
Cozy connections that led to a crisis

Book review by

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RECKLESS ENDANGERMENT
How Outsized Ambition, Greed,
and Corruption Led to
Economic Armageddon

By Gretchen Morgenson and
Joshua Rosner

Times. 331 pp. \$30

In “Reckless Endangerment,” Gretchen Morgenson and Joshua Rosner argue that cozy relationships between government and the financial industry were the primary cause of the financial crisis. In a series of clearly written narratives filled with names, dates and figures, they show that government officials took actions that benefited well-connected individuals, who in turn helped those government officials. This mutual support system thwarted good economic policies and encouraged

reckless ones. It thereby brought on the crisis, sending the economy into a tailspin.

While many economists — including this reviewer — have argued that government actions caused the crisis, Morgenson and Rosner use their investigative skills to dig down and explain why those actions were taken. To avoid reckless policies in the future, we need to understand their causes, and the authors’ identification of government-industry links deserves careful consideration by anyone interested in improving the economy.

The book focuses on two government agencies, Fannie Mae and the Federal Reserve. The mutual support system is better explained and documented in the case of Fannie, the government-sponsored enterprise that supported the home mortgage market by buying mortgages and packaging them into marketable

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securities, which it then guaranteed and sold to investors. The government supported Fannie Mae — and the other large government-sponsored enterprise that deals with mortgages, Freddie Mac — by implicitly backing up those guarantees and by providing favorable regulatory treatment and protection from competition. These benefits enabled Fannie to rake in excess profits — \$2 billion in excess, according to a 1995 study by the Congressional Budget Office (CBO).

The book gives examples of Fannie's executives — Jim Johnson, chief executive from 1991 to 1998, is singled out most — using the excess profits to support government officials in a variety of ways, with plenty left over for large bonuses. They got jobs for friends and relatives of elected officials, including Rep. Barney Frank (D-Mass.), who is tagged as “a perpetual protector of Fannie,” and they set up partnership offices around the country that provided more jobs. They financed publications in which writers argued that Fannie's role in promoting homeownership justified federal support. They commissioned work by famous economists, such as Nobel Prize

winner Joseph Stiglitz, which argued that Fannie was not a serious risk to taxpayers, countering “critics who argued that both Fannie and Freddie posed significant risks.”

They made campaign contributions and charitable donations to co-opt groups such as the community action organization ACORN, which “had been agitating for tighter regulations on Fannie Mae.” They persuaded executive branch officials — such as then-Deputy Treasury Secretary Larry Summers — to ask their staffs to rewrite reports critical of Fannie. In the meantime, Countrywide, the mortgage company led by Angelo Mozilo, partnered with Fannie in originating many of the mortgages that Fannie packaged (26 percent in 2004) and gave “sweetheart” loans to politicians who had power to affect Fannie, such as Sen. Chris Dodd (D-Conn.). The authors write that “Countrywide and Fannie Mae were inextricably bound.”

Fannie's lobbying efforts were resisted by some government officials, who are the heroes of the book. CBO Director June O'Neill is praised for refusing to stop the release of a 1995 study by CBO staffer Marvin Phaup showing that federal support increased Fannie's profits by \$2

billion. O'Neill reported that Fannie executives “Frank Raines and Bob Zoellick came and met with me and the people from CBO. All of us had the same feeling — that we were being visited by the Mafia.”

Another hero is “none other than John W. Snow, the Treasury secretary,” who in 2003 “urged the creation of a new federal agency to regulate and supervise the financial activities of the government-sponsored enterprises” and thus aligned the Bush administration with Fannie's adversaries. After that, with the 2004 presidential election in full swing, “Bush's unpopularity gave Fannie's supporters their greatest hope,” the authors write. (From 1995 to 2001, I was on the CBO's Panel of Economic Advisers but was not involved in the CBO study. From 2001 to 2005, I was undersecretary of the Treasury for international affairs, and Fannie Mae issues were not part of the international division.)

The Fed takes a beating throughout the book. Early on, the authors take on the Boston Fed, and in particular its research director, Alicia Munnell, for using a study documenting racial discrimination in mortgage lending to justify the relaxation of credit standards, even though other

researchers found the study's findings to be flawed. And they criticize the very low interest rate set by the Fed when Alan Greenspan was chairman and Ben Bernanke was a Fed governor, saying it “contributed mightily to the mortgage lending craze,” and adding that “with the Fed on a rate-cutting rampage, demand for adjustable-rate mortgages with relatively low initial interest costs had become incendiary.” I agree that the interest rate was too low for too long in 2003-05, but I do not see cozy relationships as the reason, and the authors do not provide evidence, as in the case of Fannie.

The claim of a cozy connection between the New York Fed and Wall Street gets much more attention. The book singles out economists at “Timothy Geithner's bank-friendly New York Fed” for a “see-no-bubble mentality” during the housing bubble. It claims that “the banks knew they held all the cards” when Geithner became president of the New York Fed in 2003. It says that financier Sandy Weill “cultivated Geithner” and approached him about running Citigroup, and it reminds us that “even as Citigroup was building up its hidden off-balance sheet risks in 2006, its overseers at the New York Fed did nothing to rein the bank in.”

The book certainly does not let the private sector off the hook, but it is very hard to imagine that heavily regulated banks could have engaged in such extreme risk-taking without the support of regulators. Nobel Prize-winning economist George Stigler warned long ago about “regulatory capture” — the tendency for regulated firms to get protection from their regulators — and the authors provide considerable evidence of it. Though they do not always give sources, it is important to take such claims and evidence seriously and to introduce government reforms as necessary. This, unfortunately, has not happened yet, as the authors emphasize in the conclusion, pointing to “the irony of having two of the nation's most strident defenders of Fannie Mae sponsoring” the Wall Street Reform and Consumer Protection Act of 2010 — which did not reform Fannie Mae.

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