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FINANCIAL MARKET COLLAPSE IS HUMAN FAILURE

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Three times in the last 25 years financial markets have been severely shaken due to an underlying failure on the part of human economic agents acting recklessly in financial affairs. In the 1980s it was the savings and loan debacle. In the 1990s it was the bursting of the dot.com bubble. In the 2000s it has been the subprime lending crisis.

In the late 1970s savings and loans were deregulated in the expectation that freed of the government restrictions that limited their activities to the home mortgage market, they would transform into and compete with private commercial banks thereby reducing the cost of financial services to the banking public. The transformation was successfully completed and savings and loans did indeed begin competing with banks across a wide range of services.

Savings and loans however were not prepared sufficiently to step outside the home mortgage market. Prodded by extremely high interest rates – in 1981 the prime rate of interest across the United States was 21 percent – savings and loans began making risky loans in the anticipation of the substantial revenue stream from higher interest earnings. Loan officers were rewarded with commissions based on the number of loans they were able to add to S&L loan portfolios, earning them the designation "go-go" loan officers. The virtues of moderation and prudence (due diligence) were replaced by excess and shoddy background work on prospective borrowers.

Failure was inevitable as borrowers were not able to meet their obligations and defaulted, mainly in the farm belt and the oil patch where heavy borrowings and lower-than-expected prices produced a cash-flow crisis and financial disaster. Default and foreclosure followed. For many savings and loans the losses from bad loans were so severe they were forced to close. In 1988 alone the number of failed savings and loans reached 185. Funds in the Federal Savings and Loan Insurance Corporation which insured deposits at savings and loans were exhausted making payments to depositors in collapsed savings and loans and forcing the federal government to bailout the FSLIC. Shareholders in the failed institutions suffered the loss of their invested monies, employees at those institutions lost their jobs, depositors lost any deposits in excess of the insured limit, and the federal taxpayer was burdened with an estimated $124 billion bailout of the FSLIC.

The failure was a human failure in thinking that it is possible to operate successfully without regard for moderation and due diligence.

The glitzy business plans of information and biotechnology entrepreneurs fueled by cash from venture capitalists looking for the next big innovational breakthrough contributed powerfully to a stock market climate that pushed stock prices ever higher in the 1990s on the expectation that the United States was on the verge of a new economic expansion in which a range of new goods and services so visionary in their conceptualization would create an immediate and huge demand and generate profits for so-called dot.com enterprises. Alan Greenspan, chairman of the Federal Reserve System, warned in late 1996 that an irrational exuberance was gripping the market and unduly driving up asset values.

Nevertheless, stock prices continued to rise with many traditional companies participating in the bull market and contributing to it by acquisitions and stock splits making their shares more attractive to new investors. They were ably assisted by market analysts who without declaring their own personal holdings issued public reports that were favorable though at times based on flimsy evidence thereby driving prices up even further and increasing the value of their holdings.

The bear-market downturn that began in early 2000 took many small investors by surprise and wiped out a significant part of their investment portfolios forcing them to put their retirement plans on hold. Even today, the share prices of many of the companies listed on the technology-heavy NASDAQ have not recovered fully from that ruinous bear-market downturn.

As with the savings and loan debacle, the prospect of reaping huge financial gains enticed investors to set aside the very moderation and due diligence that could have insulated them from the irrational exuberance that led to their huge investment losses.

This summer a third collapse was triggered by deep-seated problems in the subprime lending market in which prospective homebuyers with poor credit records had access to adjustable rate mortgages in which initial monthly payments were set low in order to get them to sign the mortgage contract but were increased after that initial period to make those mortgages more attractive in the re-sale market. Banks and other financial institutions became loan originators passing the risk of default to investors who were attracted by the prospect of higher returns though they were not always well-informed about the risks.

Default and foreclosure followed when these homebuyers no longer could afford the higher monthly payments. Selling their homes under foreclosure triggered a sharp decline in housing values and wiped out homeowner equity even for those who were not subprime borrowers and others whose homes were mortgage-free. Financial institutions holding assets based on bundles of subprime mortgages in default have been forced to write off those assets as worthless, leading to a drop in the value of their shares of stock.

Once again we see the financial market severely shaken by practices which set aside moderation and due diligence for the prospect of greater financial gains.

The ancient Greeks taught that moderation, prudence, justice, and courage are centrally important to human development and well-being. Their insights endured in the West until Enlightenment philosophers argued instead that backed by the "invisible hand of the market" to sort out all human conflicts individual freedom and self-interest are sufficient in conducting economic affairs. Think of the economy as a car equipped with the shock absorbers of moderation, prudence, justice, and courage to stabilize it when it hits a bump in the road or hole in the pavement. Remove those shock absorbers and the car becomes unstable when it hits the same bump or hole, bouncing up and down and becoming even more unstable at higher speeds. Driven by the IT revolution and globalization which have quicken the speed of financial transactions, financial markets are more volatile which even seasoned financial analysts can neither predict nor explain. The market in effect is telling us that the Greeks got it right.

Edward J. O'Boyle is Senior Research Associate with Mayo Research Institute. Since completing his doctorate in economics from Saint Louis University more than 35 years ago, Dr. O'Boyle has specialized in economic research and analysis increasingly from the perspective of the human person engaged in everyday activities both as a unique individual and as a community member. In January 2004 the Association for Social Economics conferred on Dr. O'Boyle its prestigious Thomas Divine Award for lifetime contributions to social economics and the social economy. He taught economics at a state university in Louisiana for 30 years prior to his retirement in 2007.

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