The Economic Crisis: Wall Street, Main Street, or K Street?

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Introductory note (Richard A. Epstein): This talk was given on October 23, 2008 in the midst of the credit crisis that was gripping the nation at the time. I had the opportunity to edit it at the end of June 2009 and am sorry to say that the predictions have proved true. The bailout process itself has become ever more politicized for ordinary businesses, including Chrysler and GM. A huge stimulus package has been put in place, which makes it difficult to spend the allocated funds in a coherent fashion. The Congress is considering ambitious new schemes of financial and health care regulation in the face of rising deficits and government expenditures. The President and the Congress are united in the belief that dangerous times require more government action. The stock market remains about where it was on January 1, 2009, and the unemployment rates have moved higher still. I regard these events as vindication of my gloomy assessment, which I don't think is likely to prove false in the short run.

Richard A. Epstein*: It is an honor to be here. I'm happy to see so many people have come to make judgments about our economic situation. Usually people in economics, or in law and economics, do not lack the confidence to talk about the major problems of the day. If this talk were a discourse on antidiscrimination laws or the minimum wage or some similar conflict, I would be situated clearly in the camp for deregulation. But money and credit and all the related topics are much more difficult to get a grip on. Therefore, I think you have to be aware of the two extremes, in order to try to find some way between the poles. This puts me in the uncharacteristic position of being a moderate, but so be it. I will bear that scorn with whatever dignity I can summon.

What are the two extremes that we have to fight against, or at least, to think hard about? Well, one is the strong libertarian position, which says any time people enter into a financial market or transaction, they know the risks. If therefore it turns out that they miscalculated, they should be allowed to fail. That, libertarians say, is the only way in which the whole system can be kept in equilibrium. Otherwise, we the people, through our government, are forced to provide massive amounts of subsidies, or to create distortions of one kind or another. By throwing good money after bad, government makes the whole situation systematically worse than it ought to be.

I think there is some truth to that particular proposition, and one ought never to ignore it. But the complexity of these interlocking transactions and the dangers peculiar to bank loans and other collective phenomena caution against the belief that mass transactions are governed by the kind of logic that normally applies to isolated or uncorrelated transactions. The two do not function in exactly the same way. So it may well be that the kinds of responses we need are different.

On the other side, many on the liberal wing of the political spectrum take a different view; for example, my friends who quote Barack Obama that the source of all evil in the credit market is in the "massive amounts of deregulation" that has taken place. There is an acerbic version of this position in a recent issue of *Slate* by Jacob Weisberg, who basically calls all libertarians—a term which is very dear to my heart—immature intellectuals who are fixated on novels by Ayn Rand,[1] which, I might add, I have never read. Weisberg believes that the case for regulation is so self-evident that anybody who opposes more state control is simply going to repeat past errors or create still greater economic crises. The opponents of additional state control ought therefore to be utterly disqualified. His basic attitude towards folks like me is: "You've done enough harm, now shut up and be quiet." The current fight indicates that in situations of major peril, name-calling seems to take over. But what we need to do is to put this aside to get back to figuring out how the system is put together.

The metaphor I like to use is medical. It turns out that the diagnosis of conditions is, in fact, quite difficult. Many times people die because they need an "upper," but they're given a "downer" because the underlying physiologies of a particular ailment are quite different, even though two manifestations of it are quite similar. And so you have to be extremely astute in figuring out the causes so that you don't aggravate the problem.

But just because you can make a diagnosis, it doesn't follow that you can actually propose something that works as a cure. What we're saying here is that no amount of human ingenuity can reverse the natural biological processes. Certain societies get themselves into such a tailspin that it's probably the case that no amount, and no form, of financial intervention will be sufficient to undo the damage at the end of the day.

The usual response to crises such as the present one is some kind of a government bailout, on the premise that the ship of state will always be above water, even after it has taken on extra baggage by its various obligations. As we know, however, one can never think about government interventions as something that does not create additional systematic risks of its own. There is no risk-free alternative. One of the things I would like to stress is that, in the effort to control various localized risks through some kind of general and comprehensive government solution, we may be systematically increasing the probability of a much larger risk. That system-wide risk may be low just now, but as the TARP gets bigger, one has to multiply and realize that a low probability of enormous risk may in fact be far greater than a higher probability of a somewhat smaller one.

So how is it that we start to diagnose such a crisis? Well, the first point I want to make is that in today's world, there is no such thing as a private market transaction—no matter how much you might like to think so. This calls attention to

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a feature of most business transactions that we might like to neglect, which is the role of money in a system that is driven by voluntary sales.

In the good old days, money essentially took on the following form: People would have something like gold, and they would store it with a trusted party for safekeeping. And they would receive in exchange a certificate that allowed them to redeem their gold upon presentation. By degrees these certificates became money, by being freely alienable from hand to hand. But the users of these certificates had to make sure that people could not fraudulently counterfeit the various receipts, which meant that someone had to make them a little more, shall we say, complicated. And when these certificates circulated in society, the great advantage of having this big store and clamping down on counterfeiting was that people knew that the supply of currency turned out to be fixed, and so therefore it was relatively free from various forms of government regulation.

There are difficulties with this system. If you tie your monetary supply to a commodity like gold, and gold itself is subject to market fluctuations, it may well be that you can't inflate the currency by adding more of these certificates of deposit to the mix. But if the underlying currency tends to be worth less and more on alternative days, you lose stability in another dimension—that of valuation fluctuation—which in fact will make these private transactions much more difficult. What happened in most modern societies is that people said, "Look, we cannot figure out how to make a commodities-based monetary system work, so we have to get—create by fiat—a government currency." When you go back to the first efforts at government currency, you find that nations always sought to have the government hoard gold in Fort Knox or the New York Federal Reserve Bank or some place of the sort; they still keep supplies of it. But sooner or later, the amount of the commodity as a fraction of the total amount of wealth in society shrinks. So you have certificates that are not backed by gold, and you must find some other way to limit the amount of those certificates that move in commerce, because otherwise you have to put terms in various contracts in pricing terms, where the ruler by which price is itself is inconstant. This is no small difficulty.

Many of you have heard about the Great Depression, but most people do not know about the great deflation that accompanied that economic crisis, which triggered so much of the difficulties. Under the stalwart Herbert Hoover, and Franklin Roosevelt later, the money supply was allowed to contract so that every debt denominated in fixed dollars was much costlier to pay off than had previously been the case. This prompted all sorts of difficulties in the foreclosure market, which in turn prompted all sorts of efforts to create moratoria. Of course, it sounds wonderful, to keep debtors who can't possibly pay their debt on the premise that the banks will be just fine. But all of a sudden, depositors understood that they were not going to be able to redeem their demand accounts, and nervousness set in. Once that took place, we had the run on the banks.

This risk is not one that is going to disappear. To give you an example, when I attended a securities regulation conference on the bailout a couple of weeks ago, here at NYU Law School, I was asked if I knew that the major money market funds were running the risk of breaking the buck. I looked at my fellow panelists and said I don't even know what that expression means. Well, it means that there's no safe place to keep your money. We put our money into various accounts, which we can redeem in part any time we want, dollar for dollar. But if the money goes into commercial paper, which itself depreciates in value, there is now a risk of a run on Fidelity. "Breaking the buck" means that the money market fund or similar organization will say there is so much money being demanded of us now that we can only redeem $.99 or $.98 or $.97 on the dollar. The moment you break the buck and go down below that par level, it's clear a run can easily take place, and the redemptions could be at a much, much lower level.

What this suggests is that there is a very low probability of an absolutely catastrophic event. People thought their money was "safe" in these accounts, which were substitutes for savings deposits at one time or another. But they were not. In fact, one of the reasons this current financial situation is so totally neurotic is that at the present time, given the various bailout strategies, we do not know whether we have to fear deflation or inflation. It could be either or both in fairly rapid succession. Generally speaking, your ability to price all sorts of transactions becomes weaker and weaker as the level of uncertainty starts to increase with respect to the basic money supply.

So, there are reasons for the enormous uneasiness about Wall Street, but you have to understand that there is no safe haven. You cannot get it in commercial paper, nor can you get it in cash. It's quite possible on the cash side of a one-to-one redemption that the valuation risks we've talked about will come back, so that the dollar saved in fact will pay you nothing by way of interest and will depreciate at seven percent a year by virtue of some kind of rapid inflation. There is, to borrow a title from the French philosopher Jean-Paul Sartre, *No Exit*, no dominant strategy available to anyone, public or private, to insulate us from the risks of a depression. When you have major contractions in the total level of certain physical and intellectual property and tangible wealth, there is no way for anyone to say, "I wish to take a risk-free position, so I'm going to do X." You still have to diversify against the risks you normally do not think of being in play, but in fact are. This is not a really upbeat story, in case you haven't caught my drift.

So what happened? Well, as I indicated to you before, when you have a financial transaction and the money valuation is insecure, people per force are exchanging goods under unreliable signals. The usual libertarian argument, that *voluntary* exchange is the greatest mechanism for wealth creation in the history of the world, is true. But if the monetary ruler is screwed up, every single voluntary transaction in the system has a gratuitous amount of uncertainty.

The great achievement of Milton Friedman, a name taken in vain too often lately, was not so much his stuff on the free market, but his work on monetary theory, a quintessential government area.[2] Friedman was able to devise a set of protocols that essentially allowed for money to keep pace with the increase in the level of goods, so that instead of having deflation of the kind we had in the 1930s, or inflation of the kind we had in the 1970s, we have had, since about 1980 or 1982, a relatively

constant money supply relative to the size of the economy. This means, in effect, that one element of insecurity in voluntary transactions has been successful contained. That is the first point I want to get across.

The second point is that government gets involved not only in defining the money supply, but also in setting the general interest rates banks can borrow. We know basically that the real rate of interest is somewhere around two, maybe three percent for risk-free investment. But when you have the federal funds rate going down to under one or one-and-a-half percent, what you essentially do is inject too much money into the system because you're not charging people the full amount of the money they have acquired. That means that they're going to acquire too much of the new money to purchase durable assets—call them homes—which are secured by mortgages obtained at these very cheap and easy rates. There's only so long you, the government, can continue to prime the pump by putting all this extra money into the system. The more that is done, the more you run a very serious inflation risk.

Yet the moment you, as government, cut back on the money supply, the refinancing options given to people who initially borrowed beyond their means with short-term paper, the standard pattern, are much more limited. They are now going to refinance at a higher rate, which will lead to additional defaults. At the same time, and this is synergistic, we had a very determined group on the liberal side in the Senate and House (Barney Frank, I think, is the chief culprit) trying to sponsor subsidized mortgages through Fannie Mae and Freddie Mac. These politicians encouraged people to buy a home, by way of a very small down payment and low interest rates. But this strategy was not sustainable at its inception, and is not going to become sustainable any time soon. Pursuing this ideal is just asking for trouble.

Now, how will private enterprise respond to all this? This is something I think libertarians will understand very well, which is that any time you have a government subsidy, private markets will respond rationally. They will aggravate and expand and magnify the error. That is the danger. You go back to this basic concept of self-interest. When you're dealing with anonymous financial transactions, you don't worry about the natural love and affection everybody has for his or her dog; these things just don't matter if self-interest applies to public financial signals.

In effect, we are now telling somebody at a bank that he has to lend this money to somebody to collect fees. Don't worry about the credit-worthiness of the borrower, you can lend against the government guarantee or the government obligation of repurchase. The moment you create this situation, we have created a wealth destruction mechanism of unparalleled significance. Somebody makes a loan on a property, and the day the paper comes back into his hand, its market value is 80 cents; the lending system so carefully nurtured has managed to lose 20 percent in one day. No matter—you can now sell off the dubious paper to a government agency or somebody else who has a government guarantee, who will receive a hundred cents on the dollar. At that point, people will lend against the guarantee or the repurchase obligation; they will not lend (because they don't have to lend) against the security of property. All the restraints that you would have placed on private parties in a market of scarcity are no longer in play.

We know what happens with bubbles. The first guy ventures into a risky market, and it works out fine. Here the government says, "Well, let's have another good idea by extending a good idea to the next group of potential borrowers." Everybody thinks the functions are linear; you can increase lending activity a little bit more and everything will get a little bit better; nothing will ever flip over on you and kill you. So we accelerate the process and, sure enough, we come to the end game. Somebody cannot resell or refinance, and the whole house of cards comes tumbling down because the salad days of easy-money are over.

The government guarantees are involved, but at the same time these guarantees now enable and help to prosper another kind of market of equal importance, the so-called securitization market. Now, most of you probably have not heard of securitization until recently, and some of you may not have the slightest idea of what the whole project entails, but essentially securitization was meant to avoid the kind of serious dislocations we had in the mortgage markets during the 1980s, which started early in the decade and blew up in the Savings & Loan crisis.

Quite simply, the securitization practice runs like this: if a bank originates a bunch of loans which pools in its bank portfolio, the bank takes a risk. Thus the bank that does not diversify is at risk if there is some local blip in the economy—Lockheed closes in Los Angeles or whatever. Now the mortgage risks are (imperfectly) correlated, so that all of the properties in that particular area are going to suffer in sync some kind of financial decline. So if you're a lender on those particular mortgages, without diversification in your portfolio, you will suffer very badly too, and your whole bank may then be at risk. Banks quickly learned that lesson. The cure they discovered had them diffuse their mortgage paper into a larger market, where it can be bundled up with loans that were originated in other areas, so that the bad luck you have in California can, with respect to the pool, be offset by the good luck in Arizona. Diversification was thought to be a powerful way to handle that problem, and securitization was one step in that larger process.

Once you get these bundles, however, the question is, how do you sell them out to the market? People realized that there were gains to be made from this trade by taking these mortgages and dividing them into tranches. This way, some people would be very secure, because they would get the first dollars coming into the pool, while other people would be in a much riskier position, essentially bearing the brunt of the first round of defaults, while others still got paid in full.

All of these complex divisions were made possible by modern computer programs capable of following, marking, and tracing the flow of these dollars, so that no matter where the money came in, it could be directed to the right parties. The securitization practice led to a strong amount of standardization with respect to mortgages, because the only way to bundle mortgages was to be sure that they all had the same basic legal attributes.

But here, again, is another version of the point I made before—diversification is a much more complicated concept than people once thought, for it turns out that certain strategies that allow you to diversify against some risks in fact make it impossible for you to diversify against others, and indeed, create a greater set of problems when risks actually correlate. So what happens is, when you start to securitize these mortgage instruments, the local variations in underlying property values are no longer able to bring a bank down, but any kind of national policy you have which impacts all of these securitized packages of mortgages simultaneously has the rare capability of bringing the whole edifice down. Sometimes private markets are not very good at anticipating regulation that will impact them.

Whether you want to call this tendency a failure of the market or a failure of federal regulation is that terminological point that has a lot of ideological baggage. But at this point I am more interested in understanding the situation descriptively, before making a normative judgment as to who the "culprit" was in this particular case. It is an effort to secure transparency on these credit issues. After parties create one securitized interest it becomes the basis for further transactions, as people can buy against them or borrow against them, or use them as security for various kinds of loans. One of the great geniuses of our market system is that anything that you buy you can resell. But as the process starts to evolve, private parties enter into certain, very complicated transactions—credit default swaps, for example, which are essentially contracts betting on the soundness of the other side's portfolio. In order for those contracts to be accurately priced, both parties have to be able to price their components. Yet in the mortgage market, these are long-term assets broken up into short-term pieces, and the real fluctuation in their value is a function not only of local conditions but of government regulation.

The government regulation that makes a difference in this case, which also helps explain the problem, is an obscure set of rules invoked both in loan covenants and by the SEC, called the mark-to-market phenomenon. This was the accounting norm that created immense dislocations in the late 1980s in the Savings & Loan business, and it has come back in the current malaise. As with many forms of public regulation, this approach has essentially been defended on the grounds that it increases transparency by forcing people to make clear what their portfolios were worth, even if they had not made the sale of any of its essential components.

If you own a capital asset on a particular book for which you pay $100, and the asset now shows $50 of appreciation, how do you treat this move on your balance sheet for tax and regulatory purposes? Do you force somebody to recognize the gain on the $50 without the asset being sold, or do you allow them to carry it at book value and make no changes? For the most part, in a tax situation, we allow the regulation of the taxation of the gain to be deferred until the holder has the realization of that debt as the sale of property in question. You get a book worth $150, subtract the original cost, subject to a certain number of adjustments, and find your gain or loss.

But in many cases, particularly when you're dealing with loan portfolios, this kind of deferment of the reevaluation of the asset is not going to work if the amount of money in your bank has to be determined in order to figure out whether you need to add reserve requirements or to meet the requirements in loan covenants. So you need to worry about some mechanism for intermediately undertaking the needed valuation. Mark-to-market starts to apply then, and again, the lesson is that if an individual firm goes bankrupt, any technique that works fairly well for uncorrelated transactions, which implies a relatively low level of failure in practice, may work quite horribly when it turns out that there is a positive correlation between the various events. Thus, genuine cascades take place and bring the whole system down, which is essentially what happened in some of the recent financial dislocations, such as Bear Stearns.

As one of my students at NYU reminded me, every one of the investment banks that failed on Wall Street was cash-flow positive at the time they were going down, which meant they were taking in more money than they were paying out, with respect to their portfolios. Stated otherwise, they were able to meet their obligations in the short run. This is not normally regarded as a sign of terrible trouble, because you have no observable behavior that announces that something may be wrong with the system. But the moment you have mark-to-market rules, you are no longer trying to evaluate the company by seeing what flows in and what flows out, figuring out the difference, and worrying about whether that positive or negative flow will last over the long run.

What somebody is requiring you to do is take one of these assets in a mark-to-market; that is, you can mark it one of two ways. If you mark up the asset, say because of an interest rate decline, the asset is worth little more than you thought, which is fine—nobody is going to go bankrupt by being told by the government that they have to declare themselves rich. In fact, with mark-to-market, under those circumstances, the use of the perceived value of the underlying assets does have a dark side because it paves the way for greater amounts in lending activity as the banks can increase their reserves without taking in new capital. On the upside, therefore, mark-to-market is a kind of stimulus.

But going into the downside is not symmetrical, because what happens is if somebody looks at this portfolio and divines under circumstances that we really don't understand that loan which you thought was worth $100 is now worth only $75. It is not just one loan the observer has wiped out, but the whole portfolio of loans that shares key common characteristics. They're saying, now, "Congratulations, you think you're making money, but if you closely look at the underlying assets, your liabilities exceed your assets." And so you are insolvent or nearly so. And the only way you can bulk up is to dump some of these uncertain securities, get cash—whatever that is—in order to build up the reserve requirements so that you can continue to operate.

But now remember, you are in an area of business in which the value of everything is positively correlated with the value of everything else, and the moment you sell your stuff, your very act of selling puts any additional pressure on the market. So

your portfolio may have been valued at 75 cents on the dollar, but the moment you start selling, that goes down to 70 because you've created this overhang on the market. Well, that's great. Then you look at bank number two, which was solvent at a valuation of 75, but for whom warning bells start to ring when its portfolio now has to be revalued at 70 cents on the dollar. One distress sale thus leads to another. Potential buyers see the second stage so that they don't bid in at the first. Owing to the correlated risks, what the mark-to-market dynamic generates is an absolutely perfect cascade.

This set of events leads to a very serious problem. You start throwing people over the cliff by marking to a market which changes in consequence of the rule of valuation under which it works. It creates, as it were, an economic kind of Heisenberg uncertainty principle with a vengeance. The mere effort to measure your level of insolvency aggravates the solvency beyond all reason with respect to original portfolios. This scenario, if correct, is not a laughing matter.

And then suddenly somebody comes up to you and says, well, what's the alternative? There's the rub. It's not so easy to figure out what the alternative valuation mechanism is to a mark-to-market system. Note that if you don't do any kind of adjusting to the market, the uncertainty about the relationship between inherited or book values six months ago and the current value of the portfolio will still create fresh difficulties. That is, the fragmentation of the interest of the system of securitization means that transparency is harder to achieve. Because there are so many part-owners, even if the various interest holders in the portfolio figured out that they had to make some key readjustments, it would very difficult for them to work a renegotiation that meets their needs.

So what happened, I think, is that the private market essentially overestimated its ability to deal with these risks. Thus it could have underestimated its own need for margin because it did not take into account the destabilization that mark-to-market created, either on the contract or government side. My own sense, and I'd like to speak to some bankers who may be able help me on this, is that if in fact we did not have a mark-to-market system, there would have emerged a voluntary market of discrete intermediaries, clearinghouse types or something of the sort, who would get this information, share with those people who needed to know in order to make the transactions workable. I suspect that some of the market makers would try to treat their data sets as a proprietary trade secret that they would sell off in competition in order to introduce some transparency that could lubricate transactions. That's my sense as to what might have happened, which would, of course, have been a much better result than the one that we have here. But it takes more detailed industry knowledge than I possess to be sure.

So now you're trying to figure out why it is that the libertarian principle is not as great as we might want. I think there are two explanations. One is that it's quite clear that herd behavior was observed in these particular cases, creating systematic externalities that engulfed everybody else. If you—if anyone—could figure out a way to stop that behavior with basic improvements across the board, no libertarian wants (or at least should want) to take the position that we are in favor of suicide pacts. I don't think that any libertarian, however extreme, would say, "You want to have writing requirements for contracts under the statute of frauds? That's a form of government regulation, it counts as a restriction on freedom of contract, so off with your head. If they want to have oral agreements, let them do it." Try telling that to the real estate business; they will kill you because high value, long duration transactions can't run on oral evidence and needs written evidence which is easy to supply given the typical transactional time frame. Essentially, what happens in these situations is that the government role has long been properly understood as a means to stabilize the security of transactions by making it easy to sort out transactions at the backend should any dispute arise in the interim.

If you can figure out a way to achieve that set of favorable in these treacherous mortgage markets, by all means be my guest and try to do it. Here, the government came up with two possibilities for handling the situation. Neither of them is crazy and both of them, I think, are consistent with a small government approach. One of them is for some government agency to buy the worst paper. That step takes these assets out of the bank so that its balance sheets are restored by getting rid of what we now call toxic assets. This operation is not easy to do, because the valuation remains subjective, and no one wants to treat them as having a zero value just because they are in government hands.

On the other hand, you don't want the government to pay the banks an enormous premium. The original purpose of the bailout was quite simply this: We, Treasury, will take some of these things; we will pay you more than you get on mark-to-market, because we think the discounted value of the future cash flows is worth more than that present exchange value of the asset, and believe good empirical evidence confirms that it is true. By setting some intermediate number, the hope is that just taking bad assets out of private hands and putting them in government hands will, at least in the short run, create a mechanism that will end the downward spiral of for-sale signs that have so disrupted the market,

The practice doesn't have any multiplier effect, however, in the sense that the nation still got this stuff around. The practice doesn't get rid of any liquidity crisis that the banks have to face, and so the Europeans first, and then later even the United States, decided to substantially inject some money into the individual banks to offset the loss of capitalization. That last step doesn't require anyone to make valuations of individual assets, toxic or otherwise, but it does require the government agents to make a valuation of what this particular share of the enterprise is worth so as to keep the transaction from giving an undeserved subsidy to the banks, or, conversely, taking over part of their portfolio.

In order for this injection of capital to work, the next step is to decide what form the government holdings will take? Is it going to be simply common stock or preferred stock? Some kind of voting preferred, nonvoting preferred, convertible preferred? Anybody who's done corporate finance knows that the number of ways in which you can divide a given pool of assets, putting share and debt claims on them, is potentially infinite. It actually takes some real technical expertise to figure out the optimal

capital structure. So now you see why bank protection always leaves everyone between a rock and a hard place. Let the government buy these assets up, and it faces valuation problems that won't quit, and for all that risk the positive effects are limited. If the government makes cash injections, the parties must answer all the business questions for which we don't have good answers: how much goes in, who gets it, and what's the form of the holdings that take place. All one can say about this venture is that doing something is likely to prove better than doing nothing. But don't hold your breath.

Now, what does the libertarian have to say? I'm going to end with two brief observations so that Steve can give some comments. First, what you learn most from this sort of situation is to prize the "never-again" maxim. Once you see the hell that is created with cheap money and subsidized mortgages, it is not beyond the capacity of government, even in a Democratic administration, to say we're just not going to go down this path ever again. But if we don't understand the origins of this stuff, we will go down this path again, so right now you have calls for additional stimulus packages, which are basically as useful to the market as stock dividends are in ordinary corporate transactions. The process of simple cash transfers creates uncertainty without generating any wealth. If Congress has not learned this brute fact, fear its future actions.

The second thing to understand about these political actors is that they cannot resist making the bailout an opportunity to achieve dubious collateral objectives. If you look at the bailout the House voted down Monday, September 29, it was about four or five pages. By the time it passed on Friday, October 3, it was 500 pages, 490 of which had nothing to do with the bailout as best one can tell. What happened was every Congressman came up and said, "Look, I will vote for the bailout if you'll do the following for my favorite project." We started sinking the effectiveness of the bailout by tying it into everything else. My favorite illustration of this is that these Solons managed to create mental health parity in health insurance markets via the Wellstone Act by tying them to the bailout bill. "Parity" means that anybody who wants to issue insurance against physical injuries now has to offer it for mental health conditions as well.

Anybody who's ever been in the health-care business understands that these are two different risks to insure. All this initiative is likely to do is create more un-insurance and make it virtually foreordained that the Obama health care campaign promise— "If you like what you have, keep it"—false. That happy scenario cannot be true because the use of mandates has already changed the older plan that employees had by larding on another mandate. So in an effort to create a bailout, we now engage in a systematic collective action of wealth destruction by interfering with markets in insurance, where they actually work pretty well and don't have any of the coordination problems we face in bankruptcy.

This set of problems is very serious. Essentially, our nation has gotten itself into a collective frame of mind where the bailout is enigmatic of a zillion other so-called market failures. Once we conclude that it is legitimate to regulate bailout, we now say it is legitimate to regulate anything we call a market failure—defined as a situation where the price at which good is offered in a competitive market exceeds the amount some people are able to pay for it. Thus we conclude that all competitive markets now have systematic failures.

So what is it we have to do? We have to learn how to focus. We have to recognize that the monetary system, the price system, the subsidy system, and so forth, are in fact government-created public goods which require government regulation. But the rest of our economic activity is something that can work if we want to let it. It covers the type of activities we don't want to regulate, or, if we think we want to do it, we have a full and complete debate that addresses these issues on their own merits, outside the bailout environment. These public choice dynamics we face will not go way. The pathology is hard to combat and it is an open question whether we will pile so much regulation onto this particular social raft to sink the entire operation, as opposed to simplifying the burdens on a few financial institutions. Think back to the good old days where all you worried about was Bear Stearns.

Thank you.

Steve Thel[*]: Thanks Richard. So, I'm billed as the Communist today, in the flattering sort of way that "communist" has come to be used by conservatives lately. That is to say, I have some reasonable suggestions.

First, I find it embarrassing that part of the financial crisis is a cascade problem. There is a panic. If assets really are being sold for less than what they're worth, why isn't somebody stepping up to buy them? If it's mortgage paper, and only worth 70 cents on the dollar, why can't they sell it? Why aren't there people out there doing it?

I think we probably agree, and it seems that many people agree, that this is not working, and that we have to do something about it. What I want to ask, though, is what got us here? I am not confident that it was either government pressure to make home loans to people who couldn't afford them or mark-to-market accounting that was the trigger for this cascade. We can get the wrong prescription here.

So, the subprime mortgages, in part, were mortgages for poor people, but they were also mortgages for wealthy people who were buying million-dollar houses and people who couldn't prove their credit-worthiness. The government wasn't forcing anybody to process those loans; Fannie Mae and Freddie Mac were not really involved in those, and they were many of the failures. Rather, I think what you've got is a set of mortgages in which the bank was long on real estate. And so long as real estate went up, everything worked. The borrower could pay his interest for two years, refinance as prices had risen, take down a lot of money and shift away from a very risky mortgage to a standard mortgage. Everything worked fine while prices were going up, and surely the banks knew that. The banks knew that this would work while prices were going up and would fail to work if prices stabilized, let alone fell.

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The people who were buying these loans knew the same thing. People who put these things into portfolios and invested in those portfolios were fairly clear that subprime loans depended on prices going up. If they failed to go up, you would have problems. But oftentimes, banks and others make loans that aren't going to be paid off, and the failure of the Internet bubble or solar power or anything else doesn't lead to this incredible contraction of the market.

So what about this failure is different and leads to a contraction of lending markets? Is it mark-to-market? If mark-to-market accounting for financial firms doesn't really reflect what they're worth, shouldn't people who are investing or lending in them or borrowing from them or managing them simply ignore it? If the accounting is misleading, if it shows their assets are worth very little, just ignore it. You know in fact that they are worth more. That doesn't work for regulation.

If a regulator says you can make loans if your capital is too low because of mark-to-market, that's a problem, but a lot of people who are having problems now aren't in that situation. These lenders are not prohibited from making loans because their capital is inadequate, because it's artificially depressed by mark-to-market. They're not making loans because they don't want to make loans. People simply don't know the situation of their counterparts. And so what I want to offer is something that Richard said also, that is the incredible complexity of the situation and the lack of transparency. Securitization, which allows for the spreading of loans, also creates instruments that nobody can look through. If you take a set of loans and divide them into a portfolio, putting them in your second portfolio and a third, and on and on, at some point it is literally impossible for anybody to figure out what you own and how risky it is.

So then, once the risk is in the system, and market prices for houses are falling, and other things, is it possible for anybody who owns those assets to know how much they're going to get in the end? This is not some mark-to-market problem; it is just impossible because of the opaque character of the assets' worth. At that point, lenders don't know whether they can pay. That turns out to be a problem across the board. And so what I wonder is whether the free market created, as you put it, incredibly complicated, opaque instruments that destroy transparency, and that, once they became widespread, made it very difficult for people to work among themselves.

If that is the problem, the easiest way to prevent it in the future is to insist on a great deal more transparency. We would probably evolve towards a clearinghouse system, and that will happen voluntarily. If it doesn't, I have no problem with the government pushing them towards that transparency, because apparently the unregulated market can't do everything perfectly. We certainly shouldn't overregulate, but transparency is a problem. We shouldn't count on transparency as a naturally arising attribute in these markets. And so, Richard agrees that transparency may be the solution, but I ask whether the government should have been pressing for transparency earlier.

I also want to congratulate him on noting that the Democrats presented a four-page proposal to save the banks, and that, in order to bring those Republicans on, it had to have 500 more pages of buying dresses for the vice president.

So I guess what I want to ask is, have we learned from this that markets can't be counted upon? That it is reasonable to have government regulation for transparency? I think we are both in favor of government relations for avoiding fraud. Is this some sort of kicker on fraud or transparency? Other than that, I agree entirely.

Epstein: Can I make a couple of responses? Yes, the Communist and the Libertarian now come together. But there are two problems I have with Steve's approach, and they're not meant as criticisms, just evidence on how difficult this whole project is. The first point is, once we say that we are in favor of regulation, pray tell, what does that regulation look like? What you have to understand about the derivative market is that these things are written or oral contracts, but they have no particular physical location which could serve as the appropriate forum for regulation. And so, parties could write a derivative contract on an American mortgage in Ireland with a Greek counterparty. Unfortunately, if the government regulates so much domestically so that the market goes offshore, we will have serious problems, which means that global solutions become more desirable. But again, there is no free lunch. At this point you are again subject to the Christmas tree effect, because you won't get sensible global regulations unless you give subsidies to poor people from different nations, and then you're off to the races again with the possible scope and size of the transfer programs,

So it's not as though, once in favor of regulation, you know what to do. My sense is, and I think Steve would agree with this, the best thing you—and it is not clear who that you is—can do is to nudge people in the direction of private clearinghouses, because those intangible assets can be extraterritorial in a way in which government regulation cannot be. Essentially, a clearinghouse is a person in the middle who is sure that these changes balance out, and who thus takes some residual risk if he can't clear the market on both sides. That's the way I understand it. And it may well be that the ability to get the third-generation derivatives makes the prospects for sound intermediation much worse.

The second point is a modest disagreement. I think that Steve is quite right that the subprime market was one and all into us. But it's wrong to assume that, because you have some of these loans in an unregulated market and some in a regulated market, they should be treated independently for regulatory or contract purposes. Once parties start bundling assets, the level of transparency necessarily goes down. The moment you get the forced sales on one side of the market, there are going to be ripple effects on the other side of the market, which will exaggerate the whole situation.

So it's not as though there is a direct or sole or exclusive cause. I think the general loss of market confidence through a series of uninformed consumers will make it hard to segregate a response to different market segments. I predict that we shall see a general decline, simply because if you don't have very clear information as to what is in each bundle, it is hard to take any prophylactic steps to avoid the flight to the ostensible certainty of cash. Faced with these risks, humility goes a long way.

So to repeat, on the government side, if you avoid the subsidies, you reduce the probability of a recurrence. This is not to say that federal regulation is the sole cause—it isn't—but it's not to say, on the other hand, that it's completely benign. What you want to do is become a kind of classical liberal, rather than a hard-line libertarian.

Endnotes

1 *See* Richard A. Epstein, *Strident and Wrong*, Oct. 28, 2008 http://www.forbes.com/opinions/2008/10/27/slate-libertarian-weisberg-oped-cx_re_1028epstein.html, commenting on Jacob Weisberg, *The End of Libertarianism, The Financial Collapse Proves that its Ideology Makes No Sense*, Slate, Oct. 18, 2008, http://www.slate.com/id/2202489/

2 Milton Friedman & Anna Jacobson Schwartz, A Monetary History of the United States, 1867-1960 (1963).