In the Shadow of Crisis: The Political Origins of the Great Recession

by

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This thesis is dedicated to my two grandfathers, Saul and Joe, who lived through the last great crisis, the Great Depression. My privilege is in large part indebted to the fortunes of my grandfathers, and by extension my parents, exploiting the opportunities afforded to them when the powers that be implemented policies that enabled the growth a large middle class. In the aftermath of the latest crisis, we are witnessing a narrowing of opportunities for social mobility reminiscent of the gilded ages. For this reason, this thesis is also dedicated to the memory of my brother Jesse, who imbued in me a thoughtful critique of the status quo and a passion for economic and social justice.
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George Orwell once suggested in a perceptive essay entitled “Why I Write” that:

Writing a book is a horrible, exhausting struggle, like a long bout of some painful illness. One would never undertake such a thing if one were not driven on by some demon whom on can neither resist nor understand. For all one knows that demon is simply the same instinct that makes a baby squall for attention.

Substitute “thesis” for “book” and the remarks still hold true. This project was a massive undertaking, and as my friends reminded me each and every time they asked, “how many pages do you have left?”—It is practically a book. It wouldn’t have been possible without so many people whom I must express my gratitude to.

First and foremost, I’d like to thank my family for their love and support. I would especially like to thank my father and mother. From giving me my foundation, encouraging my intellectual curiosity, working extra hard so that I could experience a Wesleyan education despite the high tuitions you love to remind me about, to giving me feedback on rough drafts, your steadfast support has been truly indispensable.

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Lastly, I would like to thank my friends. You know who you are. Thank you for keeping me at least partially sane throughout this process. Thank you for convincing me to enjoy myself on my last College Spring Break. Thank you for forcing me to take a break from neoliberalism, financial derivatives, and contemplating all that is depressing about our political and economic system. I couldn’t have completed this without you.
Introduction:

“History is the version of past events that people have agreed upon.”
-Napoleon Bonaparte

Today it might seem odd that in 2003, Robert Lucas, a Nobel Prize winning economist, suggested, “the central problem of depression-prevention has been solved.”¹ Likewise, it might seem puzzling that the former Chairman of the Federal Reserve, Ben Bernanke, agreeing with Milton Friedman’s claim that appropriate monetary policy could have prevented the Great Depression, said, “we won’t do it again.”² Today such daring statements would likely trigger, at the very least, an incredulous snort. For those less reserved, it might even evoke outrage. After all, we live in the shadow of the worst economic downturn since the Great Depression, a crisis in which millions of people in America lost their homes, jobs, and livelihood. We are almost six years removed from the failure, near-failure, or major restructuring of systemically important financial institutions, a series of remarkable events triggered by the unraveling of the mortgage securitization industry. As the appreciation of housing value slowed and mortgage defaults began to rise in late 2006, trillions of dollars of assets derived from these mortgages imperiled the global financial system, generating a general credit crunch that affected businesses and consumers alike. Wall Street quickly bounced back from the global economic downturn in 2009 with substantial profits and handsome bonuses, and life went on more or less as usual for the richest .1% of Americans. Yet as I write, middle and

working-class Americans with stagnating or declining real wages are still struggling to cope with a Great Recession in which jobs, retirement savings, and homes—often their major assets—were all at risk and the government safety net was scaled back when needed most.

On the eve of the crisis I was 16 years old, infatuated by the brilliant oratory of Presidential candidate Barack Obama, but displeased that I could not yet cast a vote in what I felt would be an important election. The eloquence of his words resonated with my evolving political understanding—my desire for hope and a change from the ways of the Bush Administration, my concern with rising inequality, and my sense that something was not quite right or just about the economic system in which we live. I remember vividly my confusion as the economic crisis unfolded. No matter how much I read, how many questions I asked, or how much time I spent trying to absorb information from the varying media and news outlets I followed, I couldn’t quite understand what was going on. I knew that the crisis amplified the economic suffering of already struggling households. I knew that the crisis had evaporated savings of members of my family and friends. I vaguely understood my grandfather’s warning to avoid “the casino” that was the Stock Market. An avid reader of Paul Krugman’s New York Times column, I believed him and was frightened when he indicated that the crisis “raised the prospect of a second Great Depression.”

But I refused to believe that the crisis was somehow natural, or unavoidable. From that point on, understanding the crisis became my obsession, and thus this project was born.

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2 Ibid.
I remember former Vice President Dick Cheney’s comment in an interview with the Associated Press: “Nobody anywhere was smart enough to figure [it] out.” He declared, “I don’t think anybody saw it coming.” Not only did I feel that couldn’t be the case; now I know that it is not true. In the course of my research I found that in May of 2006 John Bellamy Foster wrote an article in *Monthly Review* titled “The Household Debt Bubble,” that warned that “the weakness of incomes at the bottom” and “the squeeze on working class consumption” also known as “low-end consumption” was “a serious concern for an economy that has become more and more dependent on consumption to fuel growth, given the stagnation of investment.” I came across another article in *Monthly Review* by Fred Magdoff from November 2006 entitled “The Explosion of Debt and Speculation” that warned of “ever expanding debt” and “the shift of the financial sector into ever large-scale speculation.” On the more mainstream side, I found out that in 2005 Raghuram G. Rajan, then Chief Economist at International Monetary Fund (IMF), warned in a paper entitled “Has Financial Development Made the World Riskier?” that the ways that bankers and traders were being compensated would potentially encourage dangerous levels of risk in the financial system. I discovered that at Yale, Robert Shiller repeatedly sounded warnings about a “housing bubble.” Yet these warnings were seemingly ignored by our political system. This led me to an important question: Why?

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4 Dick Cheney, interview by Deb Riechmann, Associated Press, January 8, 2009
In the course of my research I encountered the recurring theme that since the 1970s market-based policies had been institutionalized, featuring a wave of deregulation. Marion Fourcade-Gourinchas and Sarah Babb argued “a set of economic principles often identified as ‘neoliberalism’ became part of the accepted framework for thinking about, and acting upon, the economy.” Though “neoliberalism” was often ill defined, it became apparent that it was a term used (typically by critics) to describe an embrace of the efficiency and liberty associated with uninhibited market mechanisms. It was often used to describe the general shift in the dominant “policy paradigm” of nations across the globe away from the extensive role of the state in economic life associated with New Deal policies and support for labor unions. David Harvey, in particular, suggested that with the election of Ronald Reagan and Margaret Thatcher a doctrine under the name of “neoliberalism” was transformed into “the central guiding principle of economic thought and management.”

It was within this context that the deregulation of the financial services industry was to be understood, or so I initially thought.

In an often-cited article entitled “The Rebirth of the Liberal Creed” Marion Fourcade-Gourinchas and Sarah Babb suggested “deep transformations in the structure of domestic and international economies contributed to change the cognitive categories with which economic and political actors come to apprehend the world.” This idea that the “cognitive categories with which economic and political actors apprehend the world” influences policy decisions seemed to resonate with much of what was being said by Nobel-Prize winning economists Joseph Stiglitz and Paul

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8 Marion Fourcade-Gorinchas and Sarah Babb, “The Rebirth of the Liberal Creed: Paths to Neoliberalism in Four Countries” American Journal of Sociology 108 No.3 (November 2002), 533
9 David Harvey, A Brief History of Neoliberalism (Oxford: Oxford University Press, 2007), 2.
10 Fourcade-Gorinchas and Babb, “The Rebirth of the Liberal Creed”
Krugman, who, especially after the crisis, had taken it upon themselves to emphatically engage in a battle of ideas.

I interpreted Stiglitz’s *New York Times* bestseller *Freefall: America, Free Markets, and the Sinking of the World Economy* as an indictment of market fundamentalism, which he suggested was the principled belief that unfettered market mechanisms always lead to socially optimal outcomes.\(^ {11}\) *Zombie Economics* by John Quiggin asserted that mainstream economic ideas caused the crisis.\(^ {12}\) The ideas he indicted, such as the efficient financial market hypothesis, supported the so-called “neoliberal ideology” that David Harvey and others had written about. But I soon realized that “neoliberalism” wasn’t just being used to describe a particular political and economic philosophy; Gérard Duménil and Dominique Lévy had suggested that “neoliberalism” had constituted a new phase of capitalism, and that “the fourth structural crisis in capitalism since the late nineteenth century,” should be understood as the “crisis of neoliberalism.”\(^ {13}\) The crisis did indeed seem to be a crisis of capitalism, or at least a particular form of capitalism. The diffuse Occupy Wall Street Movement that emerged at the 3-year anniversary of the crisis and the catchy slogan “*We are the 99%***” perhaps best symbolized growing discontent with the social and economic status quo associated with a “jobless” recovery in which the gains disproportionately went to the richest 1% in American society.\(^ {14}\)

Likewise, in light of the extraordinary series of seismic events that occurred at the height of the recent economic crisis, American sociologist Fred Block concluded

that the financial crisis was the culmination of an “ersatz regime of accumulation.”\textsuperscript{15} Drawing on work done by the French Regulation theorists and the U.S. Social Structures of Accumulation (SSA) approach, the term “regime of accumulation” can be understood as a reference to a system of economic production, consumption, and socio-economic phenomena associated with supportive structures that undergird high levels of productive investment conductive to economic expansion. The word “ersatz” literally means a substitute or replacement, usually of inferior quality to the good it replaces. I interpreted Block’s curious phrase as an indictment of a system of economic production, consumption, and socio-economic phenomena that was an inferior substitute for the regime that it replaced. It seemed as if Block viewed the crisis as a consequence of the decline of a pattern of accumulation in the United States that existed after World War II until the 1970s, at which point it was replaced with an inferior regime based on an unsustainable growth model. Was this a “neoliberal” regime? Was the crisis really just the culmination of a faulty macroeconomic paradigm associated with the rise of “neoliberal” ideas and policies?

Peter Hall’s “Policy Paradigms, Social Learning and the State” offers a useful way of thinking about how economic policymaking is a distinct process situated within a realm of ideas and principles that are in turn institutionalized in the form of particular policy paradigms.\textsuperscript{16} As Hall elaborates:

Policy makers customarily work within a framework of ideas and standards that specifies not only the goals of policy and the kind of instruments that can

\textsuperscript{16} Peter Hall, “Policy Paradigms, Social Learning and the State: The Case of Economic Policymaking in Britain” \textit{Comparative Politics} (1993): 25, 275-296
be used to attain them, but also the very nature of the problems they are meant to be addressing.\textsuperscript{17}

The varying pieces now seemed to connect. My critique of the status quo seemed to resemble a critique of “the age neoliberalism” that scholars were claiming had emerged in the 1970s. My belief that the crisis was not natural or unavoidable seemed to be related to the rise of “a framework of ideas and standards” referred to as “neoliberalism,” “Reaganism,” “market liberalism,” and a handful of ideological labels generally used to describe the principled belief that “free” markets produce socially optimal outcomes.

From the vantage point of hindsight, I agreed with Block’s suggestion that the “regime of accumulation” that emerged in the 1970s failed to establish a durable growth model. Comparing the startling similarity between the Great Recession and the Great Depression, Block states:

In both eras, extremely unequal income distribution had two dramatic macroeconomic consequences. First, high-income households were heavily engaged in speculative activity that fuelled a spectacular asset bubble. In the 1920s, this activity focused on the stock market; in the 2000s, it was evident in the housing market and in the markets for a variety of speculative financial instruments including collateralized mortgage obligations and credit default swaps. Secondly, the fact that the bottom 90\% of households were left with only about a half of all income meant that consumer demand was heavily dependent on increased rates of borrowing. Once the downturn began, consumer credit dried up pushing the economy steadily downward.\textsuperscript{18}

This regime was thus “ersatz” because the failure to generate significant new productive investments in the economy, coupled with growing inequality, according to Block, created macroeconomic conditions conducive to a sharp economic decline once the speculative bubble that economic growth was reliant on burst. I found the perspective that the crisis was a consequence of the decline of a pattern of

\textsuperscript{17} Hall, “Policy Paradigms, Social Learning and the State”
\textsuperscript{18} Block, “Crisis and Renewal: The Outlines of a Twenty-First Century New Deal,” 35-36.
accumulation in the United States that existed after World War II persuasive. But there was something puzzling about the manner in which the “neoliberal regime” was often being invoked.

Economic historian Daniel Stedman Jones remarked, “The most important reason for the financial crisis was the direct result of neoliberal policies.” Economists Gérard Duménil and Dominique Lévy concluded the recent financial meltdown and subsequent recession constitutes “the crisis of neo-liberalism.”

Economist Thomas Palley links the Great Recession to “the failings of the neoliberal policy program” that emerged in the United States around 1980. The commonality between these views was the perspective that “neoliberalism” is associated with a broad set of fatally flawed economic ideas, a political and economic philosophy or ideology that has increasingly influenced economic policymaking, such as financial deregulation, since the 1980s. But was the crisis from which we are recovering really the product of a particular ideology?

Long ago the great economist John Maynard Keynes concluded his magnum opus, *The General Theory*, by famously stating:

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not

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20 Duménil and Lévy, *The Crisis of Neoliberalism*.
many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.22

It has been several decades since the General Theory’s publication. Whether the power of vested interests is truly vastly exaggerated is a contentious subject, especially in the contemporary United States in which floodgates of corporate money and armies of hired lobbyists vastly influence the political system and public debate—often writing legislation, determining public policies, and establishing regulatory frameworks advantageous to themselves.

What struck me about Block’s curious phrase, “ersatz regime of accumulation,” was that the analysis was less argumentative and more analytical, rejecting common assumptions in the Regulation School or Marxist interpretations that suggest that we live in an “age of neoliberalism” that presume “relations at the points of production have a privileged role in shaping the larger social order.”23 Drawing upon what he calls “a particular reading of Karl Polanyi’s analysis in The Great Transformation,” Block’s understanding of regime of accumulation theory suggests that regimes are intimately sensitive to political struggles.24 Unlike traditional Marxist interpretations that do not recognize politics or public policymaking as an autonomous field of activity, Block’s perspective offers insight into why particular regimes might decay and be replaced. This nuance is informative because it does not suggest that this “ersatz” regime necessarily arose because of neoliberal ideology. Rather, it provided a nuanced understanding of how:

entrenched business interests such as the auto companies, the petroleum

24 Ibid.
industry, defence firms and big financial institutions worked hand-in-hand with conservative political leaders to construct a ‘free market’ regime of accumulation designed to bolster business profits at the expense of all other social groups.25

Block’s analysis did not suggest that neoliberal ideas could be reduced to economic doctrine. And it does not crudely suggest, as David Harvey does, that the “genius of neoliberal theory” is “to provide a benevolent mask full of wonderful-sounding words like freedom, liberty, choice, and rights, to hide the grim realities of the restoration or reconstitution of naked class power.”26 Indeed, as Joseph Stiglitz stated, “free-market rhetoric has been used selectively—embraced when it serves special interests and discarded when it does not,” leading him to the conclusion that “neo-liberal market fundamentalism was always a political doctrine serving certain interests.”27

In the following chapters I will demonstrate how and why this “neoliberal” doctrine served the interests of financial institutions by ensuring that regulation did not keep pace with financial innovation, resulting in the worst economic downturn since the Great Depression. A tale of market failure and political failure, the following chapters will argue that the 2008 financial crisis was the consequence of the American political system. My objective is to understand why policymakers within the American political system adhered to a particular “framework of ideas and standards" that culminated in a deregulatory environment that enabled the financial crisis.

The first chapter lays out the general timeline of the 21st century crisis of capitalism. The second chapter will demonstrate the proximate causes of the financial crisis. I will analyze an important question: is the Great Recession the product of

26 Harvey, A Brief History of Neoliberalism, 119.
flawed government policies that distorted markets or did an insufficiently regulated market simply fail? I will argue the latter and suggest that that excessive risk with thin capital margins by financial institutions, lack of transparency in derivatives markets, securitization of dubious loans, and the cooptation of an insufficient regulatory apparatus by an increasingly large and concentrated financial services industry enabled and precipitated a 21st century crisis of capitalism.

After identifying the proximate causes of the crisis in more detail, the third chapter will evaluate the perspective that regulation did not keep pace with financial innovation because of ideological adherence to a “neoliberal” framework of ideas and standards. I will evaluate the claim that the recent crisis constitutes the “crisis of neoliberalism,” explore competing understandings of what “neoliberalism” is, and evaluate the difference, if there is any, between liberalism and “neoliberalism.”

The fourth chapter will focus on the origins of the financial lobby and evaluate the influence of this lobby on the bipartisan political establishment in the context of a series of successful deregulatory campaigns. I will provide a nuanced explanation as to why financial markets were permitted to innovate in ways that existing regulations did not cover by drawing upon rulings by the United States Supreme Court that gave rise to the corrosive effect of money in politics on the American political economy.

This thesis argues that the crisis was brought about by naked profit-seeking rather than the “scribblings” of some “defunct economist.” I will demonstrate that the financial lobby benefited from the increased role of money in politics since the 1970s, which coincided with the rise of certain “neoliberal” ideas. This will provide a context for understanding why popular market fundamentalist beliefs that favored relatively free or unregulated markets as a means towards achieving socially optimal
outcomes were at times central to ‘the framework of ideas and standards’ that policymakers customarily worked within. This will also provide a context for understanding why these ideas seemingly prevailed over the belief that financial markets are inherently unstable and require rigorous regulation. The consequence, as Andrew Sorkin aptly put it in the epilogue of his *New York Times* bestseller *Too Big To Fail*, was that:

In the span of just a few months, the shape of Wall Street and the global financial system changed almost beyond recognition. Each of the former Big Five investment banks failed, was sold, or was converted into a bank holding company. Two mortgage-lending giants and the world’s largest insurer were placed under government control. And in early October, with a stroke of the president’s pen, the Treasury—and, by extension, American taxpayers—became part owners in what were once the nation’s proudest financial institutions, a rescue that would have seemed unthinkable only months earlier.28

That is, the consequence was a 21st century crisis of capitalism. Many accounts of the financial crisis have already been written. Scores of academics, journalists, and political hacks have contributed to a broad literature with distinct perspectives, some useful, some fantastic, which produce no single dominant narrative. Yet future historians and economists will one day look back upon the tumultuous years of financial mayhem and likely adopt a dominant narrative that rightly or wrongly triumphs over the rest. George Orwell, one of the twentieth century’s foremost political writers, long ago wrote, “Who controls the past controls the future; who controls the present controls the past.”29 What is insightful about this famous phrase is the idea that dominant understandings of history have immense power over the way future generations come to view and understand the world. Future understandings of the 21st century crisis of capitalism are no exception.

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The analysis that follows is my attempt to synthesize what I believe to be the most insightful contributions to the already existing literature on this important topic and to pursue the implications of this synthesis in regards to the future of the American political economy. I intend to draw upon the work of others who have suggested that failures in financial regulation and supervision proved devastating to the stability of financial markets, that failures of corporate governance and risk management at systemically important private financial institutions were critical to the crisis, that excessive borrowing, risky investments, opaque over-the-counter derivatives, and failures at the credit rating agencies collectively contributed to financial mayhem. However, my true intention is to frame this synthesis into a coherent narrative that not only brings to light the proximate causes of the crisis, but also situates those proximate causes in the context of long-term trends so that in the shadow of the crisis we may look upon the years that comprised the Great Recession and clearly understand how this became our fate.

I hope to add to this crowded literature by arguing that the debate between whether the crisis was a product of market failures or government failures distracts from the broader, more relevant story: the extent to which the crisis was predominantly a crisis of political economy—for there is a political context lurking behind all economic phenomena. I also hope to shed light as to why the belief that relatively free financial markets with minimal government interference are efficient lead to socially optimal outcomes seemingly prevailed over the belief that markets are inherently unstable. Had the belief that financial markets are unstable and unable to deliver socially optimal outcomes prevailed in establishment policy and political circles a different, more rigorous and sound regulatory apparatus might have existed,
there might have been no housing bubble, or the burst of a housing bubble might not have brought America (and the world) into a wholesale economic implosion from which we still recover. This brings me to my last and most important hope: to add an important contribution to this literature by demonstrating that money in politics and the economy of influence in the nation’s capital is not only corrosive to our democracy, but ultimately responsible for the inadequate financial regulatory architecture that enabled the Great Recession.
Chapter 1:
The Crisis of Capitalism

Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.


Nearly six years ago a historic financial crisis spilled over into the real economy with crippling effects. Wall Street, the symbol of corporate finance historically located in the financial district of New York City, and Main Street, the symbol of everyday people and small business owners seemed increasingly intertwined. As banks and other major financial institutions associated with Wall Street panicked, the system of short and long term credit for businesses and consumers associated with Main Street froze, creating a downward spiral for the economy in which consumer sentiment plummeted and the economy lost a net total of over 4.3 million jobs in 2008 and 2009. With increased uncertainty, the stock market tumbled and billions of dollars in retirement savings disappeared overnight in a remarkable display of rampant market failure. Estimates suggest that the cost of the recent crisis is between $6 and $12 trillion dollars in lost gross domestic product, destroyed household wealth, unemployment and under-employment, foreclosures, government bailouts, emergency spending measures, and other actions deemed necessary to prevent a

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second Great Depression.\textsuperscript{31} While debates over the details and proximate causes of this historic crisis of capitalism endure, the general mechanics and timeline of the crisis are generally agreed upon.

As the appreciation of housing value in the United States slowed in late 2006 and early 2007, mortgage delinquencies and defaults rose. Because financial institutions had increasingly used the cash flow provided by home loans to generate securities, as foreclosures began to rise, financial institutions that had heavily invested in subprime mortgages were left with subprime derived assets whose value had significantly plummeted. What was peculiar about this housing downturn was that by 2003 the mortgage business was booming and represented a $4 trillion industry, about 25% of the American economy as measured in Gross Domestic Product (GDP).\textsuperscript{32} Even more peculiar were the conditions of loans within the mortgage business. By 2007 unconventional loans—that is, riskier loans—represented a substantial portion of the $4 trillion industry.\textsuperscript{33} As a result, when the subprime market catered asset prices dropped. In simple terms, late payments on non-conventional mortgages, many of which consisted of high interest rate loans offered to individuals with little or no documentation or proof of income, assets, or credit history, drove down the value of bonds backed by home loans. When it became apparent that the preeminent symbol of finance known as Wall Street was seriously exposed to the subprime meltdown because of substantial losses on a number of private financial institution’s mortgage portfolios, the stock market panicked, financial chaos ensued, and the Great Recession began.

\textsuperscript{32} Fligstein and Goldstein, “Roots of the Great Recession,” 21.
In March of 2007, Ben Bernanke, then Chairmen of the Federal Reserve, had stated in congressional testimony that “at this juncture, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained.”34 However, in time economic conditions would deteriorate to the point that the business of even the largest, most renowned financial enterprises would seem no longer viable. The housing downturn inflicted increasing damage on Wall Street and Main Street alike throughout the rest of 2007 and 2008. This was in large part because of the growing importance of securitization, involving in particular secondary markets associated with home loans. In simple English, Wall Street and Main Street were connected because complex financial instruments, such as derivatives (a term that refers to securities that derive their value from underlying assets such as home mortgages) declined in value, generating a general credit crunch that affected businesses and consumers alike. The burst of the housing bubble and subsequent defaults on subprime loans jolted these secondary mortgage markets as well as the national real estate market. Put differently, the increased importance of financial activities as a source of profits in the 21st century global economy coupled with the increased importance of securitization of mortgages in the overall financial system meant that financial chaos transformed into wholesale economic downturn. Credit in general dried up, the stock market continued a downward spiral, and economic suffering in the loss of jobs and savings ensued. Far from being “contained,” what occurred represented a tale of extraordinary market failure, a crisis of capitalism in which the financial system collapsed like a house of cards, and one

33 Ibid.
by one financial giants—the very symbols of capitalism—shockingly neared insolvency.

On April 2, 2007 New Century Financial—at the time the largest subprime lender in the United States—filed for bankruptcy. On July 31st, 2007 Bear Stearns—one of the former Big Five investment banks which was trading at $170 per share in 2007—liquidated two hedge funds that it had previously managed that had been heavily leveraged through risky investments in securities backed by subprime mortgage loans. On August 6th, 2007 American Home Mortgage Investment, one of the largest retail mortgage lenders in the United states—and a firm that specialized in increasingly popular adjustable-rate mortgages—filed for bankruptcy protection. Three days later, on August 9, 2007 BNP Paribas, the biggest bank in France and the second biggest bank by market capitalization in the euro zone, froze €1.6 billion ($2.2 billion) worth of funds, citing concerns that "the complete evaporation of liquidity in certain market segments of the U.S. securitization market has made it impossible to value certain assets fairly, regardless of their quality or credit rating." This announcement was significant in its acknowledgement that the U.S. housing downturn had devalued mortgage-backed securities to the point that nobody really knew how big losses would be for those holding subprime derived assets.

Two necessary conditions for effectively functioning financial markets had now eroded: confidence and trust. As a result, in the summer of 2007 inter-bank lending froze and the financial markets began to panic. By October 25, 2007 Merrill Lynch had reported its biggest quarterly loss in its 93-year history after taking $8.4

billion of write-downs, many of which were on securities linked to subprime mortgages—a loss that Standard & Poor, one of the big three Credit Rating Agencies, called “startling.”38 At this juncture in the timeline of the crisis it became entirely apparent that the impact of the problems in the subprime market on financial markets and the broader economy were anything but “contained.”

With fears that the subprime meltdown was now spreading into other parts of the economy, financial markets froze. Countrywide Financial, one of the United State’s largest mortgage lenders, was forced to draw down its $11.5 billion credit line as its stock price collapsed.39 But Countrywide’s financial woes only continued when it disclosed that 7.2 percent of the loans in its servicing portfolio were delinquent in December of 2007, up from 4.6 percent in December 2006, and that foreclosures also more than doubled, generating speculation of an impending bankruptcy filing that only further eroded the value of Countrywide’s shares.40 The fate of this troubled loan giant who had engaged in lax subprime lending practices changed on January 11th, 2008, when Bank of America announced that it would bailout Countrywide Financial by purchasing it for $4 billion in stock, a mere fraction of the company’s $24 billion market value the previous year. Doing so helped Kenneth D. Lewis, Bank of America’s Chairman and CEO, achieve his goal of “becoming the biggest player in every major consumer finance category,” but it also ensured that Lewis’s already massive Bank would be “too big to fail” and later need capital infusions to remain afloat.41 It was now entirely apparent that the largest subprime lenders and firms at

40 Ibid.
the core of the mortgage-backed securities (MBS) market were heavily exposed to losses from the housing downturn and in need of capital infusions from helping hands. In the case of Countrywide, this had led to absorption by a large conglomerate bank willing to accept losses on its massive balance sheets. However, general lack of trust and confidence continued to imperil the financial system, which began to resemble a succession of falling dominoes. It now became increasingly evident that capital infusions in the form of taxpayer bailouts were needed to keep the largest financial behemoths afloat.

The major investment bank Bear Stearns initially became the biggest casualty of the mortgage meltdown when its liquid asset balance deteriorated and JP Morgan Chase agreed to pay $2 a share—less than one-tenth the firm’s market price only two days previously—to buy all of Bear Stearns on March 16, 2008. Bear Stearns’ Board rejected JP Morgan’s initial offer, demanding $10 per share to close the deal (to which JP Morgan eventually acquiesced), but perhaps even more notable was that this deal was secured with the urgent assistance of the Federal Reserve and U.S Treasury. The *New York Times* reported that “in an unusual move, the Fed will provide financing for the transaction, including support for as much as $30 billion of Bear Stearns’s ‘less-liquid’ assets,” such as those derived from subprime mortgages.\(^{42}\)

Catching most observers by surprise, a previously implausible scenario—both Bear Stearns’ near certain demise and its fire-sale deal to JP Morgan Chase with the assistance of the Federal Government—seemed to indicate that financial market participants alone wouldn’t correct the panic, and thus that without substantial

government intervention the world was nearing a sort of financial apocalypse. The panic didn’t stop here.

In the second week of July the stock of Fannie Mae and Freddie Mac had declined by more than 60%, prompting Congress to authorize the U.S. Treasury to rescue the GSEs if needed. On September 7th 2008, the United States federal government used that authority when it took over the two GSEs in order to add liquidity to the distressed housing market as their stock prices went into further freefall. While Treasury Secretary Hank Paulson had recently told Congress he would likely not have to use the emergency “bazooka” Congress had just granted him, deteriorating market conditions nearing the 2008 Presidential election compelled Paulson to reverse his position and authorize a $200 billion bailout of Fannie and Freddie to cover future losses and put the GSEs directly under government control. This government intervention reflected the Bush administration’s belief that if the condition of the GSEs further eroded, a crisis of confidence would reverberate through the worldwide financial system and further burden the American people. The GSEs held nearly half of America’s $12 trillion mortgages, housing prices were falling rapidly, and the GSEs only business was guaranteeing and holding mortgages. As a result, the U.S. Treasury believed that the failure of the GSEs, which was

43 The Housing and Urban Development Act of 1968 ultimately split the Federal National Mortgage Association (FNMA, or “Fannie Mae”), which was created in 1938 to finance mortgage purchases during the Great Depression, into two corporations: 1) Ginnie Mae, which provided an explicit guarantee backed by the Federal government for the payment of principal and interest on MBS secured by pools of government-sponsored home loans, and 2) Fannie Mae, which became privatized in 1968 and by 1970 could purchase conventional private mortgages that conformed to specific underwriting standards. In 1970 the private Federal Home Loan Mortgage Corporation (or “Freddie Mac”) was created to provide competition and prevent Fannie Mae from functioning as a monopoly. Though the Federal government created the GSEs (Fannie and Freddie) with the primary purpose of enhancing capital markets by assisting private lenders and private borrowers in the housing finance market, they also created the perception that the US government implicitly guaranteed MBSs sponsored by GSEs.

impending due to inadequate capital cushions, would both deepen difficulties in the
housing market and further weaken the economy in the United States and abroad. It
was feared that this might unleash an even scarier financial roller coaster dive than
what the world was already witnessing—one that might continue up until or even
beyond Election Day. But even with the use of Treasury Secretary Paulson’s
“bazooka” to save the GSEs, the panic roiling financial markets didn’t stop.

By September 2008, two months before the presidential election, nearly all of
the financial behemoths associated with Wall Street were under increasing duress.
Imprudent risk management practices meant that an unfortunate combination of
losses in their mortgage portfolios and heightened market uncertainty continued to
erode the value of their share prices and render the long-term, secure borrowing
capacity they needed to run their daily operations more expensive. Confidence in the
survival of Lehman Brothers, then the fourth-largest investment bank, faded
following reports of a nearly $4 billion loss for the third quarter of 2008—a loss
bigger than analysts had forecasted, which subsequently further eroded the value of
Lehman’s shares. On September 9th the chairman and chief executive of Lehman
Brothers, Richard Fuld Jr, had assured an uncertain Wall Street that his firm could
survive on its own. However, the continuing decline of Lehman’s share price, down
to $4.22, and the refusal on the part of the Federal government to bail out Lehman
brothers (whom Treasury Secretary Paulson’s brother worked for) prompted Lehman
to search for a buyer for the entire company. Fed Chairman Bernake and Treasury
Secretary Paulson refused to put taxpayer money at risk to prevent a Lehman collapse
the way the U.S. Federal Government had bailed out the GSEs, but they were open to
organizing a “shotgun marriage” in the manner they had for the investment bank Bear
Stearns. Potential buyers such as Barclays and Bank of America subsequently sought similar assurances: deals that would include emergency assistance from the Federal Reserve and U.S Treasury shielding their exposure to the “toxic” assets.45

In dramatic fashion, amidst growing fears that Lehman Brothers was nearing bankruptcy, and that Merrill Lynch would shortly follow, and that the American Insurance Group (AIG), the world’s largest insurer, had only days to survive, Bank of America purchased Merrill Lynch for $50 billion on September 14, 2008.46 While this took care of the impending failure of one investment titan, Bank of America’s purchase of Merrill Lynch also effectively ensured the bankruptcy of Lehman Brothers. This was because Barclays, Lehman’s last potential buyer, pulled out from a deal to acquire Lehman Brothers—allegedly because the Financial Services Authority, the British securities regulator, had discouraged Barclays from pursuing the deal.47 As a result, when Lehman Brothers, a major private securitizer of subprime mortgages, filed for bankruptcy amid the collapse of a junk bond market that threatened its highly leveraged and increasingly fragile balance sheet, interbank lending froze everywhere, including among commercial banks.48 The market continued to tumble as news of Lehman’s demise sent the Dow Jones Industrial Average, perhaps the most watched financial barometer, down by 504 points—at the time, the largest one-day drop since September 11, 2001.49

47 Ibid.
Meanwhile, the credit rating agencies had threatened to downgrade AIG’s rating if it did not raise $40 billion in cash. AIG’s eventual credit downgrade forced the financial giant to post $14.5 billion in collateral, which was problematic given the illiquid status of the assets AIG would need to sell. Put simply, AIG could not get the cash quickly enough to satisfy these demands and cover their losses. The U.S. federal government determined that the failure of the world’s largest insurer would be “catastrophic” to the market. As a result, the financial insurance giant was deemed too systemically important, i.e. “too big to fail.” Citing the Federal Reserve Act, which allows the Federal Reserve to lend to nonbanks under "unusual and exigent" circumstances, the U.S. federal government kept AIG afloat in an extraordinary far-reaching government intervention in the private sector. For the first time ever, the United States government became a substantial owner of a private insurer. Indeed, on September 16th, 2008 AIG accepted an $85 billion federal bail out that gave the United States government a 79.9% ownership stake in the company. It was an act of nationalization that socialized AIG’s private losses.

AIG had effectively insured mortgage-backed securities through the issuance of complex financial products such as credit-default swaps, but when the housing downturn lead to missed mortgage payments AIG ended up on the wrong side of a multi-billion dollar bet that these “insured” mortgages-derived products would not fail. AIG also did business with nearly every major financial institution, which increased fears that the crisis might spill over into previously safe investments held by smaller investors, such as money market funds that invest in AIG debt—especially

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51 Ibid.
since AIG was a big insurer of money-market instruments and there had already been a run on one of the largest money market funds after Lehman’s bankruptcy. Because money markets comprised a large sector with more than $3 trillion of assets under management in 2007, the Bush administration feared that a general run on these non-government insured but presumably reliable asset classes would further aggravate an already extremely fragile economic situation. But despite this extraordinary action on behalf of the U.S. government, the panic continued.

The stock market continued to crater and the Federal Government’s fear regarding a run on money markets was turning into a reality. In unprecedented fashion, money market funds like the Reserve Primary Fund, which was heavily exposed to Lehman Brothers, began “breaking the buck,” a rare phenomenon in which the net asset value of a money market fund drops below $1. What was disconcerting about this phenomenon was that these money market mutual funds, “essentially short-term mutual funds that invest in government securities, certificates of deposit, asset-backed commercial paper and other highly liquid securities,” are often regarded as being as safe as bank deposits while providing a higher yield. Because these funds are not insured by the Federal Deposit Insurance Corporation (FDIC), the U.S. Federal Government was concerned that should the subprime-mortgage induced financial crisis spill over into money market mutual funds, it would cripple Main Street by eliminating a critical source of short-term loans needed by businesses. If capital-starved companies found themselves unable to finance normal

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business operations through short-term loans, they would be effectively forced to scale back their operations, which would likely give rise to a rather vicious cycle. The concern was that this might unleash conditions equally as bad, if not worse, than the Great Depression seventy-five years earlier. Given these dire circumstances, the Treasury Department announced that it would temporarily guarantee money market funds against losses up to $50 billion. The Federal Reserve decided to expand its emergency lending program through the new Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) to help commercial banks finance the purchase of asset-backed securities from such funds to ensure that there would be an adequate market should money funds need to sell assets to meet withdrawals. The United States Federal Government was once again socializing the costs of a private-sector crisis.

Despite this resolve, and in spite of the failure, near-failure, or major restructuring of systemically important firms, the global financial meltdown continued. The Dow Jones Industrial had plummeted 504 points on Monday September 15th when Lehman Brothers filed before bankruptcy before jumping up 142 points on Tuesday when the Federal Reserve saved AIG, but then dropped another 449 points on Wednesday, September 17th.

On September 18th 2008 Stephen Pearlstein, The Washington Post’s business columnist wrote that the world was experiencing what he labeled a “Category 4 financial storm”:

> What we are witnessing may be the greatest destruction of financial wealth that the world has ever seen—paper losses measured in the trillion of

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54 Ibid.  
dollars...Finance is still a confidence game, and once the confidence goes, there’s no telling when the selling will stop.\textsuperscript{56}

This destruction of financial wealth appeared to be a crisis of capitalism in which a number of bad investments in junk mortgages had immobilized the financial system with fear. Investors were uncertain about the extent and location of now “toxic” assets derived from risky and dubious mortgages that were circulating through capital markets around the globe. As a result, lack of transparency regarding holdings of these opaque financial products made it unclear when the financial panic would stop, prompting a general credit crunch. As credit markets froze, the financial nightmare transformed into the largest decrease in consumption and private fixed investment spending of any post-war recession.\textsuperscript{57} The financial system, the engine of 21st century capitalism, had essentially stopped.

As Robert Kaiser notes in \textit{Act of Congress}, an eye-opening account of how Congress responded to the historic crisis, though the Federal Reserve Board and the U.S. Treasury Department had acted urgently with an assortment of tools in an unprecedented attempt to save the financial system, the Bush Administration concluded that they had insufficient tools to get the financial engine working again. Administration officials concluded they would need to go to Congress to ask for emergency appropriations of trillions of dollars to prevent what they would call another Great Depression, arousing fears of the most severe crisis to capitalism ever recorded.\textsuperscript{58} Kaiser describes how in a meeting with Congressional leaders in both parties, Federal Reserve Chairman Bernanke, who had been studying the Great


\textsuperscript{58} Kaiser, \textit{Act of Congress}, 5-6.
Depression for his entire adult life, told Congressional leaders that “If we don’t act in a very huge way, you can expect another Great Depression, and this is going to be worse,” while Chris Cox, then Chairman of the SEC apparently referred to the impending financial calamity as a “save-your-country moment.” Connecticut Senator Chris Dodd referred to the crisis as “the economic equivalent of 9-11.”

Initially, leaders in both parties agreed in principle to act with haste and authorize the $700 billion Wall Street bailout Treasury Secretary Paulson requested, which would auction off toxic assets through a program called the Troubled Asset Relief Program (TARP). On the eve of the vote, Congressman Barney Frank (D-Mass), then Chairman of the House Financial Services Committee, rallied support for the bill’s passage, stating to his colleagues:

If we repudiated George Bush's Treasury secretary and chairman of the Federal Reserve, joined as they were by previous secretaries of the Treasury, if we repudiate them and say -- no, calm down, we'll get over it -- I believe the consequences will be severe.

However, on September 29, 2008, in repudiation of what became perceived as a bailout for those responsible for the crisis, the U.S. House of Representatives rejected the $700 trillion taxpayer funded Wall Street bailout by a vote of 228-205. Democrats generally supported the Republican Administration’s bill, but House Republicans opposed it 133-65. Congressman Frank’s words seemed prescient, for as Kaiser notes, when the bailout plan fell short, “the worlds stock markets responded cataclysmically.” The Dow Jones Industrial tumbled 777 points, and papers losses for that day alone totaled $1.2 trillion.

60 Ibid, 13.
Republican Senator Jim Bunning, who labeled the Treasury’s bailout plan as “un-American,” perhaps most elegantly expressed the reasoning behind the Republican revolt against their President:

Someone must take those losses. We can either let the people who made bad decisions bear the consequences of their actions, or we can spread the pain to others. And that is exactly what the Secretary proposes to do—take Wall Street’s pain and spread it to the taxpayers […] This massive bailout is not the solution, it is financial socialism, and it is un-American.64

For many Republicans who believed that markets were or ought to be self-correcting, the proposed massive government interference in the market was repulsive. Yet there was also a populist frustration, shared by the political left and political right alike, regarding the prospect of socializing private-sector losses. This frustration became symbolized by the expression that “Main Street” shouldn’t suffer because of the excesses of “Wall Street,” and later by the Occupy Wall Street Movement.

But just two days after the House of Representatives voted down the $700 billion Wall Street bailout, the Senate by a vote of 74-25 passed a version of the TARP bill that, according to Kaiser, “was ‘sweetened’ with benefits for a few special interests favored by some House Republicans.”65 Two days later the House of Representatives passed the senate version 263-171, with 32 Democrats and 26 Republicans reversing their initial vote to support the bill. Kaiser presents the passage of the Emergency Economic Stabilization Act of 2008—which he notes ultimately cost more than the annual defense budget, including the wars in Afghanistan and Iraq—as intended “to rescue the very financial institutions that helped push the world into this catastrophe.”66 The reversal of votes was presumably the consequence of

64 Slavoj Žižek, First As Tragedy, Then As Farce (London: Verso, 2009), 11-12.
66 Ibid, 14-16.
“fears expressed to members by bankers and businessman at home who suddenly discovered that no one could lend or borrow” and a deep fear of prolonged financial mayhem, seemingly validated by the stock market’s historic tumble in the aftermath of the first vote.67 Put differently, Congress recognized that the crisis on Wall Street was impacting Main Street.

The Slovenian Marxist philosopher and cultural critic Slavoj Žižek claims that there is no way to separate Wall Street and Main Street, and as a result suggests that perhaps “moral hazard,” which he defines as “the risk that somebody will behave immorally because insurance, the law, or some other agency will protect them against any loss that his or her behavior might cause" is “inscribed into the very structure of capitalism.”68 Arguing that the historic financial crisis was more properly a crisis of capitalism, Žižek maintains that the bailout ultimately passed because under capitalism “while what is good for Wall Street is not necessarily good for Main Street, Main Street cannot thrive if Wall Street is feeling sickly, and this asymmetry gives an a priori advantage to Wall Street.”69 Given this premise it is not surprising that Congress ultimately passed the Troubled Asset Relief Program (TARP) in order to save systemically important institutions that were considered “too big to fail.”

Given Žižek’s premise, it is also not that surprising that the TARP legislation permitted the Treasury to switch from its initial plan of auctioning off the toxic assets, which “proved too complex to execute quickly” to instead using taxpayer money to directly invest in troubled banks.70 This proved fruitful when it became increasingly apparent that even the largest financial behemoths, those that had been involved in the

67 Ibid, 14-16.
68 Žižek, First As Tragedy, Then As Farce, 11-15.
69 Ibid, 11-12.
previous restructuring of failing firms by absorbing them on their losses on their massive balance sheets, were still having difficulty weathering the financial storm. Indeed, by November 2008, Citigroup, Bank of America, and JP Morgan witnessed devastating drops in their share prices. On November 20th, 2008 The New York Times noted fears that the financial system was again nearing the danger zone. As Floyd Norris put it, “with the stock market plunging and the credit market entering a new freeze, cries are being heard for a new government intervention to prop up major financial institutions.” Indeed, Citigroup, the second-biggest US bank by asset value, saw its already-depressed shares drop approximately in half to $5 for the first time since 1994. Given Žižek’s premise that “Main Street cannot thrive if Wall Street is feeling sickly,” it is unsurprising that on November 24th, amidst fears that Citigroup was nearing insolvency, the U.S. Federal Government offered an additional rescue package of $20 billion of capital, adding to the previous $25 billion infusion Citigroup had collected the previous month under TARP. Once again, the belief was that if the government let those who made bad decisions bear the consequences of their actions, it would have been disastrous.

It is difficult to predict how the sudden major collapse of asset values imperiling the financial system would have stopped in the absence of these government interventions, or how much damage would have been inflicted on the Main Streets of the world. There has been substantial criticism of the Wall Street bailouts, but the fact remains that a paradox of deleveraging, the rapid fire sale of assets, had ensued. As a result, the value of all assets collapsed. This imperiled the

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solvency of systemically important financial institutions, which were considered, rightly or wrongly, “too big to fail.” Yet it is important to understand how this situation happened in the first place. As recently appointed (and first female) Chairman of the Federal Reserve Janet Yellen remarked in 2009:

A process of balance sheet deleveraging has spread to nearly every corner of the economy...Once again, Minsky understood this dynamic. He spoke of the paradox of deleveraging, in which precautions that may be smart for individuals and firms—and indeed essential to return the economy to a normal state—nevertheless magnify the distress of the economy as a whole.”

The Minsky she was referring to was Hyman Minsky, who was also featured in a John Cassidy’s New Yorker article in 2008 entitled “The Minsky Moment,” named after the heterodox economist who believed “that bankers, traders, and other financiers periodically played the role of arsonists, setting the entire economy ablaze.” Minsky’s financial-instability hypothesis had been “dismissed as radical, if not crackpot” when it was developed in the 1960s and has since remained heterodox, but its basic premise, the notion of financial instability, is worth exploring in more detail.

According to Minsky’s financial-instability hypothesis non-governmental accumulation of debt is a crucial mechanism that pushes economies towards crisis or instability. Minsky identified three types of income-debt relations for economic units: hedge borrowers, speculative borrowers, and Ponzi borrowers. “Hedge financing” as Minsky defines it, “can fulfill all of their contractual payment obligations by their

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75 Ibid.
cash flows.” Speculative borrowers” on the other hand “are units that can meet their payment commitments on ‘income account’ on their liabilities, even as they cannot repay the principle out of income cash flows.” In other words, cash flow from investments can service debt (i.e. cover the interest due) for speculative borrowers, but the borrower must regularly “‘roll over’ their liabilities: e.g. issue new debt to meet commitments on maturing debt).” Lastly, “Ponzi units,” named after financial fraudster Charles Ponzi, are units in which “the cash flows from operations are not sufficient to fulfill either the repayment of principle or the interest due on outstanding debts by their cash flows from operations.” That is, such units must either sell assets or borrow. Heterodox as Minsky might have been, his analysis of financial markets is highly relevant to the 21st century crisis of capitalism.

Many analysts before the crisis were seduced into the shortsighted belief that The Great Moderation had defeated the business cycle. But Minsky’s overall point was that in cases when hedge financing is dominant the economy may very well be “an equilibrium seeking and containing system,” but that financial stability eventually leads to instability. Critically, the first theorem of his financial instability hypothesis is “that the economy has financing regimes under which it is stable, and financing regimes in which it is unstable,” and the second theorem is “that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system.” In other words, Minsky’s crucial point is that due to the internal dynamics of capitalism itself.

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77 Ibid.
78 Ibid.
79 Ibid.
and the fading memory of the most recent crisis, economies tend to transition from financial regimes dominated by “hedge finance units” to regimes increasingly dominated by “speculative and Ponzi finance” that are inherently unstable and prone to asset collapse.  

In the context of our recent crisis we can understand “hedge,” “speculative,” and “ponzi” borrowers in the following manner. “Hedge” borrowers were those who took out conventional or prime mortgages and could fulfill their contractual payment obligations by their cash flows. “Speculative” borrowers are those who take advantage of non-conventional mortgages payments, making interest payments with the expectation of later refinancing to pay back the principal. Other “unconventional” loans, like negative amortization, in which low introductory payments left borrowers owing more money after a few of years of payments were clearly “ponzi” in the sense that their mortgage payments did not cover the interest payments, the principal was actually increasing, and the terms of the loans were predicated on the assumption (or hopeful delusion) that housing values would continue to go up. Neil Fligstein and Adam Goldstein document a compositional shift towards nonconventional mortgages after 2003, which, given the terms of non-conventional payment identified above, meant an expansion of speculative and ponzi borrowing. As a result of the trillion-dollar mortgage industry derived from these (increasingly speculative and ponzi) mortgage assets, the financial system misbehaved—as Minsky would have predicted. Subprime derived assets (Ponzi units) evaporated into “toxic” assets, asset values

80 Ibid, 7-8.
81 Ibid, 6-8.
generally collapsed, confidence and trust eroded as financial markets panicked, and the financial system became increasingly unstable.

Though heterodox in the run up to the crisis, Minsky’s basic insight was that “Wall Street encouraged businesses and individuals to take on too much risk, generating ruinous boom-and-bust cycles.” Yet the notion that capitalism is inherently unstable because stability promotes instability was against the current of mainstream economic thought. As Paul Krugman notes, in 2002 at a 90th birthday celebration for Milton Friedman—who famously suggested that the Great Depression was the fault of misguided monetary policy—Ben Bernake declared of the Great Depression, “You’re right. We did it. We’re very sorry. But thanks to you, it won’t happen again.” The clear message, as Krugman puts it, “was that all you need to avoid depressions is a smarter Fed.” Hyman Minsky, an American economist who grew up during the Great Depression and died in 1996, would have been disappointed. Minsky believed that a crisis of capitalism could and would happen again. The 21st century crisis of capitalism from which we still recover suggests that Bernake was wrong and Minsky was right.

Chapter 2:
The Making of a Crisis

“Its apologists are repeating in endless variations that but for the policies advocated by its critics, liberalism would have delivered the goods; that not the competitive system and the self-regulating market, but interference with that system and interventions with that market are responsible for our ills.”

-Karl Polanyi, The Great Transformation

The 2007-08 Financial Crisis and the Great Recession that followed is generally recognized as “the worst economic crash since the Great Depression.”\(^8^5\) The global financial crisis demonstrated that markets were less stable than presumed—with devastating consequences. While few doubt that markets weren’t working the way efficient markets were supposed to, there is substantial debate over what primarily caused this crisis. The intellectually (and politically) important question is whether the crisis was primarily rooted in the failure of government policies or the inefficiency of markets. In order to assess that question, we must investigate the proximate causes of the recent crisis. How did this happen?

The Importance of Housing Finance

It is critical to understand that real housing prices in the United States remained more or less constant from 1950 to 1997, but beginning in 1997, appreciated rapidly, peaking in 2006 at nearly 160% of their long run average before depreciating in 2006.\(^8^6\) The burst of this housing bubble reverberated through the

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global economy because household wealth was important to the contemporary financial system, and, by extension, the United States economy. This raises a pressing question: how was it that housing had become so important to the American economy?

Mark Setterfield, Professor of economics at Trinity College, suggests that a growing divergence between productivity and wages, beginning in the 1970s, is a crucial part of the story. According to Setterfield, the stagnation of real wages for the great majority of wage earners over the last four decades encouraged the rapid growth of indebtedness—both absolutely and as a proportion of total household income.87 With strong upward trends in housing prices, Fred Block notes how “consumers were able to borrow against their increasing equity in housing—using their homes as automated teller machines.”88 John Bellamy Foster and Fred Magdoff suggest that though a stagnation or decline in real wages would historically have constrained consumption, consumption continued to climb until the housing downturn, in large part because easy credit (thanks to the Federal Reserve’s low real interest rates) enabled working people to accumulate substantial debt and “live beyond their means.”89 This suggests that the strength of consumption in the economy was connected to what Bellamy Foster and Magdoff term a “household debt bubble,” which, in the run up to the crisis, they had suggested, “could easily burst as a result of rising interest rates and the stagnation or decline of housing prices.”90 This is what

90 Ibid, 36
eventually happened. The American economy had been reliant on debt-financed prosperity, which provides insight as to why once the housing downturn transformed into a credit crunch, consumption plummeted and America (and much of the world) entered a severe economic slump.

When housing prices depreciated, struggling low-income workers with stagnating or declining real wages were the first to suffer—particularly African-Americans, immigrants (Hispanics), and women single-headed households. Many of these households had obtained mortgages known as “teasers,” that began with below-market payments before resetting and aligning with interest rates. These unconventional or “subprime” mortgage products had enticed many households who couldn’t post steep down payments. Often they were purchased with an expectation that the appreciation of housing value would continue, enabling new owners to refinance before their adjustable rate mortgages reflected higher interest rates. For many lower-income and middle-income households, the expectation to refinance before their interest payments skyrocketed turned out to be wrong. When housing depreciated, this “subprime” credit availability also contracted. Additionally, interest rates increased in 2006 from historically low levels, which meant that unable to refinance their mortgages, increasingly working households with adjustable rate mortgages faced the “twin problems” of higher mortgage payments and declining home values.

As Setterfield puts it, “the latent fragility of the U.S. economy” associated with unsustainable debt accumulation by low and middle-income households

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“seeking to offset weak real income growth caused by the failure of real wages to keep pace with productivity growth” became “manifest, in the form of the financial crisis, and subsequently, the Great Recession.”

By 2006 the rate of foreclosures on housing had exploded in low-income areas in cities such as Cleveland and Detroit. By mid-2007 the foreclosure wave had spread to urban and suburban areas in the south (especially Florida) and the West (especially California, Arizona, and Nevada), at which point the mainstream press, and eventually financial markets, began to take note. As the “household debt bubble” burst, millions of Americans lost their homes, and millions more were in danger of foreclosure. The escalating missed mortgage payments, first on shady mortgages, eroded the value of a large sum of synthetic assets derived from mortgages. This threatened the solvency of a number of systemically important financial institutions. The housing downturn had spread like cancer. Unlike during the Savings and Loans Crisis of the 1980s and 1990s, the entire financial system, and thus the American economy, had entered free-fall. This raises two pressing questions: Why did a crisis in one sector percolate throughout the financial system? How and why were assets derived from mortgages permeating capital markets?

**Securitization: The Rise of Asset-Backed Securities**

The reason that the housing downturn contaminated financial markets has to do with financial innovation—particularly the role of securitization and the rise of asset-backed securities (ABS), especially mortgage-backed securities (MBS).

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Securitization is a relatively obscure concept used to describe the practice by which financial institutions pool various types of debt. Mortgage-securitization involves a process far more complex than the simple days through the 1980s in which an individual would find a house, go to their local bank (most likely a savings and loan association) and apply for a mortgage that the local bank would hold onto until it was paid off or until the house was sold. Unlike the savings and loans banks that would hold onto the mortgages they sold, contemporary mortgages are “originated” by a lending company who sells off the mortgages to underwriters (GSEs, investment banks, or commercial banks) who subsequently “package” or service them into a type of bond called a “special purpose vehicles,” which pays a fixed rate of return derived from income streams on the underlying mortgages. These bonds are then rated by credit rating agencies in terms of their riskiness and are subsequently sold to various investors (and other financial institutions) around the globe.95

A MBS thus refers to a pool of debt derived from a series of mortgages in which the underlying debt is effectively sliced, diced, and packaged into assets sold to investors, such as pension funds, municipal governments, and other financial institutions. Neil Fligstein and Adam Goldstein suggest that the reason securitization is central to the financial crisis is that the mortgage securitization industry transformed from a relatively small niche market at the beginning of the 1990s into “the core activity of the rapidly expanding financial sector,” a $4 trillion industry by 2003—within a financial sector that then comprised roughly 10% of the labor force and was generating 40% of profits in the American economy.96 The proximate cause of the economic crisis, according to Fligstein and Goldstein, was thus the

95 Fligstein and Goldstein, “Roots of the Great Recession,” 30
“unraveling” of this industry. As the housing downturn accelerated, delinquencies and defaults on mortgage payments led to substantial losses of revenue to these complex mortgage-derived assets. The plummeted value of mortgage-derived assets subsequently exposed that even the most respected financial institutions had seemingly failed at effective risk management practices. These institutions were vulnerable, nearing insolvency because their balance sheets were heavily exposed to “subprime” mortgage liabilities and they had insufficient capital cushions to absorb these mortgage-derived losses.

However, the extent to which these financial institutions were vulnerable to these mortgage liabilities was magnified by the increasing importance of expanding secondary markets, such as the collateralized debt obligation (CDO) market, which enabled concentration of credit risk (i.e. defaults) by re-securitizing already existing income streams into various “tranches” that prioritized claims on loan repayment (the income stream), and a credit default swap (CDS) market, which effectively “allowed firms to insure the risks they held on CDO and other financial instruments” against the default of one or more borrowers.\(^{97}\) These mortgage-derived assets were sold as “derivative” contracts in an increasingly profitable but opaque over-the-counter (OTC) derivative market that was effectively exempt from regulation due to legislation enacted in 2000.\(^{98}\) To appreciate the scale of these secondary markets, the CDS market alone grew from $631.5 billion in notional value in the first half of 2001

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\(^{96}\) Ibid, 21.
\(^{98}\) Under the enactment of the 2000 Commodity Futures Modernization Act regulation of derivatives was prohibited. As a result, these markets were considered “opaque” because they were not subject to reporting or disclosure requirement or regulatory oversight and supervision.
to over $62.1 trillion in notional value by the second half of 2007. Because CDSs were sold as insurance against circumstances such as missed payments or credit downgrades, when the mortgage-securitization market went south in light of slowing housing appreciation in late 2006 and early 2007, both the CDO and CDS market experienced significant downturns. Much of the risk associated with these derivatives was also concentrated in a few of the major financial players. This included the largest commercial banks, the country’s five largest investment banks, and insurance giants such as American Insurance Group (AIG), which the federal government took over in an $85 billion bailout orchestrated in large part because the insurance giant was on the wrong side of what effectively amounted to a $70 billion bet on the performance of dubious mortgages.

Viral Acharya and Matthew Richardson argue that in order to understand why the CDO and CDS market experienced significant downturns, far from spreading risk to make the contemporary financial system safer, securitization had actually concentrated risk in ways that ultimately led to the wholesale implosion of the financial system. As Acharya and Richardson note, around the end of 2002 “investment banks extended the prime-mortgage securitization model pioneered by the GSEs to other, riskier asset classes” in an innovative process that “allowed banks to transfer these risks from their balance sheets to the broader capital market, including pension funds, hedge funds, mutual funds, insurance companies, and

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foreign-based institutions.”

Previously the vast majority of securitized mortgages were held or guaranteed by the GSEs. These mortgages were low-risk “conforming” mortgages, which meant that in order to be eligible for agency-securitization loans couldn’t exceed a particular size and had to meet underwriting criteria related to one’s ability to repay the loan. However, the financial innovation Acharya and Richardson describe meant that Wall Street dramatically increased its market share in the mortgage-securitization market by moving into less reliable forms of mortgage loans.

As housing sales almost tripled in volume from 1990-1998, with another rapid upsurge in 2000-2003 after the “dotcom” crash and the Federal Reserve’s subsequent decision to lower interest rates to essentially zero, large commercial and investment banks—acutely aware of cheap interest rates and strong investor demand in secondary markets derived from mortgages—increasingly involved themselves in mortgage debt products. As Fligstein and Goldstein note, because banks could now take advantage of favorable spreads in which they could borrow money at 1% and loan it at 5-7% they were encouraged to loan as much mortgage debt as they could. This created conditions of moral hazard because the financially innovative “originate-to-distribute” business model created perverse incentives, in that originators now had little incentive to perform due diligence on loans so long as they could be sold to institutional investors and other financial institutions. Cognizant that they did not bear the full cost of their risk-taking activity, a now increasingly concentrated and integrated financial community could embrace riskier mortgage lending terms as part of a highly risky but profitable mortgage-finance venture so long as rising home

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\[\text{102 Fligstein and Goldstein “The anatomy of the mortgage securitization crisis,” 40-42.} \]
prices could compensate for riskier, poorly performing loans. As a result, new asset-
backed securities (ABS) issued by private banks rather than by GSEs grew at
extraordinary rates after 2002. This development will be critical to understanding the
rise in unconventional or “subprime” loans, and thus “toxic” assets, which are central
to understanding whether government policies or market failure is primarily
responsible for the crisis.

**Failure at the Credit Rating Agencies**

By 2005 and 2006, Wall Street firms were securitizing one-third more
mortgage loans than the government-sponsored enterprises (GSEs) Fannie and
Freddie, increasingly sending riskier forms of mortgage debt to circulate throughout
capital markets.\(^{103}\) These “private-label” ABSs were not guaranteed (implicitly or
explicitly) against default. Instead, they were “structured,” meaning that their income
streams were divided into distinct “tranches” whose corresponding risk levels were
determined by private credit rating agencies (CRA).\(^{104}\) Though AAA-rated tranches
were not guaranteed against default, they represented a credit rating agency’s belief
that an obligor was very likely to meet its financial commitments. So long as there
was not an extraordinarily large number of simultaneous mortgage defaults within a
structured income stream, tranches derived from even riskier “private-label”
mortgages wouldn’t incur a loss—or so it was believed.

As we now know, many of these ratings were overly optimistic. That is, they
were inflated. This is significant because if securitization involved a form of financial
wizardry, as Nobel prize-winning economist Joseph Stiglitz stated, the credit rating
agencies were the “parties that performed the financial alchemy” that turned dubious

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\(^{103}\) Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 102

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loans into AAA-rated assets.\textsuperscript{105} Whether primarily a result of a flawed compensation model or the inadequacy of their ratings methodology and data, these private credit rating agencies unequivocally failed at their primary role of providing specialized and accurate information for use by investors.\textsuperscript{106} Instead, many investors were enticed by supposedly highly rated securitized mortgages that became “toxic.” As a result of the failures of the private credit rating agencies, “unsuspecting investors across the world, from pension funds, small regional European banks and municipal governments from Norway to Florida,” as David Harvey puts it, “found themselves holding worthless pieces of paper and unable to meet their obligations or pay their employees.”\textsuperscript{107}

Barry Eichengreen notes that one explanation for the private rating agencies’ “dismal performance” is the “imperfect models used by rating agencies to value residential-mortgage-backed securities and the associated derivatives,” which estimated default probabilities using historical data associated with a housing boom and a uniquely prosperous macro-economy.\textsuperscript{108} This is significant in that such models relied on a period in which mortgages performed well (and the terms of mortgages were less risky, one may add), but past performance is not an indicator of future performance (as we soon found out). Additionally, as the \textit{Financial Crisis Inquiry Commission} notes, the credit rating agencies failed to heed many of the warning signs indicating problems in the housing and mortgage sector after housing appreciation slowed. Instead, the private credit rating agencies proceeded to issue inflated ratings

\textsuperscript{104} Ibid, 187-188.
\textsuperscript{105} Rupert Neate, “Rating agencies suffer ‘conflict of interest’ says former Moody’s boss,” \textit{The Guardian}, August 22, 2011.
\textsuperscript{107} Harvey, \textit{The Enigma of Capital: And the Crises of Capitalism}, 1.
\textsuperscript{108} Eichengreen, “Origins and Regulatory Consequences of the Subprime Crisis,” 429.
on mortgage-related securities using analytical models they knew to be outdated. While this provides remarkable insight into how the failures occurred, if we are to understand why “the rating agencies placed market share and profit considerations above the quality and integrity of their ratings” as the Financial Crisis Inquiry Commission concluded, we must understand the incentives and motives of the private credit rating agencies. As Deep Throat, the Watergate scandal’s whistleblower would remind us, we must ‘follow the money’ a catchphrase popularized by the 1976 motion picture All the President’s Men.

When discussing alleged market failures in the recent financial meltdown, critics are quick to point to the “issuer pay” model of compensation for the credit rating agencies, which demonstrates a flagrant conflict of interest. Indeed, as Marc Eisner notes, mere awareness “that issuers could take their business elsewhere in response to a poor rating created powerful incentives to inflate ratings.” Richard Michalek, a former vice president and senior credit officer at one of the three big credit rating agencies, Moody’s and Fitch, reaffirmed this sentiment. Michalek testified: “the threat of losing business to a competitor, even if not realized, absolutely tilted the balance away from an independent arbiter of risk towards a captive facilitator of risk transfer.” William Harrington, a former senior president also at Moody’s, said in a filing to the Securities and Exchange Commission (SEC): “this salient conflict of interest permeates all levels of employment, from entry-level

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analyst to the chairman and chief executive officer of Moody’s corporation.”112 Yet it was not simply the perception of losing business that drove ratings inflation; when asked if banks actually frequently threatened to bring business elsewhere, former team managing director of Moody’s, Gary Witt, recalled: “they would threaten you all of the time...it’s like, ‘Well, next time, we’re just going to go with Fitch and S&P,” the other two of the “Big-Three” credit rating agencies.113

Eichengreen suggests that this conflict of interest was rooted in how rating agencies first earn fees from advice on how financial institutions ought to structure these assets so that they receive a desired rating, which subsequently made the CRAs feel obliged to “rate those issues in the promised manner.”114 Aside from the not-so-subtle conflict of interest associated with both advising and issuing ratings, inflationary pressure was also rooted in financial participants response to Basel II, a set of global recommendations regarding banking laws and regulations produced by the Basel Committee on Banking Supervision. Under Basel II bond ratings were used to determine the range of possible permissible bank investments. For example, if credit rating agencies rated “tranches” AAA (even if derived from risky mortgages), the AAA rating functioned as an institutional seal of approval that indicated to investors that such assets were ‘as safe as the safest corporate bonds.’ It also legally enabled large, complex financial institutions to fund themselves through short-term debt mechanisms associated with what has become known as a “shadow banking system,” an unregulated system comprised of uninsured financial intermediaries that eventually resembled a precarious house of cards.

One indication of market failure is that given the complex nature of mortgage-securitization, investors did not necessarily know the quality of the underlying loans that provided the income streams to various tranches, instead relying on credit rating agencies as a critical and reputable source of information regarding credit risk of mortgage-derived assets. Information asymmetries were thus compounded by the failures of the credit rating agencies, which by issuing inflated ratings on assets contributed to inefficient risk judgment. That is, market prices did not fully reveal all relevant information as is often presumed. Given that we now know that these financial markets were imperfect and were actually mispricing risk, the economic models purporting that markets could be self-regulated, efficient, and self-correcting, such as the efficient markets hypothesis, seem in retrospect deeply flawed. It is within this context that many scholars of the crisis also argue that regulators did not use the full set of possible instruments to ensure a safe and sound financial system. For instance, Joseph Stiglitz suggests that there were rampant market failures, but that market fundamentalist orthodoxy blinded policymakers, elected officials, and regulators alike from accounting for the possibility, let alone the probability, of market failure.\textsuperscript{115}

As a result, when U.S. housing value depreciated as mortgage defaults across all regions skyrocketed, even the “senior” tranches that had been structured to offer investors extra “protection” from housing price volatility and defaults experienced larger than expected losses. This not only brought to light the compromised quality and integrity of credit rating agencies in regards to their evaluation of mortgage-derived assets, it also aggravated the already profound consequences of the highly

\textsuperscript{115} Joseph Stiglitz, \textit{Freefall: America, Free Markets, and the Sinking of the World Economy} (New
leveraged financial system. The failure of the credit rating agencies to accurately assess risk led to underpriced risk, which, coupled with extensive leverage, in turn raised the level of systemic risk.

**Thin Capital Margins and Systemic Risk**

Central to this story regarding thin capital margins and systemic risk is that in June 2004, the Securities and Exchange Commissions (SEC) permitted investment banks to start using guidelines formulated under Basel II as an alternative to traditional net capital rules. After heavy lobbying by all five big investment banks and advocacy from Congressional leaders such as New York Senator Chuck Schumer, a powerful member of the Senate Banking Committee, the SEC relaxed net capital rules and created the Consolidated Supervised Entities Program. In essence, the SEC adopted a self-regulatory approach that relied on the voluntary submission of reports to the SEC regarding assets and activities by investment banks. After the big five investment banks disappeared during the crisis (through bankruptcy, mergers, and restructuring) amidst heightened concern about adequacy of financial institutions’ capital base (which imperiled their solvency), the head of the SEC, Christopher Cox, admitted that the voluntary regulation did not work and that the “fundamentally flawed” self-regulatory oversight helped fuel the financial collapse.116 Former chairman of the Federal Deposit Insurance Corporation (FDIC) Sheila Bair suggests that this is because the self-regulatory approach to capital requirements led to significantly more leverage than was permitted for commercial banks and thrifts,

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which was a major reason investment banks did not have sufficient capital cushions to sustain the “toxic” mortgage liabilities on their balance sheets.\textsuperscript{117}

To understand this, it is critical to point out that the combination of inflated credit ratings and self-regulation effectively enabled large, complex financial institutions to fund themselves through short-term debt mechanisms associated with what has become known as a “shadow banking system,” a term frequently used to describe the growing but unregulated market for capital parallel to the traditional banking system established in the wake of the Great Depression. As the \textit{Financial Crisis Inquiry Report} puts it, investment banks “operated in capital markets beyond the reach of the regulatory apparatus.”\textsuperscript{118} As a result, investment banks were able to borrow short term at low interest rates from this “shadow banking system” to finance holdings in higher yielding, long-term assets, treating the interest rate differential between their assets and liabilities as a profit. What was problematic about this was that many of these (uninsured) assets were illiquid; they could not be sold quickly, which made the overall strategy precarious. As the \textit{Financial Crisis Inquiry Commission} puts it:

As of 2007 the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital [margins]. By one measure, their leverage ratios were as high as 40 to 1, meaning for every $40 in assets, there was only $1 in capital to cover losses. Less than a 3\% drop in asset values could wipe out a firm. To make matters worse, much of their borrowing was short-term, in the overnight market—meaning the borrowing had to be renewed each and every day.\textsuperscript{119}

Put differently, the very firms that relied on short-term loans to fund their daily operations were also highly leveraged. They had little capital to serve as a buffer in

\begin{footnotesize}
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  \item \textsuperscript{117} Sheila Bair, \textit{Bull by the Horns: Fighting to Save Main Street from Wall Street and Wall Street from Itself} (New York: Free Press, 2012), 36-37.
  \item \textsuperscript{118} Financial Crisis Inquiry Commission, \textit{The Financial Crisis Inquiry Report}, 27.
\end{itemize}
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the event that they sustained substantial losses, which they eventually did during the housing downturn. It is therefore essential to explore why these financial firms were so highly leveraged, and how this practice of engaging in excessive risk with thin capital margins culminated in socially suboptimal outcomes.

According to Acharya and Richardson, major players in finance engaged in such high leverage to circumnavigate capital-adequacy requirements associated with the first Basel Accords, which were adopted in 1991. According to Acharya and Richardson, major players in finance engaged in such high leverage to circumnavigate capital-adequacy requirements associated with the first Basel Accords, which were adopted in 1991.120 Emphasizing the risk-taking incentives of employees within financial firms, Acharya and Richardson suggest that in the period leading up to the crisis “bankers were increasingly paid through short-term cash bonuses based on volume and on marked-to-market profits, rather than on the long-term profitability of their ‘bets.’” As a result, regulatory arbitrage—the process by which firms capitalize on loopholes in the regulatory apparatus to avoid unfavorable regulation—ensued through the creation of off-balance-sheet entities (OBSEs), like Structured Investment Vehicles (SIV) and other types of unregulated “conduits” that held onto ABS, which became “the primary business of the financial sector” due to their ability to generate short-term profitability.122 By 2007, MBS “conduits” were dominated by investment banks like Lehman Brothers, Bear Stearns, Morgan Stanley, and Merrill Lynch.123

This had important implications in regards to capital adequacy. As Acharya and Richardson put it:

With loans placed in conduits rather than on a bank’s balance sheet, the bank did not need to devote any capital to them. However, the conduits funded the

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120 Acharya and Richardson, “How Securitization Concentrated Risk in the Financial Sector”
121 Ibid, 196.
122 Ibid.
asset-backed securities through asset-backed commercial paper (ABCP)—bonds sold in short-term capital markets. To be able to sell the ABCP, a bank would have to provide the buyers, that is, the banks’ “counterparties,” with guarantees of the underlying credit—essentially bringing the risk back onto itself, even if it was not shown on its balance sheet.\textsuperscript{124}

This was notable because these “conduits” effectively moved assets off of a banks’ balance sheet because banks were able to design the guarantees as “liquidity enhancements” of less than one-year maturity, exploiting a loophole in federally adopted Basel capital requirements that allowed zero risk weight to short-term exposures, meaning they required no bank capital.\textsuperscript{125} These “liquidity enhancements,” or guarantees, according to Acharya and Richardson, also “ensured the highest ratings for the vehicles from the rating agencies,” which subsequently made it possible for banks to sell ABCPs to money-market funds, which are required by law to invest primarily in the highest-rated securities.\textsuperscript{126} Financial institutions thus became reliant on regulatory arbitrage in the form of reinvesting in the very securitized products that they (or other financial institutions) had created, or by using off-balance sheet entities that required guarantees in short-term capital markets that often had to be rolled over frequently (usually overnight). As a result, these financial firms had effectively “written huge quantities of insurance against a systemic decline in the overall economy, especially in the housing markets.”\textsuperscript{127}

Sure enough, housing appreciation did not continue indefinitely. When the sub-prime crisis ensued, credit downgrades meant that ABCPs could not be rolled over and highly leveraged financial institutions had to return the loans (and risk) back

\textsuperscript{124} Ibid, 190.
\textsuperscript{125} Ibid
\textsuperscript{126} Ibid.
\textsuperscript{127} Ibid, 190-195.
to their balance sheets, threatening their solvency. This is because the credit downgrades meant that firms were no longer able to access short-term loans they needed to run daily operations through their off-balance-sheet entities. As a result, these financial firms needed to deleverage or sell off assets in order to meet cash demands, which created a Minsky moment in which the prices of all assets dropped. As a result, banks and other major financial institutions were unwilling to sell their assets (which were sensitive to economic conditions, such as housing prices, default rates, and financial-market liquidity) at significantly reduced prices, which would have required significant reductions in their stated assets, making them, at least on paper, insolvent. In effect, these assets came to be called ‘toxic assets’ in the media, later transformed by the United States Treasury into the gentler-sounding ‘troubled assets.’ With potential sellers and buyers unable to agree on prices, inter-bank lending froze. Credit dried up, which led to sharply reduced aggregate demand because household consumption declined and firms reduced investment amidst bad economic prospects and the inability to get financing for investment projects. As a result, the Great Recession began.

**Understanding Responsibility for the Crisis**

In the darkest days of the financial crisis it became apparent that our financial system had become a precarious house of cards. As the stock market cratered, there were legitimate fears that the dominos would keep falling and lead to another Great Depression. Though emergency government action eventually rescued the economy from freefall, as of this writing the American economy is still in recovery, especially

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for struggling low and middle-income households. In explaining the question how this happened, this chapter has so far demonstrated that the proximate causes of the financial crisis include the securitization of dubious mortgages, lack of transparency in the derivatives market, failures at the credit rating agencies. It includes thin capital margins, due to low margin requirements and the choice to be highly leveraged instead of cautious. This collectively increased levels of systemic risk. These were the proximate causes that explain how this crisis of capitalism actually occurred. But this leads us to the next important question: *Why* did this happen?

One view, emphatically voiced by Nobel-Prize winning economist Joseph Stiglitz is that the crisis was a product of systemic market failures. As Stiglitz puts it:

> America’s financial markets had failed to perform their essential societal functions of managing risk, allocating capital, and mobilizing savings while keeping transaction costs low. Instead, they had created risk, misallocated capital, and encouraged excessive indebtedness while imposing high transaction costs.\(^{130}\)

One possible implication of market failure is that in principle there are government interventions that would be welfare enhancing, yet Stiglitz suggests that our leaders ignored the dire need for government interventions. An opposing view, forcefully articulated by Peter Wallison, the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute, is that government policy distorted market mechanisms, leading them astray:

> The crisis has its roots in the U.S. government’s efforts to increase home ownership, especially among minority, low-income, and other underserved groups, through hidden financial subsidies rather than through direct government expenditures. Instead of a government subsidy, say for down-payment assistance to low-income families, the government used regulatory and political pressure to force banks and other government-regulated or

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controlled private entities to reduce lending standards, so more applicants would have access to mortgage financing.\textsuperscript{131}

Wallison’s perspective is that in the run up to the crisis the market performed inefficiently, but that the inefficiency was not a result of intrinsic market failures, but rather “a demonstration that well-intentioned government intervention in the private economy can have devastating consequences.”\textsuperscript{132} The fundamental divide comes down to the question of the motivations behind originating all those mortgages that ended up securitized and packaged into “toxic” assets: Was it the government or the market? It is a question worth exploring in more detail.

Central to many claims that government policy distorted market mechanisms, leading them astray, is the role of the Federal Reserve, the central bank of the United States whose primary function is managing the U.S.’s money supply by setting interest rates and reserve requirements as well as acting as a ‘lender of last resort’ during times of bank insolvency and financial crisis. Many accounts of the recent crisis suggest that a major cause of the housing bubble was a flood of credit that pushed the interest rates paid on home mortgages—as well as on everything else—to record-low levels (Acharya and Richardson 2011; Gjerstad and Smith 2011; Stiglitz 2011; Taylor 2011). These accounts identify monetary policy set by the Federal Reserve as a primary causal mechanism facilitating the creation of a housing bubble. It is said that expansionary money supply became a market distortion, as opposed to its intended purpose of offsetting or preventing market failure. For instance, John Taylor, Professor of Economics at Stanford University, suggests that under the leadership of Alan Greenspan the Federal Reserve kept interest rates too low for too

long. Taylor notes that beginning in 2001 the Federal Reserve pushed the federal funds rate well below the optimal level prescribed by a rule he developed in 1992, commonly called the Taylor rule, which calculates optimal interest rate levels by “plugging in actual inflation and GDP.” These low interest rates presumably increased the demand for housing, which fueled the housing bubble and increased the appeal of popular adjustable-rate mortgages (which eventually backfired as housing appreciation slowed and payments exploded) and created incentives for investors to turn to mortgage-backed securities that offered higher yields than treasury bonds.

This is a criticism of government policy, specifically unsound monetary policy that led markets astray. Yet this begs two ultimate questions: Would the crisis have happened even in the absence of the Federal Reserve’s low-interest policy? Alternatively, was the financial implosion a necessary consequence of the Federal Reserve’s policy, or did intrinsic market failures come into play?

While it seems entirely plausible that the Federal Reserve’s decision to maintain historically low interest rates facilitated a housing bubble (illustrated by rapid housing appreciation) and a booming market that pulled households and firms alike into the grip of a speculative mania, it is worth noting Neil Fligstein and Adam Goldstein’s observation that “the increase and subsequent drop in housing prices might not have had such a large overall effect on the economy if it had not been for the way mortgages were being sold and financed in this period.” Put differently, low interest rates don’t of themselves explain the rise of the unconventional, riskier

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132 Ibid, 172.
loans that were central to the meltdown. Richard Posner, for instance, suggests that the financial crisis would have been averted, or at least would have been much less grave, in spite of very low interest rates, had it not been for “inadequate banking regulation: a compound of deregulation, lax regulation, regulatory inattention, and regulatory ineptitude.”\textsuperscript{136} This of course presumes the need for regulation, which itself presumes that there were limitations in the efficiency of the market that the government could have theoretically corrected (i.e. restraining dubious lending practices).

In contrast, proponents of the government failure hypothesis find it fundamentally deceptive to blame an era of “deregulation” for the recent crisis. The Department of Housing and Urban Development (HUD), the Federal Housing Finance Board (FHFB), the Federal Housing Administration (FHA), and the Federal Home Loan Bank (FHLB) continued to exist. Congress enacted legislation, such as the Fair Housing Act of 1968, the Equal Credit Opportunity Act of 1974, the Community Reinvestment Act, the Home Mortgage Disclosure Act of 1975, the National Affordable Housing Act of 1990, the Community Development and Regulatory Improvement Act of 1994, the Home Ownership and Equity Protection Act of 1994, and the American Dream Down Payment Act of 2003.\textsuperscript{137} In spite of recent rhetoric regarding a trend of radical deregulation, the market was never entirely “unfettered.” In contrast, the government failure perspective often suggests that the crisis was the culmination of misguided government intervention in a “noble” attempt to aid the less privileged and creditworthy in society, implying a massive

\textsuperscript{135} Ibid.
indictment against the last vestiges of President Johnson’s Great Society. Because of
the “altruistic” attempt to increase home ownership for the needy, “U.S. government
had riddled the mortgage market with perverse incentives” to lend to less-than-
creditworthy borrowers.” This government-induced phenomenon allegedly put the
entire financial system at “greater risk of insolvency.”\textsuperscript{138}

Given these competing perspectives, which assessment offers greater insight
into the motivations behind the large-scale securitization of these dubious loans? In
order to answer this question we must critically examine the expansion of
unconventional loans and the demand for securitization.

\textit{Securitization of Unconventional Loans}

It is important to point out that from 2003-2007, securitization of
unconventional loans became increasingly prevalent. By 2004, for the first time, the
dollar value of non-conventional loans—that is, riskier loans that the GSEs initially
stayed away from—exceeded that for the prime or conventional market.\textsuperscript{139} This
phenomenon raises a series of questions: What specifically prompted entrance into
this riskier unconventional market? What did this market entail? Who was
responsible for its rise? Though many scholars agree that securitization of
unconventional mortgage securitization is central to understanding what triggered the
recent financial crisis, there is less agreement as to how this market actually
developed. It is critical to understand how and why the risky unconventional market
expanded so quickly, which means we must understand why financial institutions
entered the unconventional market so aggressively, and why in doing so they left

\textsuperscript{137} Richard Salsman, “Altruism: The Moral Root of the Financial Crisis” in \textit{The Objective Standard}
Vol. 4, No. 1, Spring 2009.
\textsuperscript{138} Ibid.
\textsuperscript{139} Fligstein and Goldstein “The anatomy of the mortgage securitization crisis,” 49.
themselves—and the entire financial system—extremely vulnerable to a housing downturn.

As already noted, there are competing theories as to why banks embraced the market for unconventional high-risk loans. Phil Gramm, a former Republican chairman of the Senate Banking Committee and one of the leading architects of repealing the Glass-Steagall Act, blames GSEs and affordable-housing goals established in the 1990s.¹⁴⁰ Like Wallison, Gramm blames policies designed to extend credit to historically underserved communities associated with the Community Reinvestment Act (CRA) for deteriorating underwriting standards. According to this narrative, government intervention created incentives for financial institutions to originate unrealistic mortgages to un-creditworthy borrowers. On the surface this account sounds logical and convincing. As Peter Wallison notes, “from 2005 to 2007, Fannie and Freddie bought approximately $1 trillion in subprime and Alt-A loans, amounting to about 40 percent of their mortgage purchases.”¹⁴¹ Put differently, Wallison argues that by the time the crisis was triggered, nearly half of all mortgages in the United States financial system were subprime or other low quality, high-risk instruments, and that because the GSEs repurchased mortgages from originators of all types, over 70 percent of these low quality mortgages were on the books of the GSEs like Fannie and Freddie.¹⁴² From this perspective government intervention via tighter CRA requirements and affordable-housing regulations “sparked the subprime-lending

¹⁴¹ Wallison, “Housing Initiatives and Other Policy Factors,” 177.
¹⁴² Ibid, 177-179
boom, helped inflate the housing bubble, and magnified the effects” once the bubble burst.\textsuperscript{143}

On the other hand, \textit{New York Times} columnist Joe Nocera offered a concise assessment of Fannie Mae and Freddie Mac as followers, rather than leaders, in the unconventional market, arguing that “Fannie and Freddie got into subprime mortgages, with great trepidation, only in 2005 and 2006, and only because they were losing so much market share to Wall Street.”\textsuperscript{144} While critics like Phil Gramm rely on analysis by the American Enterprise Institute's Peter Wallison and Edward Pinto, which suggests increasing involvement by Fannie and Freddie in “high-risk” subprime loans, critics of Wallison, like Joe Nocera, cite data from David Min of the Center for American Progress that suggests that many of these loans are being unfairly characterized by Wallison/Pinto as “subprime” when they were not really “high-risk” or “true” subprime mortgages.\textsuperscript{145} Min suggests that not only did many of these allegedly “subprime” loans not carry the same overall risk profile Wallison/Pinto imply (as measured in average delinquency and default rates), but that many of the actual high-risk loans outstanding were made to higher-income borrowers and originated by private financial institutions, not the GSEs.\textsuperscript{146} Few dispute that the GSEs were eventually exposed to riskier mortgages, but this begs the question as to the extent to which high-risk mortgages are associated with government policy via GSE mandates, and whether the term “subprime” has been conflated and used to represent any type of loan that was strictly speaking not a

\textsuperscript{143} Ibid, 182.
\textsuperscript{145} Ibid.
\textsuperscript{146} David Min, “For the Last Time, Fannie and Freddie Didn’t Cause the Housing Crisis,” \textit{The Atlantic}, December 16, 2011.
traditional 30 year fixed loan, regardless of default risk. That is, though it is true that Fannie and Freddie eventually held large portfolios of MBS derived from high-risk mortgages, and though it is true that Fannie and Freddie were required by law to meet certain “affordable housing mandates,” it is less clear whether such mandates were the core motivation behind GSEs eventually investing in assets derived from unconventional “riskier” mortgages.

In order to address whether GSEs followed or fueled the “sub-prime” boom, and in order to fully appreciate the importance of a boom in riskier loans, we must clarify what is meant by the terms “conventional” and “unconventional” loans. In order to qualify for a prime or conventional mortgage a borrower would need to put 20% down and have a credit FICO score of 660 or above. Credit scores represent the likelihood that a person will pay back their debts and thus indicate to potential lenders the risk posed by lending. Those who aspired to take out a mortgage but could not put down 20% or did not have a credit FICO score of 660 or above were thus not eligible for prime or conventional mortgages, and instead, if they were willing to pay a higher interest rate, could qualify for an Alt-A or subprime mortgage. The terms of so-called unconventional mortgages varied, but many of these unconventional loans were structured as “teasers” with adjustable rate mortgages (ARMs) where low initial payments would reset to higher levels after a certain period, such as 24-36 months. As already noted, historically low interest rates increased the attractiveness of ARMs, which increased in frequency amongst prime borrowers from 4% in 2001 to 10% in 2003 and 21% by 2004, and among “subprime” borrowers—who were

147 Fligstein and Goldstein “The anatomy of the mortgage securitization crisis,” 50.
148 Ibid, 56.
already heavy users of ARMs—from around 60% to 76%. This is notable given that the Financial Crisis Inquiry Report also observed that serious delinquencies started earlier (in early 2006) and were substantially higher among “subprime” adjustable-rate mortgages when compared with other loan types (roughly 40% by late 2009). It is within this context, as the proportion of “subprime” mortgages in total mortgage finance also increased, that virtually every scholar of the recent crisis claims that “subprime” or unconventional loans were the financial system’s “Achilles heel.”

Given the complexity of the topic, it is useful to be specific when we describe what a rapid compositional shift towards nonconventional loans actually entailed and when this compositional shift happened. Using data from Inside Mortgage Finance regarding residential mortgage organization by type from 1990-2008, Neil Fligstein and Adam Goldstein show that approximately $2 trillion worth of conventional or prime mortgages were bought in 2003 before dropping to $1.35 trillion, by almost 50%, in 2004. Fligstein and Goldstein maintain that this steep decline "reflected neither weakness in the housing market nor slackening demand from the secondary market" where mortgages were securitized, repackaged, and sold as lucrative assets. Rather, they argue "a saturated prime market and an interest rate hike led to a significant drop off in the refinancings which had driven the 2003 boom." This would seemingly mean that while there were institutional investors looking to buy MBSs, those who were originating and packaging MBS lacked enough prime mortgages to sell. Fligstein and Goldstein argue that this underlying condition and

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150 Ibid, 217.
demand from the secondary markets created incentives for loan originators to increase the number of raw mortgages, leading them to "feed the securitization machine" through riskier unconventional loans with various names and terms like Alt-A, subprime, jumbo, and home equity loans. Though this expanded a previously niche market that offered risky loans to people with poor credit histories and/or little in down payments, the tools of securitization and blessings from the credit rating agencies transformed evidently riskier loans into attractive assets that satisfied demand from the secondary markets. This narrative suggests that the compositional shift towards unconventional mortgages was a product of financial innovation in light of a diminishing inventory of prime loans, not governmental housing policy initiatives. This seems convincing in light of Fligstein and Goldstein’s observation that “in 2001 the largest conventional (prime, government-insured) originator did 91% of its origination business in the conventional market,” but “by 2005 the largest conventional originator was doing less than half of its origination business within the conventional sector.”

As Neil Fligstein and Adam Goldstein note, it is useful to discuss residential mortgage organization by type from 1990-2008, as illustrated by Figure 1, in more detail in order to understand the changing composition of the mortgage market. Figure 1 shows that home loans originated by the Federal Housing Administration (FHA) and the Veteran’s Administration (VA)—the only loans with an explicit government guarantee—were never a significant proportion of total originated loans. Though Figure 1 demonstrates that non-conventional loans existed before 2004, conventional or conforming loans are clearly the largest part of the total market. This

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152 Ibid, 48.
meant that from 1990 until 2003 the largest market segment was mortgages for individuals who were willing and able to put down a payment of 20% and were sufficiently creditworthy, as demonstrated by a FICO score of 660 or above. These are what are called “prime” mortgages.

The crucial turning point begins in 2003, when the supply of conventional mortgages peaked before experiencing a rapid decline. It is at this juncture that originators seemingly turned to unconventional, riskier loans in order to feed the securitization-induced demand from secondary markets that required more mortgages to be securitized, repackaged, and sold as assets. As Fligstein and Goldstein put it:

“Beginning in 2003, we begin to see rapid increases in all forms of nonconventional loans as banks began to search out customers. Home equity loans refer to loans made against the value of the equity in a house. These were frequently in the form of a line of credit or a second mortgage. Alt-A and subprime mortgages (sometimes called “B” and “C” mortgages to denote their lower bond ratings) were people with poor credit history or people who lacked the ability to make a large down payment (or sometimes both). Jumbo loans have higher interest rates because the loan amount exceeds a value set by the FHA each year.”

What was also significant about this rapid increase in riskier unconventional loans was that in the 1990s and early 2000s the conventional or prime MBS market was dominated by GSEs. Using data from the 2009 Market Statistical Annual published by Inside Mortgage Finance, Fligstein and Goldstein claim that “beginning in 2001, the portion of the MBS market controlled by “nonagency” banks (i.e. private banks) rose dramatically.” This data suggests that “subprime lending and subprime securitization had long existed as a marginal niche,” but that by 2005 the unconventional market “had moved to the center of the financial sector, massive in

153 Figure 1 can be found on page 80.
154 Ibid, 49.
155 Ibid.
size and populated by the biggest financial firms.”

That the GSEs lost market share to ‘nonagency’ or private banks seemingly corroborates Joe Nocera’s claim the GSEs followed, rather than led, the sub-prime market. Additionally, the timing of this compositional shift raises questions regarding the validity of Wallison’s claim that government intervention spurred riskier lending practices. That “repackaging of nonconventional mortgages” into bonds “became the largest fee-generating business for many investment banks, including Lehman Brothers, Bear Stearns, Merrill Lynch, Morgan Stanley, and Goldman Sachs” and that “Commercial banks and bank holding companies such as Bank of America, Wells Fargo, Citibank, and Countrywide Financial also became deeply involved in all stages of the market” as Fligstein and Goldstein note, suggests that financial institutions seemingly entered this market on their own accord. This emphasizes the growing importance of riskier unconventional loans in the total mortgage finance industry in spite of affordable housing initiatives and the GSEs.

However, these loans were not simply riskier than their prime or conventional counterparts. According to former Chairwoman of the Federal Deposit Insurance Corporation (FDIC) Sheila Bair, these loans:

“were a true parade of horribles: lack of documented income, little if any down payments, steep interest rate adjustments, abusive prepayment penalties, and mortgage payments that frequently exceeded 50 percent of the borrower’s gross income.”

Bair is not alone in her representation of non-conventional loans as fundamentally predatory or her belief that government regulators were too reticent, ignoring what

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156 Ibid.
158 Bair, Bull by the Horns, 49.
she described as the “skunk at the garden party.” As a vocal advocate for consumer financial protection, legal scholar and now Massachusetts Senator Elizabeth Warren has also argued that there was insufficient government regulation in this period to protect the consumer from excessive and deceptive financial risk:

The informal names that subprime mortgage industry insiders gave to exotic mortgage instruments signaled their risks: Liar Loans (loans in which the borrower could claim an income, but never needed to document it); Teasers (also called 2-28s and 3-27s, reflecting two or three years of below-market payments that escalate wildly when the teaser periods is over); and NegAms (low introductory payments that left the borrower owing more—not less—money after a couple of years of payments.160

It is the tales of loans with these sorts of predatory conditions that invariably fuel perceptions that the Wall Street-dominated securitization industry is bloodthirsty, willing to squeeze every penny it can out of borrowers, and responsible for the recent crisis.

Yet if many of these unconventional loans were so horrible—arguably predatory—why were they originated in the first place? Pinning the blame squarely on the government by identifying housing policy initiatives such as the Community Reinvestment Act (CRA), and the GSEs as the major culprits is an incomplete—arguably misleading—analysis. Though all FDIC-insured mortgage-lending banks were required to lower underwriting standards in order to make efforts to lend to the underprivileged in their communities, Richard Neiman, the 43rd Superintendent of Banks for the State of New York, points out that banks subject to the CRA issued only roughly 6 percent of subprime loans.161 A substantial portion of riskier

159 Ibid.
161 Richard Neiman, “Don’t Blame the CRA for Causing the Housing Bubble.” Letter to the editor, Wall Street Journal, December 5 2009
unconventional mortgages were originated by mortgage specialists like Countrywide Financial and New Century Financial, which were outside of the auspices of the CRA. In fact they functioned in a regulatory shadow, hence the term “shadow banking system.” This seems to suggest that riskier lending was the product of market innovation, which brings into question the credibility of the claim that housing policy initiatives are primarily responsible for the rise of high-risk lending practices.

Indeed, Peter Wallison’s argument relies on weak foundations, such as his claim that the federal government is responsible for 19.2 million risky “subprime” mortgages. This is inconsistent with the non-partisan Government Accountability Office’s estimate that there were only 4.58 million subprime and other high risk loans outstanding, with few attributable to the federal government. Wallison’s argument is also weakened by the fact that the growth of “private-label” securitization of mortgages (the primary source of high-risk loans) increased while the market share of GSE or “agency-label” securitization substantially dropped. Additionally, Min notes that there was a “parallel bubble-bust cycle” experienced in commercial real estate, which “does not have affordable housing policies of the sort [for which] he [Wallison] criticizes for Fannie and Freddie.”

It also seems dubious that housing initiatives in the 1990s would be responsible for deteriorated underwriting standards when the rapid compositional shift toward riskier, non-conventional or “subprime” loans occurred curiously and—most importantly—rapidly after 2003. Had government efforts to increase home ownership among minority, low-income, and other underserved groups in the 1990s been a primary factor in the rise of riskier, unconventional loans, then why did the

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162 Min, “For the Last Time, Fannie and Freddie Didn’t Cause the Housing Crisis”
compositional shift towards unconventional mortgages like subprime loans occur only after 2003, as both GSEs market share declined and conventional or prime mortgage originations contracted? Those who blame housing policies fail to offer a convincing answer to this question. This suggests that despite accounting scandals at the GSEs, preferential treatment from the government, and their eventual foray into the subprime mortgage market, the GSEs simply belatedly followed the herd behavior of private firms that were driven by imperfect markets forces and a quest for greater profits.

On the whole, the more complete answer as to why there was a compositional shift towards riskier, unconventional loans is that low interest rates and strong investor demand in secondary markets derived from mortgages created strong incentives for firms to involve themselves in riskier mortgage debt products as the inventory of prime mortgage originations diminished—especially given the inflationary tendencies and conflicts of interest at the private credit rating agencies, which legally enabled financial institutions to fund themselves through short-term debt mechanisms associated with the “shadow banking system.” If the term “market failure” is used to describe scenarios in which the allocation of goods and services by market mechanisms produce socially suboptimal outcomes, then the securitization of dubious loans, lack of transparency in derivatives markets, dismal performance of private credit ratings agencies (i.e. mispriced risk), excessive risk, and inadequate capital cushions associated with the eventual collapse of the financial system seems to

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163 Min, “For the Last Time, Fannie and Freddie Didn’t Cause the Housing Crisis”
be an exceptionally appropriate use of that term. As Stiglitz puts it, “market discipline broke down.”

*Why The Market Failed*

Neil Fligstein and Adam Goldstein note that in 1996 “the top five packagers of mortgage-backed securities held a 24.5 percent market share, whereas in 2007 this rose to 41 percent,” and that “the top ten conduits’ market share in 2007 was 71 percent.” As Fligstein and Goldstein put it, “the significance of these trends is that the dynamics of mortgage-finance markets increasingly became a function of the strategies that these few leading firms pursued.” It is critical to note that these firms took advantage of regulatory changes associated with the repeal of the Glass-Stegall Act, which ended segmented banking, and, as Stiglitz suggests “created ever larger banks that were too big to be allowed to fail,” which “provided incentives for excessive risk-taking.”

Thanks to the rise of the practice of securitization, the longstanding traditional relationship between depositors and borrowers was now broken and layered in complexity. This increasingly large and concentrated financial services sector had begun to view its business as based not on long-term relationships with customers who would borrow and pay off their debts, but instead as based on generating fees from various kinds of economic transactions at every stage of the mortgage process. Banks now could profit from selling mortgages to homebuyers, packaging those mortgages into bonds, selling mortgage-derived assets to investors, and holding on to a sizable part of the MBS where they could earn profit.

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165 Fligstein and Goldstein, “Roots of the Great Recession,” 34-36.
166 Ibid, 36.
from “the lucrative spreads on high yield bonds” funded through borrowed capital acquired at low interest rates.\textsuperscript{169} Put differently, financial innovations, such as Mortgage-Backed Securities (MBS), Collateralized Debt Obligations (CDOs), and Credit Default Swaps (CDSs), “supported never-ending fees, the never-ending fees supported unprecedented profits, and the unprecedented profits generated unheard-of bonuses, and all of this blinded the bankers.”\textsuperscript{170}

The private credit rating agencies kept the delusions going with inflated assets that enabled financial institutions to fund their daily operations through short-term loans associated with an unregulated “shadow banking system.” However, the notion that primes assets could be generated from “toxic” mortgage debt was an entrenched illusion propagated by the complex tools of securitization, conflicts of interest at the credit rating agencies, and the fallacy that housing prices would continue to rise indefinitely. As Nobel-prize winning economist Joseph Stiglitz points out, “it is arithmetically impossible for house prices to continue to rise while the incomes of most Americans are falling, unless the cost of capital continues to fall.”\textsuperscript{171} With interest rates already at extremely low levels, the cost of capital couldn’t continue to fall. The foundation of the financial system, which was an important source of profits in the overall economy, was now increasingly dependent on a series of speculative bets that the housing market would continue to appreciate.

As housing appreciation slowed and defaults rose, this downturn contracted subprime credit availability. Increasingly, borrowers that had relied on the prospect of refinancing to more sustainable mortgages experienced an unexpected reset with

\textsuperscript{169} Fligstein and Goldstein “The anatomy of the mortgage securitization crisis,” 30.
\textsuperscript{170} Joseph Stiglitz, Freefall, 79.
monthly payments skyrocketing to higher and often unrealistic adjustable rates, contributing to more delinquencies, defaults, and foreclosures.\textsuperscript{172} Yet it was not just the borrowers with various unconventional loans that were adversely impacted. The rapid compositional shift towards unconventional loans since 2003 meant that these mortgages with missed payments were securitized and circulating throughout capital markets, such the opaque $62.1 trillion Credit-Default Swap (CDS) market.\textsuperscript{173} By the summer of 2007 higher than predicted foreclosure and delinquency rates on supposedly “safe” mortgage-derived assets would inevitably create a deteriorating economic environment.

In June 2007, Standard and Poor’s downgraded over a hundred previously inflated bonds backed by riskier unconventional mortgages and soon after listed hundred of securities backed by such subprime mortgages as likely to be downgraded.\textsuperscript{174} This mass downgrade subsequently sent tremors through the financial system. The downgrades meant that large, complex financial institutions—like investment and commercial banks—no longer had access to the short-term debt mechanisms associated with the “shadow banking system” that they had grown accustomed to operating on. Forced to return previously OBS\textsuperscript{175}E to their balance sheets, these highly leveraged institutions now found it increasingly difficult to raise sufficient capital to cover their loans and stay afloat.\textsuperscript{175} Uncertainty and the erosion of trust translated into financial panic and inter-bank lending froze. As a result of the

\begin{footnotesize}
\begin{enumerate}
\item Fligstein and Goldstein, “Roots of the Great Recession,” 4.
\item Gjerstad and Smith “Monetary Policy, Credit Extension, and Housing Bubbles, 2008 and 1929,” 124.
\item David Wessel, In Fed We Trust (Three Rivers Press: New York, 2010), 93
\item Fligstein and Goldstein “The anatomy of the mortgage securitization crisis,” 54.
\end{enumerate}
\end{footnotesize}
failures of financial participants, a general credit crunch ensued and the Great Recession began.

The housing downturn and overexposure of “toxic” mortgage liabilities by an increasingly integrated and highly leveraged financial community ultimately froze commercial credit lending because, as Fligstein and Goldstein put it, these deteriorating conditions “imperiled the business of large mortgage specialists” and “began eating into the revenue streams of the commercial and investment banks that had come to rely on fee revenues from their vertically integrated mortgage finance franchises.”176 In the end, the very industrial strategy that enabled private banks to grow the subprime bubble would be the source of its demise. Securitization of unconventional loans had promoted a risk-intensive culture in which complex financial instruments were wrongly perceived as mitigating the prospect of default by spreading risk and presumably diminishing its financial impact. However, while securitizing risky, non-conventional mortgages proved to be a profitable venture so long as housing appreciation continued, the underlying risk was real and the music eventually stopped.

Conclusion

This chapter has demonstrated that the historic crash of 2008 happened because of the specific character of mortgage-securitization—how mortgages, specifically unconventional (and riskier) mortgages, were being sold and financed. Given these extraordinary circumstances, it seems eminently reasonable to believe that the tools of securitization weakened incentives for financial institutions to assess responsibly the credit quality of loans to be securitized, repackaged, and sold around

the globe. Evolving into an unstable and arguably predatory practice that took advantage of households with stagnating or declining real earnings, the excessive levels of debt engineered by firms in the mortgage-securitization market were ultimately borne by the American people when the housing market went sour. As a result, millions of Americans lost their homes, jobs, and livelihoods. Many of the largest subprime lenders and firms at the core of the MBS market before the crisis are now either out of business or absorbed by large conglomerate banks like Bank of America Corporation, JP Morgan & Co., and Citigroup (a firm that, incidentally, lobbied for the repeal of Glass-Steagall to legalize retrospectively the 1998 Citigroup-Travelers Merger). However, it was taxpayer bailouts that kept even these “too big to fail” private financial behemoths afloat.177

The notion that government policy, through housing policy initiatives, cultivated an environment of excessive risk doesn’t pass the test of credibility. Private actors took private actions that undermined the economy. However, the most relevant contribution offered by the government failure hypothesis is that government policy is important. Ironically, it was the deregulatory context in which the financial system was embedded that is most significant. Though we are recovering from what may seem to be a 21st century crisis of capitalism, Karl Polanyi’s The Great Transformation reminds us that capitalism is always embedded in evolving political, regulatory, legal, and ideational contexts, and that the self-regulating market economy is a utopian project. 178 Similarly, Professor Marc Eisner suggests, “one cannot draw some clear line of demarcation between the ‘state’ and the ‘market’ even when

177 Fligstein and Goldstein “The anatomy of the mortgage securitization crisis,” 55.
discussing deregulated industries” since “markets are constituted by policy decisions, even under deregulation.” This is significant because though much commentary regarding the recent crisis shares Congressman Barney Frank’s sentiment that the crisis is an indictment of “America’s three decade-long experiment with radical deregulation,” Eisner is correct in pointing out that this “deregulation” narrative, which is often cited as the reason market discipline broke down, “may veil the important role played by the state even in an era of deregulation.”

I interpret this statement to mean that while we can speak of the erosion of market discipline and call the crisis a market failure or crisis of capitalism, it was government policies that set up the framework within which financial markets operated. The United States federal government chose to prohibit regulation of derivatives, did not reform the institutional arrangement of an “issuer pay” model of compensation for CRAs, and permitted the relaxation of net capital rules for investment banks through the creation of a voluntary Consolidated Supervised Entities Program. Likewise, the Federal Reserve chose to set interest rates too low for too long, saw warning signs that the housing market was becoming a bubble but decided not to intervene, and was too reluctant to use the powers it had to restrain dubious lending practices when the inefficiencies of the subprime market should have been apparent.

Yet while it is true that there is no clear market-state dichotomy, the framework within which markets operated in demonstrated an excessive faith in the self-correcting, efficient nature of markets, which relied on the faulty assumption that the enlightened self-interest of financial participants would be enough to induce

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proper behavior and an efficient market.\textsuperscript{181} The government could have regulated capitalism to contain its inherently unstable nature, but it chose not to, instead relying on reputational mechanisms and naked self-interest, which failed to maintain market efficiency. It is within this context that Stiglitz suggests, “the question today is not \textit{whether} to regulate,” but rather, “whether we have designed a regulatory system that is as efficient and equitable as it could be.”\textsuperscript{182} Indeed, in spite of the utopian arguments that unregulated financial markets are self-correcting and lead to socially optimal outcomes, the absence of rigorous financial regulation created a space for the emergence of a Ponzi mentality that far from self-regulating, culminated in financial implosion. The intellectually (and politically) important issue we will explore next is what motivated the state to conduct this “neoliberal” deregulation of financial markets, which evidently did not live up to its utopian promise.

\textsuperscript{181} Wessel, \textit{In Fed We Trust}, 50-66.
Figure 1:

Chapter 3:
The Age of “Neoliberalism”

“We all are, or at last were until recently, certain of one thing: that the leading ideas which during the last generation have become common to most people of good will and have determined the major changes in our social life cannot have been wrong. We are ready to accept almost any explanation of the present crisis of our civilization except one: that the present state of the world may be the result of genuine error on our own part and that the pursuit of some of our most cherished ideals has apparently produced results utterly different from those which we expected.”

- Friedrich Hayek, The Road to Serfdom

The ideas of the ruling class are in every epoch the ruling ideas: i.e., the class which is the ruling material force of society, is at the same time its ruling intellectual force.

-Karl Marx, The German Ideology

Since the 1980s, and particularly with the end of the Cold War in the early 1990s, a doctrine of “neoliberalism,” also referred to as “market liberalism,” “Thatcherism,” “Reganism,” and a handful of ideological labels generally used to describe the principled belief that “free” markets produce socially optimal outcomes presumably began to dominate the global political economy. Marc Eisner, for instance, uses the term “the neoliberal regime” to describe the mix of policies or popular ideas that characterized the decades following Ronald Reagan’s election.183 This chapter will evaluate the perspective that the proximate causes of the financial crisis should be understood within the context of an age of “neoliberalism.” Daniel Stedman Jones remarked, “The most important reason for the financial crisis was the

direct result of neoliberal policies” that lead to disastrous decisions. Economists Gérard Duménil and Dominique Lévy concluded that the recent financial meltdown and subsequent recession constitute “the crisis of neo-liberalism.” Economist Thomas Pally links the Great Recession to “the failings of the neoliberal policy program” that emerged in the United States around 1980. The commonality between these views is the perspective that “neoliberalism” is associated with a broad set of fatally flawed economic ideas, a political and economic philosophy or ideology that has increasingly influenced economic policymaking, e.g. by encouraging financial deregulation, since the 1980s. This chapter will evaluate the claim that the recent crisis constitutes the “crisis of neoliberalism,” explore competing understandings of what “neoliberalism” is, and analyze the difference, if there is any, between liberalism and “neoliberalism.” In doing so, I will examine the claim that regulation did not keep pace with financial innovation because of ideological adherence to a “neoliberal” political economic framework of ideas and standards.

**What is Neoliberalism?**

There is growing literature on “neoliberalism” in the social sciences that traces broad transformations in the global economic system, focusing on the supposed international turn beginning in the 1970s towards unfettered markets and minimal state intervention. As political scientist Rachel Turner has pointed out, the term “neoliberalism” is used with lazy imprecision in both popular debate and academic

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Economic historian Daniel Stedman Jones suggests the term “neoliberalism” has “become divorced from its complicated and varied origins. It is too often used as a catch-all shorthand for the horrors associated with globalization and recurring financial crises.” Similarly, Stephanie Mudge suggests, “Neo-liberalism is an oft-used term that can mean many different things.” According to Mudge, “neo-liberalism is a sui generis ideological system born of historical processes of struggle and collaboration in three worlds: intellectual, bureaucratic, and political.” Mudge suggests that the intellectual face emphasizes “the (disembedded) market as the source and arbiter of human freedoms,” that the bureaucratic face is expressed in state policy: liberalization, deregulation, privatization, depoliticization, and monetarism,” and that “its political face is a new market-centric ‘politics’” which is often “oriented towards certain constituencies (business, finance, and white-collar professionals) over others (trade unions, especially).” The unifying principle between these various “faces” is, as Mudge puts it, “the superiority of individualized, market-based competition over other modes of organization.” The manifestation of neoliberalism’s various “faces” in the decades leading up to the crisis might then be understood as the reduced role of state interventions in regulating the economy, and a political preference for cutbacks in social services, stable currencies, sound finance, and balanced budgets.

188 Stedman Jones. Masters of the Universe, 2.
190 Ibid, 704.
191 Ibid, 705.
192 Ibid, 706-707
However, the use of labels to describe “isms” is complicated—especially when many of these labels contain the prefixes neo, new or post—and can have different meanings depending on where one is located on the globe. Colin Crouch remarks:

‘Liberalism’ is about as slippery as a political term can be. Today it tends to move to the political left as one heads westwards. In Europe, and especially in the former state-socialist countries of central and Eastern Europe, it is associated with political parties that stand for the strict application of market principles to economic life, as well as for extensive civil liberties. The former is normally associated with the political right, the latter with the left. In the USA it tends to refer to the political left in general; this shares the European commitment to civil liberties and criticism of any political power exercised by organized religion, but is diametrically opposite to this tradition when it comes to the market. American liberals are likely to believe in government intervention in the economy, the opposite of the usual and historical meaning of the term.\(^{193}\)

Crouch suggests that part of this confusion is rooted in the liberal tradition splitting into two distinct traditions: a *social* tradition that demanded rights and freedoms but was sympathetic to expanding the right to live free from poverty, which often found itself in the company of the socialist tradition by paradoxically leaning on liberal’s old enemy, the state, for help; and an *economic* tradition that safeguarded liberties associated with of property-ownership and market transactions, which increasingly found itself united with old conservative enemies to defend “authority and property ownership of all kinds from attack, particularly from democracy.”\(^{194}\)

By the time of the Second World War, *economic* liberalism had seemingly “brought the world to major depression,” instigating the rise of Hitler in Nazi Germany and the autocratic state socialism of the Soviet Union. After the war, as Crouch puts it, “it seemed that the original liberal vision of an economy governed by

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\(^{194}\) Ibid, 4.
the market with minimal state involvement was dead.”195 But the ideas of economic liberalism never truly disappeared, as strong property rights, minimal regulation and low taxes “remained extremely attractive to very wealthy people, who were always available to fund economic liberalism’s intellectual projects and keep its protagonists going during the lean years.”196 As the Cold War waged on and the true conditions of life under state socialism became general knowledge, there was heightened skepticism and fear of state power. Crouch suggests that this was particularly true in the United States, where “a wing of political opinion that identified virtually all government action in economy and society with communism, and sought tough action to root out from public life all people who might be associated with such tendencies” emerged in the McCarthy era of the 1950s.197 It was a peculiar juncture in American history in which “the defense of economic liberalism had become highly illiberal,” even further confusing economic and social concepts.198 But it is within the enduring legacy of the intellectual origins of liberalism, “that fundamental preference for the market over the state as a means of resolving problems and achieving human ends” that “neoliberalism,” and its resurgent popularity since the late 1970s, is typically understood.199 As Mudge puts it, the “neo” in neoliberalism thus “refers to a revival of a set of ideas” from the eighteenth and nineteenth-century, which were “re-tooled to fit the institutions and politics of the late post-war environment and updated with the concepts and technologies of an increasingly competitive and mathematical economics profession.”200

195 Ibid, 5.
196 Ibid, 6.
197 Ibid
198 Ibid
199 Ibid, 7.
200 Mudge, “What is Neo-Liberalism?”, 714.
In *A Brief History of Neoliberalism*, Marxist Geographer David Harvey suggests that neoliberalism “proposes that human well-being can best be advanced by liberating individual entrepreneurial freedom and skills within an institutional framework characterized by strong private property rights, free markets, and free trade.” If liberalism is a murky concept as we have already demonstrated, so too must be “neo” liberalism. Yet if liberalism, in the European sense, is understood as *laissez-faire* capitalism, the alleged abstention by governments from interfering in the workings of free market, “neo-liberalism” can be understood as the “neo” or re-emergence of *laissez-faire* principles, with the caveat that the state plays a central role in ensuring free market competition. As Harvey puts it:

State interventions in markets (once created) must be kept to a bare minimum because, according to the theory, the state cannot possibly possess enough information to second-guess market signals (prices) and because powerful interest groups will inevitably distort and bias state interventions (particularly in democracies) for their own benefit.

It may seem obvious that markets are embedded within political processes, but as Marc Eisner notes much academic attention reinforces “the illusion that there is a clear market-state dichotomy, a line of demarcation between two realms of human action governed by their own internal logics.” This may be a reason that debates over whether the financial crisis should properly be understood as a market failure or government failure are all the more complex, and it is for this reason that there may be confusion between the difference, if there truly is one, between neoliberalism and classical liberalism.

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202 Ibid.
In Milton Friedman’s essay, “Neo-liberalism and Its Prospects,” published in 1951, he argued that the rise of “collectivist ideas” as a response to the Great Depression illustrated a basic weakness in classical liberalism:

The collectivist belief in the ability of direct action by the state to remedy all evils is itself, however, an understandable reaction to a basic error in 19th century individualist philosophy. This philosophy assigned almost no role to the state other than the maintenance of order and the enforcement of contract.204

Suggesting that *laissez-faire* policies suggested that “the state could do only harm,” Friedman called for a new theory of liberalism, a “neo” liberalism, that would

Accept the nineteenth century liberal emphasis on the fundamental importance of the individual, but it would substitute for the nineteenth century goal of *laissez-faire* as a means to this end, the goal of the competitive order. It would seek to use competition among producers to protect consumers from exploitation, competition among employers to protect workers and owners of property, and competition among consumers to protect the enterprises themselves.205

Importantly, as Friedman pointed out:

The state would police the system, establish conditions favorable to competition and prevent monopoly, provide a stable monetary framework, and relieve acute misery and distress. The citizens would be protected against the state by the existence of a free private market; and against one another by the preservation of competition.206

Though Friedman would later abandon using the term “neoliberalism,” his conception of a new liberalism mirrored Hayek’s view that “probably nothing has done so much harm to the liberal cause as the wooden insistence of some liberals on certain rules of thumb, above all the principle of *laissez-faire.*”207 Aware of why the liberal tradition had gone out of political fashion in the wake of the extraordinary market malfunction known as the Great Depression, this “neo” liberalism aimed to correct the mistakes of

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204 Milton Friedman, “Neo-liberalism and Its Prospects,” *Farmland* 17 (February 1951).
205 Ibid.
206 Ibid.
laissez-faire while challenging the trend toward collectivism, sharing Hayek’s belief that “collectivism” endangered “respect for the individual man qua man.” 208

If the rise of “collectivism” is understood as a response to the limitations of laissez-faire capitalism, “neoliberalism” might be understood as a counter movement to the expanded role of the state in economic life in the postwar era—Franklin Delano Roosevelt’s New Deal, Johnson’s Great Society, and Soviet central planning alike. Indeed, Friedrich Hayek, whom Daniel Stedman Jones considers a father of neoliberalism, used The Road to Serfdom as a warning that the replacement of “the impersonal and anonymous mechanism of the market” with the belief the “society should be ‘consciously directed’ to serve particular ends,” a belief that would seemingly invite frequent government intervention in markets, constituted “an entire abandonment of the individualist tradition which has created western civilization.” 209 Failure to grasp “neoliberal” ideology outside of a philosophical system concerned with the growing power of the state and threat of totalitarianism in the twentieth century is a mistake, for as Harvey puts it “the assumption that individual freedoms are guaranteed by freedom of the market and of trade is a cardinal feature of neoliberal thinking, and it has long dominated the US stand towards the rest of the world.” 210 Indeed, America’s stance during the Cold War against the centrally planned Soviet Union was never simply a geopolitical rivalry, but rather a competition over how best to organize society.211

It is within this context that Daniel Stedman Jones suggests that “neoliberal”

208 Ibid, 68.
209 Ibid, 73.
210 Harvey, A Brief History of Neoliberalism, 7.
intellectuals were “foot-soldiers in the fight against communism” and provided an intellectual challenge to the status quo:

In the 1950s and the 1960s, neoliberal thought established a distinct and coherent identity. Its basic concerns—individual liberty, free markets, spontaneous order, the price mechanism, competition, consumerism, deregulation, and rational self-interest—had come together in the ideas of a group of European and American economists and philosophers who developed a radical individualism that broke with the liberalisms of the past […] They saw themselves fighting the Cold War and defending their vision of the free society. Their ideas were in direct opposition to the dominant political projects of the 1950s and 1960s as well: JFK’s New Frontier, LBJ’s Great Society.212

If “neoliberalism” had a distinct and coherent identity, as David Kotz and Terrence McDonough suggest it was “a free-market version of neoclassical economic theory, associated with such names as Milton Friedman, Friedrich Hayek, and Ronald Coase.”213 But if “neoliberalism” was on the sidelines, in direct opposition to the “dominant political projects of the 1950s and 1960s,” as Stedman Jones puts it, and “neoliberalism” is also to blame for the recent crisis, it is critical to understand the presumed ascendance of “neoliberalism” as a dominant political force.

**The Neoliberal Breakthrough:**

One of the difficulties in explaining the alleged “neoliberal breakthrough” is that not all understandings of “neoliberalism” converge. Though “neoliberalism” has been invoked to mean a principled belief that unfettered market mechanisms always lead to socially optimal outcomes, Mudge importantly points out that “neo-liberal reforms do not imply ‘retrenchment’ or elimination of state bureaucracies. Rather, they imply the creation, one might say, of the ‘neo-liberal state.’”214 Mudge describes

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212 Stedman Jones. *Masters of the Universe*, 131-132
213 David M. Kotz and Terrence McDonough, “Global Neoliberalism and the Contemporary Social Structure of Accumulation,” in *Contemporary Capitalism and its Crises: Social Structure of Accumulation Theory for the Twenty-First Century*, Terrence McDonough, Michael Reich, and David M. Kotz (eds), (Cambridge University Press, 2010), 93-120.
214 Mudge, “What is Neo-Liberalism?”, 718.
this in the context of political elites contending “with the basic question of ‘how much market’ as opposed to the Keynesian era question of ‘how much state.’”\textsuperscript{215} It has also been noted that “neoliberalism” in practice deviates from neoliberal intellectual orthodoxy (the persistence of protectionist policies and corporate welfare for industries such as energy, pharmaceuticals, agribusiness, etc.).\textsuperscript{216} The Marxist tradition suggests that such deviations from neoliberal theory and practice reflect how neoliberal theory provides “a benevolent mask full of wonderful-sounding words like freedom, liberty, choice and rights, to hide the grim realities of the restoration or reconstitution of naked class power.”\textsuperscript{217} However, in spite of the apparent lack of a consensus regarding what “neoliberalism” means, “neoliberalism” or the “neoliberal regime” has become a term used to describe the mix of policies or popular ideas that characterized the decades following Ronald Reagan’s election.\textsuperscript{218}

Such understandings of “neoliberalism” typically rely on the assumption that both Keynesian macroeconomics and faith in government grew out of political fashion simultaneously. As Daniel Stedman Jones suggests, the neoliberal breakthrough occurred in the period from 1971-1984:

Economic crisis led to the breakthrough of transatlantic neoliberal politics in the 1970s. As Britain and the United States experienced stagflation—the combination of high unemployment, high inflation, and low or no growth—political leaders and policy makers, for the first time since World War II, cast around for serious alternative economic policies to Keynesian demand management. The end of the Bretton Woods international monetary system, two oil price shocks in 1973 and 1979, the Vietnam War, the Watergate break-in at the Democratic Party headquarters in Washington, D.C., at the behest of senior figures of the Nixon administration and with the president’s complicity in its cover-up, Britain’s International Monetary Fund (IMF) loan of 1976, the virtual collapse of British industrial relations, and the failure of the prices and income policies that were supposed to fight inflation in both

\textsuperscript{215} Ibid, 724.
\textsuperscript{216} Harvey, \textit{A Brief History of Neoliberalism}, 77.
\textsuperscript{217} Ibid, 119
countries all created a policy vacuum into which neoliberal ideas flowed.\textsuperscript{219} Most accounts of the emergence of a “neoliberal regime” in the USA suggest that a transatlantic network of politicians, activists, media figures, think tanks, sympathetic businessmen, academics, and journalists used this “policy vacuum” as an auspicious opportunity to advance a form of “neo” liberalism at odds with the dominant but now increasingly vulnerable “collectivist” policies that had been ideological extensions of Franklin Delano Roosevelt’s New Deal.\textsuperscript{220} Mudge suggests that this gave rise to a “neo-liberal policy repertoire” that consisted of “\textit{privatization} of public firms,” the “\textit{separation of regulatory authority} from the executive branch” (i.e. a politically independent central bank), “the \textit{depoliticization} of economic regulation” by “insulating regulatory authorities from political influence,” the “\textit{liberalization} of the domestic and international economy” and “monetarism,” which she describes as “manipulation of the supply of money rather than demand management via fiscal intervention.”\textsuperscript{221}

Stedman Jones suggests that a \textit{perception} that conventional Keynesian macro-economic wisdom was flawed enabled “neoliberal” economic ideas such as monetarism, deregulation, and market-based reforms to rise to political fashion.\textsuperscript{222} As a result, “the long-standing commitment in the US liberal democratic state to the principles of the New Deal, which meant broadly Keynesian fiscal and monetary policies with full employment as the key objective,” as Harvey suggests, were “abandoned in favor of a policy designed to quell inflation no matter what the

\textsuperscript{219} Stedman Jones. \textit{Masters of the Universe}, 215.  
\textsuperscript{220} Ibid.  
\textsuperscript{221} Mudge, “What is Neo-Liberalism?”, 718-719.  
\textsuperscript{222} Ibid.
consequences might be for employment.”

In order to make sense of this, Stedman Jones specifically suggests that governments in the US and UK, in particular, were receptive to certain technical policy adjustments to combat inflation known as Monetarism. But as Stedman Jones notes:

“what might have been a limited adjustment to the way governments managed macroeconomic policy, with some necessary microeconomic reforms thrown in for good measure, became a fundamental move to a new political culture dominated by the free market. This latter idea helped breed a culture that led to financial disaster in 2007-10.”

According to this narrative “neoliberalism” emerged as a dominant force because monetarist belief that the money supply should be the primary means that governments use to moderate fluctuations of a national economy began to replace the Keynesian macroeconomic notion that monetary and fiscal intervention ought to be used to tame the business cycle.

This was in part because the academic boundaries between the Keynesian demand framework and monetarist approaches were sometimes “blurred,” a “confusion” which, Stedman Jones suggests, stemmed in part from the fact that monetarism technically “operated within the macroeconomic framework set up by Keynes.” Amidst this “confusion” between those who emphasized fiscal policy and those who emphasized monetary policy as the most appropriate solution to the particular problem of inflation, “neoliberalism” presumably ascended. Stedman Jones suggests that this is because the elite driven transatlantic network that advocated monetarist policies emphasized budgetary restraint and a move away from countercyclical public spending, which was officially at odds with the now politically vulnerable “collectivist” (or socially liberal) interventions associated with the New

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223 Harvey, A Brief History of Neoliberalism, 23.
Deal/New Frontier/Great Society. Indeed, as David Kotz and Terrence McDonough put it, “neoliberalism is marked by glorification of individual choice, markets, and private property; a view of the state as inherently an enemy of individual freedom and economic efficiency; and an extreme individualist conception of society.” Wrapped in the rhetoric of libertarian philosophers and free-market neoclassical economics, the re-emergence of the self-correcting, efficient market, allegedly free from political interventions, was presumably reborn.

Is Neoliberalism Responsible for the Crisis?

If “neoliberalism” is synonymous with libertarian minded neoclassical economic theory, such as the Chicago school of economics, then the efficient financial markets hypothesis and general skepticism with the notion that government intervention might correct market failures in theory support “neoliberal” ideology. Financial markets are presumed efficient and the enlightened self-interest of financial institutions renders rigorous external regulation of financial markets unnecessary. Those who blame “neoliberal” ideology for the recent crisis suggest that “neoliberal” (ie the Chicago school) economic logic, popular post-1970s, justified the “deregulation” of financial markets. Of course, the Securities and Exchange Commission was not abolished, the Federal Reserve continued to exist, the Federal Deposit Insurance Corporation (FDIC) still insured commercial banks, and the Commodity Futures Trade Commission still received funding. But President Carter signed the Depository Institutions and Monetary Control Act in 1980, which relaxed financial restrictions on banks, broadening their lending powers. President Ronald

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224 Stedman Jones. Masters of the Universe, 270.
225 Ibid, 248.
226 Ibid.
Reagan signed the Garn-St. Germain Depository Institutions Act in 1982, allowing banks to offer adjustable rate mortgages. Perhaps most significantly, President Clinton repealed Glass-Steagall, ending the so-called firewall between investment banking and commercial banking, which permitted banks to use their customers’ deposits for high-risk trading activities and permitted the establishment of mega-banks through mergers that critics cite as responsible for “too-big-to-fail.” President Clinton also signed the Commodity Futures Modernization Act, which prohibited regulation of the emerging derivatives market central to the recent crisis. Additionally, the Federal Reserve didn’t restrain the dubious mortgage lending practices that contributed to “toxic” assets circulating in capital markets. This is what is often meant by “deregulation” by those who blame “neoliberalism” for the economic crisis, which more precisely refers to regulation not keeping pace with financial innovation, presumably under the assumption that market or market-like competition is preferable to bureaucratic regulations.

As Mudge suggests, neoliberalism prioritizes the question of ‘how much market’ over ‘how much state,’ but not the actual elimination of state bureaucracies.228 It is within this context that blaming “neoliberalism” for the economic crisis seems coherent. Neoliberalism, according to this narrative, rose to power based on its academic merits. It is true, as Marc Eisner notes, that from the 1950s onward academic research, such as regulatory capture, public choice, and rational choice theory, increasingly “portrayed regulatory techniques as inefficient or even counter-productive, helping to create the intellectual foundation for wide-

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227 Kotz and McDonough, “Global Neoliberalism and the Contemporary Social Structure of Accumulation,” 93-120
228 Mudge, “What is Neo-Liberalism?”
ranging moves to deregulate markets” since the 1970s. It is also true that a number of Nobel Prizes were awarded to “neoliberal” economists, most notably Hayek and Friedman in the 1970s. When critics blame this conception of “neoliberalism” for the recent economic crisis, they more or less view the economic doctrines associated with “neoliberalism” as untenable, primarily because it implicitly elevates the market in a manner that, from their vantage point, is simply unmerited.

What does it mean to say that an economic doctrine is unmerited? To answer this question we ought to evaluate the financial regulatory debates of the past decades down to a simple but powerful idea: whether the economic notion that unfettered markets, and particularly unfettered financial markets, lead to efficient outcomes is sound. Those who blame “neoliberalism” for the recent crisis suggest that since the 1970s the belief that markets are self-correcting and efficient was the folk wisdom of the age. The crisis thus presumably offers a unique occasion to reflect on the set of “dominant” economic beliefs that structured the relationship between the market, the state, and civil society in recent years. Reflecting on the state of economic beliefs in the aftermath of the global financial crisis, David Gruen of the Australian Treasury stated that:

It was as if, as the Titanic was sailing into iceberg-infested waters, those with the requisite skills and training to warn of the impending danger were instead hard at work, in a windowless cabin, perfecting the design of ship hulls…for a world without icebergs.

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230 Stedman Jones, Masters of the Universe, 338.
Gruen’s remarks were intended as a “wake-up” call to an economic discipline and public policy apparatus that in the lead-up to the crisis had seemingly gone astray, and, from the perspective of Gruen, fundamentally misunderstood how the world truly works. Gruen’s metaphor can be interpreted as a forceful plea for economists to adhere to macroeconomic theory that is “firmly grounded in the real-world behavior of markets” instead of the ideas of defunct economics, the “world without icebergs” that mainstream economists and financial lobbyists seemingly inhabited. It was an impassioned plea for economists and policy makers to move away from unrealistic principles, such as the popular “neoliberal” notion—common in the years before the crisis—that financial markets could take care of themselves, that financial regulation was unnecessary or undesirable because the enlightened self-interest of lending institutions would incentivize market participants to act both responsibly and ethically and avoid the temptation of making wild speculative bets that sooner or later would burst like a bubble.

Yet there is a puzzling irony in this story. In 1998 the Federal Reserve under the leadership of Alan Greenspan, supposedly a figurehead of “neo-liberalism,” bailed out the hedge fund Long Term Capital Management—whose leveraged investments were financed by loans from major Wall Street and international banks, thus raising concerns about systemic collapse. LTMC was co-founded by Robert Merton and Myron Scholes, Nobel-Prize-winning economists who developed the advanced mathematical Black-Scholes model that allegedly provided a sophisticated risk-management paradigm that justified the pendulum swing towards self-regulation in contemporary finance. As we now know, in extreme, rare events, the revered risk-

\[\text{Ibid.}\]
management model seemed to fail. The models underlying derivative pricing and risk management led to nearly $100 billion in potential losses for LTMC in the midst of the Asian financial crisis, but in spite of the “neoliberal” notion that markets were supposed to adequately police themselves, Federal Reserve Chairman Greenspan defended LTMC’s rescue:

Had the failure of LTCM triggered seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own.²³³ Greenspan’s comments suggested that derivative markets, which were unregulated, could pose serious negative externalities absorbed by the rest of society. This would suggest that the market was not efficient. Oddly enough, though this should have been a red-flag leading to calls for regulation, Greenspan, the Clinton Treasury Department, and congressional leaders proceeded to advocate a ban on derivatives regulation. In 2003, after large-scale losses on derivative bets had already induced the LTCM bailout, Greenspan said:

Critics of derivatives often raise the specter of the failure of one dealer imposing debilitating losses on its counterparties, including other dealers, yielding a chain of defaults. However, derivative market participants seem keenly aware of the counterparty credit risks associated with derivatives and take various measures to mitigate those risks.²³⁴ Greenspan’s comments reflected remarkable faith in risk-management at the individual firm level in spite of the widespread use of a model that seriously mispriced tail risk—which refers to low-probability events that generate large losses should they arise. Of course, when the Commodity Futures Modernization Act was

passed and signed in late 2000 by President Bill Clinton, the ban on derivatives regulation, such as credit default swaps, became the law of the land.

Now the reason I said that this is ironic is that in spite of the “neoliberal” belief that markets are efficient and self-correcting, which justified deregulation, there was no substantial movement to abolish the Federal Reserve or FDIC. However, by setting the precedent of insurance (i.e. bailouts) the government was effectively facilitating conditions of moral hazard, which is a characteristic of market failure. This is why a corollary of insurance is typically regulation. Perhaps “neo-liberal” policy only works if adopted uniformly, which would have required the elimination of the Federal Reserve, the FDIC, etc., but going half way seemed to be worse. For instance the 1998 bailout of Long Term Capital Management (LTCM), effectively legitimized that notion that some financial institutions were simply too big or interconnected to fail without bringing the entire system to a screeching halt. As John Quiggin puts it, the LTCM rescue package orchestrated by the U.S. Federal Reserve taught financial market players an important lesson: the existence of the “Greenspan put.”

As Quiggin defines it:

A put is a kind of option allowing you to sell a stock at an agreed price on a given date. In effect, the holder of a put has a one-way bet on the stock they own. If it goes up, they sell the stock on the market and collect the profits. If it goes down, they exercise the put option and collect the agreed price.

However, as Quiggin puts it, what was “special about the Greenspan put was that it was free. The treatment of LTCM showed that, if financial markets ever got into really serious trouble, the Federal Reserve would bail them out.”

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236 Ibid.
237 Ibid.
many financial institutions were making the same bet that housing prices would continue to rise, large holdings of risky subprime derived assets wouldn’t seem to constitute “excessive” risk—at least from the perspective of the “too-big-to-fail” financial institution that knew someone else would have to cover their losses.

As a result, when the recent financial crisis struck, perhaps those ‘keenly aware’ of the risk thought they would be bailed out like LTMC. Perhaps ‘taking measures to mitigate those risks’ was simply presuming or embracing that one’s institution was “too-big-to-fail.” This is the view suggested by Harvard Law Professor Lawrence Lessig, who claims “the behavior we saw—from borrowers to lenders to Wall Street to government officials—was perfectly rational, for each of them considered separately. It was irrational only for the system as a whole.” Others have suggested that the widespread ideology embraced by Greenspan was flawed and that it was a downright folly to think financial market participants would, on their own, avoid excessive risk. What is clear, however, is that in the aftermath of the global financial crisis, institutional and light regulatory arrangements coupled with what amounted to federal insurance had produced suboptimal results. It is now apparent—at least to those paying attention—that deregulation of the financial services sector while maintaining the solvency of financial institutions can and indeed does threaten the stability of the entire financial system.

This leads me to the most insightful part of Gruen’s metaphor: that it was “those with the requisite skills and training to warn of the impending danger,” that gave credibility to the dubious, but influential belief that financial market players

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238 Lawrence Lessig, Republic Lost (New York: Twelve, 2011), 68.
would sufficiently self-regulate themselves and avoid excessive risk. It was the ‘experts’ and ‘intellectuals’ whom civil society should trust and expect to get economics “right” that gave credence to what John Quiggin refers to as “zombie ideas,” a term used to categorize economic ideas that remain influential in spite of apparent logical inconsistencies and empirical failures, that presumably produced the recent crisis. If “neoliberalism” is understood as a euphemism for the mainstream economic thoughts presumed infatuation with efficient markets, Gruen’s analogy resembled a wholesale rejection of “neoliberalism.” In a sense, this criticism seems valid. One can make the case that “neoliberalism” provided the implicit economic rationale behind The President’s Working Group on Financial Markets 1998 report entitled “Over-the-Counter Derivatives Markets and the Commodity Exchange Act,” a report signed and submitted by the chairman of the Securities and Exchange Commission, the chairman of the Commodity Futures Trading Commission and, most notably, Treasury Secretary Lawrence Summers and Federal Reserve Chairman Alan Greenspan. Thus, when the President’s Working Group on Financial Markets submitted a final report suggesting that “to promote innovation, competition, efficiency, liquidity, and transparency in OTC derivatives markets,” to “reduce systemic risk,” and “to allow the United States to “maintain leadership in these rapidly developing markets” derivatives should be exempted from all federal regulation, the report seemed to have credible economic credentials. As those who blame “neoliberalism” for the recent crisis would likely point out, these credible credentials were “neoliberal” credentials. They advanced the belief that government

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239 Quiggin, Zombie Economics.
cannot possibly possess enough information to second guess-market signals or participants, and that it is the self-interest of freely choosing sophisticated financial participants that make financial markets efficient to begin with.

Commenting upon this pervasive expectation that the self-interest of Wall Street firms would be enough to induce proper behavior and an efficient market, Judge Richard Posner retrospectively writes:

That was a whopper of a mistake for an economist to make. It was as if the head of the Environmental Protection Agency, criticized for not enforcing federal antipollution laws, had said he thought the self-interest of the polluters implied that they are best capable of protecting their shareholders and their equity. They are indeed the best capable of doing that. The reason for laws regulating pollution is that pollution is an external cost of production, which is to say a cost not borne by the polluting company or its shareholders, and in making business decisions profit maximizers don’t consider costs they don’t bear. Banks consider the potential costs of bankruptcy to themselves in deciding how much risk to take but do not consider the potential costs to society as a whole.241

Indeed, this ‘whopper of a mistake’ became apparent when society as a whole bore the cost of financial participants excessive risk-taking activity in the form of repeated taxpayer bailouts. The global financial meltdown that began in the United States in the summer of 2007 demonstrated that these over-the-counter speculative bets were pervasive, non-transparent, and—because they were unregulated and often connected to dubious underlying mortgages—ultimately toxic. On the eve of the crisis financial participants were not so enlightened and their balance sheets reflected a failure of social responsibility (and arguably ethics, as in the cases of Madoff and other frauds) that imperiled the entire financial system. Rather than spontaneously generating responsibility, trust, and the reduction of systemic risk, lightly regulated financial markets generated systemic imprudence that eventually eroded inter-bank trust and
market confidence as the housing bubble deflated. Asset prices subsequently plunged, credit markets froze, production and investment plummeted, and millions of people all over the world lost their homes and jobs in an extraordinary series of events that resembled John Maynard Keynes’ old warning of what would happen when “the capital development of a country becomes the by-product of the activities of a casino.”

But did these extraordinary series of events occur because of the influence of “neoliberal” ideas? Given the “neoliberal” belief that government attempts to correct market failures by and large make things worse, David Harvey has remarked that “the neoliberal presumption of perfect information and a level playing field for competition” is either “innocently utopian” or “a deliberate obfuscation of processes,” that will lead to the restoration of class power. The most famous commentary cited as evidence of the role of “utopian” ideology in the recent crisis occurred in congressional testimony with the premier symbol of “neoliberal” market fundamentalism himself. On October 23, 2008 Congressman Henry Waxman of California, then Chairman of the Oversight Committee, asked Alan Greenspan if his “ideology” influenced his decision not to curb the explosive growth of risky (and often fraudulent) mortgage lending that, as Chairman of the Federal Reserve, Greenspan had the authority to prevent. A humbled Greenspan famously confessed that he was in a state of “shocked disbelief.” He stated:

243 Harvey, A Brief History of Neoliberalism, 68
I made a mistake in presuming that the self-interest of organizations, specifically banks, is such that they were best capable of protecting shareholders and equity in firms […] I found a flaw in the model that I perceived as the critical functioning structure that defines how the world works.  

To many observers this meant that the “neoliberal” view since the 1970s that an economy in which major decisions are left in the hands of private firms is superior to a mixed economy was proven deeply flawed. The rationalization behind prevailing self-regulatory architecture or “neoliberalism” was proven defective. The logical basis for “neoliberal” policies, such as light financial regulation, now seemed suspect. Most importantly, the largest proponent of the set of “neoliberal” market fundamentalist ideas that underpinned light regulatory arrangements to begin with had seemingly conceded his blunder.

Chicago economist (and 2000 Nobel Prize Winner) James Heckman observed that “[rational expectations] became a kind of tautology that had enormously powerful policy implications, in theory.” Former chairman of the Federal Reserve, Paul Volcker, subsequently remarked “it should be clear that among the causes of the recent financial crisis was an unjustified faith in rational expectations, market efficiencies, and the techniques of modern finance.” The “neoliberal” efficient financial market theories demonstrated that lightly regulated markets generate optimal security prices and risk levels, and preclude booms and crashes. The crisis

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had suggested otherwise, demonstrating that Hyman Minsky’s ignored financial-instability hypothesis seemed prescient. The “neoliberal” perfect financial market paradigm seemed suspect. The “neoliberal” logic that “the parties to these kinds of contracts are largely sophisticated financial institutions that would appear to be eminently capable of protecting themselves from fraud and counterparty insolvencies,” as then Treasury Secretary Larry Summers suggested, seemed retrospectively implausible. The “neoliberal” logic that derivatives regulation was unnecessary because “market pricing and counterparty surveillance can be expected to do most of the job of sustaining safety and soundness,” as Former Federal Reserve Chairman Greenspan had suggested in 1998, seemed fanciful. The crisis of capitalism had seemingly demonstrated that there was a “flaw” in the “neoliberal” model for how the world works.

In “Politics and the English Language” George Orwell famously remarked “political language is designed to make lies sound truthful and murder respectable, and to give an appearance of solidity to pure wind.” But perhaps political language is reliant on economic language to legitimize the belief that the lie is true, make greed sound respectable, and convince even the most critical of observers that wind is indeed somehow solid. When Eugene Fama suggests that prices are right and Alan Greenspan suggests that the self-interest of Wall Street firms is enough to induce them to behave properly, markets seem efficient, bubbles can’t exist, and protective regulation for the benefit of society at large seems unnecessary—and scores of hired

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249 Alan Greenspan, “Testimony Before the House Committee on Banking and Financial Services,” September 16, 1998
250 George Orwell, “Politics and the English Language” Horizon, April, 1946
lobbyists have credibility when they regurgitate the same “neoliberal” economic logic.

As romantic as that story might be, it is unclear that the primary reason regulation did not keep pace with financial innovation is rooted in the academic scribblings of some particularly influential economists and philosophers. It is true that Minsky’s belief that the internal dynamics of capitalism lead to an occasional day of financial reckoning was presumably unaccounted for in the prevailing economic models, and with it the policy implication that it is unwise to trust financial market participants alone, especially when it comes to leverage—that is if the objective is to mitigate systemic risk. It is possible that had the financial-instability hypothesis not been heterodox before the crisis, a different regulatory paradigm would have emerged in which financial regulation (that prohibited excessive leverage, or was upgraded to keep pace with financial innovation) was viewed as necessary rather than unnecessary. But if economic policy is the mere reflection of influential economists, why was Joseph Stiglitz, former chief economist of the World Bank and a former member and Chairman of the Council of Economic Advisors under the Clinton Administration, in this instance ignored?

Far from a marginal economic figure, Joseph Stiglitz has long critiqued “neoliberal” economic orthodoxy. The Nobel-Prize winning economist has suggested that “neo-liberalism” is a “grab-bag of ideas based on the fundamentalist notion that markets are self-correcting, allocate resources efficiently, and serve the public interest well.”251 On the eve of the crisis Stiglitz remarked:

The economics profession bears more than a little culpability [for the global financial and economic crisis]. It provided the models that gave comfort to regulators that markets could be self-regulated; that they were efficient and self-correcting. The efficient markets hypothesis – the notion that market prices fully revealed all the relevant information – ruled the day. Today, not only is our economy in a shambles but so too is the economic paradigm that predominated in the years before the crisis – or at least it should be.\textsuperscript{252}

Stiglitz comes from a tradition that I would term the \textit{imperfect market paradigm}, a school of thought that believes that government ought to play a substantial role manipulating markets that alone are unable to administer socially optimal outcomes. If the economic paradigm that predominated in the years before the crisis is considered a “neo-liberal” paradigm, it is the very paradigm Stiglitz has spent his entire academic career challenging. In fact, in his Nobel Prize lecture in 2001 Stiglitz began his remarks by stating that information economics undermined Adam Smith’s old theory that free markets lead to efficient outcomes. It was a statement that rejected the premise for liberalism’s (and “neoliberalism’s”) view of the minimalist government on economic grounds. Stiglitz suggested that the findings of information economics suggest that the reason that the “invisible hand” is in fact invisible is that “it is simply not there—or at least that if it is there, it is palsied.”\textsuperscript{253}

It is worth quoting Stiglitz’s crucial critique of the dominant or “neoliberal” paradigm that Greenspan, among others, presumably adhered to at length:

Perhaps the most important single idea in economics is that competitive economies lead, as if by an invisible hand, to a (Pareto) efficient allocation of resources, and that every Pareto efficient resource allocation can be achieved through a competitive mechanism, provided only that the appropriate lump sum redistributions are undertaken. It is these (fundamental theorems) of welfare economics, which provide both the rationale for the reliance on free markets, and the belief that issues of distribution can be separated from issues of efficiency, allowing the economist the freedom to push for reforms which

\textsuperscript{253} Joseph Stiglitz “Information and the Change in the Paradigm in Economics”, “Nobel Prize Lecture, December 8, 2001
increase efficiency, regardless of their seeming impact on distribution; if society does not like the distributional consequences, it should simply redistribute income.\textsuperscript{254}

Stiglitz maintained that his findings undermined the perfect market paradigm by demonstrating that markets are inherently unstable and imperfect and thus incapable of producing socially optimal outcomes without government manipulation (i.e. the sort of regulation neoliberals typically and misleadingly dismiss as “collectivist”):

The essential insight of Greenwald and Stiglitz was to recognize that externality-like effects are pervasive whenever information is imperfect or markets incomplete—that is always—and as a result, markets are essentially never constrained Pareto efficient. In short, market failures are pervasive.\textsuperscript{255}

Put differently, though Arrow and Debreu had established the singular set of conditions under which markets were efficient (perfect competition, no externalities, no public goods), there was an implicit assumption that everyone had perfect information, and subsequent theorists “hoped that a world with imperfect information was very much like a world with perfect information.”\textsuperscript{256} Stiglitz’s subsequent work on information asymmetries theoretically demonstrated the pervasive nature of market failures, and the theoretical rationale upon which \textit{in principle} there are government interventions that can be welfare enhancing. What is curious is that though Stiglitz’s work should have weakened “neoliberal” arguments on technical economic grounds, providing a theoretical basis for why government \textit{could} correct market failures, this strand of thought was seemingly ignored.

Perhaps this was simply a product of the marketplace for ideas, in which the imperfect market paradigm simply did not come out on top. As Paul Krugman noted

\textsuperscript{254} ibid.
\textsuperscript{255} Ibid.
in his influential “How Did Economists Get It So Wrong?” column, mainstream finance theorists continued to believe that their perfect financial models “were essentially right, and so did many people making real-world decisions,” such as congressional staffers, legislative directors, elected officials, and so-called policy wonks.\(^{257}\) Indicting the state of the economics profession, the 2008 Nobel Prize-winner Paul Krugman answered the question he posed in his column’s title “How Did Economists Get It So Wrong?” with intensity and flair:

As I see it, the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth. Until the Great Depression, most economists clung to a vision of capitalism as a perfect or nearly perfect system. That vision wasn’t sustainable in the face of mass unemployment, but as memories of the Depression faded, economists fell back in love with the old, idealized vision of an economy in which rational individuals interact in perfect markets, this time gussied up with fancy equations. The renewed romance with the idealized market was, to be sure, partly a response to shifting political winds, partly a response to financial incentives. But while sabbaticals at the Hoover Institution and job opportunities on Wall Street are nothing to sneeze at, the central cause of the profession’s failure was the desire for an all-encompassing, intellectually elegant approach that also gave economists a chance to show off their mathematical prowess.\(^{258}\)

Krugman’s remarks evoke Friedrich Hayek’s 1974 Nobel Lecture warning regarding the Economists “propensity to imitate as closely as possible the procedures of the brilliantly successful physical sciences,” an attempt which he concluded “in our field may lead to outright error,”\(^{259}\) but Krugman’s greatest insight is in regards to the consequence of following these allegedly misguided models, an indictment of prevailing economic vision:

Unfortunately, this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets —

especially financial markets — that can cause the economy’s operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don’t believe in regulation.\textsuperscript{260}

If “neoliberalism” is understood as a euphemism for mainstream economic thought’s blindness to the possibility of market imperfection, as it often is invoked to mean, than Krugman’s appraisal of economics can be understood an indictment of “neoliberal” economic orthodoxy.

But if we truly lived in a “neo-liberal” era as has been proposed, and the intellectual, bureaucratic and political “faces” of “neoliberalism share a common and distinctive ideological core” that elevates the market “over all other modes of organization” as Stephanie Mudge suggests,\textsuperscript{261} why is it that the central guiding principles of economic thought and management, adhered to the vision of retrospectively implausible theories generally framed under the umbrella of “neoliberalism,” as opposed to the vision of those who adhered to an imperfect market paradigm, like Minsky and Stiglitz? One possibility is that though Stiglitz’s work might have weakened “neoliberal” arguments on technical economic grounds, it did not intellectually weaken the “unadulterated emphasis on the market as the source and arbiter of rights rewards and freedoms—and, by extension, its marked disdain for politics, bureaucracies, and the welfarist state.”\textsuperscript{262} As Hayek had put it in \textit{The Road to Serfdom}, “by giving the government unlimited powers, the most arbitrary rule can be made legal; and in this way a democracy may set up the most complete despotism imaginable.”\textsuperscript{263} David Harvey also suggests that the popular legitimacy of “neoliberalism” had to do with the seductive allure of freedom, augmented by the

\textsuperscript{260} Ibid.
\textsuperscript{261} Mudge, “What is Neo-Liberalism?”
\textsuperscript{262} Mudge, “What is Neo-Liberalism?”, 708.
memory of a Cold War against state socialism. As Harvey puts it, “for any way of thought to become dominant, a conceptual apparatus has to be advanced that appeals to our intuitions and instincts, to our values and our desires, as well as to the possibilities inherent in the social world we inhabit,” and framing the market in the rhetoric of freedom and human dignity did just that.\(^{264}\) With fresh memories of Vietnam and Watergate, the reminders of the reality of state socialism, and lack of trust in Keynesian macroeconomics, the imperfect market paradigm, it might be suggested, simply did not have the same appeal. This is the sort of narrative that lends credence to the idea that the election of Ronald Reagan gave birth to a “neoliberal” regime that continued under President Clinton and President Bush, culminating in the financial crisis.\(^{265}\) Yet there are a number of problems with this narrative.

**The Contradictions of Neoliberalism**

As a Senior Fellow for International Finance at the Council on Foreign Relations noted in *Foreign Affairs* back in 1990, “the irony of U.S. trade policy of the 1980s is that President Reagan, the postwar chief executive with the most passionate love of laissez faire, presided over the greatest swing toward protectionism since the 1930s.”\(^{266}\) As Professor Marc Eisner points out, Reagan also promoted the largest peacetime expansion of the military in US history. “In 1981 alone,” Eisner states “inflation adjusted defense spending increased by 17 percent and by 1985, it had increased by 53 percent,” a phenomenon that Eisner dubs “military Keynesianism.”\(^{267}\) But it was not just Reagan that presumably didn’t preside as a “slave” to these so-

\(^{263}\) Hayek, *The Road to Serfdom*, 119.
\(^{264}\) Harvey, *A Brief History of Neoliberalism*, 5.
\(^{265}\) Stedman Jones, *Masters of the Universe*
called “neoliberal” market fundamentalist economists. Professor Christopher Howard has noted that there remains a “hidden side” of the American welfare state, where tax expenditures or “tax loopholes” often are designed to favor particular industries.\footnote{Eisner, The American Political Economy, 124.} The affordable housing policies often blamed for the crisis by the political right are the antithesis of pure neoliberal ideology.\footnote{Christopher Howard, “The Hidden Side of the American Welfare State.” Political Science Quarterly, 108, 3 (Autumn, 1993), 407.} Additionally, despite advocating free markets and free trade, President Bush imposed steel tariffs.\footnote{Peter J. Wallison, “Housing Initiatives and Other Policy Factors” in What Caused the Financial Crisis. Jeffrey Friedman (ed.) (University of Pennsylvania Press, 2011).} In the so-called “age of neoliberalism” America also never defunded the pentagon or NASA. Thus, the notion that the economic crisis is the product of hegemonic “neoliberal” ideas falls in the face of the reality that actually existing “neoliberalism” diverged from its presumed intellectual origins, which seemingly did not have the hegemonic influence in shaping economic policy often alleged. This bipartisan divergence from the narrative of an “age of neoliberalism” constitutes a problem, or it at least creates confusion.

However, this isn’t a problem, nor is it shocking for the Marxist interpretation. Indeed, David Harvey suggests that the neoliberal state’s primary function is to preserve a form of freedom that prioritizes “the interests of private property owners, businesses, multinational corporations, and financial capital,” which means usually, but importantly not always, ascribing to “neoliberal” market fundamentalist orthodoxy.\footnote{Harvey, A Brief History of Neoliberalism, 71.} Yet this caveat is not always explicit in popular debate and academic scholarship, even if it is typically assumed that “neoliberal” policies generally advance the interests of the affluent. Again, this creates confusion. This caveat is
important however, because it changes the way we perceive seeming contradictions, whether they be the U.S. government’s history of bailing out financial institutions to protect them from insolvency (i.e. the 1998 bailout of LTCM), or protectionist policies that distort market mechanisms to aid particular industries (energy, pharmaceuticals, agribusiness, etc.).\textsuperscript{272} The reason this is important is that the Marxist understanding (i.e. Harvey’s) of neoliberalism suggests that ideology has always been ancillary to the primary project to restore the interests of capital.\textsuperscript{273}

Think about what this means. It is not difficult to believe that Chicago school or Hayekian arguments might be used to advance special interests through deregulatory policies, but it is difficult to use Chicago school or Hayekian arguments to justify a variety of domestic energy investment and production tax subsidies for oil companies that began with a fledgling oil industry back in 1916 yet continued well into the so-called “neoliberal” era (and continue today).\textsuperscript{274} But the contradiction goes beyond just the persistence of protectionist policies for industries such as energy, pharmaceuticals, agribusiness, and steel. As Harvey notes,

> While the virtues of competition are placed up front, the reality is the increasing consolidation of oligopolistic, monopoly, and transnational power within a few centralized multinational corporations: the world of soft-drinks competition is reduced to Coca Cola versus Pepsi, the energy industry is reduced to five huge transnational corporations, and a few media magnates control most of the flow of news.\textsuperscript{275}

Increased size and concentration of markets by a few dominant players in spite of the ideal competitive order dreamed by the likes of Hayek was also true in the financial services sector, which in part leads Harvey to the conclusion that “neoliberalism” is

\textsuperscript{271} Ibid, 7.
\textsuperscript{272} Ibid, 77.
\textsuperscript{273} Ibid, 73.
“a failed utopian rhetoric masking a successful project for the restoration of ruling-class power.” Put differently, “neoliberalism” becomes understood as an intellectual project used when necessary to support the interests of the business and financial community, of capital. This is possible because, as Harvey suggests, “the production of ideas and ideologies” occurs through business elites and financial interests investing in think-tanks, training technocrats, and in the command of the media,” promoting a free market utopian vision concealing how the world truly works. Whether we recognize it or not, in traditional Marxist fashion Harvey is suggesting that the ideas of the ruling class are our ruling ideas. It is with this important caveat that “neo-liberalism” is understood as “the guiding principle of economic thought and management” and thus culpable for the recent crisis.

The basis for these claims are largely rooted in the insights of economists such as Gérard Duménil and Dominique Lévy, who in *Capital Resurgent* argued that the stagflation of the 1970s and the changed political landscape since the 1970s were a response to a structural crisis: a decline in the profitability of capital. Duménil and Lévy, similarly conclude that:

> Neoliberalism is the expression of the desire of a class of capitalist owners and the institutions in which their power is concentrated, which we collectively call “finance,” to restore—in the context of a general decline in popular struggles—the class’s revenues and power, which had diminished since the Great Depression and World War II.

In the aftermath of the crisis, Duménil and Lévy published *The Crisis of Neoliberalism*, which argued that that the very characteristics associated with this

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275 Harvey, *A Brief History of Neoliberalism*, 80.
276 Ibid, 204.
277 Ibid, 115.
“neoliberal” project were unsustainable. Declining domestic investment in manufacturing, unsustainable household debt, widening inequality, dramatic expansion of financial activity and financial deregulation, amongst other trends, combined to form what they called “the fourth structural crisis in capitalism since the late nineteenth century,” which they term a “crisis of neoliberalism” due to the system of economic production, consumption and socio-economic phenomena that emerged in the wake of the structural crisis or stagflation of the 1970s.\textsuperscript{280}

This understanding of the rise of “neoliberalism” follows a similar timeline as the rise understood by Daniel Stedman Jones and also identifies the proximate causes of the financial crisis in relation to an instrumental association with “neoliberalism.” Yet under Harvey, Duménil, and Lévy’s understanding, orthodox intellectual doctrine is always ancillary to a project to advance the interests of private property owners, businesses, multinational corporations, and finance capital at the expense of labor.\textsuperscript{281} This seemingly accounts for the contradictions noted earlier that weaken the general argument that a set of economic ideas associated with “neoliberal” ideology had hegemonic influence in shaping economic policy that contributed to the recent crisis. Indeed, the phenomenon described by Harvey and Duménil and Lévy is important, offering a nuanced understanding of the motivations and power guiding so-called age of neoliberalism. Yet even if one presumes, as Harvey and Duménil and Lévy do, that neoliberalism should be understood as a project for the restoration capitalist power, in terms of blaming “neoliberalism” for the crisis it becomes a level of analysis that abstracts from the proximate causal mechanisms at work. Yes, neoliberal ideology

\textsuperscript{279} Ibid, 2.
\textsuperscript{281} Harvey, \textit{A Brief History of Neoliberalism}, 7.
and the interests of financial services (i.e. in terms of profitability) are considered important (and they are), but it is simply assumed that “finance” has a privileged role in shaping economic policy with little explicit deliberation on why that might be so.

**Conclusion**

The so-called age of “neoliberalism” is often presumed responsible for our recent financial mayhem, justifying regulation not keeping pace with financial innovation and facilitating pervasive moral hazard. Yet one of the outstanding faults of blaming “neoliberalism” for our recent crisis is the remarkable lack of precision regarding what that statement actually means. Do we mean that civil servants and politicians are the unwitting “slaves” of “neoliberal” economists and political philosophers? Do we mean to suggest that the deregulation of financial services was done on the basis of primarily “neoliberal” doctrines? Or should we understand “neoliberal” doctrine as a mere utopian “mask” for privileging the interests of corporate power? Sometimes blaming neoliberalism is meant as an indictment of corrosive corporate power, but it also might be interpreted as the suggestion that a set of intellectual ideas or economic doctrines is the primary motivation behind a collection of policies that contributed to financial instability. Blaming an age of neoliberalism might mean a euphemism for the failures of mainstream economists, or it might even mean that particular economic ideas were selectively used as an intellectual “cover” justifying the retrospectively destructive demands of the business and financial community. The remarkable lack of precision regarding what blaming “neoliberalism” actually means obscures what is really intended, which subsequently makes it challenging to understand the presumed motives underlying why Congress
constructed financial regulatory architecture the way it did (i.e. prohibiting regulation of derivatives, self-regulation, etc.).

Keynes’ famous words about the “ideas of economists and political philosophers” is frequently cited as an acknowledgement that the ways in which economists and political philosophers apprehend the world is what invariably shapes the policy paradigms that order our economic system. In a certain sense that is clearly true. But if we haven’t reduced government across the board and we haven’t made financial markets more competitive, was this really an “age of neoliberalism” or merely a facade for another agenda?\(^{282}\) Given the seeming contradictions of the so-called age of “neoliberalism,” one has to wonder to what extent a fundamental “neoliberal” faith in the uninhibited market is truly responsible for the recent crisis. The fact that there wasn’t an across the board reduction of government spending or the absence of government involvement in all markets seems to suggest that shaping economic policy over the past thirty years consisted of more than just “neoliberal” academic scribblers successfully whispering into the ears of our political leaders and policymakers. While there is an element of truth in this ideological explanation, and “neoliberal” reductions in government involvement in financial markets created a space for the emergence of the financial crisis, we will now explore whether there is an alternative, more persuasive account for why regulation did not keep pace with financial innovation than mere ideological adherence to a “neoliberal” framework of ideas and standards.

\(^{282}\) According to Fligstein and Goldstein, the top five packagers of mortgage-backed securities in 2007 rose to 41% and the top ten conduits’ market share in 2007 was 71 percent, which is demonstrably non-competitive.
Chapter 4: The Financial Lobby

The Banks are still the most powerful lobby on Capitol Hill. And they frankly own the place.
-U.S. Senator Dick Durbin

In the aftermath of the greatest financial crisis since the Great Depression, scores of commentators—including academics, journalists, and politicians—have indicted the belief that unfettered market mechanisms lead to socially optimal outcomes and that financial markets are efficient. Economic doctrine is identified as critical to the development of the “neoliberal” political economy that culminated in the recent financial mayhem from which we still recover. To be sure, “neoliberal” ideology was no small factor in advancing arguments to justify a thirty-year trend towards deregulation that culminated in regulatory architecture that both enabled an unsustainable housing bubble and was ill prepared for its inevitable burst. But as Marc Eisner notes:

Ideas are not abstract entities that are scrutinized by neutral and dispassionate actors. Rather, competing ideas or arguments are tightly bound with interests. They justify alternative policy proposals that can have very different implications for the core questions of politics: who gets what, when and how. Thus, it is necessary to discuss ideas and interests together.  

This chapter concurs with this line of argument and evaluates how an alliance between ideas and vested interests, in particular the emergence of a highly influential financial lobby, captured the establishment of the Democratic and Republican Parties.

This chapter maintains that shifting political winds and intellectual currents

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since the 1970s that suggested that big government was the problem and that free markets were the solution corresponded with the politicization of business and the growing importance of financial activities as a source of profits in the overall economy. As a result, the notion that “what was good for Wall Street was good for America” became folk wisdom. Additionally, in Lawrence Lessig’s perceptive book Republic, Lost—an alarming narrative on how special-interest money corrupts Congress—the Harvard Law Professor concludes an insightful chapter entitled “Why isn’t Our Financial System Safe?” by stating:

The real story of the Great Recession is simply this: Stupid government regulation allowed the financial services industry to run the economy off the rails. But it was the financial services industry that drove our government to this stupid government regulation. They benefited enormously from this policy. And as carefully as I have tried to frame these puzzles in a way that might allow both sides some space, this case brings even me to the brink. Strain as I may, I find it impossible to believe that our government would have been this stupid had congressmen from both sides of the aisle not been so desperate for the more than $1 billion in campaign contributions given by individuals and groups affiliated with these firms, and the $2.7 billion spent by them lobbying.

What Lessig finds “stupid” is the absence of sufficient regulation and the assumption that individually, profit-maximizing banks would take into account the consequence of their risks from an overall social standpoint (as opposed to the firm standpoint), which he concludes is the primary role of government to begin with. According to Lessig the true reason the deregulatory campaigns by the financial services industry culminated in regulatory architecture that enabled the crisis is because Democrats and Republicans alike are starved for campaign contributions in a process that corrupts the independence of Congress—that is the will and interests of we the people. Some catered to the financial lobby’s campaign to deregulate the financial services sector in

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284 Simon Johnson and James Kwak, 13 Bankers: The Wall Street Takeover and The Next Financial...
part out of genuine belief, others in part as political mercenaries, but the campaign’s success in shaping the regulatory structure (or lack thereof) that enabled the crisis was in large part the product of an economy of influence whose origins date back to a series a Supreme Court cases that enabled the increased politicization of business, substantially increased the role of money in elections, and fundamentally altered the Democratic Party.

**The Politicization of Business**

September 15th 2008, the day Lehman Brothers filed for bankruptcy, may very well live in infamy as the symbolic date future historians use in textbooks to describe what has become known as The Great Collapse. But the vigilant historian, one can hope, will understand the connection between the political origins of the inadequate financial regulation ill-suited to handle the burst of a housing bubble and a relatively obscure date in history: August 23, 1971. In the current era of *Citizens United*, the Supreme Court has maintained that corporations have the same right to make independent campaign expenditures that individuals have, and unsurprisingly corporations, like banks, utilize their legal privilege of spending an unlimited amount of money promoting or opposing particular ideas and candidates. But the precursors to *Citizens United* occurred in the 1970s and the peddling influence of corporations, such as financial institutions, in politics existed long before the Supreme Court’s ruling on January 21st 2010.

On August 23, 1971, future Supreme Court Justice Lewis Powell, then a corporate lawyer, wrote a memo to his friend the Director of the U.S. Chamber of Commerce. Two months before his nomination by President Nixon to the U.S.

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Supreme Court, Powell’s secret memo, intended to galvanize business circles, asserted that the “American economic system is under broad attack.” As Mark Blyth describes it, a combination of “inflationary pressures, regulatory initiatives, hostile tax legislation, and general policy paralysis” in the 1960s and 1970s combined to “convince business that it was under siege.” It was an attack that, as Blyth concluded, taught business how to “spend as a class.” In the postwar period in which there was an accord between labor and business, Jacob Hacker and Paul Pierson suggest that business interests had little compelling need to mobilize beyond a network of trade associations, but from 1969 until 1972, as the political scientist David Vogel summarized in a book on the political role of business, “virtually the entire American business community experienced a series of political setbacks without parallel in the postwar period.” In Winner-Take-All Politics Hacker and Pierson suggests that an explosion of policy activism, such as the rise of public interest groups, including those affiliated with Ralph Nader, had created a fundamental challenge for business interests. Powell’s confidential memo symbolized the presumed need and motivation for the large-scale political mobilization of business.

Asserting “the time had come” for businessmen of the world to strike back “against those who would destroy it,” Powell’s memo emphasized a need for corporate political mobilization:

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285 Lessig, Republic Lost, 85.
287 Mark Blyth, Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century (Cambridge: Cambridge University Press, 2002), 152.
288 Ibid, 155.
290 Ibid, 117.
Business must learn the lesson, long ago learned by labor and other self-interest groups...that political power is necessary; that such power must be assiduously cultivated; and that when necessary, it must be used aggressively and with determination — without embarrassment and without the reluctance which has been so characteristic of American business.\textsuperscript{291}

Invoking fear of an “attack on the enterprise system,” Powell’s memo offered a blueprint for an organized and effective business lobby:

Independent and uncoordinated activity by individual corporations, as important as this is, will not be sufficient. Strength lies in organization, in careful long-range planning and implementation, in consistency of action over an indefinite period of years, in the scale of financing available only through joint effort, and in the political power available only through united action and national organizations.\textsuperscript{292}

This effort, Powell maintained, would be particularly suitable for an expanded National Chamber of Commerce, which could spearhead the assault by uniting a coalition of firms that would advance “the shared interests of business as a whole.”\textsuperscript{293}

In such a short period of time the response was truly staggering.

Hacker and Pierson suggest that “the organizational counterattack of business in the 1970s was swift and sweeping,” referring to the increased number of corporations with public affairs offices in DC from just 100 in 1968 to 500 in 1978, the increased amount of firms with registered lobbyists from 175 in 1971 to 2,500 by 1982, and the number of corporate political action committees (PACs), which increased from under 300 in 1976 to over 1,200 by the middle of 1980.\textsuperscript{294} Meanwhile, think tanks, such as the American Enterprise Institute, the Center for the Study of American Business, the Heritage Foundation, and the Hoover Institute were formed with corporate funding, according the David Harvey, in order to “polemicize, and when necessary, as in the

\textsuperscript{291} Lewis Powell, “Confidential Memorandum: Attack of American Free Enterprise System,” August 23, 1971
\textsuperscript{292} Ibid.
\textsuperscript{293} Hacker and Pierson, Winner-Take-All Politics, 118.
\textsuperscript{294} Ibid.
case of the National Bureau of Economic Research, to construct serious technical and empirical studies and political-philosophical arguments” broadly in support of policies that reflected the interests of business. Business, indeed, had learned to “spend as a class,” and these developments would have important implications on an American political system that shaped the regulatory architecture that enabled the financial crisis.

During the 1980s, Thomas Edsall recognized the emergence of a major shift in the balance of power in the United States related to the politicization of the business community, as well as the implications this would have on policy making. In one of the most striking passages in his classic *The New Politics of Inequality*, Edsall wrote:

> During the 1970s, the political wing of the nation’s corporate sector staged one of the most remarkable campaigns in the pursuit of political power in recent history. By the late 1970s and the early 1980s, business, and Washington’s corporate lobbying community in particular, had gained a level of influence and leverage approaching that of the boom days of the 1920s.

Edsall observed that along with rising inequality a new sort of politics was emerging, one in which “the relatively recent and fragile American tradition of government participation in the market system in order to protect those at the bottom of the income distribution” and to encourage upward social mobility was being severely undermined. Edsall observed with horror how the substantially increased role of money in politics (in part because of television and new computer-based technologies, and in large part because of the political strategy of business) had the noxious consequence of altering the traditional ethos of the Democratic Party. Transitioning away from a previous loyalty towards those in the bottom of the income distribution, the increased role of money in elections created powerful incentives for

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295 David Harvey, *A Brief History of Neoliberalism* (Oxford: Oxford University Press, 2007), 44
the Democratic Party to align with the interests of the more affluent. This phenomenon had the curious consequence of transforming “what had been in 1974 an anti-business Democratic Congress into, by 1978, a pro-business Democratic Congress” that, as Edsall put it, paved the way for the election of Ronald Reagan.\textsuperscript{298} But this trend continued past the 1980s and by the end of the 1990s the emergence of the pro-business Democratic Leadership Council symbolized how, as Jacob Hacker and Paul Pierson put it, the Democratic Party’s “populist tradition more and more appeared like a costume—something to be donned from time to time when campaigning—rather than a basis for governing.”\textsuperscript{299} The politicization of the business community and the growing importance of financial activities as a source of profits in the overall economy had shifted the balance of political power in America.

In order to really understand this transformation, it is essential to understand how an explosion of money in politics since the 1970s culminated in business’s triumph over organized labor. The political strategy of organized business met success in large part because of campaign reforms enacted in 1971, and expanded in 1974 in response to the Watergate Scandal. Thomas Edsall suggests that these campaign reforms were “intended to prevent any single political contributor from gaining excessive influence over Congress or over a presidential administration,” but that the law also fundamentally changed the role of PACs, which since the 1940s “had been the province of organized labor.”\textsuperscript{300} As Edsall put it “the law was changed to explicitly permit the sponsoring organizations, unions, or corporations, to use money from corporate or union treasuries to pay the costs of forming a PAC, of

\textsuperscript{297} Ibid, 22.
\textsuperscript{298} Ibid, 20-21.
\textsuperscript{299} Hacker and Pierson, \textit{Winner-Take-All Politics}, 224.
staffing, and of soliciting contributors.”\textsuperscript{301} This change proved suitable to the interests of corporations, demonstrated by the growth of corporate PACs themselves, because the $5,000 restriction on the size of contributions any single PAC can give to a candidate (in primaries or the general election) effectively “forced separate business and trade association interests to band together in the course of major legislative battles.”\textsuperscript{302} The money of labor (which itself was deteriorating with ever declining unionization levels) could not match well-endowed corporate interests. Once a pillar of the Democratic Party and “corporate America’s most enduring competitor,” organized labor, as Hacker and Pierson describe it, was “left gasping for air far beneath the peak of power.”\textsuperscript{303} As a result, the politicization of business was as development that, as Edsall notes, prompted Elizabeth Drew, Washington Correspondent for the \textit{New Yorker}, to write “the role of money has delivered us into the special interest state.”\textsuperscript{304} By the 2000s, after a series of successful deregulatory campaigns by the financial services lobby, one might have said the role of money had delivered us into the finance capitalist’s state.

\textit{The Role of The Supreme Court}

The expanded role for Corporate PACs and the success of the political strategy of business (including finance) found an ally in the Supreme Court that Lewis Powell joined shortly after urging businessmen to unite for the purpose of acquiring political power. According to David Harvey:

A crucial set of Supreme Court decisions began in 1976 when it was first established that the right of a corporation to make unlimited money contributions to political parties and political action committees was protected

\textsuperscript{300} Edsall, \textit{The New Politics of Inequality}, 129-130.
\textsuperscript{301} Ibid, 130.
\textsuperscript{302} Ibid, 132.
\textsuperscript{303} Hacker and Pierson, \textit{Winner-Take-All Politics}, 135.
\textsuperscript{304} Edsall, \textit{The New Politics of Inequality}, 139.
under the First Amendment guaranteeing the rights of individuals (in this instance corporations) to freedom of Speech. Political action committees (PACs) could thereafter ensure the financial domination of both political parties by corporate, moneyed, and professional association interests.\(^{305}\)

Indeed, on January 30, 1976 the Supreme Court’s landmark ruling in *Buckley v. Valeo* introduced the idea the money counts as speech, eliminating restraints on unlimited spending in US elections associated with provisions in the 1974 amendment to the 1971 Federal Election Campaign Act. On April 26, 1978 the Supreme Court’s ruling in *First National Bank of Boston v. Bellotti*, that the use of corporate funds for the purpose of influencing or affecting voter’s opinions was “protected speech,” prompted Arthur S. Miller to state that the Supreme Court’s decision is arguably “the most important first amendment decision in recent memory.”\(^{306}\)

Lewis Powell, now an Associate Justice of the Supreme Court of the United States, wrote the majority opinion, which, as Miller puts it, reasoned, “that the corporation is a constitutional person and is to be treated as any other person (i.e., a natural person) when first amendment issues are raised.”\(^{307}\) Arthur S. Miller warned in 1981 that coupled with the decisions in *Buckley v. Valeo* and *Consolidated Edison Co. v. Public Service Commission*, the consequences of *Bellotti* would be corrosive to American democracy:

Since corporate assets may now be used to further the interests of corporations by allowing them to “speak” even if the issues do not materially affect their businesses, the corporate enterprise as a political actor will, simply because of its vastly superior assets, dominate the “democratic” process of elections and direct voting by referenda or initiatives.\(^{308}\)

\(^{305}\) Harvey, *A Brief History of Neoliberalism*, 48-49


\(^{307}\) Ibid, 22.

\(^{308}\) Ibid, 36.
Corporations, such as banks, Miller claimed, now “have constitutional carte blanche to try and manipulate the political process,” in a noxious manner that “makes corporations more equal, as Orwell might have said, than natural persons, who by federal statute are limited in their electoral contributions.”

Whether the “myopia” of the Supreme Court, which included the very Powell who coined the confidential memo that galvanized businessman of the world to unite, was “willful” as Miller alleged is an issue to be taken up elsewhere. Whether these majority opinions were the reflection of judicial wisdom or an egregious error of constitutional interpretation is beyond the scope of this writing. But the implication of these rulings, regardless of the true motivations that led to their eventual outcome, has had a profound consequence on the American political economy.

Money in Politics in the Age of Financial Innovations

The enhancement of corporate power through the emergence of a powerful business lobby subsequently shifted the balance of political power in America. This shift of power, enabled in large part because of the legal, but corrosive influence of money in the American political system, is essential to a historical understanding of why our financial system wasn’t “safe and sound” in 2007 and 2008 when an asset bubble derived from housing popped, unleashing financial mayhem and the contraction of the global economy. We have already explored how the Supreme Court legitimized tools that increased the political clout of the ‘captains’ of industry and finance since the 1970s, but now we must evaluate the consequence of this influence in the context of the specific financial regulatory architecture. Far from ensuring that

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309 Ibid, 23.
the financial system was “safe and sound,” this architecture enabled the largest financial crisis since the Great Depression.

Roger Congleton notes that the Great Recession revealed “the limits of existing institutions and laws that frame competition in credit markets,” for “the standing rules and regulations” that assured a great deal of transparency in “old-fashioned” stock and bond markets were not “upgraded” to assure “equivalent transparency in the new financial markets that emerged in the 1990s.”\textsuperscript{310} Regulation existed, but as Congleton notes “many of the laws and regulations that regulate capital reserves, assure transparency, and deal with bankruptcy for publicly traded firms did not apply (or could not easily be applied) to the new highly integrated international finance markets that emerged in the past two decades.”\textsuperscript{311} Though Congleton’s analysis “concludes that the housing and stock bubbles were generated largely by market forces, rather than by government policies,” he concedes that government policies and institutions played a significant role.\textsuperscript{312}

We know that financial markets were innovating in ways that existing regulations did not adequately cover, but the question is whether Congleton’s conclusion should be understood as an error of judgment rooted in misguided ideology, or as a consequence of the clout of an immensely powerful financial services lobby. According to the conclusions of the \textit{Financial Crisis Inquiry Commission}:

The financial industry itself played a key role in weakening regulatory constraints on institutions, markets, and products. It did not surprise the Commission that an industry of such wealth and power would exert pressure on policy makers and regulators. From 1999 to 2008, the financial sector

\textsuperscript{311} Ibid, 314.
\textsuperscript{312} Ibid, 289.
expended $2.7 billion in reported federal lobbying expenses; individuals and political action committees in the sector made more than $1 billion in campaign contributions. What troubled us was the extent to which the nation was deprived of the necessary strength and independence of the oversight necessary to safeguard financial stability.\textsuperscript{313}

The extent to which the United States was “deprived of the necessary strength and independence of the oversight necessary to safeguard financial stability” should give us pause for concern. And if the amount of money the industry expended to influence the “weakening” of regulatory policy truly had the corrosive influence the Financial Crisis Inquiry Commission suggested, than money in politics is not only noxious to our democracy, but also, by extension, economic policymaking and our economy.

Frank Partnoy’s Infectious Greed: How Deceit and Risk Corrupted the Financial Market explores this question by providing a penetrating historical account of the dramatic changes in markets during the two decades before the subprime mortgage boom and bust.\textsuperscript{314} Partnoy’s analysis emphasizes the role that technological innovation, in particular the use of computer technology that could quickly crunch numbers, had on a financial industry that increasingly engaged in more and more risk. His analysis also stresses the political importance of a broad financial services lobby, consisting of commercial banks, insurance companies, investment houses, hedge funds (etc.) that seemingly adopted a political strategy in the same spirit as Powell’s memo. Indeed, coordinated action amongst corporations and disparate industry sectors that collectively fell under the broader umbrella of financial services proved crucial in the legislative battles that eventually prohibited regulation of complex financial instruments, such as derivatives.

In simplified form, until the early 1990s most financial assets of our economy

\textsuperscript{313} Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report, xvii.
were subject to the basic regulatory regime established after the Great Depression. After the 1980s, there was an emergence of new classes of financial instruments, such as derivatives, which were exempt from the basic regulatory framework that provided oversight to stocks and traditional bonds. Though there were a number of distinct new financial instruments, the financial services industry began to develop financial assets derived from mortgages, a market that, thanks to a Securities and Exchange Commission (SEC) ruling in 1992, was exempt from any SEC oversight.315 As the market for assets backed by mortgages was developed, and the volume of derivatives grew to $13 trillion by the middle of the Clinton administration, a debate ensued about whether and how derivatives ought be regulated. But that debate turned into a fight, and as Lawrence Lessig describes it, while one side argued that derivatives should be treated just like any other asset, the financial lobby “saw this as a chance to launch a project to deregulate financial assets generally.”316 It was a project by the financial services lobby that deserves closer exploration.

_The Successful Deregulatory Campaigns_

On February 4th, 1994 the Federal Reserve “sent an arctic blast through Wall Street,” as The New York Times reported, when it suddenly raised overnight interest rates to 3.25% from 3%. As Frank Partnoy puts it, an estimate of total damage to the bond market at around $1.5 trillion had “made the rate hike more costly than any other market debacle since the 1929 stock-market crash.”317 But instead of the pendulum swinging towards derivatives regulation, Mark Brickell, Chairman of the International Swaps and Derivatives Association (ISDA), and a banker at J.P.

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315 Lessig, _Republic Lost_, 73.
316 Ibid, 72.
Morgan, insisted to legislators that “although recent derivatives losses looked bad, regulators couldn’t possibly understand or control the situation any better than market participants.”\(^{318}\) As Partnoy puts it, Brickell asserted that new legislation “would cause unforeseen damage, potentially imperiling not only Wall Street and the derivatives industry, but—by implication—campaign donations as well.”\(^{319}\) As a result, the ISDA, whose members were major political contributors, launched a campaign throughout 1994 and 1995, which was supported by Clinton’s Treasury Department and the Federal Reserve, to effectively kill legislation introduced to regulate derivatives.

The support of the Clinton Administration was crucial and also deserves closer exploration because it provides a revealing sub-story within this larger project that powerfully illustrates the influence of the financial services industry. As the debate on derivatives regulation ensued, in 1998 the Commodity Futures Trading Commission (CFTC), headed by Brooksley Born, reasoned that derivatives, which Warren Buffet warned were “weapons of mass destruction,” functioned much like futures contracts, which were already regulated by the CFTC.\(^{320}\) When the CFTC circulated a draft that suggested that it should increase supervision of these financial “weapons of mass destruction,” the reaction of other relevant federal agencies, as Lessig describes its, was “quick and harsh.”\(^{321}\) It wasn’t just Mark Brickell and the financial services lobby that resisted derivatives regulation, according to Lawrence Lessig Clinton’s Cabinet, headed by the Treasury Department, effectively killed Born’s recommendation. Treasury secretary Robert Rubin, a former cochairman of the

\(^{317}\) Partnoy, *Infectious Greed*, 110-113  
\(^{318}\) Ibid, 142.  
\(^{319}\) Ibid.  
\(^{320}\) Hacker and Pierson, *Winner-Take-All Politics*, 249.
investment titan Goldman Sachs, was allegedly “extremely hostile,” and Larry Summers, then Rubin’s top deputy at the Treasury Department, allegedly “berated” Born with a call about how there were thirteen bankers in his office who warned that if the CFTC’s proposed oversight of derivatives was published “we’ll have the worst financial crisis since World War II.”³²² Though Born persisted, publishing a draft in May of 1999 that called for further study on derivatives regulation, Federal Reserve Chairman Alan Greenspan, Treasury Secretary Rubin, and Rubin’s top deputy Larry Summers, who later succeeded Rubin, announced that they would seek legislation to prevent the CFTC from regulating derivatives. With Born effectively silenced, her efforts all but blocked, she resigned.³²³

This story is useful to understand how the United States political system invariably provides consistent advantages to entrenched groups who resist reform initiatives. As Fred Block puts it, interest groups, like the financial services industry, have “multiple veto points for defeating reform initiatives—two houses of Congress, the court system and the possibility of capturing or defunding the regulatory agencies that implement reform efforts.”³²⁴ Likewise, as Hacker and Pierson remark, often all that is needed to advance or halt government initiatives is “the ear of a crucial committee chair.”³²⁵ The financial services industry had the ears of many Congressional Representatives, but it especially had a symbiotic relationship with a powerful committee chair in Senator Phil Gramm from Texas—the same Phil Gramm that blames the financial crisis on government policy that provided “distortions” in the housing finance market instead of the financial participants that engaged in

³²¹ Lessig, Republic Lost, 74.
³²² Ibid, 75.
³²³ Lessig, Republic Lost, 65.
³²⁴ Block, “Crisis and Renewal: The Outlines of a Twenty-First Century New Deal,” 54
excessive risk by securitizing dubious loans.\footnote{Hacker and Pierson, \textit{Winner-Take-All Politics}, 72}

Phil Gramm, initially a Democratic Congressman before changing to the Republican Party in 1983, became a Senator in 1985 and from 1989 to 2002 “was the top recipient of funds from commercial banks, and one of the top five recipients from Wall Street overall.”\footnote{Phil Gramm and Mike Solon, “The Clinton-Era Roots of the Financial Crisis” \textit{The Wall Street Journal}, August 12, 2013} By 1995 Gramm became the Republican chair of the Senate Banking Committee, which as Hacker and Pierson notes, “gave him enormous power to shape legislation that Wall Street favored and to block initiatives it opposed.”\footnote{Ibid, 198.} One such example was when Gramm threatened to cut the SEC’s budget when the agency “sought to introduce rules for accounting firms to prevent conflicts of interest—the kind of conflicts that played a pronounced role in the collapse of Enron and a spate of corporate scandals.”\footnote{Ibid, 197.} Another example was when “in the waning days of the 2000 legislative session,” as Hacker and Pierson put it, Gramm inserted the Commodity Futures Modernization Act “within a must-pass budget bill,” a rather crafty way of ensuring a prohibition on regulation of derivatives, which as we have already noted eventually played a critical role in the degree of leverage and speculation that ultimately imploded financial markets and froze credit markets, transitioning the financial crisis into a devastating economic recession.\footnote{Ibid.}

While the Commodity Futures Modernization Act symbolized the enduring success of the financial lobby’s campaign to exempt derivatives from oversight, in the midst of debates over whether regulations ought to cover new financial innovations, the financial lobby also succeeded in its campaign to dismantle the New Deal
regulations that, since the Great Depression, had seemingly prevented the emergence of a large-scale financial crisis. With support from Federal Reserve Chairman Alan Greenspan, Treasury Secretary Rubin, and his eventual successor, one of Phil Gramm’s greatest legislative achievements was the passage of the 1999 Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act, which effectively repealed an already eroded Glass-Steagall Act.\textsuperscript{331} Since the 1980s the Federal Reserve reinterpreted the Glass-Steagall Act, lifting major restrictions and by 1996 the Federal Reserve had permitted bank holding companies to earn up to 25\% of their revenues in investment banking.\textsuperscript{332} But the Financial Services Modernization Act formally ended the boundaries between investment and commercial banking that had been constructed in the aftermath of the Great Depression to limit systemic risk and conflicts of interest.\textsuperscript{333} It also retroactively legalized the 1998 Citigroup-Travelers Merger, which combined a commercial bank with an insurance company that owned an investment bank, in “blatant violation of the Glass-Steagall Act,” to establish the world’s largest financial services company—a firm that Treasury Secretary Rubin would soon join as a senior advisor.\textsuperscript{334}

This legislation had far-reaching consequences related to the recent financial crisis. As Amar Bhide notes, the enactment of the Financial Services Modernization Act effectively established a new kind of holding company:

- one that could own, as subsidiaries, banks and other entities that could engage in a variety of financial activities (including underwriting and dealing in securities; sponsoring and distributing mutual funds; insurance underwriting

\textsuperscript{330} Ibid.
\textsuperscript{331} Hacker and Pierson, \textit{Winner-Take-All Politics}, 249-250.
\textsuperscript{333} Hacker and Pierson, \textit{Winner-Take-All Politics}, 197
\textsuperscript{334} Sherman, “A Short History of Financial Deregulation in the United States”
and agency activities; and merchant banking) that banks or their subsidiaries might be otherwise forbidden from performing.\textsuperscript{335}

By effectively permitting the construction of “mega-banks,” new vertically integrated holding companies prompted increased “expansion into nontraditional domains such as securitization and the trading of derivatives.”\textsuperscript{336} By permitting new strategies amongst banks for vertically integrating and mass-producing mortgage debt products, the legislation also had the consequence of increasing consolidation of the housing-finance market around a small set of dominant firms, like Lehman Brothers, Bear Stearns, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bank of America, JP Morgan Chase, Wells Fargo, Citigroup, and Countrywide Financial, firms who eventually required mergers or public infusions of capital (i.e. bailouts) to survive.

When the housing bubble burst, many of these firms sustained substantial losses in their mortgage portfolios. The vast size of these firms, enabled through mergers in the aftermath of The Financial Services Modernization Act, lead many to consider them too systemically important to fail. In this sense, the Financial Services Modernization Act legalized “too big to fail” while the Commodity Futures Modernization Act of 2000 prevented the sort of regulation that might have prevented these institutions from engaging in excessive risk in the first place. Ironically, during debate in the House of Representatives, Rep. John Dingell (Democrat of Michigan), the longest-serving member of the House of Representatives, argued that the Financial Services Modernization Act, which was about to be passed with “very little consideration, written in the dark of night without any real awareness on the part of


\textsuperscript{336} Ibid, 98.
most of us of what it contains,” would result in the creation of “a group of institutions
which are too big to fail” and warned that “taxpayers are going to be called upon to
cure the failures that we are creating tonight, and its going to cost a lot of money, and
it’s coming.” As the $700 billion Wall Street bailout demonstrated, Representative
Dingell was simply right.

In the aftermath of the financial crisis Congressman Barney Frank, who had
referred to the Gramm-Leach-Bliley Act as “a complete Christmas list to the financial
institutions,” presented the crisis as an indictment of America’s three decade-long
experiment with radical deregulation, a zealous embrace of free market doctrines that
since the 1980s predominated the policy establishment. In a certain sense
Congressman Frank was correct. Deregulatory legislation such as the Gramm-Leach-
Bliley Act and Commodity Futures Modernization Act embodied Alan Greenspan’s
“neoliberal” market fundamentalist belief that “no market is ever truly unregulated”
because “the self-interest of market participants generates private market regulation,”
which was a sufficient (ideal for many) form or regulation. Using this reputational
incentive logic the financial services lobby convinced the three branches of American
government that the so-called “morals of the marketplace” would sufficiently self-
police the financial system and ensure that it would be “safe and sound.” The problem
with this, as Judge Posner writes, is that banks “do not have regard for consequences
for the economy as a whole…that is not the business of business. That is the business

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339 As quoted, in Lessig, *Republic Lost*
of government.”340 Intuitively that should be obvious, but Posner’s point is that “deregulation made bankers and through them borrowers take risks that were excessive from an overall social standpoint” because:

   Competition will force banks to take risks (in order to increase return) that the economic and regulatory environment permits them to take, provided the risks are legal and profit-maximizing, whatever their consequences for the economy as a whole.341

Yet it was the government that was responsible for regulation not keeping pace with financial innovation, perhaps in part under the genuine assumption that financial markets would police themselves, but also in large part because of pressure from the most powerful lobby on Capitol Hill. This pressure is what Lawrence Lessig refers to as “the economy of influence.”

The “Economy of Influence”

In order to understand the power of the financial lobby within this economy of influence, it is useful to explore Lessig’s point that the increased role of money in politics—by starving Democrats and Republicans alike for campaign contributions—corrupts the “independence” of Congress. It is a particularly salient point. To convey this point Lessig conducts a thought experiment and asks whether you can honestly and credibly state that the regulatory mistakes of the past three decades, which culminated in the proximate causes of the crisis—such as excessive risk, thin capital margins, lack of transparency, failures at the credit rating agencies, securitization of dubious loans, and the cooptation of regulators by an increasingly large and concentrated financial services industry—were unrelated to the fact that from 1998 to 2008, the financial services lobby spent $1.7 billion on campaign contributions and

341 Ibid, 264.
$3.4 billion on lobbying expenses, with the securities industry alone spending $500 million on campaign contributions and $600 million on lobbying.\textsuperscript{342} It is a particularly useful thought experiment, especially given recent attention to ideology as an explanation for why we had the recent crisis. To be sure, Lessig recognizes that there “were plenty in the army of financial deregulators who were true believers, not just mercenaries,” citing the importance and power of cognitive capture, but he asserts, “Pure ideas are not the whole story. Not by a long shot.”\textsuperscript{343} This is where the role of the financial lobby, the most powerful lobby in the economy of influence in our nation’s capital, played an instrumental role.

The Financial Services Modernization Act of 1999 was approved in the Senate by a vote of 90 to 8 and in the House of Representatives by 362 to 57 before being signed into law on November 12, 1999 by Democratic President Clinton. As Lessig puts it, “the campaign to deregulate the financial services sector was a campaign, even if it was also an ideology” and it succeeded because:

both Democrats and Republicans alike became starved for campaign funds. And as that starvation grew, both parties, but the Democrats in particular, found it made both dollars and sense to believe as the ideologues of deregulation told them to believe. It paid to believe. And that made believing easy.\textsuperscript{344}

Indeed, the Financial Services Modernization Act and Commodity Futures Modernization Act both received bipartisan support. They were also both crucial to the framing of the insufficient regulatory structure on the eve of the crisis. After the bills passage \textit{The New York Times} reported that Treasury Secretary Lawrence Summers stated “Congress voted to update the rules that have governed financial services since the Great Depression and replace them with a system for the 21\textsuperscript{st}

\textsuperscript{342} Lessig, \textit{Republic Lost}, 83-86.
\textsuperscript{343} Ibid, 82.
\textsuperscript{344} Ibid, 82.
Congressman Dingell’s warnings were dismissed under the notion that “the concerns that we will have a meltdown like 1929 are dramatically overblown,” as Senator Bob Kerrey, Democrat of Nebraska suggested, and because there was a belief that because of globalization “if we don’t pass this bill, we could find London or Frankfurt or years down the road Shanghai becoming the financial capital of the world,” as Democratic New York Senator Charles Schumer suggested. It is worth noting that an SEC official once told The New York Times that “if you get Chuck Schumer on your side, you’re okay,” a reference to Schumer’s elevated standing in his party.

It is also worth noting, as Hacker and Pierson do, that from 1989-90 to 1997-98 Schumer raised $2.5 million in contributions from securities and investment firms, “more than triple the haul of the runner-up in the House,” before a successful (and well funded) campaign moved Schumer to the Senate, where he has become an influential member on the powerful Senate Banking and Finance Committee. To be sure, Schumer is an unapologetically liberal voice in the Democratic Party on social issues, but Schumer is nevertheless also a symbol of “the increasing reliance of Democrats on finance-industry donations,” which itself is symbolic of the financial services industry’s “growing economic and political clout.” In fact, a detailed New York Times profile notes how “Mr. Schumer became a magnet for campaign donations from wealthy industry executives.” To further put this in perspective,

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346 Ibid.
349 Ibid, 227.
350 Lipton and Hernandez, “Champion of Wall Street Reaps Benefits”
following the Democratic Party’s disappointment in the 2004 elections, Schumer became head of the Democratic Senatorial Campaign Committee (DSCC) and helped orchestrate a Democratic comeback, in large part because of his fundraising prowess, were the DSCC raised “an unprecedented 240 million,” in large part thanks to the generous contributions of Wall Street.\textsuperscript{351} Indeed, the politicization of business and the growing importance of financial activities as a source of profits in the overall economy shifted the balance of power in the American political system.

Now reliance on large sums of money from the financial services industry didn’t literally purchase financial regulatory architecture in the sense of \textit{quid pro quo}. It is not that our political leaders are all venally corrupt. Yet, in the words of Lawrence Lessig, “a much more virulent, if much less crude, corruption does indeed wreck our democracy,” an “improper dependence” or “dependence corruption.”\textsuperscript{352} While describing “dependence corruption,” a phrase that emphasizes the corrupting process of governance, Lessig makes the unusual assertion that in contrast to the populist view, government officials are in fact underpaid, which he views as detrimental to the inner workings of Congress as our Framers intended. However, this unusual statement offers penetrating insight as to why Congressional Representatives might have voted yes on legislation such as the Financial Services Modernization Act, which as Congressman Dingell said, was passed with “very little consideration, written in the dark of night without any real awareness on the part of most of us of what it contains.”\textsuperscript{353} That is, the economy of influence impacts Congressional staffers.

Stating that “staffers on Capitol Hill get paid on average between $29,890.54, 

\textsuperscript{351} Hacker and Pierson, \textit{Winner-Take-All Politics}, 227. 
\textsuperscript{352} Lessig, \textit{Republic Lost}, 8.
for a staff assistant, and $120,051.55, for a chief of staff” and that “the starting salary for an attorney at the SEC is $78,000” whereas “the starting salary for an analyst working in investment banking on Wall Street with just a bachelor’s degree is from $100,000 to $130,000 after bonus,” Lessig describes how many government employees initially accept living in “the farm league,” a metaphor used to describe how many staffers, both on Capitol Hill and within major regulatory agencies, view their relatively low pay as an “investment.” This “investment” eventually pays off when after six or eight years they cash out and become a lobbyist (with salaries that often increase by five or six times). Lessig is careful to suggest, “that there’s nothing evil in the story of these staffers turned lobbyists. Or at least, there need be nothing evil,” but he nevertheless suggests that this phenomenon inherently distracts representatives from their constituents. More precisely, it cultivates an “improper dependence,” that systematically draws members of Congress “away from the focus, or dependence, they were intended to have,” thereby undermining the republic, a representative democracy, a government that was intended by our framers to be “dependent upon the People alone.”

It is not hard to believe that this economy of influence has a conscious or subconscious impact on the decision memo’s that staffers give to their bosses, whose job consists of literally voting on a multiplicity of different items, many of which are technical and esoteric. It is virtually impossible to be an expert on every topic, and even knowledgeable congressional representatives aren’t always well read on the minutia of every bill to be voted upon. That’s precisely why trusted staffers deliver

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354 Lessig, Republic Lost, 221-223
decision memo’s to their bosses that summarize dense legislation into succinct bullet points, followed by a recommendation on whether the candidate should vote yes or no.

The notion that Capitol Hill is the “farm league” for future lobbyists can distract representatives from their constituents because it builds a dependency on an economy of influence which conflicts with the dependency the framers of our constitution intended, a dependency on the People.\textsuperscript{356} An example of this phenomenon at work might be understood in the passage of the Commodity Futures Modernization Act and the Financial Services Modernization Act of 1999. The titles of the legislation themselves imply a need to adapt or tweak policy for financial stability. It’s not hard to believe that regardless of whether the staffer’s decision memo recommended a “yes” vote or “no” vote these memos were likely inundated with language such as “to promote innovation, competition, and efficiency in financial markets” as well as “will reduce systemic risk.” Now this is a crude simplification of what these decision memo’s might have looked like, and certainly scores of representatives knew which way they were voting before their staffer handed them a piece of paper, but aside from those who genuinely believed that financial participants would adequately self-police themselves because of preexisting ideological dispositions, one can understand on a psychological level how the economy of influence impacted (i.e. “dependence corruption”) Congressional staffers who recommended a “yes” vote on legislation that retrospectively seems to be misguided policy.

Keep in mind that the overworked staffers \textit{depend} on lobbyists to do their job (i.e. understand complex topics and recommend policy stances and votes to elected

\textsuperscript{355} Lessig, \textit{Republic Lost}, 89.
officials) and that the relationship between staffer and lobbyist is frequently viewed in the context of developing relationships and connections that might advance one’s future career. Now consider this: there hadn’t been a major financial crisis in over seventy-five years, Wall Street was willing and capable of providing generous campaign contributions to those who toned down populist appeals, even the establishment of the Democratic party had become aligned with the interests of the more affluent (i.e. Wall Street), and it was an environment in which candidates (i.e. bosses) are starved to meet crucial fundraising deadlines in perpetual campaign cycles—especially for those in the House of Representatives. Add to this the possibility of spoiling future social connections and infuriating important donors by drawing attention to relatively esoteric policy concerns regarding low-probability events that almost certainly have the consequence of hurting Wall Street profitability. Meanwhile there are warnings from “experts” (lobbyists) in the field who claim that financial markets are too complicated for regulators, that Wall Street knows what its doing (remember, it doesn’t matter that its debt-financed prosperity so long as the economy is growing!) and that failure to pass this legislation might imperil both Wall Street, and by extension the economy of ordinary Americans, the constituents you or your boss serve. And don’t forget that well respected economists, Nobel-Prize winners, the leaders of the Treasury Department, the revered Chairman of the Federal Reserve, and the President of the United States of America (possibly the leader of your political allegiance) are all indicating that this proposed legislation is “A-Okay.” Now this set of incentives and disincentives might not be evidence of venal corruption, but as Lessig points out, this economy of influence, “the pattern of

356 Ibid, 225.
influence operating on individuals within” Congress steers the Republic away from its proper dependence, which the Framers of our Republic clearly intended to be upon the People alone.  

The substantially increased role of money doesn’t necessarily mean that individuals are necessarily corrupt (though scandals suggest some are), as much as it means the actual process of governance is corrupt. This is the sort of “dependence corruption” that Lessig is referring to when he suggests, “it paid to believe” in deregulatory initiatives, which “made believing easy.” It wasn’t just “neoliberal” ideology. It wasn’t some grand conspiracy by the illuminati. It was Democrats and Republican shaping markets with laws and regulations and institutional arrangements favorable to an alliance between ideas and vested interests because they were starved for campaign contributions. It was an “economy of influence” that privileged the financial lobby, turned its back on the middle class, and ignored John Maynard Keynes warning of what would happen when “the capital development of a country becomes the by-product of the activities of a casino.”

Conclusion

This chapter has demonstrated that the debate between whether the crisis was a product of market failures or government failures in part distracts from the broader, more relevant story: the extent to which the crisis was predominantly a crisis of political economy. Indeed, there is a political context lurking behind all economic phenomena—from why the trillion-dollar derivatives market was opaque (The Commodity Futures Modernization Act), to why investment banks were highly

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357 Ibid, 242
358 Ibid, 83.
359 Keynes, The General Theory, 159.
leveraged (the fundamentally flawed voluntary Consolidated Supervised Entities Program adopted by the SEC), to why the mortgage-finance market became a function of the strategies of a few leading firms (the Financial Services Modernization Act). It is important to note that this does not mean that political decisions forced the market to misbehave. It was private actors that took private actions that undermined the economy. However, this chapter suggests that there is more to the story of financial deregulation than an excessive intellectual faith in the self-correcting, efficient nature of markets. The crisis was brought about by naked profit-seeking rather than the “scribblings” of some “defunct economist.”

Indeed, this chapter suggests that the crisis is best evaluated as an indictment of regulatory failures, and by implication, complex political failures associated with the substantially increased role of money in politics, which has privileged the interests of the financial services lobby. Put simply, the substantially increased role of money in politics, in creating “dependence corruption” and an “economy of influence” in our nation’s capital, made the campaign to deregulate the financial services industry a successful campaign. This campaign is responsible for a deregulatory environment conducive to the emergence of the Ponzi mentality in financial markets that culminated in financial implosion. Thus, a series of successful deregulatory campaigns by the influential financial lobby is responsible for high levels of systemic risk. Ex post facto a series of successful deregulatory campaigns by the financial lobby was instrumental to the worst economic downturn since the Great Depression.
Conclusion:  
In The Shadow of Crisis

It’s a systemic corruption when there is a huge imbalance between too few people with so much wealth and so much power and so much access and so much say and the vast majority of people in the country who don’t make the big contributions, aren’t the heavy hitters, aren’t the investors, and who believe that if you don’t pay you don’t play. I think that’s the corruption. I think the corruption is that the standard of the democracy, a representative democracy, which says that each person should count as one and no more than one, is violated.

-The Late Minnesota Senator Paul Wellstone

By the middle of 2007 there was between $6.7 trillion and $9.1 trillion in outstanding bonds and derivatives backed by American mortgages.\textsuperscript{360} Purchasing homes, particularly by borrowing money in the form of mortgages, had facilitated a sophisticated and lucrative private enterprise—at least until value of assets derived from these underlying mortgages declined. This happened when, to the surprise of many, appreciation of housing value slowed and reversed, resulting in an increase in delinquencies, defaults, and foreclosures. This jeopardized the value of increasingly complex and interconnected financial instruments derived from underlying mortgages, many of which were traded in a trillion-dollar over-the-counter (OTC) derivative market that, thanks to the enactment of legislation in 2000, was opaque. That is, the derivatives market, such as the Credit-Default Swap (CDS) market which alone grew from $631.5 billion in notional value in the first half of 2001 to over $62.1

\textsuperscript{360} Neil Fligstein and Goldstein, “Roots of the Great Recession,” 31.
trillion in notional value by the second half of 2007, was not subject to reporting or
disclosure requirements or regulatory oversight and supervision. Notably, the risk
associated with this market was concentrated in a few large firms, financial
institutions with extreme leverage, such as Lehman Brothers, Bear Stearns, Goldman
Sachs, Morgan Stanley, AIG, JP Morgan, Citigroup, and Bank of America—the very
firms that ultimately failed, were restructured, or received bailouts.

An increase in delinquencies, defaults, and foreclosures associated with the
housing downturn had turned into losses on mortgage-backed securities. These losses,
magnified and spread by the sale of derivatives, threatened the solvency of
systemically important financial institutions with insufficient capital cushions. This
turned into a global financial contagion in large part because, as Fligstein and
Goldstein suggest, the mortgage industry itself had become a system linking financial
institutions in the economy, making them dependent on the continued increase in U.S.
housing prices. This suggests that the concentration of risk derived from mortgages
in an already concentrated financial services sector dominated by a few large
financial institutions became a source of systemic risk.

All that was needed to expose the limitations of a highly concentrated and
integrated financial system that engaged in excessive risk-taking was a housing
downturn. When the housing downturn began, the rampant ponzi and speculative
activity in the financial markets became apparent. Assets derived from dubious loans
that had been securitized, repackaged, and sold as valuable assets deflated into
“toxic” assets. But because the trillion-dollar OTC derivatives market was

361 Gjerstad and Smith, “Monetary Policy, Credit Extension, and Housing Bubbles, 2008 and 1929,”
124.
363 Fligstein and Goldstein, “Roots of the Great Recession,” 23.
nontransparent, investors were uncertain about the extent and location of these mortgage-derived “toxic” assets. Uncertainty and lack of trust translated into financial panic, inter-bank lending froze, and a general credit crunch, hurting businesses and consumers alike, ensued. As a result, the Great Recession began.

As I write, scores of able-bodied men and women in America are unemployed, a great many live below the poverty line, and far too many hard-working individuals fail to receive a basic living wage. The rich grow richer, the poor grow poorer, and the American republic increasingly appears more interested in serving moneyed interests than attending to the needs of the people who are suffering. Joseph Stiglitz notes that the Gini coefficient, one standard measure of inequality, is .47 for the U.S., and suggests that the United States is slightly more unequal than Iran and Turkey and much less equal than any country in the European Union.364 The legacy of the financial crisis also lingers on in the prolonged economic immiseration experienced by the one out of six Americans who would have liked to find a full-time job but couldn’t get one a half decade after the crisis.365 It persists in the fraction of Americans officially living in poverty increasing from 12.5% in 2007 to 15.1% in 2010. It endures in the hollowing out of the middle class, income growth primarily occurring at the top 1 percent of the income distribution, and the fact that the chances that those at the bottom or in the middle of the income distribution—who are hurting even more after the recession—will make it to the top are dramatically lower than the chances that those already at the top will remain there.366

365 Ibid, 1.
366 Ibid, 25.
The central thesis of Joseph Stiglitz’s recent *The Price of Inequality* is that while there may be underlying economic forces contributing to growing inequality, politics has shaped the market by embedding it in ways that advantage the top at the expense of the rest.\(^\text{367}\) My central thesis runs parallel to Stiglitz’s claim, suggesting that our political system, in being sensitive to moneyed interests such as business and finance, has governed under a “framework of ideas and standards” that disproportionately favors entrenched interests. The “economy of influence,” as Lawrence Lessig calls it, has distorted our regulatory apparatus for the worse, contributing to an inadequate financial architecture that enabled the Great Recession.

The ignored warnings that economic prosperity was reliant on shaky foundations, such as an unsustainable housing bubble and heavy indebtedness, seemed all too prescient. The decision to repeal Glass-Steagall and give rise to a housing finance market concentrated around a core set of dominant firms now seems disastrous. The decision to prohibit regulation of derivatives now seems imprudent. The expectation that the enlightened self-interest of Wall Street firms would be enough to induce proper behavior and an efficient market with socially optimal outcomes for society as a whole now seems to have been a utopian delusion.

*The Way We Were*

For thirty years after the Great Depression, the United States political economy embraced an ethic of shared prosperity. It was an era in which John Maynard Keynes’ declaration that “the outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes” resonated loudly in establishment

\(^{367}\) Ibid, xx.
The ‘Fordist regime,’ as it now is often called by the Regulation School and the U.S. Social Structure of Accumulation (SSA) school, was a regime of accumulation based on “mass production of automobiles and other consumer durables by unionized, semi-skilled workers whose income kept pace with productivity advances.” It was an age of expanded consumption in which the suburbs were born, TVs were manufactured, variations in cars became plentiful, energy was cheap, and the interstate highway became paved.

As Robert Reich pointed out, it was the era of “the basic economic bargain,” where workers were understood to be consumers whose earnings were continuously recycled to buy goods and services other workers produced. It was a period referred to as “The Great Prosperity” because from 1947-1975 the basic economic bargain associated with the legacy of President Franklin Delano Roosevelt’s New Deal produced “the most dramatic and widely shared economic growth in the history of the world.” Indeed, it was a period in which the economy enjoyed an unprecedented boom combined with low unemployment, low inflation, and the rapid growth of material living standards. The wages of lower-income Americans and productivity alike grew rapidly, the booming economy advanced the bargaining position of workers (almost a third of which were unionized by the mid 1950s), and the government both expanded access to education and provided Americans with security against the risks of economic life with bold initiatives such as Social Security in 1935 and Medicare and Medicaid in 1965.

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368 Keynes, The General, 372
369 Block, “Crisis and Renewal: The Outlines of a Twenty-First Century New Deal,” 34.
What Went Wrong?

Though this mass consumption economy built around suburbanization and the purchases of consumer durables, including automobiles and cheap energy was, as Block puts it, “a powerful formula for sustained economic growth,” he also cautions against bathing in nostalgia because, despite its strengths, the post-war mass consumption economy had its limitations. Block notes that “there were periodic recessions, minorities and many women who were excluded from desirable job opportunities” and that substantial military spending was necessary to push the economy closer towards full employment.” Most importantly, the limitations of this growth model were further exposed, especially under conditions of stagflation during the 1970s, when business began to “spend as a class.”

From the late 1960s through 1975 economic stagflation in conjunction with the intensification of the Vietnam War “placed severe strains on the US position within the global economy,” including increasing inflationary pressures which made the New Deal or Fordist regime of accumulation politically vulnerable. The evolution of the economy was such that “the pattern of growth based on suburbanization, automobiles and cheap energy began to run up against geographical and environmental limits.” Duménil and Lévy describe this turbulence in the context of a structural crisis in which inflation skyrocketed to record rates, “wages entered into a period of near stagnation; the profit rate dropped, and above all, a great wave of unemployment supplanted full employment.” These deteriorating

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373 Block, “Crisis and Renewal: The Outlines of a Twenty-First Century New Deal,” 33.
374 Ibid, 33.
375 Blyth, Great Transformations, 155.
376 Block, “Crisis and Renewal: The Outlines of a Twenty-First Century New Deal,” 38
377 Ibid.
378 Duménil and Lévy, Capital Resurgent, 14.
conditions, in particular the decline in profitability of capital, adversely impacted “the complex of upper capitalist classes, whose property materializes in the holding of securities (stock shares, bonds, Treasury bills, etc.), and financial institutions (central banks, banks, funds, etc).”

Heeding the message of Lewis Powell’s memo entitled “Attack of American Free Enterprise System,” corporate PACs expanded from 300 in 1976 to over 1,200 by the middle of 1980. Business began to “spend as a class” and the substantially increased role of money in politics (in part because of television and new computer-based technologies, and in large part because of the political strategy of business) subsequently altered the ethos of the Democratic Party, which became increasingly aligned with business interests by the 1990s. As a result, the “framework of ideas and standards” policymakers worked within increasingly reflected an “economy of influence” representative of affluent interests.

After the 1970s, a new “regime of accumulation” was needed. While “environmentalists and post-industrial analysts argued that the economy needed a radically different growth model and major shifts in government policy,” the views of ascendant business interests, covered in rhetoric that “if the government would cut taxes and regulation, private sector investment would produce substantial job and income growth,” ultimately prevailed. As a result, the US government subsequently abandoned the basic economic bargain, and instead “embraced massive tax cuts, weakening of labor unions, reductions in public provision for the poor and a shift of regulation to allow business and finance to shift costs onto other groups.”

James Bellamy Foster and Fred Magdoff, like Fred Block and Robert Reich, have

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379 Ibid, 7-18.
380 Hacker and Pierson, Winner-Take-All Politics, 118.
381 Ibid.
382 Block, “Crisis and Renewal: The Outlines of a Twenty-First Century New Deal,” 33.
suggested that these trends created macroeconomic conditions conducive to a sharp economic decline once the speculative bubble that economic growth was reliant on burst.\textsuperscript{384} As Fred Block puts it, these developments culminated in the American political system’s creation of an “ersatz regime of accumulation.”\textsuperscript{385}

As I understand it, this regime was “ersatz” or inferior because the emergence of an “economy of influence” had hegemony over the “framework of ideas and standards” within which policymakers worked. This had profound effects on the American political economy and the recent crisis of capitalism was a product of regulatory failures, and by implication, complex political failures associated with the substantially increased role of money in politics since the 1970s. Specifically, the politicization of the business and financial community amidst the growing importance of financial activities as a source of profits in the overall economy shifted the balance of political power in America. Not only did the emergence of this “economy of influence” have a corrosive effect on the American political economy; it was also at odds with what the Framers of our constitution intended.

The ancient Greek historian Thucydides famously said, “right, as the world goes, is only in question between equals in power, while the strong do what they can and the weak suffer what they must.”\textsuperscript{386} The financial crisis is in many ways a repetition of the maxim of Thucydides. The financial sector, using its political muscle based on the substantially increased role of money in politics, waged a series of deregulatory campaigns that made sure that the failures of inherently unstable

\textsuperscript{383} Ibid, 39
\textsuperscript{384} See Bellamy Foster and Magdoff, The Great Financial Crisis, Reich, Aftershock, and Block, Crisis and Renewal: The Outlines of a Twenty-First Century New Deal."
\textsuperscript{385} Ibid.
\textsuperscript{386} Thucydides, The Peloponnesian War, trans. Richard Crawley (New York: Modern Library, 1951), 331.
financial markets were not corrected by government intervention that might reduce industry profitability. The emergence of an “economy of influence” in our nation’s capital effectively ensured that policymakers and political leaders worked within a “framework of ideas and standards,” often referred to as “neoliberal,” that benefited affluent interests, such as the interests of the financial services industry. Regulation of derivatives became prohibited. Capital requirements became reduced. Conflicts of interest at private credit rating agencies persisted. Financial innovations such as the emergence of Mortgage-Backed Securities (MBS), Collateralized Debt Obligations (CDOs), and Credit Default Swaps (CDSs), supported never-ending fees, unprecedented profits, and lucrative bonuses, which together distorted incentives, generated moral hazard, and contributed to a mortgage-finance industry predicated on dubious mortgages and a housing bubble. As the appreciation of housing value slowed and reversed, missed payments on mortgages eroded the value of mortgage-derived assets circulating through capital markets around the globe. The precarious model of the 21st century financial system became exposed and the significance of Minsky’s financial-instability hypothesis became apparent. Asset values collapsed, interbank trust eroded, fear permeated the financial markets, and credit froze. As a result, household consumption declined and firms reduced investment amidst bad economic prospects and the inability to get financing for investment projects. The Great Recession began, inequality heightened, and economic suffering continues to endure.

What Is To Be Done?

Nearly six years have passed since the peak of the financial crisis, yet the debate over its ultimate causes and the US government’s response to save the
financial system and promote economic recovery endure. To be sure, excessive risk with thin capital margins by financial institutions, lack of transparency in derivatives markets, securitization of dubious loans, and the cooptation of an insufficient regulatory apparatus by an increasingly large and concentrated financial services industry all contributed to the financial meltdown and Great Recession. But these proximate causes should be understood within the context of long-term political and economic trends shaped by asymmetric political clout. Private actors took private actions that undermined the economy because inefficient financial markets were insufficiently regulated. While there is an element of truth in ideological explanations regarding an age of “neoliberalism,” this thesis argues that the crisis is best evaluated as an indictment of regulatory failures, and by implication, complex political failures associated with the corrosive effect of money in politics on the American political economy.

For America to return towards a path of sustainable prosperity, policymakers must reconfigure the American economy so that it works for the American people—not just vested interests in an “economy of influence.” This is why we had an “ersatz” regime of accumulation that was doomed to fail. Yet imaginative proposals for a new growth model that runs counter to the status quo, such as Fred Block’s proposal of a “green” mass consumption economy in which “there is a positive synergy between rising real income levels and expanding output,” remain on an uneven playing field so long as our political system, and thus the American political economy, continues to cater to entrenched and well-funded special interests in an “economy of influence” that dominates the policymaking process.\(^{387}\) Indeed, any project that attempts to

\(^{387}\) Block, “Crisis and Renewal: The Outlines of a Twenty-First Century New Deal,” 43.
construct a more egalitarian income distribution for establishing a new growth model, that attempts to consolidate a new structure of demand, or that attempts to reorganize capital flows faces an inherently uphill battle in today’s political system. Yet in the shadow of the recent crisis, it is clear that we need to end the corrosive influence of money in politics so that political debates engage in a rational discourse regarding the ideal American political economy. Only then can political economic analysis provide a coherent vision that, based on its academic merits, becomes “the source of an awareness of ways by which a capitalist structure can broaden its motivations, increase its flexibility, and develop its social responsibility.”

Put differently, we need to end political corruption, not just in the sense of quid pro quo, but in the sense of a system, that, due to the substantially increased role of money in politics, jeopardizes the “independence” of Congress as our framers intended. Only then can intellectual clarity and political will triumph so that the government is more representative of and responsive to the American people. As Lessig puts it:

If the independence of our Congress has been weakened—if the intended dependence “upon the People alone” has been compromised by a competing dependence upon the funders—the solution to this corruption is to end the compromise.

There are a number of strategies for real campaign finance reform that aim to achieve such circumstances, such as federal legislation to create “clean” or “voter-owned” federal elections based on state models in Connecticut, Maine, and Arizona. These models allow candidates to opt into a system that limits contributions to a sum, such as $100 per citizen, matched, after the candidate qualified, by a sum, such as four to

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389 Lessig, Republic Lost, 264
one, by the government.\textsuperscript{390} In fact, this is the basic model of the currently proposed Government By the People Act, which supports a model whereby smaller contributions to candidates who attract significant grassroots support and forgo traditional political action committee funding would be matched at a six-to-one rate, along with a “My Voice” $25 refundable tax credit to spur small contributions to candidates.\textsuperscript{391} Lessig refers to this strategy as “the conventional game,” and suggests that:

Candidates opting into these public-funding systems spend more time talking to voters than to funders. They represent a broader range of citizens than the candidates who run with private money. And they have succeeded in increasing the competitiveness of state legislative elections, making incumbents if not more vulnerable, then at least more attentive.\textsuperscript{392}

However, Lessig suggests that the probability of its success on the federal level is limited because of the already existing economy of influence, which would likely, unfortunately, effectively ensure its legislative defeat. Another strategy Lessig suggests is a constitutional amendment, which, if ratified, could make it unequivocal that corporations do not have Constitutional rights, that money is not speech, and that legal corruption is no longer acceptable in the American republic. This strategy, he suggests, is the most likely to succeed.

In the shadow of the crisis, it should be clear that markets, by themselves, neither lead to efficient, let alone equitable outcomes. Yet perhaps more importantly, it should be clear that there is no clear market-state dichotomy. The outmoded confrontation between ‘state and market’ that occupies much academic, policy, and political attention, including narratives of the financial crisis, conceals the real debate.

\textsuperscript{390} Ibid, 273.
\textsuperscript{392} Lessig, \textit{Republic Lost}, 273.
If markets are embedded in evolving political, regulatory, legal, and ideational contexts, the debate should not be about whether to regulate, but over what constitutes sufficient regulation. One can only speak of more or less regulation, of better interventions, of how to efficiently and equitably intervene with various aspects of market exchange. Thus, we must realize that our recent regulatory and market failures, which have created unnecessary human suffering, are related to our political failures. This means that as a society we ought to reassess how markets and our political system work (and don’t work), reconsider our priorities, reappraise the role of regulatory architecture, and reframe how we conceptualize intervention in markets. This means reasserting the importance of regulated capitalism and pushing the question as to whether constructing a more just, equitable, sustainable, and socially responsible capitalist democracy is possible from the realm of theory into the realm of practice. In the shadow of the crisis, it is clear that less government involvement in certain markets, such as financial markets, was imprudent. Indeed, so-called “neoliberal” reductions in government involvement in financial markets created a space for the emergence of a generalized financial crisis that would have been more limited and containable in the past, such as previous low interest rates or bursting asset bubbles.

As Karl Polanyi would remind us, humans need not be subordinate to the logic of an impersonal market mechanism. It is incumbent on humans to use the tools of democratic governance to embrace the central task of creating more abundant freedom for all by rejecting our subordination to the impersonal economy and directing the economy to meet our individual and collective needs.\(^\text{393}\) That means

designing an efficient and equitable regulatory system. Yet to do so it is incumbent that we end this corrosive “economy of influence” that imperils the American political economy. We have the basis for judging the status quo and thinking critically about ways the American political economy can improve. The true task is recognizing this, having hope, and harnessing the intellectual clarity and political will necessary to restore freedom of opportunity and integrity to our old Republic.
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