The God that Failed: Free Market Fundamentalism and the Lehman Bankruptcy

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As Christianity advanced inexorably through the Roman Empire, distraught Roman pagans were sometimes slow to give in. Many found solace by imagining Jupiter, Mars, Venus, and their other deities dwelling serenely in the heavens above, far removed from painful earthly concerns.

A year after Hank Paulson, Ben Bernanke and Timothy Geithner decided to allow Lehman Brothers to go bankrupt and precipitated the greatest financial meltdown since 1931, believers in efficient markets theory—free market fundamentalism—find themselves in a position strikingly reminiscent of the Roman pagans.

Politicians, the general public, many economists, and even some of the press now recoil from extravagant claims about the beneficence of deregulation and the 'invisible hand.' Repudiating the spirit of Milton Friedman and exalting J. M. Keynes and Franklin Roosevelt, a consensus appears to be crystallizing in favor of government action to counterbalance the disastrous extremes of free market fundamentalism. Only a wall of political money and its friends in Congress and the Obama Administration now protect Wall Street from serious reform.

SCANT EVIDENCE THAT THE TARP BAILOUT RATHER THAN LEHMAN TRIGGERED THE COLLAPSE

Alas, just like the old Roman believers, partisans of efficient markets show strong signs of a headlong flight into fantasy. High priests from two of the old time religion's holiest temples—the Hoover Institution's (and Stanford University's) John Taylor, and the University of Chicago's John Cochrane and Luigi Zingales—now flatly deny that Lehman's demise occasioned the meltdown.

Letting Lehman go broke, they imply, was the right thing to do—an unavoidable, if nasty, expression of the 'creative destruction' that is essential to free market capitalism. What triggered the financial collapse, they argue instead, was not Lehman's failure, but Paulson and Bernanke's decision a little over a week later to involve the government by going to Congress and demanding $700 billion in bailout funds. This breach of free market principles, which eventually morphed into the now notorious Troubled Asset Relief

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Program (TARP), was what really destroyed world markets, they assert.

The evidence they offer in support of this astonishing claim is breathtakingly thin. Essentially it consists of variations on a single picture. Both Taylor and Cochrane and Zingales plot the cost of banks' borrowing funds from each other for three months in the London Interbank Borrowing market (3 month LIBOR) and compare that to rates paid on Overnight Index Swaps of the same duration (3 month OIS rate). The latter records the market's guess about what the Fed funds rate will be over the same period, so the difference between the two rates should reflect banks' anxieties about lending to each other.

The difference between the rates doesn't appear to jump until around September 23rd or 24th, around the time Paulson and Bernanke slammed the gun down on the table in front of Congress.

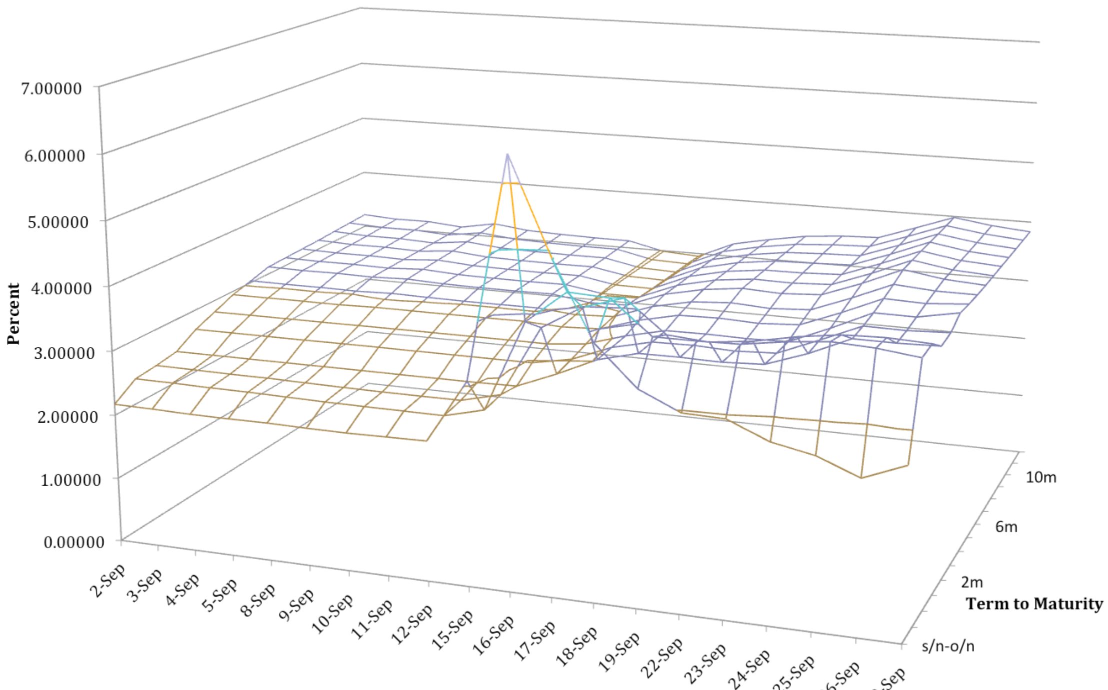
Cochrane and Zingales add a Rococo embellishment—a second line charting the price of credit default swaps (CDSs) for one bank, Citigroup. Credit default swaps are essentially insurance against the possibility of collapse; their prices therefore rise with perceptions of instability.

The arabesque traced out by Citigroup's CDS, though, is a touch ambiguous. It looks a bit like McDonald's Golden Arches, rising for the first time with Lehman's demise, falling back quickly, then spiking again around the time Paulson and Bernanke headed to Congress.

If the chart is small enough and you do not examine the data too closely, the trio's case might look persuasive. But in fact it involves a flight from reality almost as profound as the pagan's faith in the planets. We scrutinized Taylor's original argument in an essay published in the Summer 2009 issue of the *International Journal of Political Economy*. Familiar from economic history with catastrophic events in which published rates did not reflect actual market practice, we took a closer look at the entire spectrum of LIBOR rates rather than just the three month rate that Taylor and Cochrane and Zingales rely upon. We found something remarkable: In the wake of Lehman's bankruptcy, the term structure of LIBOR rates inverted—very short term interest rates abruptly shot up over longer term rates. See Figure 1. This pattern of explosive demand for money with the shortest possible maturities is incompatible with claims that money markets behaved normally and inconsistent with notions that money was freely available for longer periods, say, three months. Claims at the time, and subsequently, by Richard Robb and others that inter-bank markets had essentially dried up appear well founded.

Other financial indicators further testify to the profound desperation in money markets that Lehman's failure produced. Lehman went down on 9/15, 2008, as that dark day is now rightly singled out. Sam Jones, in a penetrating critique of Taylor for a Financial Times blog, drew attention to how bankers' balances at the Fed suddenly ballooned and documented the panic flows out of money market funds that followed the collapse. Within a day or so, markets for bank commercial paper completely dried up. Banks instead piled up their funds in reserve balances at central banks, which can't fail; while holders of money market funds frantically pulled funds and placed them into insured deposits, forcing the government temporarily to insure money market funds.[1] As Aaron Edlin pointed out in *The Economists' Voice*, rates on Treasuries went to three basis points on September 17, 2008, two days after Lehman's bankruptcy filing, and might have

Figure 1
Lehman's Collapse Inverts the LIBOR Yield Curve



Source: British Bankers Associaton

gone negative in the absence of the bailout, since there was nowhere outside of Treasuries that was safe to hold money (even hoards of cash are subject to theft and fire).

The Federal Reserve's H.4.1 statistical release for the seven days ending Wednesday, September 17, 2008,[2] shows that borrowings from the Fed's Primary Dealer Credit Facility, which carried a clear stigma, jumped sharply, as indeed, did the whole category of 'other loans.' The former had been zero the week before. Then all at once they jump to an average of $20 billion. The use of weekly averages disguises the real dimensions of the explosion, because the Wednesday total is $59 billion.

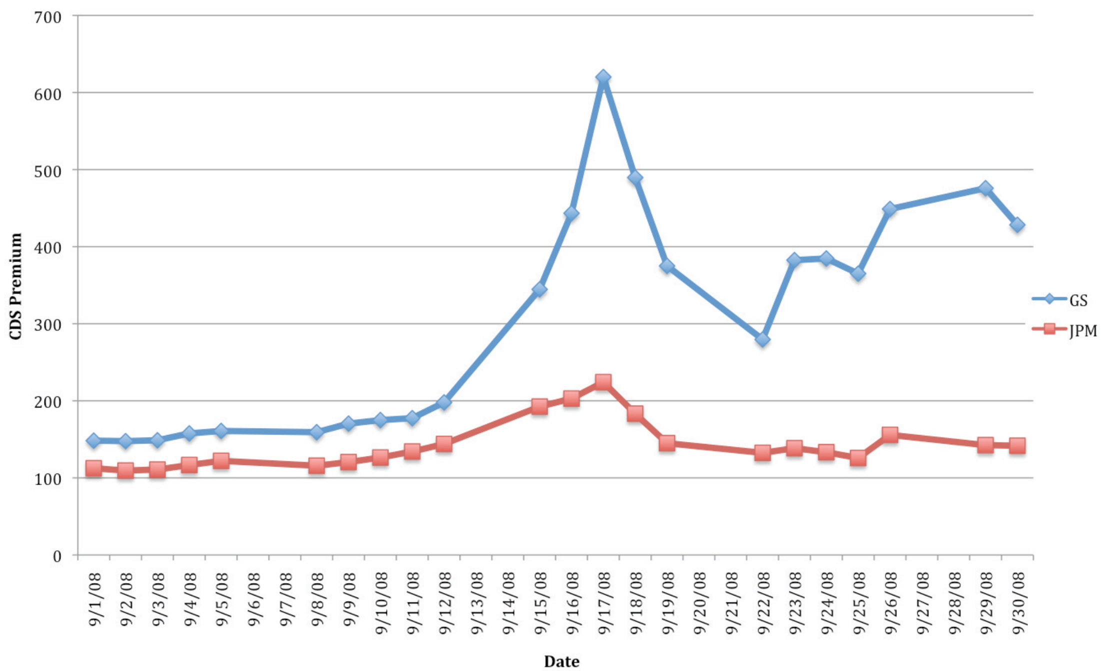
Every other direct indicator of financial risk we examined also blows out with Lehman, in some cases a day or two in advance of the actual declaration of bankruptcy: Prices of credit default swaps on the four largest American banks, controlling some 40 percent of all deposits, for example, all rose like rockets before falling back when Paulson, Bernanke, and Geithner reversed course barely a day later and dramatically embraced Single Payer Insurance for AIG.

The same holds for credit default swaps of Goldman Sachs and Morgan Stanley, the two most important remaining investment banks.[3] (See Figure 2, which shows credit default swap prices for Goldman Sachs and JPMorgan Chase.) Another excellent general indicator of stress, the 'option adjusted' spread on broad investment grade bank debt—what banks had to pay to raise new capital—also jumps as Lehman gave up the ghost and it stays up thereafter, as shown in Figure 3. Eventually, of course, the FDIC stepped in to guarantee new bank debt.

What then should we conclude about Taylor's and Cochrane and Zingales' assertions that Paulson and Bernanke's trip to Congress triggered the ever spiraling market collapse that their graphs assuredly depict? First of all, Cochrane and Zingales' claim about the market for CDSs—"On Sept. 22, bank credit-default swap (CDS) spreads were at the same level as on Sept. 12"—could not be more misleading. To the extent any return to lower levels happened, it was because of the government bailout of AIG, which we now know was the counterparty to many of the world's largest financial institutions. The AIG bailout surely bolstered stock markets also, though these were also relieved by the Securities and Exchange Commission's sudden decision to ban short selling.[4] The market improvements, in other words, reflect stabilizing actions by the government, not the magic of the private marketplace. Neither CDS prices nor the brief pause in the stock market's decline are evidence of any return to 'normalcy.'

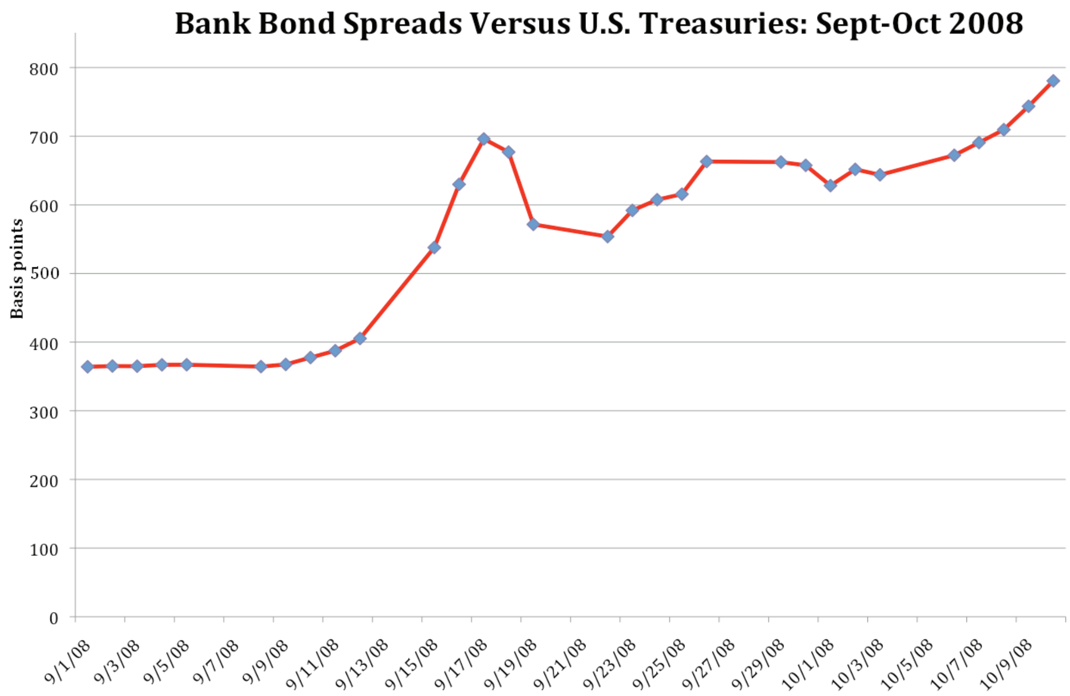
More broadly, Taylor and Cochrane and Zingales drive a good idea into the ground. This is the celebrated methodology of 'event analysis,' in which one tries to partial out the impact of events by means of careful comparisons of how each individually affected markets. But their informal use of this device, which Chicago-oriented economists rightly

Figure 2
It Was Lehman: Prices of Five Year Credit Default Swaps
Goldman Sachs and J.P. Morgan Chase



Source: Bloomberg.

Figure 3
Spreads on Bank Debt Blow Out as Lehman Collapses



Source: Citibank OAS Broad Investment Grade Financial Bonds Spread Against Treasuries

take credit for promoting, is inappropriate once you get past Lehman's demise.

As Gunnar Myrdal wrote long ago, cumulative and circular causation is a constant problem in real life economies. It makes at least provisional sense to single out the Lehman shock, which came like a cannon shot in the night. But Lehman's collapse triggered a cascade of disasters—AIG's collapse, WaMu's bankruptcy and fire sale to JP Morgan Chase, runs on the crown jewels of American capitalism, such as Morgan Stanley and Goldman—that put enormous pressures on regulators to find counterbalances. They reacted by banning short selling, rescuing AIG, using the FDIC in new ways, and taking other steps almost as epoch-making as the serial disasters. They did all this in a matter of days, as private investors scrambled to digest what they had done.

Whatever efficient markets theory's claims about perfect foresight on average, there is no question that market participants and regulators often badly misunderstood what was going on around them. American brokerage houses with operations in London, for example, only slowly awoke to the dangers that English bankruptcy laws posed to their ability to gain access to funds they had deposited with Lehman. The Federal Reserve just as clearly misjudged its ability to fund the UK part of Lehman's broker–dealer business. Such confusions took some time to sort out, or even to be recognized. They imply that singling out particular actions in this chain via event analysis is a task of Sisphyean dimensions; once the avalanche starts, trying to partial out the influence of particular boulders is fruitless.

KEYNES EXPLAINS WHY TARP DIDN'T FIX THE TROUBLES

In our view, Keynes is a better guide than Taylor or Cochrane and Zingales to why the world kept exploding as Bernanke and Paulson headed to Congress. Market participants recognized that TARP was not accompanied by a broader plan to stimulate national income. It was equally obvious that TARP's initial stated goal—to purchase assets from a handful of lucky financial institutions at above market prices—made no sense, except for managers and investors in the affected banks. TARP was plainly light years away from a sensible bailout on the lines of, say, the Swedish model of the early nineties or even the New Deal's Reconstruction Finance Corporation, where governments got the assets off the books of the banks and then recapitalized banks on terms that were fair to taxpayers so they could lend again.

Once candidate Barack Obama advised Democrats not to pursue mortgage relief during Congressional deliberations on TARP, it also became certain that there would be no meaningful action on housing or mortgage relief. With every indication that international cooperation on fiscal expansion would not happen for months, investors rightly diagnosed that the case was terminal—unless you were a pet bank or politically connected.

In the face of a collapsing economy, of course, it was only to be expected that credit default swaps of weaker banks, such as Citigroup, the Incredible Hulk, would do a Golden Arches—until the authorities demonstrated that another Lehman would not be tolerated by guaranteeing bank debt, handing out public money, and more steps than can be inventoried here. Bill Gross of Pimco's famous advice to investors to buy enterprises backed by the state only registered the literally depressing truth.[5]

Taylor and Cochrane and Zingales are right to nourish suspicions about the moral hazard implications of the Bush and Obama Administrations' unwillingness to take the profits out of going broke—that is, to rescue not only the banks, but bankers' compensation and bonuses with public money while demanding almost nothing in return. This is truly wretched and assuredly is storing up big trouble for the future. But for free market fundamentalists to advise that we were OK until Paulson and Bernanke went to Congress is outlandish. The interactions between the state and market in the money-driven American political system are now too deadly and expensive to tolerate. They need to be fixed—by aggressive government regulation of both political finance and banks.

But for this process to get airborne, our modern counterparts of the Roman pagans need to stop advising people that it is enough to go back to the old cults. They need to see the relevance for public policy of the famous rhetorical question that opens Nietzsche's *Also Sprach Zarathustra*: "Have you not heard that God is dead?"

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev.

NOTES

1. Sam Jones (2009) "Why Letting Lehman Go Did Crush the Financial Markets," Financial Times, March 12. Available at: http://ftalphaville.ft.com/blog/2009/03/12/53515/why-letting-lehman-g.
2. Available at http://www.federalreserve.gov/releases/h41/20080918.

3. Various spokespersons for Goldman, Sachs have since maintained that the firm was in no danger of collapse during this hectic week; the data shown in the graph suggest that markets were much more skeptical.
4. Under heavy political pressure; see Ferguson and Johnson, "'Paulson Put,' Part II." p. 27.
5. Barbara Kiviat, "Even Bond Guru Bill Gross Can't Escape," Time, September 18, 2008.

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