1.25% of insurable deposits. In 2007, the ratio was 1.22% for half the year. In the wake of the crash and the bank failures, the deposit insurance fund (DIF) was in the red by $15 billion at June 30th this year. That's with the FDIC requiring banks to pay three years of assessments in advance to prop up the fund.

On top of this, a couple thousand banks still have tremendous real estate exposure and weak balance sheets, so there will likely be more closures so the DIF will be pressured even more. However, the FDIC has decided not to raise the assessment rate believing the coast is clear. We'll see. May people forget the deposit insurer for the S & Ls--the FSLIC. It was declared insolvent and it went away with the FDIC taking over.

As the amount of deposit insurance per account has increased (from $2,500 to $250,000) over the years, the ratio of loans to deposits and real estate loans have increased. At one time banks were forced to be liquid and lent primarily to businesses for seasonal cash flow needs. But, with deposit insurance, banks have been lured into riskier lending to consumers and on real estate that is not based upon cash flow for repayment but refinance or sale of assets for repayment. Commercial and Industrial (C & I) loans have fallen tremendously in this downturn and even before that hadn't grown in decades, while real estate lending exploded.

LMR: In your experience as an actual banker, how accurate is the economics textbook description of fractional reserve lending? Would a more realistic

description lead to fundamentally different recommendations for government policy?

DF: I never remember reserve ratios being discussed. When we explain fractional reserve banking to students we use 10 percent as an amount of a particular deposit that must be held in reserve and with that 10 percent reserve, money can be multiplied 10 times from a Fed asset purchase. However, a number of banks run loan-to-deposit ratios of 100 percent or more, especially the large banks. The reserve requirement must be satisfied some way, but if you went into your local bank and asked your friendly banker, "what's the reserve requirement?" I'm not sure he could tell you or maybe even know what you're talking about.

For banks, it's all about capital. Required capital levels constrain banks' ability to accept deposits and make loans with those deposits. Bankers joke that FDIC stands for "forever demanding increased capital." That's why the government's TARP money was used to buy preferred stock in banks rather than being used to buy toxic assets, which was the original plan that was scraped after about a week. Once capital levels were increased by government equity injections, banks could write off some loans, and start repairing their balance sheets.

It also helped that in April 2009, FASB rules were changed to allow banks more leeway in valuing their assets. These rule changes helped banks preserve capital because they didn't in some cases have to write-off loan losses and losses on mortgage securities right away. Once the stock market recovered the big banks were able to sell stock and repay the government. However, a number of small banks have not repaid the TARP funds and 115 were delinquent in making quarterly payments to the Treasury at the end of August. Small banks are still having a hard time raising equity capital.

By the way, the number of banks has nearly been cut in half during the past two decades, from 15,000 to the current 7,760. My guess is the number will be cut in half again over the next decade.

LMR: In your capacity as President of the Mises Institute, what have you seen in terms of the respect given to the Austrian theory of the business cycle? Is the Federal Reserve really on the ropes vis-a-vis public opinion, or will it soon fade back into boring obscurity?

DF: Interest in (and respect for) the Austrian school and particularly in the Austrian theory of the business cycle has definitely grown while I've been here. I started here in the wake of the fall financial crash of 2008. Web traffic, along with book sales, spiked with that event and that level of interest has been maintained and continues to grow.

The mainstream press has suddenly awakened to the ideas of Mises and Hayek. Off the top of my head, the *Wall Street Journal*, *Barron's*, the *Economist*, *Newsweek* and the *Financial Times* have had articles with Austrian themes. The *Atlantic* magazine ran an extensive article on Ron Paul that provided some good background on ABCT. I have spoken at length with a reporter from the *New York Times*, but the Grey Lady has only made reference to the Austrians when writing about Charles Koch that I know of.

Tom Wood's *Meltdown* was a *New York Times* best seller in 2009 as was Ron Paul's *End the Fed*. Banking analyst Chris Whalen who appears often on CNBC and Yahoo Finance cites Rothbard multiple times in his new book entitled *Inflated: How Money And Debt Built The American Dream*. Matt Ridley's *The Rational Optimist: How Prosperity Evolves* cites Hayek many times. Skeptic magazine's Michael Shermer refers to the Austrians often in his *The Mind of the Market: How Biology and Psychology Shape Our Economic Lives*.

I'm sure there are many other examples. Austrian economics is popping up in unusual places like rap videos and YouTube animated cartoons and that will continue. The digital world is a game changer for Austrian economics.

In the blogosphere, Austrian economics has much more of a foothold. And because of that, and the fact that the Keynesian interventions will continue to fail, the Austrians aren't going away. We may be boring, but we won't be obscure.

At the same time, only if we are completely wrong will the Fed return to printing and distorting in the shadows. And if mises.org traffic and Institute book sales are any indication, as educated young people become business and political leaders they will put more and more pressure on, not just particular Fed policies, but the idea of a central bank controlling interest rates and money supply period. The flame cooking the Fed continues to get turned up, soon the pot will suddenly boil over.

1. See http://mises.org/books/walkaway_french.pdf.

PRIVATIZED BANKING

Bring a *Privatized Banking* Seminar to your city.

Present the powerful combination of
Austrian Economics,
The Sound Money Solution
& The Infinite Banking Concept
to your Special Group

- **Demystifies Fractional Reserve Banking**
- **Learn how you can personally secede from our crumbling monetary regime and improve your financial future.**
- **Sound economic reasoning with a sound private strategy to direct the individual toward the escape exit.**
- **Learn the warning signs of a coming crash and the steps you need to take to avoid them.**

3 Speaker / Authors from the
Austrian School of Economics

L. Carlos Lara
Robert P. Murphy, Ph.D.
Paul A. Cleveland, Ph.D.

3 Dynamic, Informative, Inspirational and Educational Hours

Inquire directly with Carlos Lara 615-482-1793,
or Robert P. Murphy 212-748-9095,
or e-mail us at info@usatrustonline.com