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# Speculators, Politicians, and Financial Disasters

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FUELED BY easy credit, the real-estate market had been rising swiftly for some years. Members of Congress were determined to assure the continuation of that easy credit. Suddenly, the party came to a devastating halt. Defaults multiplied, banks began to fail. Soon the economic troubles spread beyond real estate. Depression stalked the land.

The year was 1836.

The nexus of excess speculation, political mischief, and financial disaster—the same tangle that led to our present economic crisis—has been long and deep. Its nature has changed over the years as Americans have endeavored, with varying success, to learn from the mistakes of the past. But it has always been there, and the commonalities from era to era are stark and stunning. Given the recurrence of these themes over the course of three centuries, there is every reason to believe that similar calamities will beset the system as long as human nature and human action play a role in the workings of markets.

LET US begin our account of the catastrophic effects of speculative bubbles and political gamesmanship with the collapse of 1836. Thanks to a growing population, prosperity, and the advancing

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frontier, poorly regulated state banks had been multiplying throughout the 1830’s. In those days, chartered banks issued paper money, called banknotes, backed by their reserves. From 1828 to 1836, the amount in circulation had tripled, from \$48 million to \$149 million. Bank loans, meanwhile, had almost quadrupled to \$525 million. Many of the loans went to finance speculation in real estate.

Much of this easy-credit-induced speculation had been caused, as it happens, by President Andrew Jackson. This was a terrific irony, since Jackson, who served as President from 1829 until 1837, hated speculation, paper money, and banks. His crusade to destroy the Second Bank of the United States, an obsession that led him to withdraw all federal funds from its coffers in 1833, removed the primary source of bank discipline in the United States. Jackson had transferred those federal funds to state banks, thereby enabling their outstanding loans to swell.

The real-estate component of the crisis began to take shape in 1832, when sales by the government of land on the frontier were running about \$2.5 million a year. Some of the buyers were prospective settlers, but most were speculators hoping to turn a profit by borrowing most of the money needed and waiting for swiftly-rising values to put them in the black. By 1836, annual land sales totaled \$25 million; in the summer of that year, they were running at the astonishing rate of \$5 million a month.

While Jackson, who was not economically so-

phisticated, did not grasp how his own actions had fueled the speculation, he understood perfectly well what was happening. With characteristic if ill-advised decisiveness, he moved to stop it. Since members both of Congress and of his cabinet were personally involved in the speculation, he faced fierce opposition. But in July, as soon as Congress adjourned for the year, Jackson issued an executive order known as the “specie circular.” This forbade the Land Office to accept anything but gold and silver (i.e., specie) in payment for land. Jackson hoped that the move would dampen the speculation, and it did. Unfortunately, it did far more: people began to exchange their banknotes for gold and silver. As the demand for specie soared, the banks called in loans in order to stay liquid.

The result was a credit crunch. Interest rates that had been at 7 percent a year rose to 2 and even 3 percent a month. Weaker, overextended banks began to fail. Bankruptcies spread. Even several state governments found they could not roll over their debts, forcing them into default. By April 1837, a month after Jackson left the presidency, the great New York diarist Philip Hone noted that “the immense fortunes which we heard so much about in the days of speculation have melted like the snows before an April sun.”

The longest depression in American history had set in. Recovery would not begin until 1843. In Charles Dickens’s *A Christmas Carol*, published that same year, Ebenezer Scrooge worries that a note payable to him in three days might be as worthless as “a mere United States security.”

**M**ODERN STANDARDS preclude government officials and members of Congress from the sort of speculation that was rife in the 1830’s. But today’s affinities between Congressmen and lobbyists, affinities fueled by the largess of political-action committees, have produced many of the same consequences.

Consider the savings-and-loan (S&L) debacle of the 1980’s. The crisis, which erupted only two decades ago but seems all but forgotten, was almost entirely the result of a failure of government to regulate effectively. And that was by design. Members of Congress put the protection of their political friends ahead of the interests of the financial system as a whole.

After the disaster of the Great Depression, three types of banks still survived—artifacts of the Democratic party’s Jacksonian antipathy to powerful banks. Commercial banks offered depositors both checking and savings accounts, and made mostly commercial

loans. Savings banks offered only savings accounts and specialized in commercial real-estate loans. Savings-and-loan associations (“thrifts”) also offered only savings accounts; their loan portfolios were almost entirely in mortgages for single-family homes.

All this amounted, in effect, to a federally mandated cartel, coddling those already in the banking business and allowing very few new entrants. Between 1945 and 1965, the number of S&Ls remained nearly constant at about 8,000, even as their assets grew more than tenfold from almost \$9 billion to over \$110 billion. This had something to do with the fact that the rate of interest paid on savings accounts was set by federal law at .25 percent higher than that paid by commercial banks, in order to compensate for the inability of savings banks and S&Ls to offer checking accounts. Savings banks and S&Ls were often called “3-6-3” institutions because they paid 3 percent on deposits, charged 6 percent on loans, and management hit the golf course at 3:00 p.m. on the dot.

These small banks were very well connected. As Democratic Senator David Pryor of Arkansas once explained:

You got to remember that each community has a savings-and-loan; some have two; some have four, and each of them has seven or eight board members. They own the Chevy dealership and the shoe store. And when we saw these people, we said, gosh, these are the people who are building the homes for people, these are the people who represent a dream that has worked in this country.

They were also, of course, the sorts of people whose support politicians most wanted to have—people who donated campaign money and had significant political influence in their localities.

The banking situation remained stable in the two decades after World War II as the Federal Reserve was able to keep interest rates steady and inflation low. But when Lyndon Johnson tried to fund both guns (the Vietnam war) and butter (the Great Society), the cartel began to break down.

If the government’s first priority had been the integrity of the banking system and the safety of deposits, the weakest banks would have been forced to merge with larger, sounder institutions. Most solvent savings banks and S&Ls would then have been transmuted into commercial banks, which were required to have larger amounts of capital and reserves. And some did transmute themselves on their own. But by 1980 there were still well over 4,500 S&Ls in operation, relics of an earlier time.

WHY WAS the integrity of the banking system not the first priority? Part of the reason lay in the highly fragmented nature of the federal regulatory bureaucracy. A host of agencies—including the Comptroller of the Currency, the Federal Reserve, the FDIC and the FSLIC, state banking authorities, and the Federal Home Loan Bank Board (FHLBB)—oversaw the various forms of banks. Each of these agencies was more dedicated to protecting its own turf than to protecting the banking system as a whole.

Adding to the turmoil was the inflation that took off in the late 1960's. When the low interest rates that banks were permitted to pay failed to keep pace with inflation, depositors started to look elsewhere for a higher return. Many turned to money-market funds, which were regulated by the Securities and Exchange Commission rather than by the various banking authorities and were not restricted in the rate of interest they could pay. Money began to flow out of savings accounts and into these new funds, in a process known to banking specialists by the sonorous term "disintermediation."

By 1980, with inflation roaring above 12 percent—the highest in the country's peacetime history—the banks were bleeding deposits at a prodigious rate. The commercial banks could cope; their deposit base was mostly in checking accounts, which paid no interest, and their lending portfolios were largely made up of short-term loans whose average interest rates could be quickly adjusted, not long-term mortgages at fixed interest. But to the savings banks and S&Ls, disintermediation was a mortal threat.

Rather than taking the political heat and forcing the consolidation of the banking industry into fewer, stronger, and more diversified banks, Washington rushed to the aid of the ailing S&Ls with quick fixes that virtually guaranteed future disaster. First, Congress eliminated the interest-rate caps. Banks could now pay depositors whatever rates they chose. While it was at it, Congress also raised the amount of insurance on deposits, from \$40,000 to \$100,000 per depositor.

At the same time, the Federal Home Loan Bank Board changed the rules on brokered deposits. Since the 1960's, brokers had been making, on behalf of their customers, multiple deposits equal to the limit on insurance. This allowed wealthy customers to possess insured bank deposits of any cumulative size—an end-run around the limit that should never have been tolerated in the first place. Realizing that these deposits were "hot money," likely to chase the highest return, the Home Loan

board forbade banks to have more than five percent of their deposit base in such instruments. But in 1980 it eliminated the restriction.

With no limits on interest rates that could be paid and no risk of loss to the customers, the regulators and Congress had created an economic oxymoron: a high-yield, no-risk security. As money flowed in to take advantage of the situation, the various S&Ls competed among themselves to offer higher and higher interest rates. Meanwhile, however, their loan portfolios were still in long-term home mortgages, many yielding low interest.

As a result, they went broke. In 1980 the S&Ls had a collective net worth slightly over \$32 billion. By December 1982 that number had shrunk to less than \$4 billion.

To remedy the disaster caused by the quick fixes of 1980, more quick fixes were instituted. The FHLBB lowered reserve requirements—the amount of money that banks must keep in highly liquid form, like Treasury notes, in order to meet any demand for withdrawals—from 5 to 3 percent of deposits. "With the proverbial stroke of the pen," the journalist L.J. Davis wrote, "sick thrifts were instantly returned to a state of ruddy health, while thrifts that only a moment before had been among the dead who walk were now reclassified as merely enfeebled."

For good measure, the Bank Board changed its accounting rules, allowing the thrifts to show handsome profits when they were, in fact, going bust. It was a case of regulators authorizing the banks they regulated to cook the books. Far worse, the rule that only locals could own an S&L was eliminated. Now anyone could buy a thrift. High-rollers began to move in, delighted to be able to assume the honorific title of "banker."

And Congress, ever anxious to help the Chevy dealers and shoe-store owners, lifted the limits on what the thrifts themselves could invest in. No longer were they limited to low-interest, long-term, single-family mortgages. Now they could lend up to 70 percent of their portfolios for commercial real-estate ventures and consumer needs. In short, Congress gave the S&Ls permission to become full-service banks without requiring them to hold the capital and reserves of full-service banks.

Now came the turn of state-chartered thrifts, whose managers understandably wanted to enjoy the same freedoms enjoyed by federally-chartered S&Ls. State governments from Albany to Sacramento were obliging. California, which had the largest number of state-chartered S&Ls, allowed them to invest in anything from junk bonds to

start-up software companies—in effect, to become venture-capital firms using government-guaranteed money. The consequence, as predictable as the next solar eclipse, was a collapse of the S&Ls en masse. Between 1985 and 1995, over a thousand were shut down by the government or forced to merge. The cost to the public is estimated to have run \$160 billion.

AS THE SORRY tale of the S&L crisis suggests, the road to financial hell is sometimes paved with good intentions. There was nothing malign in attempting to keep these institutions solvent and profitable; they were of long standing, and it seemed a noble exercise to preserve them. Perhaps even more noble, and with consequences that have already proved much more threatening, was the philosophy that would eventually lead the United States into its latest financial crisis—a crisis that begins, and ends, with mortgages.

A mortgage used to stay on the books of the issuing bank until it was paid off, often twenty or thirty years later. This greatly limited the number of mortgages a bank could initiate. In 1938, as part of the New Deal, the federal government established the Federal National Mortgage Association, nicknamed Fannie Mae, to help provide liquidity to the mortgage market.

Fannie Mae purchased mortgages from initiating banks and either held them in its own portfolio or packaged them as mortgage-backed securities to sell to investors. By taking these mortgages off the books of the issuing banks, Fannie Mae allowed the latter to issue new mortgages. Being a government entity and thus backed by the full faith and credit of the United States, it was able to borrow at substantially lower interest rates, earning the money to finance its operations on the difference between the money it borrowed and the interest earned on the mortgages it held.

Together with the GI Bill of 1944, which guaranteed the mortgages issued to veterans, Fannie Mae proved a great success. The number of Americans owning their own homes climbed steadily, from fewer than 15 percent of non-farm families in the 1930's to nearly 70 percent by the 1980's. Thus did Fannie Mae and the GI Bill prove to be powerful engines for increasing the size of the middle class.

IT CAN BE argued that 70 percent is about as high a proportion as could, or should, be hoped for in home ownership. Many young people are not ready to buy a home; many old people prefer to

rent. Some families move so frequently that home ownership makes no sense. Some people, like Congressman Charlie Rangel of New York, take advantage of local rent-control laws to obtain housing well below market rates, and therefore have no incentive to buy.

And some families simply lack the creditworthiness needed for a bank to be willing to lend them money, even on the security of real property. Perhaps their credit histories are too erratic; perhaps their incomes and net worth are lower than bank standards; or perhaps they lack the means to make a substantial down payment, which by reducing the amount of the mortgage can protect a bank from a downturn in the real-estate market.

But historically there was also a class, made up mostly of American blacks, for whom home ownership was out of reach. Although simple racial prejudice had long been a factor here, it was, ironically, the New Deal that institutionalized discrimination against blacks seeking mortgages. In 1935 the Federal Housing Administration (FHA), established in 1934 to insure home mortgages, asked the Home Owner's Loan Corporation—another New Deal agency, this one created to help prevent foreclosures—to draw up maps of residential areas according to the risk of lending in them. Affluent suburbs were outlined in blue, less desirable areas in yellow, and the least desirable in red.

The FHA used the maps to decide whether or not to insure a mortgage, which in turn caused banks to avoid the redlined neighborhoods. These tended to be in the inner city and to comprise largely black populations. As most blacks at this time were unable to buy in white neighborhoods, the effect of redlining was largely to exclude even affluent blacks from the mortgage market.

Even after the end of Jim Crow in the 1960's, the effect of redlining lingered, perhaps more out of habit than of racial prejudice. In 1977, responding to political pressure to abolish the practice, Congress finally passed the Community Reinvestment Act, requiring banks to offer credit throughout their marketing areas and rating them on their compliance. This effectively outlawed redlining.

Then, in 1995, regulations adopted by the Clinton administration took the Community Reinvestment Act to a new level. Instead of forbidding banks to discriminate against blacks and black neighborhoods, the new regulations positively forced banks to seek out such customers and areas. Without saying so, the revised law established quotas for loans to specific neighborhoods, specific income classes, and specific races. It also encouraged

community groups to monitor compliance and allowed them to receive fees for marketing loans to target groups.

But the aggressive pursuit of an end to redlining also required the active participation of Fannie Mae, and thereby hangs a tale. Back in 1968, the Johnson administration had decided to “adjust” the federal books by taking Fannie Mae off the budget and establishing it as a “Government Sponsored Enterprise” (GSE). But while it was theoretically now an independent corporation, Fannie Mae did not have to adhere to the same rules regarding capitalization and oversight that bound most financial institutions. And in 1970 still another GSE was created, the Federal Home Loan Mortgage Corporation, or Freddie Mac, to expand further the secondary market in mortgage-backed securities.

This represented a huge moral hazard. The two institutions were supposedly independent of the government and owned by their stockholders. But it was widely assumed that there was an implicit government guarantee of both Fannie and Freddie’s solvency and of the vast amounts of mortgage-based securities they issued. This assumption was by no means unreasonable. Fannie and Freddie were known to enjoy lower capitalization requirements than other financial institutions and to be held to a much less demanding regulatory regime. If the United States government had no worries about potential failure, why should the market?

Forward again to the Clinton changes in 1995. As part of them, Fannie and Freddie were now permitted to invest up to 40 times their capital in mortgages; banks, by contrast, were limited to only ten times their capital. Put briefly, in order to increase the number of mortgages Fannie and Freddie could underwrite, the federal government allowed them to become grossly undercapitalized—that is, grossly to reduce their one source of insurance against failure. The risk of a mammoth failure was then greatly augmented by the sheer number of mortgages given out in the country.

That was bad enough; then came politics to make it much worse. Fannie and Freddie quickly evolved into two of the largest financial institutions on the planet, with assets and liabilities in the trillions. But unlike other large, profit-seeking financial institutions, they were headquartered in Washington, D.C., and were political to their fingertips. Their management and boards tended to come from the political world, not the business world. And some were corrupt: the management of Fannie Mae manipulated the books in order to trigger executive bonuses worth tens of millions of dollars,

and Freddie Mac was found in 2003 to have understated earnings by almost \$5 billion.

Both companies, moreover, made generous political contributions, especially to those members of Congress who sat on oversight committees. Their charitable foundations could be counted on to kick in to causes that Congressmen and Senators deemed worthy. Many of the political contributions were illegal: in 2006, Freddie was fined \$3.8 million—a record amount—for improper election activity.

**B**Y 2007, Fannie and Freddie owned about half of the \$12 trillion in outstanding mortgages, an unprecedented concentration of debt—and of risk. Much of the debt was concentrated in the class of sub-prime mortgages that had proliferated after the 1995 regulations. These were mortgages given to people of questionable credit standing, in one of the attempts by the federal government to increase home ownership among the less well-to-do.

Since banks knew they could offload these sub-prime mortgages to Fannie and Freddie, they had no reason to be careful about issuing them. As for the firms that bought the mortgage-based securities issued by Fannie and Freddie, they thought they could rely on the government’s implicit guarantee. AIG, the world’s largest insurance firm, was happy to insure vast quantities of these securities against default; it must have seemed like insuring against the sun rising in the West.

Wall Street, politicians, and the press all acted as though one of the iron laws of economics, as unrepalable as Newton’s law of universal gravity, had been set aside. That law, simply put, is that potential reward always equals potential risk. In the real world, unfortunately, a high-yield, no-risk investment cannot exist.

In 2006, after an astonishing and unsustainable climb in home values, the inevitable correction set in. By mid-2007, many sub-prime mortgages were backed by real estate that was now of lesser value than the amount of debt. As the market started to doubt the soundness of these mortgages, their value and even their salability began to deteriorate. So did the securities backed by them. Companies that had heavily invested in sub-prime mortgages saw their stock prices and their net worth erode sharply. This caused other companies to avoid lending them money. Credit markets began to tighten sharply as greed in the marketplace was replaced by fear.

A vicious downward spiral ensued. Bear Stearns, the smallest investment bank on Wall Street, was forced into a merger in March with JPMorgan

Chase, with guarantees from the Federal Reserve. Fannie and Freddie were taken over by the government in early September; Merrill Lynch sold itself to Bank of America; AIG had to be bailed out by the government to the tune of \$85 billion; Lehman Brothers filed for bankruptcy; Washington Mutual became the biggest bank failure in American history and was taken over by JPMorgan Chase; to avoid failure, Wachovia, the sixth largest bank in the country, was taken over by Wells Fargo. The most creditworthy institutions saw interest rates climb to unprecedented levels—even for overnight loans of bank reserves, which are the foundation of the high-functioning capitalist system of the West. Finally it became clear that only a systemic intervention by the government would stem the growing panic and allow credit markets to begin to function normally again.

**M**ANY PEOPLE, especially liberal politicians, have blamed the disaster on the deregulation of the last 30 years. But they do so in order to avoid the blame's falling where it should—squarely on their own shoulders. For the same politicians now loudly proclaiming that deregulation caused the problem are the ones who fought tooth and nail to prevent increased regulation of Fannie and Freddie—the source of so much political money, their mother's milk.

To be sure, there is more than enough blame to go around. Forgetting the lessons of the past, Wall Street acted as though the only direction that markets and prices could move was up. Credit agencies like Moody's, Standard & Poor's, and Fitch gave high ratings to securities that, in retrospect, they clearly did not understand. The news media did not even try to investigate the often complex economics behind the housing market.

But remaining at the heart of the financial beast now abroad in the world are Fannie Mae and Freddie Mac and the mortgages they bought and turned into securities. Protected by their political patrons, they were allowed to pile up colossal debt on an inadequate capital base and to escape much of the regulatory oversight and rules to which other financial institutions are subject. Had they been treated as the potential risks to financial stability they were from the beginning, the housing bubble could not have grown so large and the pain that is now accompanying its end would not have hurt so much.

Herbert Hoover famously remarked that “the trouble with capitalism is capitalists. They're too greedy.” That is true. But another and equal trouble with capitalism is politicians. Like the rest of us, they are made of all-too-human clay and can be easily blinded to reality by naked self-interest, at a cost we are only now beginning to fathom.