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DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

So they all knew it was a bubble, now?

Posted by Jerome a Paris on August 18, 2007 - 1:45pm
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(*Note: this was written Thursday for European Tribune. There's a lot of additional info in the original thread, including insider info from several French bankers. I also posted an add-on on the (partisan) political lessons emphasising the last part of this text this morning on DailyKos, where the recent Fed decision is also discussed.*)

As the markets keep on going through turbulence, and many conflicting opinions are heard as to whether this is just a harbinger of things to come (my position) or just a "welcome correction" (still that of most "serious" pundits and the conventional wisdom), what's most striking to me - and very revealing on its own - is how suddenly everybody is talking about the real estate bubble as it if were the most obvious thing.

The very people that, in many instances, denied that there was any kind of bubble, or that house prices were a problem in any way, and denied that market valuations of certain assets were completely unreasonable, are now saying, in hindsight, that it was indeed a bubble and, while they are still saying that nothing much will really happen fro mthe end of the bubble (other than silly people getting punished), they are already hard at work trying to pin the blame *elsewhere*.

"A cheerleader, moi?", they ask, outraged.

But their new attitude ensures, right now, that the crisis WILL spread. Let me tell you why.

Thus, Martin Wolf, the senior economics correspondent of the Financial Times, the European business version of a Broder in Washington:

> Fear makes a welcome return (FT, 15 August)
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> The world has witnessed four great bubbles over the past two decades - in Japanese stocks in the late 1980s, in east Asia's stocks and property in the mid-1990s, in the US (and European) stock markets in the late 1990s and, finally, in the housing markets of much of the advanced world in the 2000s. There has been too much imprudent finance worldwide, with central bankers and ministries of finance providing rescue at virtually every stage.

This is a polite version of my "Bubbles" Greenspan moniker: cheap money, especially in times of turmoil, has cause runaway asset price inflation. But as wages were under control thanks to the Chinese, there was nothing to worry about. But now, this is deemed "imprudent". And a classic mania:

> The process starts with "displacement", some event that changes people's perceptions of the future. Then come rising prices in the affected sector. The third stage is easy credit and its handmaiden, financial innovation.
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> The fourth stage is over-trading, when markets depend on a fresh supply of "greater fools". The fifth stage is euphoria, when the ignorant hope to enjoy the wealth gained by those who came before them. **The warnings of those who cry "bubble" are ridiculed**, because these Cassandras have been wrong for so long. In the sixth stage comes insider profit-taking. Finally, comes revulsion.

Ridiculed we were indeed. But whether this takes the form of Jim Cramer begging the Fed to bail out feckless financiers, or Wolf's more prudent assertion that the "central bank must save not specific institutions, but the market itself," two thing are certain, and undoubtedly acknowledged by all: that there was a bubble, and that it has come to and end. That people say that this is just the beginning, or that it is a healthy correction to still high levels is mostly irrelevant, because what matters is that the notion of the end of the bubble is now widely public, because this is the single most important driver of things.

To make it simple: market psychology has flipped - from "prices will continue to go up" to "prices will no longer go up" - and thus the herd will stop buying. It doesn't really matter if it starts selling, or if it holds tight - buyers have become scarce (both because they suddenly don't think it's a good thing to buy, and because banks have stopped lending them money to do so - that's the credit crunch bit of the current crisis), and people don't expect prices to go up anymore. That, in itself, in enough to cool the markets. No expectations of quick gains and fewer buyers means, at the very best, stagnant markets.

But too many things in recent years have been predicated on ever increasing prices. Ninja mortgage loans (no income, no job, no assets) can only be repaid by flipping houses. Too many private equity buy outs of corporations made sense only in the expectation of a quick resale within 2-5 years at a premium. Now these homeowners and the companies have to live with crippling debt burdens - and many will collapse under that weight. That means, down the road, houses dumped on the market, and companies going bust, with the attendant layoffs, loss of pension and loss of healthcare. To be honest, the scale and the timing of these phenomenons is still very hard to pin down, which explains why prognoses go from 'speed bump' to 'major economic depression.'

But again, the end of the great bull market is, in itself, enough to seriously cripple what has been the main engine of growth in recent years: construction, financial engineering and increasing debt. Wages, which remained stagnant in supposedly booming economies, are not going to go up now, and the lower ability of households and corporations to borrow yet more money will necessarily cause ther spending to shrink.

Again, I have not yet talked in any way about the cost of the financial bubble itself - only about the expected changes in economic behavior due to new conditions. The financial meltdown, if there is one (as I personally think there will be) will only add to that and make thing worse by weakening banks, causing asset dumps and bringing down all sorts of asset classes down, and all the business they underpinned.

For samples of what might happen, read this Hedge Fund Sell Outs Threaten Markets or this excellent summary by **stoneleigh** earlier here at the Oil Drum: The Resurgence of Risk - A Primer on the Developing Credit Crunch.

Without going into these scenarios, what strikes me, again, is how quickly the pundits have flip-flopped to the new common wisdom of the bubble and are out looking for scapegoats.

Here's Martin Wolf, again:

> Financial markets, and particularly the big players within them, need fear. Without it, they go crazy. Moreover, it is impossible for outsiders to regulate a global financial system riddled with conflicts of interest and dominated by huge derivatives markets, massive trading by highly leveraged hedge funds and reliance on abstruse mathematics and questionable statistical models. These markets must regulate themselves. The only thing likely to persuade them to do so is the certainty that the players will be allowed to go bust.

"they go crazy" (i.e. they overpay for assets) "conflicts of interest" (i.e. cheerleaders profit from higher prices) "highly leveraged" (i.e. too much easy debt) "questionable statistical models" (i.e. models work only so long as there are no crises). And the culprits are indeed now all over the media:

> Rating agencies hit by subprime probe
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> The European Commission is to investigate credit ratings agencies amid growing dismay over their slow response to the subprime mortgage crisis.
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> Officials in Brussels, and many other critics, believe the **ratings agencies failed to act** quickly enough to warn investors about the risks of investing in securities backed by US subprime mortgages - the sector whose troubles triggered the recent global market volatility.
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> In the US, Barney Frank, Democrat chairman of the House financial services committee, said he planned to hold hearings on the agencies' performance next month. He said the agencies had "not done a good job" in the current crisis.

Rating agencies got paid by banks to provide ratings. Good ratings meant more sales by the banks. Of course there was pressure for rating agencies to be optimistic. Thier only restraint was their reputation, and we saw how effective that was for Arthur Andersen. Plus, the more they rated junk bonds favorably, the easier it was to refinance dodgy companies, and the fewer defaults there were, thus providing more fuel for that cycle.

This has been said for months by the Cassandras but, as usual, investigations get started when it's too late. Hopefully, this will at least lead to a fundamental rethink of the role of the rating agencies in the lending markets. Giving such a fundamental gatekeeper role to private entities essentially paid for by sale-side bankers is not a good way to avoid bubbles.

> [Limitations of computer models]
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> "Models (ours including) are behaving in the opposite way we would predict and have seen and tested for over very long time periods," said Lehman Brothers last week.
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> A glance at recent financial history shows that this type of "rare" event is not so unusual at all.
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> (...)
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> "People say these are one-in-a-100,000-years events but they seem to happen every year," says Satyajit Das, a consultant to hedge funds and investment banks. "This episode should make people ask questions about models - I think it could lead to a real reassessment."
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> Any such reassessment could have far-reaching consequences. The spread of financial models is at the heart of the growth of modern banking. Indeed, were it not for modern computing power, this decade's remarkable explosion in finance would not have occurred at all.
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> (...)
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> But while computers are often able to operate better than humans in "normal" markets, this month's events demonstrate that during times of stress they have some crucial flaws. One problem is that models typically predict the future on the basis of past data. This can lead to distortions, given the speed at which the financial industry is currently evolving. Indeed, many of the instruments at the heart of the current credit storm barely existed before this decade - which means that **computers can only model these markets based on the benign conditions of the past few years**.
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> Another big problem is that computer models do not always take account of the way that their own behaviour is affecting markets.

The dirty secret of bankers is that they are bad at science and maths, and do not understand that a model, however sophisticated, cannot provide output of a qaulity better than the input. Lots of data does not mean better data; what makes data "good" is qualitative analysis, i.e. risk assessment by bankers doing their job instead of relying on fancy models. They do use extremely smart mathematicians to play around with data, but these guys' jobs are not that of bankers. I mean, "*models typically predict the future on the basis of past data*" - anybody that has ever bought any financial instrument gets told (or sees written in small print) right from the start that the past is no indicator of the future...

Thus, models work until they don't. LTCM's lesson has visibly not been learnt.

But blaming rating agencies and computer models, of course, is a way to avoid the real debates, the ideological ones - that over the supposed superiority of the "efficient markets" to drive economic behavior, that over the insistence that things be valued in dollars (discounted cash flow) or be worthless, and that over the idea that greed is good and leads to socially acceptable outcomes. The core of the Reagan-Thatcher revolution is that greed (especailly that of financiers capturing future cash flows of the real world for their personal, immediate profit) spontaneously improves the common good, and that all regulations and taxes that limit it should be dismantled.

Well, we're about to see the price of that grand collective delusion. But we, especially those of us that call ourselves progressives, should not mistake our target. Bankers and financiers should be made to pay for their follies but that is only a small part of it. The big thing is to blame it on the failed, and utterly dangerous, ideology of the efficient markets/society doesn't exist/government is the problem crowd. otherwise it will start again - and not only that, but their proposed remedy WILL be lower wages, fewer worker rights, lower taxes and the other usual "reforms."

Again, the fact that a bubble is now publicly acknowledged ensures that there will be a major economic correction, irrespective of whether there is a full financial meltdown or not. There will be pain. There will be calls for bailouts. There will be further pressure on the lower and middle classes to bear the brunt of the price. Unless we have a coherent alternative economic discourse on the crisis - that of strict regulation of the financial world (real regulation, not the busybody but pretend kind like we have right now), bankers will continue to capture wealth, even as the pie shrinks.