5. Regulation vs. self-regulation

Adam Smith and the invisible hand

The new science of economics: capitalism is perfect, immortal

Karl Marx had claimed that capitalism was showing weaknesses and that it was mortal. The reaction, from the new "science" of economics, encouraged by the financial establishment, was to claim that capitalism is on the contrary perfect and therefore immortal. It is perfect because it is the system corresponding to the very nature of man. Man is rational and capitalism is the perfect fit for the rational man. However, to prove this, "rationality" needed to be redefined in a somewhat surprising manner, not in line at all with the way that rationality had been characterised so far.

Classical rationality

Rationality was classically defined as the capacity of exercising reason and reason was the ability to think along the syllogism which allows us to discover new truths from existing ones deductively.

Taking two propositions, known to be true (the premises), and having one term in common (the middle term), it is possible to create a new true proposition (the conclusion), by connecting the other two terms (the extremes).

Example: Mammals feed their young with milk; the whale is a mammal.

"Mammal" is the term that the two - true - propositions have in common: the "middle term". The middle term is called "logos" in Greek, "ratio" in Latin, meaning the reason. It will be the "reason" for why it is possible to connect the two other terms, the extremes: "feed their young with milk" and "whale", in a new true proposition while being itself eliminated: "Therefore, whales feed their young with milk". “Mammals” is the “reason” why whales feed their young with milk.

Aristotle was the first to give the laws of the correct ways to build the syllogism, according to whether the premises are expressed positively or negatively and the predicates (middle term and extremes) expressed as universals (all...), particulars

(some...) or singulars (Socrates, Jane, Fido...). Later logicians would be interested in, for instance, what can be said about the future (necessity, impossibility, contingency, possibility), etc.

The rationality of the new "science" of economics

The new rationality is of an entirely different nature: is rational, a person who will optimally allocate scarce resources according to preferences ranked by personal utility. The question of rationality is therefore here a question of optimisation, and has nothing to do with rationality in the classical sense of the term as was defined by Aristotle and accepted during the Middle Ages and Modern Times.

The "rational man" or "homo oeconomicus" was not accepted without debate. With resources in excess that he/she is not too sure what to do with, isn't he the perfect "bourgeois", as opposed to the "commoner" who has no choice but to allocate all his/her resources to subsistence and survival? With his obsessive self-concern and ignorance of other issues than wealth, isn't he/she a misanthropist, if not a sociopath? Even more essentially, it looked like the *homo oeconomicus* wouldn't much be concerned with ethics and even worse: that his/her special type of rationality would run counter to ethics in most circumstances.

The main advantage of expressing all economic questions in terms of allocating scarce sources according to utility was however that they could be formulated in terms of the *calculus*, the mathematical method that had allowed to solve the problems of celestial mechanics and had become since then the epitome of scientific methodology.

What if ethics were wrong?

In the second half of the twentieth century, economists expressed their sympathies towards their forefathers in a way revealing of the views they hold regarding ethics.

Economists have expressed much sympathy towards the notion of the "invisible hand" as mentioned in Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). It goes like this:

"It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their own interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages,"

However there is a major misunderstanding in the fact that many of the views current economists assign to Adam Smith were never held by him but rather by one of his predecessors: Bernard Mandeville. The subtitle of Mandeville's *Fable of the Bees* (1714) is "Private vices, publick benefits", and this is his central idea: the common good emerges from individual vices.

Mandeville's view is that moralists have been wrong all along: it is not virtues that comfort the social order but vices. Adam Smith wrote in his *The Theory of Moral Sentiments* (1759): "Virtue is the great support, and vice the great disturber of human society... Virtue, which is, as it were, the fine polish to the wheels of society (...) while vice, like the vile rust, which makes them jar and grate upon one another, is as necessarily offensive" (pp. 463-464). But this is wrong had said Mandeville: it is the reverse, vices support (unwittingly) the common good, while the consistent exercise of virtue would make it collapse.

Mandeville's views are that vices raise demand and therefore stimulate the economy: protection against burglars requires heavy protection in houses, etc. The vices of the rich feed their demand for luxury products and their expenses then "trickle down" the economy (a view still popular among some economists).

If Mandeville were right, there would of course be no room for ethics in the economy or in finance as the outcome would be counterproductive. This view has in fact been most popular until the onset of the crisis in 2007.

Where did the "invisible hand" go wrong?

Talk about "moralising" finance became very fashionable again in the aftermath of the collapse of finance (the "money market" in particular: the market for short-term debt instruments <= one year) in September 2008, following the bankruptcy of the investment bank Lehman Brothers.

The collapse of Lehman Brothers was a test for the "invisible hand", for self-regulation of the financial markets. The test failed.

On 23 October 2008, Alan Greenspan was asked to testify during a Congressional hearing about the causes of the collapse of the financial system. Greenspan had been head of the Federal Reserve, the American central bank, from 1987 to 2006 and there was a feeling in the general public that his policy during these years must have had a responsibility for the crisis: he was a "hands-off" person, who had allowed a large amount of deregulation during his term and had refused in particular regulation of the new "derivative" financial instruments, and had refused to intervene when alerted about the outset of the *subprime* crisis.

Greenspan defended his own behaviour staunchly but when asked if there had been a major flaw in his worldview, he mentioned "persons who had failed to act according to their self-interest", a transparent allusion to Smith's "invisible hand", a theme he had developed in a speech in 2005 when visiting Kirkcaldy, the birthplace in Scotland of Adam Smith.

The limits of self-regulation became even more obvious in April 2010 when executives of the investment bank Goldman Sachs were asked to testify before a Senatorial committee about their ABACUS 2007-ACI deal.

When it had become clear that securities composed of *subprime* loans were depreciating fast, the first move of Goldman Sachs was to repackage them as CDOs (*Collateralised Debt Obligations*) made out of elements ("certificates" or "tranches") of ABSs (*Asset-backed Securities*) composed each of several thousand *subprime* home loans, then sell those CDOs in a hurry to its best clients before they would become aware of their loss in value. Their second move was to ask the Paulson *hedge fund* to help them set up one CDO most likely to depreciate because being composed of loans most likely to default (*subprime* borrowers not being able any longer to make their monthly payment).

Goldman Sachs then organised bets on the depreciation of CDOs, setting itself as the party betting that their value would come down. This was done in particular with the ABACUS 2007-ACI deal, a *synthetic Collateralised Debt Obligation*, meaning a CDS (*Credit-default Swap*) on a CDO, i.e. a *derivative* financial instrument the value of which is the loss incurred on the CDO that underlies it. This allowed Goldman Sachs to multiply its gains at the expense of the set of customers it had managed to assemble in order to bet against them. The *Wall Street Journal* headed the article where it revealed Goldman Sachs' fraud: "Senate's Goldman Probe Shows Toxic Magnification." One deliberately

damaged CDO, called Soundview, was used as a target for betting within 30 different synthetic CDOs; its own value as a debt instrument was $38 million, but as a target for betting it generated for Goldman Sachs an income of $280 million.

All this of course contributed at accelerating the collapse of the market for *subprime* securities.

The Goldman Sachs case was a negative test for the "invisible hand": it showed that when circumstances deteriorate, the pursuit of self-interest will not necessarily contribute to the common good: everyone will run for his life, making chaos even worse.

The notion of “moral hazard” refers to set-ups where there is a benefit for the persons involved to make the situation worse. Such are “bail-outs” by States of financial institutions: the higher the risk they take, the higher the chance that the State will come to their rescue and provide the sums required to cover the losses incurred. *Moral hazard* is the very contrary of the *invisible hand*: it runs counter to self-regulation by having the opposite effect: when *moral hazard* is present, bringing the system down is the way for an agent to pursue its own self-interest. Unfortunately new laws more often than not generate unwittingly opportunities for *moral hazard*.