# Notes

## 1 The Nature and Effects of the 2007–2010 Crisis and Ways to Resolve It

1. http://en.wikipedia.org/wiki/Lehman_Brothers_bankruptcy, accessed 17 February 2012.
2. http://en.wikipedia.org/wiki/Austrian_economics, accessed 17 February 2012.

## 2 The Roots of the Crisis

1. The agenda item for the 'open meeting' (anyone could attend; few did) reads as follows: Alternative Net Capital Requirements for Broker-Dealers that are Part of Consolidated Supervised Facilities and Supervised Investment Bank Holding Companies. See http://www.sec.gov/news/openmeetings/agenda042804.htm, accessed 25 January 2010. The rule change had been proposed in writing several months before the meeting. Comments on the proposal are to be found at http://www.sec.gov/rules/proposed/s72103.shtml, accessed 25 January 2010. The risk and software consultant Leonard D. Bole was the sole opponent to the change among those who commented the proposal; Commissioner Goldschmid expressed reserves at the meeting but received no support.
2. Some of the investors in these mortgage-backed securities again sought to maximize the return on their capital, and again used other people's money to do that. They bought a portion of the entire issue of securities and combined it with other kinds of debt that they purchased – such as long-term leases, credit card debt – and create another legal entity, to which they sold this debt and which in turn issued securities which gave a right to a participation in the payments on these debts.

   Mortgage-backed securities are part of a more general category called asset-backed securities. These assets may be of many kinds – such as debts, for example. (Debts in the sense that the holder of the debt has a contractual right to a series of payments against the debt.) Thus, within asset-backed securities there is a class of securities that are all backed by debt. The nomenclature for this is not 'debt-backed securities' but rather 'credit debt obligations', with the more often used acronym 'CDO'. When different securities that are all various kinds of CDOs are incorporated into a new issue of securities, as we saw in the previous paragraph, the result is called a 'CDO squared'. (Note that the homeowner with a mortgage would have great difficulty in finding where his mortgage payments go, and so would have an almost impossible task if he wanted to renegotiate different terms with the recipients of his payments.) Including other CDOs in a new CDO issue had the effect of creating demand for the first CDO, somewhat analogous to illegal practices in promoting Ponzi-scheme investments. The SEC has been investigating several ex-investment banks for securities fraud in this regard. Unfortunately, the cases are usually settled with a payment before completion of the process, so that detailed judgements are not rendered and the data will not be accessible to the public. For interesting analyses and graphics illustrating the ownership of CDOs, see http://projects.propublica.org/tables/circular_cdos and also http://www.propublica.org/special/a-banks-best-customer-its-own-cdos. On the cross-ownership of CDOs, see http://orgnet.com/cdo.html.

## 3 Three Chronologies and the Genesis of the 2007–2010 Crisis

1. Both commercial banks and thrifts ('savings and loans') are depository financial institutions in the United States. In other words, people deposit money in accounts with them. Thrifts are intended to encourage saving capital and homebuying, whereas banks exploit a variety of assets (lending activities).
2. While an individual participates in the economy as a real person, groups of people may act in concert by constituting a moral person, for example a registered business. This registered business has little juridical status, and 'employees', for example, are treated as independent agents before the law with limited legal obligation or right to loyalty to and from the 'employer'. This situation is remedied by obtaining juridical status for the moral person, constituting a new legal entity. Different laws may apply to this new legal entity depending on the goals for which it is created and also depending on the juridical authority that proclaimed and sanctions the law under which it was constituted. In the present case, corporations created to provide financial services may be constituted according to federal law (Washington) or the law of a specific US state, and the constraint is mentioned for those created with a federal charter.
3. The concrete reality of business does not assemble itself in straightforward conceptual ranks, at least in the United States of America. Business law there does not inhibit initiative, at least not to the extent of making facts easier to gather for the researcher! As opportunities arise, businesses exploit them, and thus history is as important as logic in explaining the particular configuration a business organization may have. Some opportunities are ... opportune to exploit, others are not. In the case of the warehouse business, warehouse lending can be a way to participate in the business drummed up by competitors. Some warehouse lenders were also originators, some were not. This empirical complexity of business in free markets gives rise to many questions that can only be answered by hard work – either by years of experience in the field or by painstakingly detailed research. For example, how did the multifaceted organizations deal with the unraveling of the securities and securities boom? Were those warehouse lenders that also issued securities the first to stop warehousing lending? Did they have the courage to act more rapidly because they had other sources of income than mortgages? Or did warehouse lenders who were not active in issuing securities react as quickly?

## 4 Saltwater Economists

References will be given in title, date format for Professors Krugman and Stiglitz, due to the abundance of sources for 2008, 2009 and 2010.

1. Their argument was based upon the behaviour of a mathematical model: a series of equations that represent all of their hypotheses. Because the human mind can handle more than four or five variables only with great difficulty, economists resort to this method to 'verify' the import of a series of hypotheses. Fortunately or unfortunately, such mathematical models require a simplification of reality; for example, one improvement of the Eggertsson and Krugman model was to explicitly take into account ... the distinction between debtors and creditors!
2. Although Stiglitz does not actually say that Adam Smith was against government intervention, he comes close: 'Interestingly, there has been no intellectual challenge to the refutation of Adam Smith's invisible hand: individuals and firms, in the pursuit of their self-interest, are not necessarily, or in general, led as if by an invisible hand, to economic efficiency.' Beppe Grillo's Blog (From an interview with Joseph E. Stiglitz entitled *The pact with the devil*, available at http://www.beppegrillo.it/eng/2007/01/stiglitz.html, accessed 10 December 2010.)

   Stiglitz does *not* say that Adam Smith is against any government intervention, but most readers assume this. Smith uses the expression 'invisible hand' once only, in order to explain an effect present in economic transactions. Elsewhere he recognizes that businesses often attempt to avoid this effect. Stiglitz knows this: 'Even Adam Smith recognised that unregulated markets will try to restrict competition' (A crisis of confidence, 22 October 2008).
3. I do not mean that morality is only sentiment, as do some philosophers – simply that some people are emotional rather than rational in their moral judgements and that most of us react emotionally to bad moral behaviour (particularly if we are victims, or the weak are victims).

## 5 Freshwater Economists, Austrian Economists and Popular Opinion

References will be given in title, date format for Professors Zingales and Cochrane and Schiff due to the abundance of sources for 2007, 2008, 2009 and 2010.

1. In practice the bailouts appear to have been very effective and perhaps a fair deal for taxpayers because the majority of the firms helped (particularly if we look at the size of the firms helped) are back to normal operations, and most have also returned the money received with interest or with a profit. Although this latter fact does not necessarily make the bailout fair, it certainly would reduce the gravity of the injustice if it had been unfair to help the banks and not the average citizen.

## 6 Conclusion

1. In October 2010 I still entertained the possibility of covering the academic literature and narrowed down the field to 30 articles available on the Social

Science Network website. A week before Christmas 2010, a cursory search for papers on the financial crisis submitted over the previous month returned 178 papers. In March 2011, there were over 4500 papers available on the same database. At the start of November 2011, nearly 8000 documents. While many of these are too specific (to less relevant topics, such as changes in consumer behaviour during the financial crisis), this indicates that it is still too soon to do a literature review.

2. This then raises the inconvenient question of what service economists provide to governments. Perhaps the Austrians are right in wanting governments out of the economy. Austrian economists do recognize a role for government in supporting the market with adequate laws and their sanction. The followers of Ayn Rand – perhaps more radical than Rand herself – go further. See Epstein, 2010.
3. Soros provides an alternative, but with a caveat that he did not permit the models he wishes to replace: 'Some timelessly valid generalizations can serve to explain events but not to predict them.' His alternative, reflexivity, is actually a very interesting insight for the professional investor with a few hundred million to spare, as it provides a rule of thumb for recognizing opportunities for 'arbitrage' between fanciful investors (victims of what he calls 'positive feedback reflexivity') and a more sober appreciation of the market.
4. Marx built his theory on David Ricardo's theory of value, leading necessarily to an unjust (of course in Marx there should be no moral values) distribution of wealth, and on the extension to the whole economy of the tendency of some kinds of manufacture towards scale and concentration. As a result, the end state of the economy was supply in the hands of a few rich families, with the vast mass of population without work and impoverished: thus there would be no demand to supply goods to. There are three problems with Marx's theory. First, even if we accept the incorrect hypotheses about value and concentration, the supply-demand problem would be corrected long before the ultimate crash he alludes to. Second, not all manufacture tends towards concentration, and certainly not all services. Third, Marx is right in concluding that wages are necessarily unjust if we accept Ricardo's incorrect theory of value. This theory is that the value of a good or service is the amount of work 'contained' in it. This is very appealing because it would mean – in theory, not in practice – that we could account for the value of any good or service given the time and the money to get all the information. We would simply have to account for all the work involved from the moment shovel hit the ground (well, we may have a vicious circle here, since you need to dig to get the iron ore for the shovel – but that is just going into too much detail, and we guess the contribution of that vicious circle). It is also very illusory, because no one values anything simply because there is a lot of work put into it (an exception being middle-level art, such as the small series silk embroideries of Vietnam, for which prices vary according to the complexity of the image rather than the size of the embroidery). This illusion leads to subsistence wages. How much work is 'contained' in a worker? There is the work used to produce food, shelter and sufficient education to do his job, count his money and communicate with workers: the work that produces a subsistence level of goods and services.

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Rajan, Raghuram (2005), *The Greenspan Era: Lessons for the Future*, speech transcript available at http://www.imf.org/external/np/speeches/2005/082705.htm The published article is Raghuram Rajan (2006), 'Has Financial Development Made the World Riskier?', *European Financial Management*, Vol. 12, No. 4, 499–533, available at http://onlinelibrary.wiley.com/doi/10.1111/j.1468-036X.2006.00330.x/full Donald L Kohn's commentary on the paper is a tribute to the Greenspan 'doctrine' and makes the unfortunate implication that systematic risk had NOT increased -although in remarkably unquotable wording. See http://kcfed.org/publicat/sympos/2005/pdf/Kohn2005.pdf, p. 373. In contrast, Hun Song Shin's commentary provided and a simple metaphor to understand the potential for systematic risk. This metaphor provides a complement to Keynes metaphor of musical chairs. The Hun Song Shin commentary is available at http://www.kc.frb.org/publicat/sympos/2005/pdf/Shin2005.pdf. All documents accessed 1 June 2011.

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