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How Markets Fail: The Logic of Economic Calamities

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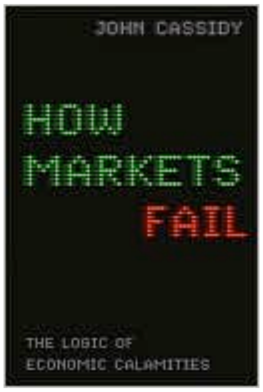

How Markets Fail: The Logic of Economic Calamities

Introduction

JOANNE MYERS: Good afternoon. I'm Joanne Myers, Director of Public Affairs Programs. On behalf of the Carnegie Council, I would like to thank you all for joining us.

Today I'm delighted to welcome John Cassidy to participate in our ongoing discussions on the recent financial crises.

If you want to fully understand the rise and fall of free-market ideology and economic thinking over the last three centuries, from Adam Smith to Ben Bernanke, *How Markets Fail: The Logic of Economic Calamity* is the book for you. In this illuminating work, our speaker combines not only economics, but the history of ideas, a narrative of the financial crisis, and a call to arms.

As America and the world's economy slowly crawl from the decline of 2007 and the depths to which they had fallen in the autumn of 2008, questions about how we got into this difficulty, along with the commentaries offered to explain the debacle, have fallen rather short—that is, until the publication of this book. As Mr. Cassidy clearly indicates, the crisis which engulfed the global financial system was not just a function of greed on Wall Street, poor regulation, or even property bubbles which got out of control. It was far more significant. It was a failure of the ideology of the free market, which is to say the belief that markets left to themselves will self-correct without the need for government intervention or regulatory control.

In writing this book, Mr. Cassidy says that he wanted to address the underlying economics of the crisis and to explain how the rational pursuit of self-interest created and prolonged it. In doing so, he talks about "Rational Irrationality," the title of an article which many of you may have read in *The New Yorker*, which was recently published, in which he defines people pursuing their own interest in the market, but the market somehow aggregates their actions into a collectively disastrous outcome. He warns that in the current economic fiasco, conforming to the antiquated orthodoxies isn't just misguided; it is downright dangerous. Accordingly, he offers a new way to understand the consequences of decisions taken by private firms in an environment of minimal regulation.

John Cassidy has been writing about Wall Street and finance since 1987. Before coming to New York, he was the business editor of *The Sunday Times* in London, where he was known for his brilliance as an economic historian. Now based in America, still considered as brilliant as ever, today he is recognized even more so for his astute and insightful analysis of business and financial journalism. If you follow his writings in *The New Yorker* or read his articles which frequently appear in *The New York Review of Books*, you will know this to be quite accurate.

Our speaker is also the author of the widely admired book *Dot.con: How America Lost Its Mind and Money in the Internet Era*. This afternoon Mr. Cassidy invites us to move beyond the daily headlines and think about the way modern capitalism operates and about the theories that informed economic policy.

Now I invite you to join me in welcoming him to the Carnegie Council.

Remarks

JOHN CASSIDY: After that introduction, I haven't really got much left to say. Perhaps we should just go straight to questions.

There are two books out at the moment, as you know probably, about the financial crisis with "fail" in the title, my book *How Markets Fail* and Andrew Ross Sorkin's book *Too Big to Fail*. I look on these two books as complementary in many ways. If you're looking for a book about Hank Paulson retching and Tim Geithner running around Wall Street at 6:00 a.m. worrying about what he's going to have for breakfast, then you should read Andrew's book, which is a very good narrative. When people ask me what the difference is between the two books, I say Andrew's is the fly-on-the-wall account; mine is the view from the orbiting satellite.

What I try to do in this book is explain how the various elements of the crisis fit together. It seems to me there have been three, possibly four, theories of what happened put forward so far:

- The first one, which probably the man on the street subscribes to, is that it was all a matter of greed. It was basically "Bernie Madoffism" writ large.
- The second theory, which quite a few behavioral economists, such as Bob Shiller and George Akerlof, have put forward, is that this was basically an instant of the madness of crowds, that we had sort of collective irrationality, disaster myopia. People thought the housing market was going to go up forever. They sort of lost their minds and the traders lost their minds temporarily. I saw Bob Shiller giving a speech a couple of weeks ago, and he said it's all about the stories people were telling each other. That's the second theory.
- The third story, which is very common on the right, is that this was a government failure. It comes in various guises, mostly to do with Fannie Mae, Freddie Mac, and the Community Reinvestment Act. Basically, the government caused the problem by encouraging people to invest in subprime —banks to lend to people who otherwise wouldn't have got their loans, Fannie Mae and Freddie Mac propping up the subprime market, et cetera. As I say, quite a few people take it all the way back to the Community Reinvestment Act of 1979.

I don't believe any of those theories. I think there's an element of truth in each of them. But I really see this as an example of market failure writ large.

What does market failure mean? It means that markets fail to act in the way they are supposed to according to the free-market theories going all the way back to Adam Smith. The basic theory of the free market is that if you add individual rationality to competition, you get a good outcome. The market aggregates people's actions and produces an overall socially beneficial outcome. That's the theory of the invisible hand. Of course, it was applied to financial markets in this case.

My argument is that ultimately this is not a failure of the government—although the government, as I'll speak about a bit later, did make some mistakes— and it's not just greed; greed is a perennial on Wall Street. Probably a lot of people in the audience work on Wall Street, so I don't want to be too insulting. But there is an element of self-selection. If you want to make a lot of money, you go to Wall Street, so it's not surprising that we find some greed there. The third one, mass stupidity—again, I think there was some stupidity, but my argument, which again I'll lay out in a bit more length in a while, is that this was more to do with rational self-interest rather than irrational self-interest.

So the way I structured the book is in three parts. As I say, I ultimately see this crisis as a crisis of ideas, and misapplied ideas. For the first third of the book I try to explain where this idea of the free market as a self-regulating device comes from. I go all the way back to Adam Smith. I probably am the only person in the room who has actually read *The Wealth of Nations*. Even though I have been writing about economics for 20 years, I can honestly say I had never read it front to back before, although I have frequently referred to it. It's a very long book. In this case I did actually go back and read it all.

I ultimately see this crisis as a crisis of ideas, and misapplied ideas.

So I take it back to Smith. I'm not making a wholesale critique of the free market. As I say in the introduction, I'm not saying we should resurrect Gosplan or switch to some other system completely. My argument is that free markets are all good in their own place. I try to point out in the first third of the book what the strength of the free markets is. It has been elucidated in all sorts of ways since Smith, but I think the basics are there in Smith.

One is the division of labor. People specialize in what they do best, going back to Adam Smith's famous pin factory, where if you have one guy trying to make pins by himself, he may make one or two in a week; if you have ten people, each doing specialized tasks—one cutting the metal, one sharpening, one attaching the heads—they can churn out thousands in a week. Free markets encourage specialization. That leads to big productivity growth.

The second very desirable aspect of free markets is that they encourage innovation. If you innovate and produce something which people want to buy, you generally make a profit, at least for a while. If you produce shoddy products or bad products, people don't want to buy and you go out of business. So there is a feedback mechanism: If you do well, you're rewarded; if you do badly, you're punished. Most other economic systems, like feudalism and communism, lacked that basic feedback mechanism.

If you add those two things together, the division of labor and this feedback mechanism, you basically have a machine for productivity growth. That's incredibly important. The other person I went back and read was Malthus. If you go back to when Smith was writing and just after that, people really thought —Malthus wasn't an outlier—a lot of people thought, like him, that there was going to be mass starvation with mass population growth. Why didn't it happen? Because productivity grew faster than the labor force, and it's based on specialization and innovation in the free market.

The third very desirable aspect of free markets is that you don't need a central planner. The market is a coordination mechanism. When you think about that, we take it for granted, but if you think about the tens of millions, hundreds of millions, of people just in the U.S., billions of people around the world, each going out to work every day, producing goods and services, who tells them what to make? Who tells them how much to make? It's the market that tells them. There's a price system. They react to the price system.

Attempts have been made to supplant that with sort of indicative planning in Europe, with straightforward planning in the Eastern Bloc. None of them worked very long. They can work in the early stages of industrialization. You get sort of Stalin's five-year plans. They can ramp up steel production or grain production. But it's not a very effective mechanism for advanced economies. It can't produce the product differentiation and all the different goods and services we want to buy.

The Economist actually said this book provides a strong argument for free markets. I think it's true for the first third of the book, in which I take Smith and I then go through more advanced derivations of it, bringing you up through the Chicago School and general equilibrium theory and lots of other subdisciplines, which are probably only of interest to economists. But the basic ideas were all there in

Smith. Most of the stuff since then—actually, Milton Friedman, to give him his due, was very explicit about this. If you go back and read *Capitalism and Freedom* or *Free to Choose*, he says that most of this is in Smith, "I'm just sort of updating it and producing some new examples."

So that's the first third of the book. I call that "Utopian Economics" because I think the basic good ideas have been misapplied. I'll explain why in a minute. I think the Chicago School, in particular, when they sort of applied these to financial markets, through the rational-expectations hypothesis associated with Bob Lucas and the efficient-market hypothesis associated with Gene Fama and others—they took these ideas about free markets and applied them to financial markets. In my opinion, because of the speculative aspect of financial markets, you can't apply these theories. When you do, you get into big trouble, as I'll explain in a couple of minutes.

So that's the first third of the book.

In the second third of the book I try and explain something called "reality-based economics," which is just a sort of fancy phrase for—not even, really, heterodox economics—what I would call mainstream Keynesian economics, as I was taught it 20 years ago, 25 years ago, in Oxford and at Harvard. I start off with Keynes himself. I was going to say he is unfashionable. He's actually becoming very fashionable. Even some of the Chicago School, including Judge Posner, have come out as Keynesians recently. Until recently, unfashionable Keynes.

I think Keynes's great contribution was this idea that a financially driven economy is different to just a sort of agrarian economy. There's something about a financial system which adds a level of complexity and potential instability to the economy.

I spend a lot of time on the so-called beauty contest analogy, which I think is very instructive. That's the idea that investors, instead of investing on ultimate value, basically try and outguess each other. In the 1930s in England, there were beauty contests. It's a bit sexist, this story, but I'm afraid that's how it was in the 1930s. They would have a page given over to pretty girls, and the readers had to write in and you won a prize if you picked the prettiest—except it's not quite that simple, because you win a prize if you pick the prettiest girl, the one who comes at the top of the opinion poll.

So what are you trying to do when you are trying to win a contest like that? You are not trying to say who the prettiest is. You are trying to figure out the girl whom average opinion will think the prettiest. Keynes figured that out. Then he said, actually, if you get clever, then there's a second degree. You don't think about what the average opinion thinks the prettiest girl will be; you have to think about what the average opinion thinks the average opinion thinks the prettiest girl is going to be. And there are third, fourth, and fifth derivations, as he said.

Actually, a lot of what happens in financial markets is this sort of approach. If you work on a hedge fund, most of the hedge funds have got momentum funds, they have got value funds. But even the value funds tend to be driven by how they think the analysts are going to react to various statistics. It's very much trying to outguess everybody else.

So I take you back to Keynes. It's not just about financial markets. The idea of market failure is much broader than just finance. I have a chapter about spillovers, externalities, global warming, taking you back to Pigou, the other famous British economist—not as famous as he should be—of the early 20th century, which I actually wrote up in *The Wall Street Journal* a couple days ago. Pigou's idea, which again is now a mainstream idea—there's a Pigou Club for Republicans, which Greg Mankiw at Harvard set up—his great contribution was this idea of spillovers or externalities, that the market is very good at measuring private benefits and private costs, but very poor at measuring social costs and social benefits. Pigou's example is a train, a new rail service which sets up, say, between New York and Boston. That clearly provides a lot of value for the customers. They can go faster. That's all good. The prices reflect what people are willing to pay.

But what about if—he was writing in the steam age—there are lots of sparks emitted from these engines and pieces of fire coming out of the engine? What about if it sets the surrounding woods ablaze? Who pays for that? It's the owner of the field. The market mechanism doesn't give the railway company any incentive to pay that.

If you think about global warming for a second, it's exactly analogous. The people who produce the greenhouse gases—the power stations or the SUV drivers or anybody else who burns a lot of carbon fuel—don't take into account the costs they are creating for, in this case, future generations, usually—or maybe some people who are young; maybe global warming will be so serious by 2050. But they don't take into account the ultimate social consequences of their actions.

What Pigou said is, to make them take account of it, we need a tax system—what he called extraordinary restraints. So that's the sort of underlying basis of the argument for carbon taxes, which is not a controversial idea in economics anymore. As I say, even Republican economists agree with that, or quite a few of them do. It's just incredibly politically unpopular, so nobody wants to put it forward.
So that's another example of market failure.

I had better speed up a bit, because I promised not to speak for more than half an hour.

The other examples which I run through are sort of informational problems. If you think about health care, for example, another very topical aspect, the problem with the health-care system is another form of market failure. The private insurers—there's a big informational problem there. If you try to buy private insurance, the private health-care insurers don't know your medical history, obviously. So they tend to assume, if you are out on the open market looking for insurance, you have probably been bumped by somebody else and you may be chronically ill. So they are very reluctant to offer individual coverage at reasonable rates. They will offer you a very extortionate rate. That's why, unless you have employer coverage, it's just very expensive.

That's an informational asymmetry, as economists would call it in the jargon. It's very difficult to deal with.

There's another form of market failure called moral hazard, which is, if you're insured, you then have no incentive to reduce your costs. Everybody knows that. We get a cold; we say, "Oh, I need a brain scan. I may have cancer." We're not paying the cost of the brain scan. The insurers are paying it. That's moral hazard. Again, it turns out to be quite important in financial markets, too.

So those are two big examples, not to do with finance—health care and global warming—both of them very topical, which are ultimately forms of market failure.

So I run through them and various forms of what I call reality-based economics, including some behavioral economics, some of the theories that Shiller and Akerlof and people have come through. There have been other books on that. Some of you may have read those. I won't dwell on that. But there are chapters in there about that.

In the final third of the book, which is sort of the meat of it in a narrative sense, I try and apply these ideas to what happened in the financial crisis. As I say, I have dismissed greed, I have dismissed stupidity, I have dismissed the government, so I had better have something else to say.

What do I have to say? What I have ultimately to say is that this is an incentive problem. As I said in the first part of the book, the market's great defense is that it provides good incentives in some areas. In financial markets, though, as we saw, it provides bad incentives. Friedrich Hayek called the market mechanism a telecommunications system. He said the prices are signals. That's exactly right. What Hayek didn't realize or was reluctant to admit was that the signals the market can send out, especially in a speculative bubble, can be the wrong ones. Once you get speculation started, prices depart from fundamentals and then the incentive structure gets completely out of whack.

In the book, if you think of the subprime mortgage, which obviously underlies all this, I take you through the chain from the people who are buying the houses, the people who are issuing the mortgages, the mortgage brokers, the mortgage lenders, the people on Wall Street who are securitizing the mortgages, the investors, the hedge funds and banks that are buying the subprime mortgage securities, and the credit-rating agencies who are rating the bonds.

It seems to me, in every one of these cases, the incentive structure was misaligned. Just think of—I won't go through them all, but let's just focus on a couple of them—the mortgage brokers and the people issuing the mortgages. Why would they conceivably give $300,000 to some guy out of work in East L.A., who is buying a house maybe ten times his income, if he had a job?

There are two answers. Number one, because of securitization, they didn't think they would be holding the mortgages. Obviously, in the old days, if you issued a mortgage and you were a mortgage lender, you kept it on your books for 30 years. If the guy defaulted, you were in trouble. If you had issued that mortgage, you had to explain to your boss why you did.

In this case, because of securitization, firms like AMERITRADE and Countrywide and all the others really didn't give a damn who they were giving the mortgages to, as long as Wall Street was willing to buy them, and for a long time it was. So the mortgage standards completely evaporated—the famous NINJA loans, "no income, no job, no assets." As long as you could stand up and sign your name, you could get $250,000 to buy a house. It got to the stage where we are not even sure if you bought it, because they were issuing these things so quickly that a lot of the paperwork was never put through. So in a lot of cases —there are famous cases in Ohio where the judge is throwing out the foreclosure judgments because the bank can't prove that the guy owned the house, because they were too busy issuing mortgages to actually fill in the paperwork.

That's an example.

On Wall Street, then. Most of the attention has been focused on Wall Street. Why did the banks, all these smart people, get involved in this thing? This is where my theory of what I call "rational irrationality" comes in. The idea basically is that it was rational for them to do things which they knew, ultimately, could well turn out to be irrational. The example I use in the book is Chuck Prince, chairman of Citigroup, who obviously has been pilloried from A to Z since the whole thing blew up.

Actually, if you go and look at the history of Citigroup, they were far from the worst offender. From 2000 to 2005, they had a home mortgage department, a sort of housing finance for lower-income people, but it wasn't one of the big securitization machines. They were lagging behind Merrill Lynch and Countrywide and various others, so much so that in the start of 2005, the board of directors, including Bob Rubin, the former Treasury secretary, came to Prince and said, "Look, we're falling behind our competitors. We need to do something to catch them up. We need to increase our risk profile. We're not taking enough risks."

What should Prince have said? Well, obviously, in retrospect, he should have said, "You're crazy. An august institution like Citigroup doesn't want to bet its future on people who can't afford their mortgages. It's all going to blow up." But there were very few people saying that at the time. Given the incentive structure Prince faced, given the enormous short-term stock options he had, given that he was judged on a quarterly or an annual basis, and given that he was already under pressure for not doing what everybody else was going, he would have probably lost his job if he had said the sensible thing and said, "Look, we shouldn't get involved in this."

Is this my theory of what happened or is it Prince's theory? I think Prince himself understood the logic of this very well. Actually, the one thing I would like to read from the book, very quickly, is a reference to an interview with Prince in 2007. This was in July of 2007, when the market was already starting to crack. One of their best hedge funds had got into trouble, I think. Citi was big in subprime at that stage. They were also big in LBOs [leveraged buyouts], which was also starting to crack.

Prince went to Japan. He must have been outside his usual security cordon or something, because the *Financial Times* managed to catch up with him,, and they asked him a question. I should say two weeks before this, in fact, the Bear Stearns hedge funds had lost $3.2 billion, I think it was. In June 2007, just a few weeks before Prince's *Financial Times* interview, as I say, the Bear Stearns hedge funds had blown up.

Prince conceded that a full-scale blow-up in subprime could cause liquidity to dry up in other asset-backed securities markets, leaving Citi and other banks saddled with numerous loans of questionable value. Still, he insisted, Citi had no intention of pulling back.

He said, "The depth of pools of liquidity is so much stronger now than it used to be, and a destructive event now needs to be much more destructive than it used to be. At some point, the destructive event will be so significant that its liquidity, instead of filling in, will go the other way. I don't think we're at that point. As long as the music is playing, you've got to get up and dance."

That now I think will go down as one of the quotes of the decade. As I say, whether he knew it or not, Prince was channeling Keynes, who, in Chapter 12 of *The General Theory*, pointed to the inconvenient fact that there's no such thing as liquidity of investment for the community as a whole. Whatever the asset may be, stocks, bonds, real estate, or anything else, if everybody tries to sell it at the same time, prices will collapse and the market will seize up.

Given this possibility, Keynes said, financiers were forced to keep a close eye on the mass psychology of the market, which could change at any moment. He said, "This is the inevitable result of investment markets organized with a view to so-called liquidity," referring back to the quote there. "For it is, so to speak, a game of Snap, of Old Maid, of Musical Chairs, a pastime in which he is a victor who says, "Snap," neither too soon nor too late, who passes the Old Maid to his neighbor before the game is over, who secures a chair for himself before the music stops. These games can be played with zest and enjoyment, though all the players know that it is the Old Maid which is circulating or that when the music stops, some of the players will find themselves unseated."

It seems to me, if you compare those two quotes, they are very similar. It seems to me Prince knew exactly what he was doing, and he was just responding to the incentive structure quite rationally, from his narrow point of view. But, of course, when everybody does that, you get a blow-up. That's my theory of rational irrationality.

A secondary piece of evidence to support this, which actually comes from Andrew Ross Sorkin. He was telling me the other day that he was talking to John Mack, the head of Morgan Stanley, and Mack was basically saying, "Look, we can't regulate ourselves. Somebody else has got to come in. The government has got to come in and impose some rules. You can't leave it to Wall Street because, given where I sit"—he's the chairman of Morgan Stanley—"there's no incentive for me to draw back from risky situations."

I think the smart people on Wall Street know what happened. They know it wasn't just greed. That's why I think they are so angry at being pilloried all the time. Of course, some of them are greedy, so they deserve some criticism. But I don't think that was the primary force at fault here.

So that's my theory of the crisis. In the final chapter or two, I just try and take us up to where we are now. I'll just spend a minute on that, and maybe if anybody has questions, they can ask me more detail on that.

It seems to me that the government did a pretty good job preventing a return to the 1930s. I think the Fed did a terrible job in getting us into this mess by keeping interest rates too long and provoking a speculative bubble. But I think, once they realized, at the end of 2007, that things were really serious, they shifted to pumping money into the markets, reducing interest rates to zero. I think they did a good job.

I think Hank Paulson, for all the criticism he gets, did what needed to be done. He screwed it up by first going to this sort of complicated TARP [Troubled Asset Relief Program] structure, where they were going to buy back the bonds. But they pretty quickly realized that that wouldn't float and then they decided to recapitalize the banks. A very unpopular thing to do, still very unpopular. But I think it did avert a catastrophe.

So if you add those two things together, and maybe a bit of kudos to Obama for introducing the stimulus package, which has had, I think, some impact, we have successfully avoided the mistakes of the 1930s, when the Fed basically let the banks go under. That was Milton Friedman's great insight, and he was right on that. You can't just let the banking system collapse, much as some of Friedman's actual followers in Chicago would like to now. They say, just let it collapse and everything will come back in a few weeks. As I say, I think we tried that in the 1930s. I think that didn't work.

So short-term, I think the government did a good job.

Long-term, I'm a lot less sanguine. I think the administration has made a strategic error in not trying to reform Wall Street first and then focusing on health care. Now we have the situation where the market is coming back, the banks are making a lot of money, they are a lot more cocky, lobbyists are empowered again, and the sort of political imperative to do something about Wall Street has sort of diminished. It looks like health care is going to take the next two or three months. It's going to be at least the start of the year, possibly the spring, before we get on to financial regulation. By then you are sort of into midterm election season. That means politicians need to raise a lot of money. Who do they raise the money from? They raise it from the banks on Wall Street.

So it seems to me that even the administration's pretty moderate ideas for reregulation, which I'll address in questions and answers—I don't think they go far enough—even those relatively modest reforms, it seems to me, are by no means certain to be put through. Obviously, nobody asked my opinion, but if they had done that, I would have done it the other way around and exploited the great sort of revulsion at Wall Street in the public at the start of the year, to try and put some reforms through quickly and to keep a laser focus on the economy, then, when you get that through, switch to health care.

So I think that was a political error on the part of the White House. I can understand why they did it. He had obviously campaigned on health care. But I think they should have pirouetted and gone for financial regulation first. I think it was probably a political economy error, and we may live to regret it.

So that's pretty much all I have to say, and in half an hour, I think. I'm happy to answer questions on any aspect of that or anything else I didn't cover.

JOANNE MYERS: I thank you very much for making the irrational rational. It was a terrific discussion.

Questions and Answers

QUESTION: You said that you didn't think that the proposals so far being considered for financial regulatory reform go far enough. What other steps would you propose?

JOHN CASSIDY: I'm sort of in the Volcker camp on this, Paul Volcker, the former chairman of the Fed. I think regulation is good. I think all the ideas the administration has put forward are good ones—increasing capital regulations, forcing the banks to hold some of the securities that they securitize, setting up a consumer financial products commission, having some sort of systemic risk regulator, whether that be the Fed or whether it be some new institution, as in the House bill. They are all good ideas.

I don't think they necessarily go far enough, because if you do all that, you are still going to have these enormous, too-big-to-fail financial institutions, like Citi, like Bank of America, like Wells Fargo, Barclays—you know the names—Goldman Sachs, et cetera. They are still going to face the same incentive structures which got us into this mess. You can't just proscribe rational irrationality. It's part of the logic of the situation. That's the whole point. It's intrinsic in the market.

I think the only way you can deal with that—regulators will do their best, but ultimately they will be out-gamed—I think the only way you can do it is to try and split up the banking system in some way, so that you have a safe sector, the so-called utility sector, which is banks which take in customer deposits, maybe brokerage deposits. They have a pretty much explicit government guarantee. If they get into trouble, we're going to bail them out. But they also face high capital requirements, large restictions on their activities, and a complete ban on proprietary trading and some of the riskier sort of derivatives trading. So you should have the safe, the utility sector.

Goldman Sachs or Morgan Stanley or maybe Citigroup might say, "We don't want to do that."

That's fine. You can go and be a casino—the sort of casino aspect. You can do as much proprietary trading as you want. But explicitly—I don't know if we would need a constitutional amendment or whatever—there would be an explicit law that we are not going to bail you out if you get into trouble; you will be allowed to go under.

People say that wouldn't be realistic. I'm not so sure. I think what would happen is that if you did introduce that split, the capital markets themselves would start to introduce and enforce—and they would start to charge these banks a lot more for the loans. Goldman Sachs without a government guarantee is going to find it difficult to raise money. We saw that last year. That's why the FDIC [Federal Deposit Insurance Corporation] had to ensure the debt, which was the big giveaway of the whole crisis.

So I think by splitting them in two, you would not only separate the utility aspects, sort of bank clearing —money market accounts are complicated. They would have to be in that sector somehow. You would also encourage the market to put some more restrictions on the risk takers. Once the system is up and running, it doesn't really need regulating that much. It's just a set of laws on the books, similar to Glass-Steagall. People say it's Glass-Steagall. It's not Glass-Steagall. Glass-Steagall was investment banking and commercial banking. Under this system, the banks in the regulated sector would still be allowed to underwrite securities for their clients, because that's not, actually, a risky thing. They're just providing a service for their clients.

The risk comes in when they start expanding their balance sheets exponentially, on their own account. If you go back and look—I wrote a big thing on Merrill Lynch a couple years ago—if you go back and look at firms like Merrill from 2002 to 2008, the balance sheets went up 150 percent or something. When you see that sort of balance sheet growth, there's something going wrong. It's always a telling sign of a problem.

As I say, if there is explicitly no guarantee, the markets will restrict the banks' ability to raise capital and to raise funds. They'll just charge them a lot more. That's my argument. As I say, it's not original. It's Volcker's argument.

QUESTION: You didn't mention the Community Redevelopment Act and what role that probably played in the subprime—and that's government regulation.

JOHN CASSIDY: I think I did mention it. Maybe I misnamed it.

There is this argument that the Community Reinvestment Act of, I think, 1979, which then developed under various administrations—Cisneros in the Clinton Administration, Bush, the "homeownership society"— that was ultimately to blame. I think it played some role. Whenever I speak, people stand up and say it was all the government's fault, that it was the Community Reinvestment Act. But if you go and look at the research and see how much of the bonds that were issued were linked to the Community Reinvestment Act, how much of the subprime bonds, it's very small. It's about 10 percent of the market. So 90 percent of the subprime bonds have nothing to do with Fannie Mae and Freddie Mac and nothing to do with the government. They didn't have any guarantees.

So I think it played a role in persuading banks like Citi or Chase or whoever that they should set up consumer finance departments, because the regulators, especially in the Clinton and Bush administrations, were saying you can't redline areas anymore. But I don't think it can be held responsible. It's only a 10 percent contribution, I think.

QUESTION: What do you think the prospects are for some sort of coordination in terms of regulation globally? One of the obvious problems is, if in the United States we try to regulate the banks more heavily, where we make it more costly or have additional capital requirements, if they are out of the business there are plenty of other banks globally that would be probably happy to step into their shoes.

JOHN CASSIDY: I may be completely wrong, but I actually think this one is a bit of a red herring. I think the banks use it as an argument to avoid regulation. It seems to me these big banks need to be active in New York. They need to be active in London. I agree, if the U.S. does something and London doesn't do it, that's a big problem. It may be with Tokyo, too. But if the big Asian, European, and U.S. markets agree on a set of rules, I think they could then call Wall Street's bluff and say, "Look, if you want to bank in the U.S., if you want clearing by the Fed, you have to abide by these rules. If you want to go to Bermuda or Curaçao or Panama, good luck to you."

I think it will be very difficult for them to do it because they can't get access to the funds in the U.S. unless they can clear through the Fed. So I think the government has stronger bargaining leverage than it appears. Wall Street always uses this argument: "Oh, we can't regulate stricter in the U.S. because Citigroup will relocate to China," or something. I actually don't think that. Alot of the money is here. A lot of the infrastructure is here. If it's imposed on everybody so there is not this sort of rational irrationality problem, where one is trying to beat the other, if everybody has to agree to the regulations at the same time so no individual can get a competitive advantage if they want access to the U.S. and U.K. markets, I think the government can do quite a lot.

The U.S. and the U.K., for some reason, don't seem to be on the same—they are on the general same page in terms of capital requirements, et cetera. But the British—it's interesting, actually. As you can probably tell, I'm British, but I have been here 20, 25 years. But I was actually in the U.K. last week. The political climate there is different. The political climate there is still where it was here six or 12 months ago. People loathe the banks in London. You can't admit you're a banker or people give you abuse in a restaurant. Banks are seen as primarily responsible for the crisis.

Because of that, Brown, the government, is under strong pressure to take as tough a line as possible. That's why they are pushing—Brown floated the idea of a Tobin tax on international financial transactions. The British floated the idea of stricter limits on CEO pay, even stronger capital requirements.

The Obama Administration is ultimately still pretty much in bed with Wall Street. As I say, a lot of intelligent people on Wall Street realize the need for reform, but they are not willing to go as far as the Brits. They are not motivated. If I was Obama, I would go populist on this. But for some reason, he doesn't appear willing to do that. The Treasury is basically still running the show, rather than the White House political advisers, and the Treasury is strongly opposed to most of the British ideas.

QUESTION: I saw a little breaking news. I think Bank of America just jumped out of bed with the government. At 5:00, they announced they were repaying the TARP. You have to raise a lot of money to do that.

If you had to say there was one common denominator of financial crises over centuries, would it be a four-letter word, "debt"?

JOHN CASSIDY: Ken Rogoff, who I think was here a few weeks ago, would probably be able to answer this better. Sure, the common denominator is almost always very rapid credit growth in various forms. That's why the old monetarists, I think, had it right, to some extent. They used to look at broad measures of the money supply, which include a lot of these debts. If you look at the financial ratios, what happened here was that the Fed basically stopped—M3 was discontinued about four years ago, which was very convenient, because it was starting to go through the roof because it included a lot of the short-term debt instruments.

Again, one way is just looking at the aggregate monetary ratios. Another way is to look at the balance sheets of the individual financial institutions, because they are the guys who are issuing all this debt. If their balance sheets are expanding at 20, 30 percent a year, as they always do in a credit bubble, that's an almost certain sign of trouble ahead.

Everybody knew this in developing economies. That's why the IMF and the World Bank monitor this stuff on a day-to-day basis in the developing world. But, unfortunately, the U.K. and the U.S. basically turned into developing economies in the last ten years, as far as the financial sector goes.

QUESTION: [Not at microphone] There's always the problem of excessive risk and excessive regulation, which can stifle [inaudible] industry. Could you comment on the advantage of having IMF, through the Group of 20, impose minimum reserve requirements on all the financial banks and the transactions and maximum leverage requirements on the same things, and also to avoid this consumer [inaudible] bureaucracy, simply restore the old usury and bankruptcy regulations that we used to have?

JOHN CASSIDY: You mean put a regulation queue back in or something? I hadn't thought of that one.

On the IMF, again you need coordination. I'm not saying you don't need international coordination. You do need some international coordination. So it would be a good idea. It's never going to work through the IMF, I don't think.

QUESTIONER: [Not at microphone]

JOHN CASSIDY: The Group of 20? It's like Stalin said about the pope: How many divisions do they have? Nobody takes any notice of the Group of 20. Unless the U.S. Treasury is behind it, nothing will happen. Brown tried to float these ideas at the G-20. He actually tried to sue the G-20 as cover for sort of doing an end run around the Americans. But you can't do an end run around the Americans. They run these institutions, and they run the IMF, too. So unless the U.S. government signs on for anything, it is not going to happen.

The consumer bureaucracy thing—it may turn into a terrible bureaucracy. I don't know. It seems to me a reasonable idea. There were large sectors of the mortgage market, for example, which just weren't regulated, because they are regulated at the state level. In California, where all these enormous financial institutions, like AMERITRADE and Ameriquest, et cetera, were all based, there were, like, ten regulators in an office in Sacramento looking after 20,000 loan offices. That's why they incorporated at the state level, because they knew they could out-game the local regulators. At least if you have a national level of regulation, I think it's harder for these institutions to game them.

I know what you are saying. It may degenerate into just another bureaucracy. But I think the idea of regulating at the federal level has got something to be said for it, because it just avoids people going to different states.

QUESTIONER: Wouldn't simple criminal prosecution for violating the usury laws and bankruptcy laws solve the problem?

JOHN CASSIDY: The FBI would need another 200,000 agents, wouldn't they? It's a federal crime to lie about your income on a mortgage application form. If we had enforced that in the last five years, I would have said, at a rough guess, probably 30 million, 40 million, 50 million Americans would have been found guilty of a felony.

It's easy to say to enforce this stuff, but it's sort of a social norm issue, I think. The FBI were issuing warnings back in 2004-2005 about the growth of mortgage fraud, but nobody would listen. It's easy to say to just prosecute them, but you are going to have to build a lot of jails if you're going to start prosecuting people for lying on their mortgage statements.

QUESTION: There's a hypothesis that I heard recently which was that if it hadn't been for Y2K and the sort of reconciling and rebuilding of all of the computer systems in the financial services industry, the velocity of transactions would have been a lot less, the interconnectedness would have been a lot less, and it might have been a lot less dangerous. I wondered if anything like that had—

JOHN CASSIDY: You mean it was all the computers' fault and they were boosted enormously by Y2K? I'm really not qualified to answer that question. It seems to me it's a convenient excuse for the bankers.

Certainly I think technology played a role, in that a lot of the risk models which the Wall Street banks were relying on were based on computer simulations. That is certainly true. They used computer simulations to price a lot of the CDOs [collaterized debt obligation] and the CDOs-squared, et cetera. Guys like Chuck Prince clearly had no idea what was going on in these sort of "quant" departments. But I think it's too easy to just blame the computers. Somebody programs these computers, right? I would tend to blame them.

QUESTION: I wonder if you could talk a little bit about how you approach efficient-market theory. I ask because a lot of these large portfolios had values put on them, and it strikes me that a lot of the valuations were disseminated more widely than they should have been, based on limited data and limited models, through daisy chains of markets.

JOHN CASSIDY: It's a fascinating question. Actually, I'm writing something for *The New Yorker* at the moment about the efficient-market hypothesis. I've just been out in Chicago to talk to the sort of high priests a year after, including Gene Fama, who was the founder of efficient markets.

I'm pretty critical of it, to be honest. I think there are two versions of the efficient-market hypothesis. One I'm willing to go along with: That it's difficult to beat the market, that it is efficient enough to make it difficult for an individual or a firm to beat the market. I think there are 30 years of research showing that. There are some sort of anomalies which you can exploit from time to time. But the market is efficient enough that once one person learns them, somebody else learns, and it gets eliminated pretty quickly. If that's where the efficient-market hypothesis is, you can sign me up; I agree.

But the idea that markets never depart from economic fundamentals and that the market price is always right, in some sense, I think has been completely discredited by what we have seen. These credit products were chronically mispriced for years. Fifty basis points above Treasuries? They should have been trading at 1,500 basis points above Treasuries or something.

Gene Fama and people have got a very convoluted argument for why the market wasn't failing, which I'm trying to convert into English. If you keep reading *The New Yorker*, you should get a version of it.

But it seems to me it's a bit like when Hubble discovered that the universe was expanding. There were some guys who said, "Well, actually, he's got the results wrong. If you reinterpret these results, the universe is actually still stable," which Einstein believed. I think that's all nonsense. This was clearly an example of chronic inefficiency in the capital markets for years on end.

We had another example of that ten years ago in the stock market. We probably had an example of it in the commodities market last year. Financial markets are prone to speculative bubbles. That seems to me to be fundamentally—they are not always, but periodically they are prone to it. That seems to me to be very difficult to reconcile with the efficient-market hypothesis.

QUESTION: I'm very concerned about the fact that the banks, especially the big banks, are still sitting on all of these toxic assets, so-called. Until those toxic assets get written down—and, of course, the Fed has a whole heap of them, too, now—they are not going to lend. The question is, what do you do? How do you force them to—they eliminated mark-to-market rules. So they are just going to sit there for ten years waiting for the rising tide.

JOHN CASSIDY: I get the argument. It's a very good question. I was on a panel, actually, with Carmen Reinhart, who is Ken Rogoff's co-author, the other day, and she was pointing to this and saying she thinks the U.S. is turning into Japan, that we're on the Japanese timetable. She thinks the most important thing that happened last year was the FASB ruling [Financial Accounting Standards Board], which is that you don't have to mark these things to market anymore. So the banks are basically putting whatever prices on them they want.

I'm a bit more optimistic than that. I'm not massively optimistic, but I'm a bit more optimistic than that. In a recession, the banks always get criticized. I'm not a big fan of the banks, as you probably gathered. But in a recession, the main reason they stop lending is because there's not a massive demand, I think. So I think the test will come when the economy starts to grow again, if it's still difficult to find credit.

Maybe I'm wrong, but I haven't seen big lists of industrial corporations who are having difficulty getting access to credit. They are obviously not getting it as cheaply as they used to do. But they were getting it too cheaply. The market was mispricing credit.

The second aspect of it is that there is a covert recapitalization of the banking system going on, through monetary policy. The Fed is giving these guys money at zero and they invest at 4 percent. That might be morally terrible, but it's economically quite effective. They are making enormous profits, so their capital ratios are coming back up. As I say, it's not something you like to see, but it's clearly a covert recapitalization. If their capital ratios all come back up, they make so much profit. When the economy ticks up again, they shouldn't be capital-constrained; they should be able to lend more.

I'm not saying that's definitely going to happen, but I'm not willing to totally buy into the Japanese argument as yet. If the economy starts recovering over the next year, if the recovery picks up a bit, and there are lots of stories about how small businesses and big businesses can't get any money from the banks, then I may reappraise my optimism.

JOANNE MYERS: I think after listening to you speak today, if you're not a subscriber to *The New Yorker*, you would probably want to become one in order not to miss any of your articles. I thank you very much for your presentation.

JOHN CASSIDY: Thank you. Thank you, everybody.