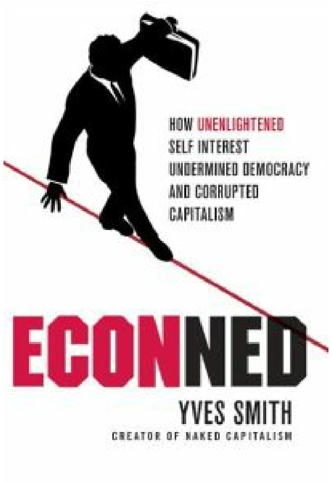

Book Econned

How Unenlightened Self Interest Undermined Democracy and Corrupted Capitalism

Yves Smith
Palgrave Macmillan, 2010
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Recommendation

Neoclassical economists contend that the economy naturally seeks equilibrium, an optimal point where the supply of goods and services equals the demand. This intellectual view has encouraged politicians to deregulate markets to make them more competitive and efficient. But deregulation of financial markets has been a failed experiment in freeing banks and investment firms, says financial writer Yves Smith. She argues, convincingly, that the global financial crisis that began in 2007 has provided ample justification for greater regulation of banks and other related institutions. This book went to press in late 2009, prior to the 2010 passage of the Dodd-Frank Act, a sweeping reform of the US financial services industry that embodies some of the author's proposed changes. *BooksInShort* suggests Smith's book to all those affected by the 2008 meltdown for its incisive description of the symptoms, causes of and cures for the financial crisis.

Take-Aways

- Late 20th-century economic theories rested on flawed assumptions that led to the financial crisis beginning in 2007.
- Once a social science, economics now uses mathematics and abstractions that conflict with real-world financial behavior.
- Neoclassical economics professes that markets are better off unfettered by regulation.
- Lawmakers liberalized real markets to make them resemble theoretical "free markets."
- An unregulated "shadow banking" system fed a global borrowing binge.
- Securitizing mortgages allowed bankers to assume more – but less-creditworthy – loans.
- Collateralized debt obligations and credit default swaps created secondary markets that offered opportunities to hedge against – or bet on – rising real estate values.
- Private and public investors, as well as financial institutions, suffered massive losses amplified by leverage.
- Lawmakers should restore the separation of commercial banks from investment firms.
- Economists must become more "explicit and transparent" in their logic and ideas.

Summary

The "Self-Correcting" Economy

In his influential 1776 book, *The Wealth of Nations*, Adam Smith popularized the classical economic concept of market equilibrium. Smith is famous for comparing individual self-interest to an "invisible hand" that nudges each seller of goods and services to supply just enough to satisfy the needs and wants of buyers. His use of such an evocative metaphor was typical of the times; economics was a social science prior to the 20th century. Today, respected economists take a much more mathematical approach to their field.

> "We need to implement economic policies that treat finance as the handmaiden of commerce, not its master."

Since the 1940s, mathematical expressions of Smith's ideas have made the economics discipline more accurate, in a narrow sense, but also more abstract and arguably less applicable to real problems. Neoclassical economics, the quantitative descendant of classical economics, developed formulas that identify theoretically optimal economic states – that is, mathematical points where the demand for a product equals its supply.

> "Widespread acceptance of the phony precepts of financial economics and neoclassical economics helped bring about the financial crisis by endorsing policies and practices that allowed financial firms to exploit customers, shareholders and taxpayers on a scale heretofore seen only in banana republics."

But disciples of the neoclassical school did more than just reduce the metaphor of the invisible hand to numbers. They embraced unrealistic assumptions about markets as they examined their use of mathematics to explain market phenomena. They misused Adam Smith's concept of "free markets" by encouraging deregulation of financial markets for the sake of economic efficiency; and they professed that markets with less regulatory intrusion would work better and would reach equilibrium with greater ease.

> "It is actually difficult to prove anything conclusively in economics. In fact, some fundamental constructs are taken on what amounts to faith."

But this neoclassical belief is laden with debatable assumptions, which make the math simpler. Neoclassical economists assume, for the sake of analytical simplicity, that no one has more information than anyone else, that no one has enough sole purchasing power to affect prices, that transaction costs are nonexistent, and that markets remain open without interruption. This simplistic model of pure competition can serve as a guide for economic policy making, but many lawmakers have gone too far. They have embraced deregulation in the vain hope of being able to reshape financial markets to make them resemble the neoclassical model.

"Financial Economics" and Risk Management

The view of unbridled commerce as an equilibrium-seeking force seeded the growth of a branch of neoclassical economics known as financial economics. Its intellectual foundations emerged during the 1960s and 1970s and provided political justification for deregulation of the financial markets in the 1980s and 1990s. Paul Samuelson, the first American to win the Nobel Prize for economics, and Eugene Fama of the University of Chicago developed the "efficient markets hypothesis." They proposed that prices of traded securities fully reflect all information about them. Economist Harry Markowitz introduced the concept of the "efficient portfolio." He theorized that each investor seeks an optimal portfolio mix, balancing returns with risk.

> "Despite economists' attempts to position themselves as benign umpires, their role is profoundly political."

But financial economics rests on illusory suppositions. Real markets sometimes stop functioning for one reason or another, so their continuous operation is never guaranteed. The assumption of perfect knowledge among all investors is equally unrealistic. In sales of assets, one party often knows more about the market than the other party.

> "Economists love to twiddle with models to prove the existence of optima, but that begs the question of what is society trying to optimize?"

Markowitz's theory of efficient portfolios suffers from dubious assumptions about risk management. Investors can adjust expected returns for risk only if they correctly measure that risk, but most modern tools for assessing investment risks have failed to predict the most serious threats. Modern models designed for financial risk management have consistently displayed three common weaknesses, even as their mathematical sophistication has grown. First, the designers of risk management tools such as the Value at Risk (VaR) model have relied too much on normal probability distributions, which consistently underestimate "tail risk" – that is, the probability of extreme events. Second, risk management tools have performed poorly because of built-in assumptions that markets will not halt and, third, that asset classes will not depreciate in unison.

Deregulation and "Shadow Banking"

The Great Depression of the 1930s led the US to tighten regulation of financial markets following an era of minimal regulatory interference that ended with the stock market crash of 1929. Subsequent to the crash, lawmakers mandated insurance for bank deposits, established the Securities and Exchange Commission (SEC) to regulate markets, and passed the Glass-Steagall Act to separate commercial banks from investment firms. But after about half a century of relative calm, financial markets became more dynamic during the deregulatory trend of the 1980s and 1990s.

> "The United States tried unregulated securities markets and the result was periodic crashes, culminating in the spectacular 1929 meltdown."

Financial market deregulation then became widespread because so many economic policy makers believed that reduced government regulation of financial markets would make the markets more efficient. One consequence of this school of thought was the US government's deregulation of interest rates on bank deposits, a move which increased the competition between banks and securities firms that offered uninsured money market accounts. Federal lawmakers also gradually demolished the regulatory wall between commercial banks and securities firms, finally in 1999 repealing what remained of the Glass-Steagall Act. The SEC, which has focused more on crime prevention than prosecution, requires ongoing financial disclosures by public companies and prosecutes illegal insider trading and stock market manipulation. Yet budget limitations and other constraints have kept the SEC and Justice Department from pursuing complex civil and criminal litigation to deter financial fraud. They have been "sticking with easy-to-prove cases" instead.

> "Effective risk management took a giant step backward with the creation of a widely used risk management tool, Value at Risk."

Lax regulation contributed to the development of an unregulated shadow banking system comparable in size to the legal banking system. For example, securities repurchase agreements ("repos") allow financial institutions to borrow increasing amounts of money by selling US Treasury securities or other types of collateral, including mortgage-backed securities. The institutions then repurchase the collateral at a higher price. The bank gains a bit of short-term liquidity and the markup is equivalent to loan interest.

> "Risk management is often an exercise in providing cover for managers and directors, and thus serves as another tool to hide looting."

Other forces drove the development of the shadow banking system. Market growth of repos reflected the inflated issuance of mortgage-based securities and insurance against losses on these securities. Trading in these instruments ballooned in a shadowy corner of the financial services industry that lacked effective regulatory oversight. Investment banking firms increasingly acquired, assembled and securitized large pools of mortgage loans, marketing them to investors as high-yield bonds. A breakdown in the relationship between mortgage lenders and borrowers was one of the counterproductive side effects of the shadow banking system.

> "Financial deregulation spawned a shadow banking system, an unregulated sector that came to rival the traditional banking system in size."

Mortgage-loan securitization, in particular, undermined lenders' scrutiny of loan applicants. When housing prices were rising rapidly, especially from 2004 to 2007, securitization provided a vast secondary market for the originators of mortgage loans, allowing them to raise cash for additional lending by making new loans, collecting closing fees and selling the loans. But credit quality suffered, because so many lenders were originating mortgages primarily to sell them, not to hold them. By 2008, mortgage bonds were sinking under the weight of widespread defaults among borrowers.

Synthesis and Leverage: Piling More Paper on Mortgages

The collateralized debt obligation (CDO), a type of structured credit instrument, essentially provided a secondary market for financial institutions that wanted to cut their inventories of mortgage-backed bonds. Returns from the underlying pools of interest-bearing securities pass through to CDO investors. CDOs backed by mortgage bonds surged from 2004 to 2007.

> "In banking, moral hazard results when devices to prevent bank failures encourage banks to take greater risks."

Major banks and investment firms built many CDOs based on layers of mortgage bonds of uneven quality. Underwriting standards were stringent for some of the loans underlying mortgage bonds, but "subprime" standards applied to others, meaning the lenders permitted lenient loan terms or allowed loan applicants to qualify without proof of income. Like a butcher who can earn more money by selling pieces of an animal instead of the whole beast, financial institutions marketed mortgage-based CDOs in different slices with different credit ratings, descending from the top score of AAA and ending in unrated bottom layers, referred to as "equity" tranches.

> "There is no economic theory of how the financial system interacts with the real economy."

The leading CDO issuers, including Citigroup, Deutsche Bank, Merrill Lynch and UBS, retained approximately two-thirds of the tranches with the highest credit ratings in 2006 and 2007. The availability of insurance mitigated their difficulty in marketing the lower-rated tranches. Investors in these riskier CDO layers hedged against possible losses by purchasing credit default swaps, comparable to insurance policies. Sellers of credit default swaps collected premium payments from buyers and, in return, guaranteed to cover losses on CDOs arising from defaults on the underlying mortgage loans. These sellers basically bet that housing prices would keep rising and that the quality of mortgage credit would remain stable.

> "Data do lend support to the notion that the shadow banking system was the main culprit in the meltdown."

Synthetic borrowers and lenders deepened the black hole of mortgage finance that the shadow banking system had dug with the help of real borrowers and lenders. Credit default swaps became more than just hedges against losses; investors with nothing to hedge increasingly speculated by trading in credit default swaps. In this large and liquid market, Wall Street was thirsty for more.

> "The dirty secret of the credit crisis is that the relentless pursuit of 'innovation' meant there was virtually no equity, no cushion for losses anywhere behind the massive creation of risky debt."

Then, as the blazing growth in subprime mortgage borrowing started to cool, investment banks offset the impact by issuing synthetic CDOs. These securities have underlying pools of credit default swaps, unlike collateralized debt obligations composed of mortgage bonds. With credit default swaps, the CDO market was "no longer bound by earthly constraints" on the real market for mortgage financing and "could ascend skyward."

Rescue and Reform

Numerous buyers of synthetic CDOs regarded these securities as complex but safe bets on the future of the mortgage market, so they borrowed money to buy more securities. Unfortunately, these and similar leveraged bets heightened the financial crisis that began to unfurl in 2007 amid a surge in mortgage loan defaults. Synthetic CDOs were intricate instruments that crushed unsuspecting buyers, especially those who compounded their losses with leverage.

In one case, five school districts in the state of Wisconsin invested $35 million of their cash and borrowed another $165 million to buy a synthetic CDO that went bad, and their $200 million investment plunged to $50 million. The damage spread much further: Some of the biggest financial institutions in the world lost vast sums of money on CDOs, which sank in value as mortgage defaults spread. Estimates of aggregate bank losses on all kinds of CDOs ranged from $160 billion to $190 billion, which partly explains why US regulators have made gargantuan financial commitments to rescue leading banks and investment firms from this catastrophic mess. By the end of 2008, the Fed and the Treasury Department had committed combined funding of more than $8.5 trillion to the rescue of impaired financial institutions.

Multiple regulatory reforms are necessary to contain the types of market forces that led to the financial crisis. One is a revival of the old separation of banks and investment firms that disappeared with the repeal of the Glass-Steagall Act. Credit default swaps provide insurance, so issuers should submit to insurance regulations. Credit rating agencies should lose the legal protection the First Amendment provides for freedom of expression when they issue ratings that mislead investors. The economics profession is due for reform, too. Economists could perform a valuable service to society by improving their communications with the public. They must become more "explicit and transparent" in describing the logic of ideas and their impact. Excessive reliance on opaque, mathematical explanations of economic concepts remains a pervasive weakness of the discipline.

About the Author

Yves Smith (the pen name of financial writer Susan Webber) established Naked Capitalism, a website focused on economics and finance. Her articles have appeared on *Slate* and in *The New York Times* and *The Christian Science Monitor*.