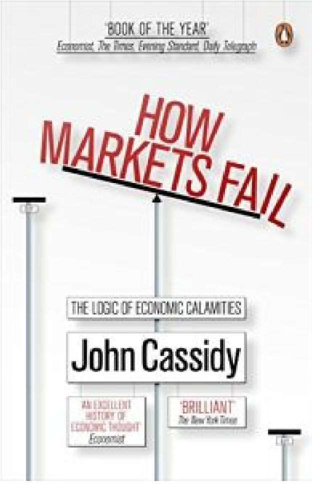

Book How Markets Fail

The Logic of Economic Calamities

John Cassidy
Penguin, 2010
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Recommendation

Adam Smith laid the intellectual foundation for free enterprise in his widely hailed 1776 book, *The Wealth of Nations*, but he also supported tight regulation of banks to suppress speculation and stabilize credit, a message most modern-day free market advocates have overlooked. Journalist John Cassidy's thorough review of the events leading up to the 2008 financial crisis underscores how strict application of "utopian economics" can lead to disaster. He makes a strong argument for incorporating "reality economics" into the US's supervision of the financial system. *BooksInShort* recommends this weighty book to readers with a background in finance and to those interested in how free markets can coexist – and stabilize – with judicious government oversight.

Take-Aways

- The boom-and-bust financial sector of the economy defies the theories of free markets and market equilibrium.
- Recent events challenge the belief that unrestricted markets tend toward stability.
- Economist Adam Smith extolled free enterprise but encouraged bank regulation.
- Increases in the prices of financial assets compound, rather than reduce, public demand for them.
- "Rational irrationality" reigns when individual incentives undermine a group's best interests. For instance, it explains why investors withdraw their deposits in a bank run.
- The financial crisis of 2008 upended the notion that removing regulatory restraints – like Glass-Steagall – from financial institutions is socially beneficial.
- Deregulation encouraged commercial and investment banks to amass riskier assets.
- Private credit-rating agencies have replaced government agencies as bank monitors.
- Former US Federal Reserve chairman Alan Greenspan backed financially destabilizing public policies.
- The Fed should ensure financial stability, not just stable prices and labor demand.

Summary

Theory and Reality in the Financial Industry

Few government regulators foresaw the financial crisis that peaked in 2008 when investment bank Lehman Brothers filed for bankruptcy. The Lehman insolvency panicked banks around the world, withered their willingness to lend and deepened an economic recession that was already underway. The financial crisis surprised even powerful central bankers: Neither former US Federal Reserve Board chairman Alan Greenspan nor Ben Bernanke, who succeeded Greenspan in 2006, predicted the collapse in home prices that led to the "Great Crunch" in credit availability.

"Once a bubble begins, free markets can no longer be relied on to allocate resources sensibly or efficiently."

By 2008, a sharp increase in mortgage loan defaults had popped a massive bubble of inflated US home prices, undoing widespread faith that the value of residential real estate could only rise. Lehman and many other financial institutions got into trouble because they had purchased too many securities bundled with subprime mortgages that were in default. Overnight lending between banks plunged because financial executives were uncertain about other institutions' exposure to the mortgage mess. These financiers lacked a clear idea of the worth of their own subprime mortgage securities, let alone those belonging to other banks.

"The notion of financial markets as rational and self-correcting mechanisms is an invention of the last 40 years."

Credit availability gradually improved after the government intervened, recapitalizing and restructuring many of the US's largest financial institutions and thus stabilizing the financial environment and preventing the 2008 crisis from becoming a full-blown catastrophe. The turmoil seemed to have been unpredictable – largely because it contradicted conventional views of the economy. In mainstream economic theory, buyers and sellers who face few transaction obstacles compose a "free market." They make decisions in a theoretical commercial environment free of government interference, the burden of missing data and the risk of exogenous threats. The theoretical free market constantly heads toward equilibrium – a virtuous model of efficiency that uses price increases and decreases to adjust the supply of anything to suit the public's appetite for it until supply equals demand.

"Just because central planning failed, it doesn't necessarily follow that markets always get things right."

However, the boom-and-bust financial sector of the economy defies the theory of market equilibrium. For example, while the theory holds that a price increase tends to cut the sales of any good or service, a rise in the price of a financial asset may actually increase the number of investors who want to buy it, further inflating the price. This particular proclivity toward disequilibrium is a "herding" response, one of the everyday realities of financial markets that classic economic theory fails to capture. The problem is more than just academic. The common belief that all markets, including financial ones, tend toward a state of equilibrium has resulted in misguided public policy. Indeed, a major cause of the 2008 crisis was the multiphased deregulation of the US financial industry that began in the second half of the 20th century, when the free market doctrine became widely accepted.

The Invisible Hand of Speculation

Scottish economist Adam Smith was one of history's most influential promoters of the free market doctrine. In his acclaimed book on capitalism, *The Wealth of Nations*, published in 1776, Smith memorably compared the dynamic of an open, unplanned economy to a benevolent "invisible hand" that moves markets toward states of equilibrium, adjusting supply and demand through price changes. But Smith was wary of speculative excesses in financial markets, and he advocated limits to banks' freedom. Some of Smith's modern-day supporters who have used his insights as a pretext for deregulation overlooked his concern about the risk of lax banking regulation. He advocated government intervention to deter financial frauds and panics.

"The proper role of statistical models is as a useful adjunct to an overall strategy of controlling risk, not as a substitute for one."

Smith believed that banning banks from issuing interest-bearing notes to "speculative lenders" would halt recurring gaps in credit availability. While he also wrote that such a ban could be considered "a violation of natural liberty," he added, "but these exertions of the natural liberty of a few individuals...might endanger the security of the whole society."

Setting the Financial Industry Loose

As the 20th century progressed, lawmakers deregulated banks and other types of financial institutions and thus relaxed the US government's grip on the banking system. But proponents of free markets underestimated the destabilizing potential of setting the financial industry loose.

"In the best 19th-century tradition, the housing bubble and the subprime craze would be allowed to run their course."

The 1980 enactment of the Depository Institutions Deregulation and Monetary Control Act removed regulatory caps on the interest rates that banks could pay depositors. The law injected free market competition into the market for bank deposits, but it also motivated banks to put money into loans and other assets with higher returns, which meant taking greater risks. In 1999, federal lawmakers repealed the 1933 Glass-Steagall Act, which had prevented deposit-taking banks from engaging in investment activities such as selling bonds, stocks and other securities. Even though housing prices hit a long-term peak in 2006, financial deregulation continued apace. The US Congress passed the Financial Services Regulatory Relief Act of 2006, lowering banks' minimum capital requirements.

"There is now a wealth of evidence from all around the world that the existence of deposit insurance encourages banks to take bigger risks and raises the probability of financial crises occurring."

Over the two decades prior to 2000, the US and many other countries also started requiring banks to adjust their capital based on the credit ratings of the securities they owned. As a result of these public policy changes, the three major credit rating agencies Fitch, Moody's, and Standard & Poor's replaced government regulators as the leading examiners of banks and their balance sheets. But because these three agencies get their income from the debt issuers they rate, the agencies' efforts to please their clients can reduce the reliability of their ratings. Allowing issuers of debt securities to pay for credit ratings causes "inherent conflicts of interest."

"One of the key assumptions of the free market model is that everybody has all the information they need to make the right decisions."

Unfettered product innovation, which usually benefits society, proved disastrous in the mortgage business. New, riskier types of mortgage loans to subprime borrowers were among the leading culprits in the 2008 financial crisis and its recessionary aftermath. Lenders made "stated-income" mortgage loans based on borrowers' unverified statements about their personal income. Another risk-filled innovation – the "option ARM," an adjustable-rate mortgage – gave borrowers the choice to pay only part of the interest on their loans, thereby inflating their principal balances.

"During a speculative bubble, the laws of supply and demand don't get repealed, but they do get suspended."

The intrinsic risks in option ARMs and stated-income loans, also known as "liar loans," did not deter lenders, because investment banking firms had developed a vast secondary market for such packages. Instead of holding these dubious loans, lenders sold them to investment firms. Wall Street packaged the loans as interest-bearing securities and resold them to American and global investors, usually after obtaining a top credit rating for each issue from the rating agencies. Unfortunately, the long upward trend in housing prices apparently blinded the agencies to the possibility of a national collapse in residential real estate. Prior downturns in the US housing market had been confined to individual regions, but the drop that began in 2006 was national; risky mortgage practices had spread across the country, not just to a cluster of states.

The Greenspan Effect

Alan Greenspan did more than any other individual to create the conditions for "letting the hogs run wild." As Fed chairman from 1987 to 2006, Greenspan encouraged a borrowing binge by keeping interest rates very low – below 2.5% – in the final years of his tenure. In addition, he long championed a laissez-faire environment of slack regulatory oversight. In 1999, for example, Greenspan criticized the Glass-Steagall Act and its wall between commercial and investment banking as an "archaic" regulatory arrangement that blocked financial services from operating in a free market. Greenspan believed that, compared to government agencies, banks could do a better job of assessing each other's solvency because they conduct so many open-market transactions with one another. By the time Ben Bernanke succeeded him, Greenspan had presided over a massive accumulation of debt. Together, low interest rates and financial deregulation did more to expand credit availability than either development could have done alone. In 2006, total US indebtedness was almost four times the country's GDP.

Game Theory and "Rational Irrationality"

Empirical research says stock prices exhibit momentum, tending to move in the same direction, up or down, over short time periods. Many investors decide to invest or divest based on stocks' momentum, buying them as they appreciate and selling them as prices fall. This "rational herd behavior" happens because momentum often is a reliable short-term indicator of stock price direction. Yet this phenomenon pokes holes in the "efficient market hypothesis," the free market theory that says stock prices are always and only a reflection of all the known information about those publicly traded securities.

> "Wall Street and Main Street, for all their mutual suspicion, are locked in a symbiotic embrace."

Herd behavior among investors also can distort price signals. For example, the 129% increase in average US home prices from 1996 to 2006 indicated a demand for residential real estate greater than population or income growth. Before the long-held myth of perpetual property appreciation finally faded, it helped to sustain a massive market failure in which banks made mortgage loans to borrowers who were unable to repay, construction companies built homes no one wanted to buy and investment firms peddled mortgage securities no one could resell.

> "A new way of thinking about economics has to be articulated as a replacement for utopian economics – an economic philosophy that acknowledges the usefulness of markets but also their limitations."

Game theory may elucidate economic phenomena that the free market doctrine cannot explain. Consider the game that depositors must play if they suspect their bank is nearly insolvent. They may want to withdraw their money, but if all of them do so at the same time, the bank will fail. If all of them leave their deposits untouched, the bank will remain solvent. But the self-interest of each depositor dictates withdrawal, so a fatal run on the bank is the most likely outcome. In this rational irrationality, individuals sometimes make logical decisions that serve their self-interest but produce disastrous results for the group as a whole. The prevalence of rational irrationality is an element of "reality-based economics" that conflicts with free market "utopian economics."

> "The idealized free market is a fiction, an invention: It never existed, and it never will exist."

Rational irrationality helps illustrate how the investment bank Bear Stearns folded in early 2008. Counterparties that lent to the firm accepted risky mortgage securities as collateral. But once lenders began to have doubts about the value of Bear's securities, so many of them withdrew funding from Bear at the same time that they forced the investment banking firm into a government-assisted merger with JPMorgan Chase in March 2008.

A Need for Tighter Financial Regulation

Regulatory intervention in March 2008 kept the financial problems at Bear Stearns from spreading rapidly to the rest of the economy. The Fed made a $13 billion loan to Bear through JPMorgan Chase by invoking its seldom-used authority to lend money to any type of business "under unusual and exigent circumstances." Bear had borrowed heavily from money market mutual funds, so the unimpeded collapse of the investment firm could have caused the failure of many such funds, thus harming countless individual investors.

> "The proper role of the financial sector is to support innovation and enterprise elsewhere in the economy. But during the past 20 years, it has grown into Frankenstein's monster, lumbering around and causing chaos."

Yet only six months later, the Fed and the US Treasury handled similar problems at Lehman very differently. Rather than save Lehman from insolvency, regulatory authorities allowed the market to determine its fate. After free market forces led Lehman into bankruptcy and spawned a global slump in lending, US regulators changed course and intervened to rescue AIG. They publicly promised that the government would prevent any systemically important financial institution from failing.

> "It is essential to put Wall Street in its place and to confront utopian economics with reality-based economics."

Critics assail this "too big to fail" policy as an assault on the free market doctrine. But this type of government procedure is justified; constraining financiers' speculative impulses warrants further regulatory intervention in the financial services industry. For example, a new regulatory regime could revive the market for mortgage-backed securities, but lenders that sell loans into the secondary market would have to keep on their books a large portion of the mortgages they originate to maintain the integrity of their loan portfolios.

Lawmakers also should expand the Fed's "dual mandate" – to strive for "maximum sustainable employment and price stability" – to encompass a third objective:

“preservation of financial stability.” Without significant regulatory reforms, rational irrationality will continue to create calamities in the financial sector that spill into the rest of the economy.

About the Author

John Cassidy is a British-American journalist and author. He writes for *The New Yorker* and contributes to *The New York Review of Books*. He is the author of *Dot.con: How America Lost Its Mind and Money in the Internet Era*.