A Brief History of Market Failures, Yesterday and Tomorrow

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Many of us are waiting — and wondering how long the U.S. economy will continue to roll along? How long will the topsy-turvy stock market continue to weekly create fortunes or take them away? How long will the business media continue to talk about the New Economy, built on intellectual property such as computer software and internet services? We read from analysts that specific locations are thought to be less and less important because people are working from their homes and companies are building their headquarters in places far from downtowns and no longer in suburban office parks. Despite what Groundswell readers know to be the case, the rising cost of land is not identified as a drain on economic growth or a potential cause for a recessionary downturn. In fact, the negative effects of rising land prices are simply accepted as an unfortunate aspect of how markets operate and a problem that has to be addressed by special government and philanthropic programs to subsidize housing expenses for those whose incomes are insufficient. The fact that more and more working families are finding their way to homeless shelters is a clear indication that something more structural must be done.

Another aspect to the New Economy mentality is the suggestion that old economic theories no longer apply. Is the business cycle a relic of times past? Has the information age combined with finely-tuned fiscal and monetary controls to keep economic growth on track? Is inflation dead? Is deflation dead? What does history provide for us as signposts of what is happening now and what to expect?

Our economic history is the documentation of regional or more widespread downturns. All too frequently we and the generations before us have endured enormous shocks to the system. Each time this occurs some of our elected and civic leaders undertake continued on page 9
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progresses of reform. Progressives in the late 19th and early 20th centuries fought to introduce laws against child labor and on behalf of the rights of workers to organize and bargain collectively. The control over the issuance of paper currency was taken away from commercial banks by the creation of the Federal Reserve system and the declaration of the FED’s notes as legal tender (backed by government’s authority to raise revenue via taxation and borrowing). A Constitutional amendment was adopted allowing the government to tax individual incomes, ostensibly to be restricted on an ability to pay basis to those with the highest incomes, but gradually filtering down to all but the lowest income earners. Corporate monopolies came under attack, and laws against the worst forms of securities frauds were enacted. Across the land protests combined with sighs of relief. People waited and wondered. Would these reforms enable the U.S. economy to recover and roll along without another major downturn?

In the Old World, the balance of power was dissolving as corrupt empires imploded under pressures of resurgent ethnic nationalism and competition from the industrializing and centrally-controlled states. When war finally erupted in 1914, the immediate impact on the United States was to stimulate demand for the goods the belligerent nations needed but could not produce for themselves. When the Old World governments ran out of gold stocks they negotiated purchases from producers in the United States and other countries on credit. War in the Old World seemed to be just the tonic for U.S. producers, who adapted to the production of war goods and expanded capacity. Labor unions were temporarily strengthened because companies could simply pass on to governments any increased labor costs in order to avoid strikes or other disruptions. Food exports and prices soared, inducing farmers to purchase ever more acreage on credit, much of it marginal and dependent on irrigation and heavy chemical fertilization. Given the demand and high prices this seemed like good business sense, and the government and bankers encouraged farmers to expand.

By 1918 the Old World nations were drained of manpower and financial reserves. The armies stopped fighting and were decommissioned. Woodrow Wilson naively contemplated a new world order where nations voluntarily subordinated national sovereignty to an international governing body. In much of the Old World just the opposite mindset erupted following the demise of German and Austro-Hungarian control over central Europe. The collapse of the Russian empire had the same effect on the peoples long under the rule of Czars. In Asia, Japan emerged as a legitimate competitor to European power; and even the Chinese were beginning to develop a modernized military capable of challenging the European (or Japanese) colonial presence. Thus, although the war between the European peoples came to an end, numerous other wars between nationalist groups broke out in the power vacuum that appeared throughout much of the Old World.

In France and England domestic production of agricultural commodities resumed. As U.S. exports declined and prices for agricultural products fell, American farmers found themselves faced with bank debts that could not be repaid. Many tried to sell off unneeded acreage to raise cash, but the market for agricultural land was collapsing as well. Thus began the first large-scale forced migration of families off of the land and into the cities. Farmers with enough foresight to know the high commodity prices would not last saved their windfall profits for the rainy days (or, as actually occurred, the drought-plagued years) to come. Undercapitalized rural banks became insolvent and closed their doors. U.S. involvement in the war was not long enough to achieve anything close to full mobilization of resources, and as soon as the war ended military contracts were cancelled and returning soldiers competed for scarce jobs. Although U.S. producers shifted to the production of consumer goods, with the automobile as the new necessity for an increasing number of U.S. households, the expansion was more short-lived than anyone anticipated. Goods began to pile up on shelves, companies released workers and scaled back production. The depression of 1921 had arrived.

By the late 1920s, those who remained attached to the movement initiated by Henry George waited and wondered: “When will this latest speculative bubble burst?” The land market boom in Florida had just come to a crashing halt. Hurricanes destroyed new coastal communities, and those who had purchased land on credit defaulted in the thousands as land values disappeared overnight. Northern banks that had supplied the credit were threatened with insolvency; some were forced to close. And, then, the credit-fueled stock market collapsed in October of 1929. Few in a position to influence public policy directed attention to the boom-to-bust nature of the land markets. Ironically, as conditions in the cities worsened there began a movement of people back to the countryside. Franklin Roosevelt declared his commitment to helping people succeed in this reverse migration and was able to get the Congress to appropriate funds to promote subsistence farming efforts. These years found the decentralist reformer Ralph Borsodi as a leading proponent of this migration, which he documented in his 1933 book, Flight From The City.

The key member of Franklin Roosevelt’s so-called “brain trust” charged with helping him deal with the Depression was Raymond Moley, a political science professor at Columbia University sympathetic to the ideas espoused by Henry George, and who later worked with Georgists to promote Henry George’s system of tax reform. Another person with strong Georgist convictions to join Roosevelt’s administration was Frederic C. Howe, who had served as Commissioner of Ellis Island and before that worked in Cleveland alongside Tom L. Johnson. Howe was called on by Henry A. Wallace to serve as counsel to the Agricultural Adjustment Administration. Remarkably, both Moley and Howe were close to

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Rexford Tugwell, another key member of Roosevelt’s early group of advisers. No one suggests that there was discussion in the White House or even between Tugwell, Moley and Howe about making a national land tax part of the Depression recovery program. Perhaps Moley or Howe left a record of such discussions I have not come across.

The one consistent voice in the wilderness came from an obscure economics professor named Harry Gunnison Brown, whose book, The Economic Basis of Tax Reform, was published in 1932. Some years later, in an article published in the American Journal of Economics and Sociology, Brown wrote: “The truth probably is that central banking policy has more to do than anything else with the alternation of prosperity and depression, and that central banking policy affects business activity through affecting the volume of circulating medium of which bank deposits subject to check are the major part. Unwise bank policy can quickly turn prosperity into depression.” Brown was totally perplexed by the current generation of experts who ignored “central bank policy as the most significant cause of depression” and “spent[ed] their time in speculations as to whether relatively inconsequential conditions, and conditions perhaps largely generated by depression itself, are the significant causes; or whether the causes are to be found in conditions that cannot convincingly be shown to operate in that direction at all?” A few of his colleagues listened and supported Brown’s views. But the winds of conventional wisdom were blowing in another direction. Thanks to the efforts of Alvin Hansen, a version of the ideas of John Maynard Keynes gradually found a stronger and stronger voice in academia and in government. Brown waged a losing battle against economics becoming “a source of confusion” that “must work against rather than for the adoption of wise policy.”

Raymond Moley abandoned Franklin Roosevelt as the President became increasingly interventionist and opened the door to an enlarged, permanent role for the Federal government. Frederic Howe left to serve as an adviser in the Philippines, returned to the U.S. before the outbreak of war and died in 1940. Harry Gunnison Brown carried on, his most important legacy the students who came to share his ideas and his passion. Roosevelt’s rhetoric gave people hope; his programs mitigated the worst hardships and prevented a serious erosion of the status quo. However, what brought a return to economic growth and low unemployment were the preparations for war. The Second World War became an experiment in total mobilization.

As the surviving soldiers returned home to the United States late in 1945, they found a country much changed from the one they left in 1942. This time there was no return to isolationism. This time the global devastation demanded an ongoing U.S. commitment of financial reserves, food and other goods. This time the United Nations included the U.S. as a leading member. New international aid organizations were created, and the Marshall Plan was adopted to create an integrated global economy. Thistime Americans had had four years to accumulate savings in the banks that now financed the construction of millions of new suburban communities and financed the purchase automobiles. And, this time the Federal government kept on spending.

Throughout the 1950s the economy continued to grow, not without periodic downturns, not without worker strikes and indications by African-Americans that they would no longer stand for the first to feel the pain and the last to benefit. By the early 1960s the nationalistic zeal that characterized the previous two decades started to disappear, replaced by the Civil Rights and Peace Movements. Lyndon Johnson unleashed the latent powers of the Federal government to wage war on poverty and on the communist-led people of North Vietnam. Heavy taxes and still heavier borrowing combined to weaken the U.S. economy. Richard Nixon and the Republicans then arrived and were faced with the challenge of the OPEC orchestrated stagnation. Some economists were shaken by a reality that countered the long-held conviction that the cure for inflation was higher unemployment. Neither Richard Nixon, Gerald Ford nor Jimmy Carter or their economic advisers demonstrated much appreciation for the fundamentals at work. What softened the crash and allowed the process of recovery to begin was the development of oil deposits under the North Sea and in Alaska. The Saudis also figured that a lower oil price was necessary to keep the global economy going (and would maximize Saudi returns, since they were major investors in banks, real estate, construction and many other businesses in the countries where oil prices were causing serious harm). Oil fell back to under $25 a barrel - still a rather profitable level of rent-seeking charge on producers but not so great that alternative energy production became a critical national objective. Solar energy and windmills would have to compete with moderate subsidies and wait for the next period of rising energy prices.

For the several years when OPEC dominated global energy supplies and costs, prices for most other commodities also escalated. Banks loaned heavily to countries on the basis of forecasted revenues from commodity sales. As should have been expected, global demand collapsed as country after country drifted into recession. The banks were left with hundreds of billions of dollars in non-performing loans. One after another failed, particularly the smaller banks whose officers had seriously over-committed to participate in these high risk loans because of the paper profits. In the U.S. the savings and loan associations and savings banks were the hardest hit. Until 1979 they had been caught in a serious squeeze. Nearly all of their loans were long-term and made at fixed rates of interest, restricted by law to under double-digit rates of interest. Newly-created money market funds were paying more than this to investors, who withdrew hundreds of billions of dollars from the banks. Finally, in 1981, the savings banks got approval to issue certificates

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of deposit at rates competitive with the money market funds. But, with their portfolios severely under water, the savings banks (and all banks to some extent) had to not only make a spread over the higher cost of funds but make up for what they were losing on existing mortgage loan portfolios. So, they entered far riskier types of lending in areas where they had little or no experience. When the third world countries started to default and small businesses failed at home, the banks closed their doors in droves. Thousands of banks disappeared forever. Weak banks were acquired by other weak banks in a desperate effort to achieve economies of operation. The era of the global bank arrived.

The people of the United States then responded to what sounded like a return to fundamentals, a simplistic presentation of the means by which American industrial might had been created. Ronald Reagan preached a reduction in central control, a return of decision-making to the states and local communities, and a scaled-back regulatory environment. His economic doctrine was described as supply-side economics and called for a deep reduction in taxation on incomes and capital gains. Lower tax rates would allow U.S. producers to keep producing here and still match global competition in prices. Supply-siders predicted that these measures would actually raise more revenue while simultaneously stimulating economic growth. One serious problem was that Reagan was also committed to a level of spending on the military that virtually dictated an unbalanced budget and a rising national debt. So, although the U.S. economy gradually began to recover and expand, the side-effect was a national debt that eventually reached and exceeded $6 trillion during the administration of Reagan’s successor, George Bush.

Had Reagan been paying attention, he could have heard warnings coming from the wilderness. An economics professor named Arthur P. Becker forecasted in a 1977 article titled, Full Employment Without Inflation, that the tax cuts proposed by the supply-siders would be siphoned off by speculative investments in stocks and land. And, that is exactly what occurred. Beginning in 1983 interest rates began to fall. After the inventory of existing unsold housing units was absorbed, prices began to rise. Land prices skyrocketed upward in many markets, but particularly in New England and southern California. Japanese and Korean banks, flush with deposits, were funding speculative real estate developments and purchasing many buildings outright. Recession then hit New England. The Federal government began to consolidate military bases and thousands of military jobs were lost in New England. At the same time, the high costs of doing business in New England caused many high tech companies to look elsewhere — to Silicon Valley in California, to Austin, Texas and to the Raleigh-Durham area of North Carolina. By mid-1988 the signs of a real estate collapse appeared. Completed office buildings and new condominiums sat empty. Developers and homeowners defaulted on loans, banks foreclosed, were declared insolvent by regulators and closed their doors. The Japanese and Koreans were soon forced to dump much of their newly-acquired real estate in the U.S. in order to stave off insolvency in the face of the land market collapse at home. An enormous quantity of real estate in California and Hawai’i came on the market all at the same time, driving down prices. New projects then under development, on land acquired at the height of the market, became unworkable. Residential properties could not be profitably completed and sold. Office buildings could not generate enough cash flow to cover debt service.

These recessions were contained. They were regional. Companies moved to the lower cost regions of the country. Global investment capital poured into the U.S. to take advantage of the high technology revolution. Foreign-owned companies constructed new production facilities in the United States. A sustained reduction in tariffs expanded imports and exports, applying enormous pressure on U.S. companies to achieve productivity gains - to which U.S. producers responded with remarkable speed and commitment. The fact that the bottom half of the U.S. population was working longer and harder to make ends meet became the subject for political speeches but generated no new public policy commitments other than a constant drive for reform of the programs that gave "welfare" benefits to families whose adult members made no attempt to support themselves and their dependents.

Where are we today, as we are nearing the end of William Jefferson Clinton’s second term in office? I am amazed that so few of the people I work with recognize the signs. Even people who lived through the events chronicled above have not understood what was happening and why. Forget the fact that investors in the stock market are possessed by a speculative fever, that billions of dollars are moving in and out of one segment and into another without regard to fundamentals. All around the country land prices are rising, escalating or skyrocketing. The median price of a modest house and lot in Silicon Valley is over $500,000 and not much lower in San Francisco. The Boston area housing and office markets have come back stronger than ever, and prices in metropolitan New York are climbing. There are fewer banks, and they are now global with assets in the hundreds of billions of dollars. Real estate developers are required to have more equity in the projects they build, reducing the exposure of banks to falling values and loan defaults. Borrowing for investing in the stock market is a minor part of the total funds involved. The global economy is larger than ever before, with large and growing middle class populations in India and China. And yet, I wait and worry. I know the New Economy is not strong enough to outpace for long the workings of our flawed land market. There is no "if" in question. There is only "how soon" and "how deep" the downturn will be.

(Editor's note: Edward Dodson has 26 years experience in the housing finance industry. He is a graduate of Shippensburg and Temple Universities.)

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