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The Repetitive Syndrome

CAN WE EXCUSE financiers for failing to prepare for the panic that swept through their banks in 2008? Ignorance is no defence for what they allowed to happen. The evidence is overwhelming that, by showing due diligence, they could have anticipated the crisis, and protected their shareholders and savers.

Banks keep records of their dealings. They have a corporate memory that stretches back to their origins. And on the simple principle of learning from experience, they can be expected to maximise their shareholders' value by avoiding the mistakes of the past. On that basis, the capacity for banks to lose vast sums on a cyclical basis is, frankly, criminal. Unless, that is, there was some mechanism at work, a form of selective amnesia, that inhibited bankers from recalling what happened just two decades ago. In the case of Citigroup, it was a case of forgetting what repeatedly happened over the course of two centuries.

Citi became the world's largest bank with assets of $2.4 trillion,. In 2006, its sales exceeded $96bn (£47bn), to 200m customers scattered in 100 countries. Citi had access to the best possible flow of information about what was happening in the global economy. But Citi had something that was even better than the information coming in from its economists and dealers in branches around the world. It has an institutional pedigree that dates back to 1812, when City Bank of New York set up shop with $2m of capital. By 1865 its name had changed to The National City Bank of New York, eventually becoming the largest American bank. By 1918, it was the first US bank to hold assets exceeding $1 billion, and it became the largest commercial bank in the world in 1929, the year the world learnt that modernity came at a price: Depression.

With that history, a prospective investor could expect the management of this bank to have some insight into the cyclical history of booms and busts. Right? And that they would not be caught out by the credit crunch of 2007. Right?

Wrong.

In 2007, the bank began to lay off 17,000 employees to cut the losses arising from its mishandling of money. In the final quarter of 2007, Charles "Chuck" Prince III quit as Chief Executive Officer after Citi announced it had lost as much as $11bn as a result of its deals in mortgages. Was this a performance consistent with the claim that free enterprise is more efficient than a state-controlled economy? Western governments have engaged in some terribly wasteful projects – but few come anywhere near matching the waste of resources on the scale that we now see in the financial sector alone.

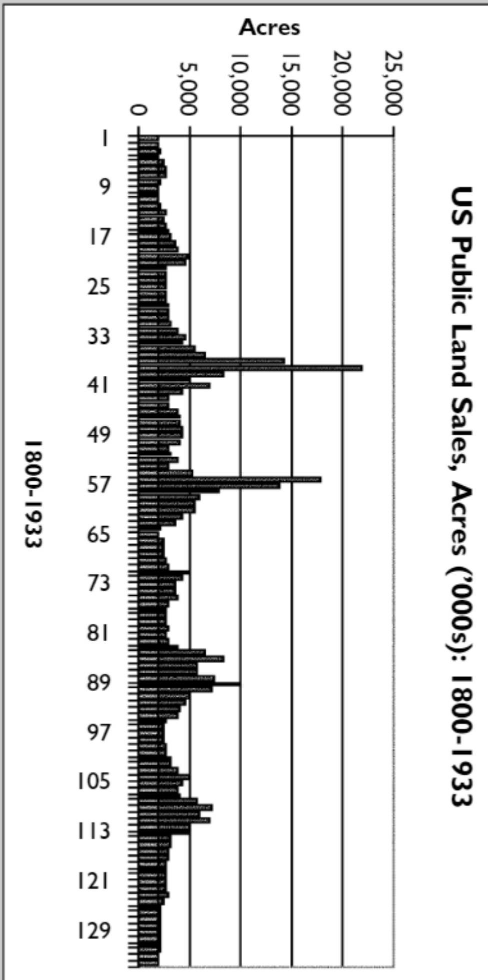
According to William Mills, chief executive officer of Citigroup's markets and banking division in Europe, his employer had suffered "reputational damage" as a result of its losses.[1] But did Citigroup deserve its reputation? Was it gullible? Ignorant of the ways of the property market into which it has poured billions over the decades, as loans to buyers of real estate? Misinformed about trends in the money markets? Could Citigroup retreat to any of these excuses for the massive losses it incurred? Let's take a closer look at the information at Citi's disposal.

Reflect on the implications of the trends displayed in the graph on page 71. This chronicles the sale of public land from the day that the federal government began to privatise the continent's real estate. Land deals are the most sensitive monitor of an economy's health. They are the economy's cardiograph. Citibank, as it evolved through the 19th century, lived through every property boom since the first one that led to recession in the early 1820s.

- The 19th century banking crises were spiced with some of the most colourful episodes of financial shenanigans,

1 Mills was giving evidence to the Treasury Committee of the House of Commons on December 16, 2007.

Graph 4:1 Cardiograph of the US Economy



leaving their indelible marks on the historical record.

- Citi Bank's name survived mergers and acquisitions such as the deal with Bank Handlowy in 1870, Smith Barney in 1873, Banamex in 1884 and Salomon Brothers in 1910. Today, Citicorp's signature building dominates New York City's skyline.

Citi had the information on booms and busts in the real estate market in its archives. This institutional memory gave it the best possible preparation for the crisis that would erupt at the beginning of the 21st century. Citi was uniquely placed to ensure that it exited the mortgage market with fat profits before America's housing cycle peaked in 2006. And yet, it walked into the trap of its own making.

The tragedy for people who invested their savings in the shares of Citigroup – and the pensioners whose modest funds were entrusted to it – is that they relied on the prudence of their bank. Citi's corporate history, and its vaults, contained all the clues that were needed to alert them to the prospect of losses. Instead, the bank dissipated the capital of its shareholders. Was this negligence? Didn't it have a duty of care to its clients? Was this a record of carelessness, or idiocy? Or something more sinister?

The Repetitive Syndrome

ECONOMISTS ARE accomplices (wittingly or otherwise) in a social process to dupe the man in the street. By *process*, I mean a systematic pattern of behaviour, over time, that has predictable outcomes. If my pronouncement is harsh, I invite you to assess my judgement after you have reviewed all the evidence. Let's look at the way huge losses are inflicted on people which, with a little attention to the detail, could be avoided.

Some of the brightest brains in the world are engaged in formulating complicated mathematical and econometric models to make sense out of the mass of information that comes out of the markets. But they seem to fail, time and again. And, sometimes, they fail spectacularly, even when they have the most celebrated intellectuals at their disposal. This was the case with

Box 4:I

Casino Capitalism

Much of what passes for high finance is more like the activities of the high street bookmaker than the pin striped, bowler hatted bankers of old. Investment funds have become gambling institutions like the casinos with their roulette wheels. Churning the money makes some people rich, but the business is old-fashioned gambling.

When brokers talk about "trading" in financial instruments, they are likely to be telling you that they have placed bets on whether shares are going up or down. Creative language disguises their activities. But punters betting on their favourites at the local dog track would have little difficulty in decoding what the financiers were up to.

A "short-sell", for example, is a bet that shares will fall. The intention is not to invest in capital formation, to help enterprises expand their productive capacities, create

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Box 4:I (contd)

jobs and sell products. It is not investing in firms that are most likely to deliver the highest profits by satisfying customers. It is gambling on the vagaries of the stock market.

The gambling fever reached down to small-time punters like Joe Patterson from Fulham, in southwest London. He bet £2,500 that Citigroup shares would decline in early 2008. He was correct, as luck would have it (for him), and he made a profit of £25,500 – a return of 1,020% on his stake.*

There are differences between betting on horses and betting on whether a share's price will go up or down, however. Other people are not affected by a punter's losses at the race track. But when multi-billion dollar hedge funds bet, they can move markets and affect other people's lives.

* David Budworth, "How to make 1,000% in the credit crunch", *Sunday Times*, April 6, 2008.

Long-Term Capital Management (LTCM), which began operations in 1994 with a billion dollars of investor's capital. Two founding directors were Myron Scholes and Robert C. Merton, who shared the 1997 Nobel prize in economics. The company developed complex mathematical models to deal in the markets. Surely with their wizardry with numbers, money would be made? Initial results were spectacular: annualized returns of over 40%. But there is an old English saying: Too clever by half. In 1998, LTCM lost $4.6bn and had to be rescued to prevent contagion spreading in the money markets. It folded two years later. If anyone doubted that this was the era of casino capitalism (see box 4:I), the arrival of hedge funds should dispel any illusions about the public service ethos of the modern banking sector.

If economists are gifted with luminous intellect, why is it that they fail so spectacularly, so regularly? As savers, we generally want to minimise the risks attached to our savings. We know that the highest returns are associated with the greatest risks. Exercising the choice between low-return security and the high risk associated with jackpot dividends ought to be based on the fullest possible information. Unfortunately, much of the information *is* available, but is being withheld. What could possibly be the motive?

The financial crises that wipe out people's savings recur so regularly that we can diagnose a repetitive syndrome in the economic system. That syndrome, however, is ignored in the mainstream economic literature. Could the reason be to do with the fact that it is related to real estate? Reach your conclusion, after reviewing the historical trends and asking yourself: why don't governments take this pattern of behaviour into account when they formulate their policies?

Take another look at the graph on page 71. You see a pattern of land deals which conforms to a cycle of activity that lasts for an average of 18 years. Using this cycle as a clue, I investigated whether there were similar patterns traced in other modern economies around the world. I chose culturally diverse and geographically separated countries such as the UK, Japan in the Far East and Australia in the southern hemisphere. The similarities were uncanny. Based on that historical evidence, which I published in 1983, I was able to anticipate the recession of 1992.[2] If I could do it, so could the economists at Citi.

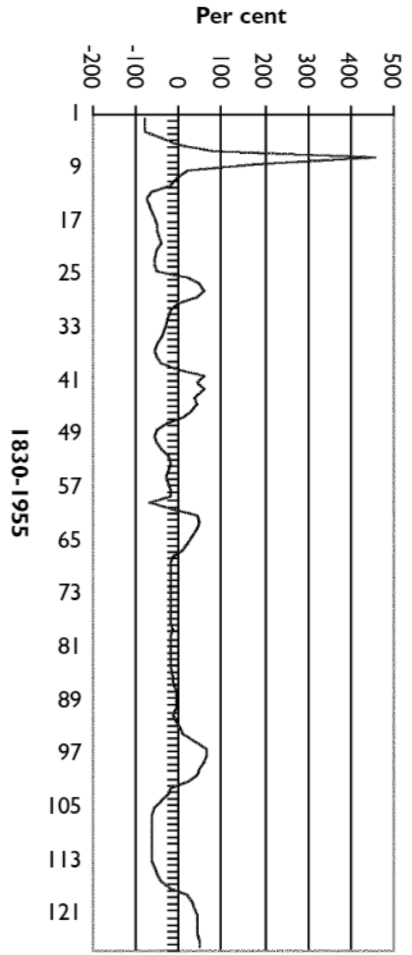
The trends revealed by the sale of public land can be cross-checked against the *value* of land from the 1830s to the restoration of economic "normality" after World War 2. The data in Graph 4:II is drawn from the land market in Chicago, collated and analysed by Homer Hoyt.[3] The two exceptions to the cyclical pattern are due to the dislocations caused by the explosive impact of two world wars. Otherwise, the trends conformed to the pattern thrown up by the sale of federal land in the 19th century. The Chicago cycles are a good proxy for what happened in local land markets throughout the US over the decades from the 1830s to the 1950s.

The 18-year cycles re-established themselves in 1955. The cycle that began in 1992 (see Graph 4:III) meant that the US

2 Harrison (1983).
3 Hoyt (1933, 1966). For an account of Hoyt's land speculation activities in the postwar years, see Harrison (1983).

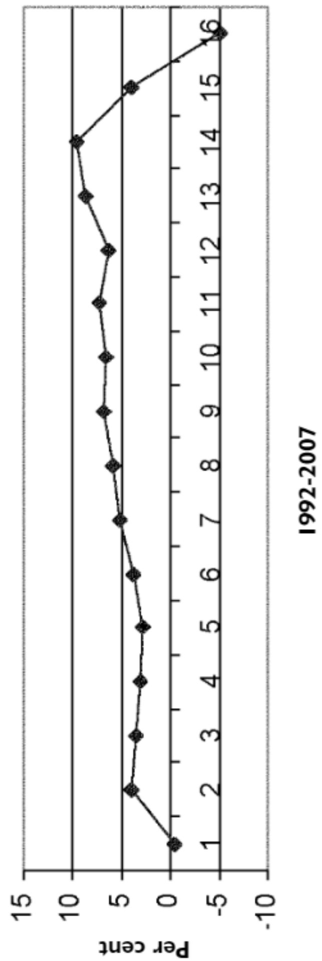
Graph 4:II

Chicago Land Values: % Annual Change (1830-1955)



Graph 4:III

US House Price Index (seasonally adjusted, Q2): 1992-2007



housing market would peak – with a high degree of predictability – in 2006. This US cycle was now locked into the global property cycle. By comparing the trends in the major markets, I was able to predict, *10 years* before the credit crunch of 2007, that the characteristic crisis in real estate would be diffused throughout the world economy. And the clues to understanding the crisis were to be found in the land market. Speculation in land and the downturn in the economy – historically, these were like Siamese twins.

> The two events will not be coincidental: the peak in land prices not merely signalling the looming recession but being the primary cause of it.[4]

Ten-year forecasts offering such precision are not available from any other analyst. They were based on the common sense reading of history linked to time-tested classical economic theory which directed me to the relevant clues.

Now that housing markets around the world have toppled, we need to answer the question that I posed in 1997: "Why can't

4 Harrison (1997: 27).

we prepare for this tragedy?" A left-wing historian like Eric Hobsbawm claims that economic instability cannot be explained, and therefore cannot be anticipated. Hobsbawm asserts that "we may have to wait for some years before the economists are able to use the historians' ultimate weapon, hindsight, to find a persuasive explanation".[5]

Economists fare no better. One of them, Nobel laureate Joseph Stiglitz, offered his pronouncements with the authority of the mighty western political and financial agencies behind him. He served as Chairman of President Bill Clinton's Council of Economic Advisors, and moved to the World Bank as Chief Economist in 1997. At about the time when I published my 10-year forecast of the next market crisis, Stiglitz pronounced:

> There is no higher likelihood that we will enter a recession in the near future than there is at any other time. In fact, quite the contrary … we don't have any inflationary pressures right now, so I don't see any potential for a downturn.[6]

5 Hobsbawm (1994: 404).
6 Stiglitz (1997: 34).

But from 1997 the “inflationary pressures” were already building up in the housing market. The data available to me was also at the disposal of Joseph Stiglitz. People are not interested in forecasts that tell them what is in front of their noses. They want the best possible information about the future. Stiglitz, who has no axe to grind, had access to all the tools in the economist’s kit. By offering a benign outlook, back in 1997, he helped to foster the climate of reassurances that caused governments – and private investors – to drop their guard at just the point in the business cycle when the property speculators and bankers began to dig their claws into people’s pockets …

Blame Game: America

HUNDREDS OF THOUSANDS of America’s families lost their homes as the crunch on their household budgets squeezed them into bankruptcy.

The biggest losers took out mortgages which they could not afford. But the victims also included investors who expected capital gains from trading in exotic financial packages that contained mortgages. When these flopped in 2007, many investors decided to sue the companies that had placed their funds at risk by investing in sub-prime mortgages. Who was responsible for the grotesque waste of people's wealth?

Ben Bernanke, who succeeded Alan Greenspan as Chairman of the Federal Reserve, turned a blind eye on the fundamental cause. Instead, he shifted the blame on to the shysters who mis-sold mortgages to low-income people.

> Unfair and deceptive acts and practices hurt not just borrowers and their families, but entire communities, and, indeed, the economy as a whole. They have no place in our mortgage system.[7]

Bernanke was desperately trying to reassure people that, never again, would dodgy financial practices be allowed in America. The public was once again being duped. The Federal Reserve wanted to limit the damage. Damage, that is, to its

7 Bernanke's testimony was to Federal Reserve Governors at a meeting on December 18, 2007, when, for the first time in history, TV cameras were admitted to such meetings.

reputation as the regulatory agency that was supposed to protect small-time savers from falling into the clutches of big-time fraudsters.

None of the reforms proposed by the Fed is capable of preventing a repeat of the financial practices that have been exposed, and which will be repeated in the years leading up to 2024. That is because *nearly every speculative land boom is associated with scams in which a few crooks cream the froth off the top of the property bubble.*

In the 1980s, savers discovered that their money had been fraudulently milked by crooks in the savings and loan (S&L) sector. That episode cost America's taxpayers something like $500bn.

What happened during the early years of the 21st century was a variation on the old theme. Morally challenged individuals will exploit every opportunity. This time, the cyclical return to fat profits from land speculation was the bait with which to lure the gullible into signing contracts and parting with their money.

The middle-men pocketed their fees and passed on the mortgages to the banks. The banks, in turn, re-sold the mortgages as investments to pension funds and insurance companies. The risk was intentionally shifted on to others. But the chickens came home to roost. When property prices hit their peak in 2006, the defaults on mortgage repayments revealed that many houses were constructed on financial quicksand. The banks could not trust the value of the collateral offered by other banks that wanted to borrow their money. So they all fell victim to yet another land market-led crisis. And there is nothing that the Federal Reserve can do to prevent similar financial scams in the future. The rules of the economic game, which legitimise windfall gains from land, inspire crooks to search for the huge holes in the regulatory system. This is not a conspiracy theory of mine: it is prescribed by the laws and institutions that were adopted to define the market economy.

Blame Game: Britain

IN THE SUMMER of 2007, Britain witnessed the first run on a bank in 140 years. People queued outside branches of Northern Rock to get their money out before disaster befell the nation's fifth largest mortgage-granting institution.

No-one in authority saw this disaster coming. They ought to have taken pre-emptive action, because that was their job. They were paid handsome salaries to tell the public the truth. That was their remit. Their responsibility was to expose the risks. They failed. One of them was Mervyn King.

When the Governor of the Bank of England was quizzed by MPs in the House of Commons, he placed responsibility for the financial crisis on people's greed. Once again, human nature – not faulty laws – were blamed for the financial cardiac arrest that caused investment banks to seize up.

According to King, in his evidence to the parliamentarians, the credit crisis was the result of "human nature and the wish to get higher returns … some people call it greed".[8] Such an explanation is convenient, because it relieves the custodians of High Finance of responsibility for catastrophes like the credit crunch. For, as King

8 Conway (2007).

volunteered: "I don't think you can regulate against human nature."

This was disingenuous testimony. I do not deny that King believed it, so in that sense he was not lying. But the evidence was available to him and his battery of economists at the Bank of England that Britain's toxic sub-prime mortgages were polluting the financial sector, exposing it to a level of risk that would one day result in a financial implosion.

But even if the backroom economists at the Bank of England were snoozing, the archivists could have sent a memo to the Governor reminding him that previous property booms were linked to banking crises. Alarms bells would have rung in Mr. King's ears. After all, he was old enough to remember the "secondary banking" crisis which shook the financial system in the early 1970s in the run-up to the recession of 1974, and the financial lifeboat operation that was launched to restore order to the banking sector.

But if the historical evidence was not persuasive to the Governor, there was still no excuse for the level of incompetence that allowed the financiers to put people's pensions at risk. For in 2005, I issued this warning (on page 181 of *Boom Bust*): "The regulatory authorities lost track of this debt mountain, because it was quickly repackaged in new financial instruments and sold to institutions."

The bankers coined fancy terms like *collateralised debt obligations* and *securitised investment vehicles*. These terms were crafted to deceive. Understanding the implications of such tactics was the business of the Bank of England, the Financial Services Authority (FSA) in the UK, and the regulatory authorities in the USA.

It was also the job of the IMF to spot the risky trends and to broadcast warnings, so that investors could choose their level of preferred risk. Instead, the IMF misled people by stating that the world's banking system was in rude health.

None of these agencies did its job. They *could* have warned people, because the information was in the public domain. Yet, they remained silent, allowing pensioners to tie up their funds in ways that would cost them dearly.

Bankers like to embellish their activities by persuading themselves – and others –

that they sell *products*. But there is one major difference between a product sold by a financial institution and a product purchased from a store on Main Street. In the latter case, if the goods are faulty you can return them to the store and obtain a replacement – or your money back. That is your statutory right. In the case of faulty "products" purchased from bankers – if the law was not broken, then once your money's gone, it's gone.[9]

A BLANKET of silence is wrapped around the role of builders in the boom that drove the bust. Nothing about greedy "banking" directors of construction companies – they made fortunes out of land banks. Convenient for ideologists who want to preserve a crippled market economy, but a problem for families that want affordable homes. First and foremost, builders are land speculators. Their biggest returns are from tracts they buy before planning permission is granted.

9 Governments do offer some insurance against losses, up to a ceiling; but this protection only applies when a bank is forced to close down.

Buildings are stuck up to release windfall gains from land. The interests of buyers are incidental. That's why inner cities were blighted with buy-to-let apartment blocks. These were the cost effective way of squeezing the last penny out of the land market, equivalent to bankers' sub-prime mortgages.

Now, builders are forced to construct family dwellings. One of them is Redrow, whose founder, Steve Morgan, came out of retirement to condemn the properties built in the last decade as "more at home in Stalingrad". Morgan appeals for government help to ease the land market because owners are not selling. "Vendors perceive [land] to be cheap at the moment, so they won't sell".[10] It's called land speculation. And that's something builders don't want to deter.

10 Hammond (2010).