the weekly Standard

High Anxiety

We went from playing inflation-era Monopoly to playing depression-era Monopoly in mid-game.

by Lawrence B. Lindsey

09/29/2008, Volume 014, Issue 03

Friends and tradesmen, not to mention clients, have all been asking me the same question in the past few weeks. Is this 1929? Are we headed for a depression?

Let's begin with the somewhat reassuring point that even if we are headed for a depression, it will not be like the memories or pictures in history books we have of the 1930s. In 1929, Americans had the per capita GDP of people now living in the Balkans. Today it is five times higher. So even if we have a depression, there won't be any Hoovervilles or soup lines. There may be a massive increase in demands for public assistance and rental housing, but this is hardship, not the privations of the 1930s.

We have learned from what happened back then and from Japan's experience in the 1990s. We will probably not make the same mistakes. We will, however, make other mistakes (and indeed we already have). Although conditions change, the basic human motivations of fear, greed, ignorance, and hubris are enduring.

Keep in mind as we go through these tough times that even the smartest people can be wrong. Isaac Newton lost money in the South Sea Bubble. He not only figured gravity out, but was Master of the Mint, as close to being a central bank governor as one could be back in the seventeenth century. Recognizing the developing bubble, he sold his position. Then, when prices continued to rise, he decided that he must have been mistaken and bought back in just before the top, ultimately losing a small fortune.

More than three centuries have passed, but the model is still the same. A great idea comes along that has some grounding in economic reality: exotic spices from afar; the beauty of tulips; canals as the hot new mode of transport; railroads making canals obsolete; a radio in every home or a car in every garage; the Internet and dot commerce; home prices that can only go up. Those who first pursue the idea make money. They tell their friends, and their friends pile in. More buyers mean higher prices for assets related to the core idea. Lenders, seeing a new idea whose price is rising, lower prudential standards as those investing in that idea have all made money and never defaulted on their loans. Higher asset values means improved balance sheets, a greater feeling of economic security, and so even more willingness by all parties to borrow and lend.

We all fell for it again. Who do you think we all are? Geniuses like Newton?

Most readers, I trust, have played the board game Monopoly. But probably few of us actually play by the original rules, which provide insight into hard times. One popular embellishment of the original version is to pool all the money collected from Chance, Community Chest, Income Tax, and Luxury Tax and pay it out to the person who lands on Free Parking. Some expand this further, adding one of every kind of bill (a total of $686) to the take of the lucky player who lands on the space that the original rules designed as a free space where nothing happens. Improvisations like this turn a game originally designed for adults in the hard times of the 1930s into a much faster "Inflation Era" Monopoly, a game in which even children can accumulate cash and have a good time. Indeed, the desire to use the game to teach children the rudiments of money and economics in a manner which is fun is one of the reasons most players end up changing the rules.

The biggest rule change most contemporary players use, though, is to have the bank pay the owners of houses full cost when they sell them back or "liquidate" them. The original rules paid the owners only half. This changes the game completely. Property development becomes a very risky proposition rather than a sure thing. The pace of "economic activity," building houses and hotels, is excruciatingly slow as the money supply in the game is restricted to the income supplied when players pass GO and the risk of losses is high. Then, after a long process of building, just as the game board gets nearly fully developed, an economic accident occurs when one of the more aggressive players hits Street Repairs in Chance or Community Chest and must liquidate his holdings at fifty cents on the dollar. Wealth is destroyed and houses and hotels crumble. Welcome to Depression Monopoly.

I stumbled on this when trying to explain what was happening in the economy to my 16-year-old son with whom I had played many games of Monopoly under the inflation version of the rules. We had found the 1930s version too demoralizing, quit before finishing the game, and resolved that, whenever we played with my younger son, we would use the inflation version, pumping as much money in through Free Parking as possible and definitely giving full price for houses. The American economy has just moved from the Inflation Monopoly rules to the Depression ones in mid-game.

For at least the past 15 years, house prices have risen in most parts of the country. Money was ample. Fortunes were made by acquiring as much land as possible and developing it. Risks were minimal. If you ran into an unforeseen event and had to sell, you could get at least as much as you paid for the house, repay the bank, and move on with a small profit. It was such a sure thing that a record number of American families bought second homes. Owning rental housing became fashionable again for the first time since the 1980s when tax law changes converted it from the one-of-each-bill version of Free Parking into the economically neutral "free space" version.

Our financial institutions evolved to meet the new rules. Lending that required the traditional 20 percent down payment became passé. In 2006, the median down payment for first-time homebuyers was just 3 percent. Proof of income (i.e., that when you passed GO you would collect $200) became optional as did basic tests of past ability to repay debts.

Most important, the accounting and regulatory rules for holding reserves against these loans evolved from hard and fast provisioning to ones based on "historical experience," meaning the low default rates of the past few years with prices only going up. These provisions were not adequate when prices went down. The reason our financial institutions are in trouble is that they are now taking back homes on which they lent 90 cents on the dollar, but which their owners can only sell for 75 or 80 cents. So, even if the bank repossesses the house, it loses money and does not have adequate provision for the loss.

The problem got more complex as financial institutions borrowed and lent to each other, creating a so-called counterparty risk. When one institution got into trouble, it suddenly couldn't pay its counterparties. That meant the other institutions began to run short of cash as well. Cash-short financial institutions had to start dumping financial assets, typically securities backed by real estate, into the market thus depressing prices further. This produced another round of problems for financial institutions and a downward spiral.

Authorities responded by trying to arrange deals where relatively healthy institutions bought the ones on the verge of bankruptcy. In the case of Bear Stearns, they succeeded in getting J.P. Morgan to deal only by agreeing to absorb potential losses up to $29 billion. But the list of potential purchasers is now getting very slim.

Whenever a financial institution expands by buying another, less solvent, institution, its own capital position is weakened. So, this phase of industry consolidation through government-encouraged acquisitions will prove quite limited. Collectively, the amount of capital that exists in the entire financial services industry is already stretched, so unless more capital is injected from outside the system, some institutions will inevitably not find buyers and will fail. (This is what happened to Lehman Brothers.) And when an institution fails, losses due to counterparty risk ripple through the system. The collective amount of capital in the financial services industry drops still further, forcing still more failures.

This is why so many people are now wondering if we are headed for an economic depression. This dynamic of spiraling failure is eerily reminiscent of what happened in the early 1930s--just as there are many good analogies between the 1920s and what has happened in our economy since the early 1990s. There are important differences, of course, but since most of us are really mini-financial institutions, the issues are not merely of academic interest. A digression into economic self-preservation in a game of real-life Depression Monopoly might be useful.

First, readers would be well advised to actually sit down and write up a budget if they have any doubts about whether their current income is covering their bills. Just to be clear, expenses include not only the minimum payment on an item like a credit card, but all the charges incurred in the month *plus* the minimum payment. And income does not include any draws on saving or home equity lines of credit. I once went through a budget exercise with a struggling 20-something and asked why he didn't have anything budgeted for gasoline for his car. His response was that he simply put it on his credit card so it didn't count as long as he was making the minimum payment.

Second, people should make sure that they have at least three, and ideally six, months' income saved in a place where they can get at it readily like a bank account or money-market fund. This is on top of items like retirement saving and college accounts.

Third, once this threshold is met, it is doubtless a good idea to start reducing debt, particularly on credit cards and auto loans. These are about to get much harder to obtain as the credit crunch inevitably spreads from the commanding heights of the financial sector into the consumer credit arena. It will not be surprising to see the limits on credit cards lowered sharply, fees for holding cards rise, and auto loans tough to qualify for. The goal for households should be to be able to use credit cards for convenience only--paying the bill in full each month--and to have the ability to pay cash for larger purchases like a car.

Finally, for those lucky enough to meet the above criteria, where one deploys one's assets becomes a serious matter in the current environment. There was a saying in the 1930s that you should not have all your eggs in one basket. It meant spread the assets around. In the calm environment of the last few decades this dictum was rejected for the convenience of one-stop financial shopping. You might want to consult a financial adviser or at least inquire at the institutions where you have assets what the insurance limits are and under what circumstances your assets can be seized by creditors of the institution. This means asking questions about deposit-insurance limits, the assets backed by money-market funds, and whether your investments are in custodial accounts.

It is sad that we have to waste time in our busy lives worrying about things that people have not had to concern themselves with since the 1930s, but, frankly, aside from officials at the Fed and Treasury, the political leadership in both parties seems clueless about what is happening. Their inattention to these matters has contributed to our current mess, and this must change now.

First, President Bush should ask Congress to immediately remove the limit on FDIC insurance for transactions accounts at banks. This is central to protecting the payments system that allows the economy to function. Currently the cap is $100,000, which might seem like a lot, but barely covers the biweekly payroll and vendor costs of a company with a dozen employees. Once there is a commercial bank failure in which uninsured depositors see their accounts frozen, ripple effects will start to emerge that will end with a run on the banking system. Small and larger businesses alike will have no choice but to seek safe havens for their working capital, as will well-off individuals for the money they use to meet monthly expenses.

Second, politicians and regulators need to decide on the appropriate rules for reducing consumer credit lines once delinquency rates start to rise or market conditions make carrying credit card receivables--the amount of money you owe on your cards--difficult for banks. Currently these decisions are made by rules programmed into computers that were established when few thought we would ever see the kinds of credit conditions we are experiencing today. Prudent cash management by credit card companies will come into direct conflict with the credit needs of the household sector and the ability of the economy to sustain both spending levels and employment.

Third, and most important, policymakers are going to have to force us back from the current Depression Monopoly downward spiral toward the Inflation Monopoly arrangements. This is not as obvious a choice as one might expect. As recently as late summer Fed officials were expressing concerns about inflation being their main challenge, and politicians of both parties found it easy to oppose "bailouts" of seemingly well-heeled financial institutions, their owners, and their employees.

I realize that we risk rekindling all the imprudent behavior and excessive leverage that comes under the phrase "moral hazard" by trying to change the rules back. But continuing along our current track also involves morally dubious risks, like widespread unemployment and household and business bankruptcies. In this global economy, it also involves noneconomic risks that are reminiscent of the 1930s. Do we really want to chance the hundreds of millions of people who have joined the global middle class during the last decade dropping back into poverty? Do we think this can happen without geopolitical consequences? Despite some disappointing comments on the credit crisis, at least John McCain seems to understand the links between free trade and global security issues, something his opponent apparently fails to grasp.

The government's decision on Thursday to buy mortgage-backed securities--adopting the "full price for houses" rule--is a major step toward propping up the mortgage market and the financial industry. It was coupled with a variety of other rule changes that constitute a big step back toward "Inflation Monopoly." But as with any change in the rules there are going to be a lot of unintended consequences.

Start with the centerpiece of the plan, the purchase of mortgage-backed securities by the Treasury. This should help prop up prices, at least initially. But, there are some unusual aspects to the rule change. The government is purchasing assets from financial institutions that are still solvent, i.e., still playing the old game. Back in the days of the 1989 Thrift Bailout and the Resolution Trust Corporation, the government simply assumed the assets of any bankrupt institutions that the FDIC had to step in and insure. This time, ongoing businesses will have to decide which assets to sell and at what price.

In our Monopoly example, imagine you need cash and own Park Place but haven't been able to make a deal with the owner of Boardwalk. The government will take it off your hands, but for a price that is yet to be determined. One problem: You and the other players don't know if the government is going to turn around and auction the property off, allowing the player with Boardwalk to buy it. If so, that other guy might make a huge windfall at your expense and at the expense of the other players.

Also, this appears to be a onetime deal from the government. Should you sell now or take your chances in the market place? Say you own the three Yellows and have invested in placing three houses on each. You're solvent, but no one has landed on your houses leaving you cash strapped and disillusioned about the value of your investment. If you sell now to the government, they are probably going to give you something close to full value for those houses. But, property values are still depressed and the government now owns a ton of property and the financial paper behind it that could be dumped on the market at any time. So, if you don't sell to the government now while they are offering to buy at something close to full price, you could be forced to dump those houses in the market at half price sometime in the future. Thus, the government may have set up the incentive structure to take on more property, and more taxpayer risk than might otherwise have been the case.

Another example of unintended consequences has to do with the decision to insure money-market funds. Treasury officials probably thought they had to. (An estimated $180 billion came out of the funds on Thursday alone--giving some idea of how quickly a bank run can develop and how large the magnitude could be.) But, the Treasury is not insuring the uninsured depositors in the banks. Likely consequence: a run of money out of the banking system and into the newly insured funds. That's what happens when you change the rules suddenly.

To make things more complicated, the Securities and Exchange Commission placed a temporary ban on "short-selling," i.e., making a bet that the price of a stock would go down and also changed the rule that allowed companies to buy their own stock on the open market. They did this on a day when trillions of dollars of stock options came due, thereby manipulating the price of stocks higher. Serious questions are now being raised all around the world about whether or not U.S. markets are being politically manipulated.

Finally, it is far from clear that the Federal Reserve is going to be monetizing this process, or whether the financing is just going to be through more government debt in the market. If there is simply more debt, there will be little long-term increase in economic activity as the higher Treasury borrowing crowds out other investment. Continuing our Monopoly analogy, unless more money is pumped into the game through Free Parking or other devices and on a continuing basis, there will still not be enough money in the game to assure the profitability of all the houses and hotels that have been built. The odds are high that the Fed will ultimately print the money, and in volumes equivalent to giving players one of each kind of bill, but a formal decision on that still lies ahead.

It is very hard to play a game in which the rules change continuously. Once the novelty wears off, much of the fun will have gone out of the game as players will not know how to develop a winning strategy. This is even more true when the game is real and one's life savings is at stake. The government's ad hoc approach to the rules of the game to date--soon to be followed by investigations by state attorneys general and federal agencies and endless litigation--has probably permanently impaired the attractiveness of U.S. financial markets. That is a price we all are going to pay for decades to come. As we are all learning, Depression Monopoly is no fun to play.

Lawrence B. Lindsey, a former governor of the Federal Reserve, was special assistant to President Bush for economic policy and director of the National Economic Council at the White House. His most recent book is What a President Should Know… but Most Learn Too Late *(Rowman and Littlefield).*