PERSONALLY SPEAKING

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WHAT WENT WRONG?

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What went wrong with U.S. financial markets and the real economy? A simple enough question, with a simple answer – gross human failure. Although specific examples of human failure abound, the reasons for that failure aren't so simple to track down. It's best to begin with the basics.

All economies are systems designed by and set in motion by human beings acting alone as individuals or together as either private groups or public agencies. To refer to the U.S. economy as a market system means that decision-making is vested primarily in individuals and to a lesser extent in private groups such as professional and trade associations and labor unions, and public agencies.

The market system functions well when economic agents act knowledgeably, rationally, fairly, and with restraint especially as regards self-interest. Share prices on stock exchanges move up and down depending largely on the underlying fundamentals of the public corporations whose shares are being traded.

Greed **takes over when that restraint on self-interest is cast aside leading in the extreme to what the chairman of the Federal Reserve in 1996 called "irrational exuberance" -- a type of market failure in the sense that the underlying fundamentals of the corporations whose shares are being traded indicate that those shares are grossly over-valued. However, the opportunity to buy shares and cash in on the gains that derive from rising share prices which seem to continue indefinitely attract additional investors who drive prices even higher.**

Fear **takes over when shareholders begin to realize that the shares they hold in fact are over-valued and they must sell quickly before the price falls precipitously and wipes out their gains. This too is a type of market failure in the sense that panic selling drives share prices well below the prices that the underlying fundamentals otherwise would support.**

Financial markets dysfunction whenever human behavior is driven mainly by fear and greed, traits which are deeply embedded in human nature. Fear follows greed which has morphed into irrational exuberance but is not a proper corrective for that greed anymore than another round of drinks cures a hangover. Personal restraint on self-interest is the proper corrective. In the past we called that corrective moderation. Libertarians including many mainstream economists today argue otherwise: "let the market sort through the problem by shaking out the losers whose own bad judgment got them into trouble in the first place." Their remedy can be characterized as a form of social Darwinism: the weak die, the strong survive.

While attractive to many, that solution presents one major problem. Those who behave responsibly may be taken down with those who acted irresponsibly, as with homeowners whose property has slipped in value because their neighbors got mortgages they could not afford, eventually defaulted and were pushed into foreclosure. Limits have to be imposed on stock traders because experience has shown that left unchecked greed and fear can trigger not just a financial market meltdown but also a collapse of the entire economy. Reasonable limits, for example on naked short selling and buying on margin (borrowing from a broker to buy stock), are necessary to assure orderly trading activity and in the worst case scenario to ward off a bloodbath like the Great Depression of the 1930s.

Those limits are imposed by individuals, private groups, and public agencies. Individual investors are routinely instructed to exercise due diligence – carefully examining the details of an investment opportunity – before instructing their broker to invest their funds. Sadly, many did not and bought securities about which they knew little or nothing at all.

Private groups such as publicly traded corporations are required to have their books examined by independent auditors to assure their shareholders and the public that their performance is accurately reported. The same requirement applies to publicly traded financial institutions including notably investment banks and commercial banks. Here too there was a failure to exercise due diligence and assets were carried on their books which initially were over-valued thereby inflating the institution's net worth. When it became clear that those assets were not producing the expected revenue stream, they had to be sharply lowered in value thereby reducing the institution's net worth, cash flow, and profitability. Inevitably the price of their shares tumbled, and for a small number of troubled commercial banks triggered a silent run – withdrawal of their deposits by electronic transfer -- forcing them to close or to be bought out.

In their eagerness to promote wider home ownership, Congress through its oversight committees failed to rein in the risky practices at Fannie Mae and Freddie Mac that purchased sub-prime adjustable rate mortgages on which borrowers simply could not make their monthly payments when interest rates and interest charges were ratcheted upward.

Some commentators assert that the current financial market crisis originates from too little regulation. Others hold exactly the opposite view. Strictly speaking, both are wrong. The central problem is that there has been widespread failure to *enforce* the limits already in place, limits on individuals, private groups, and public agencies.

One of the most important lessons of the current financial crisis is that regulation alone is not sufficient to control irrational exuberance or panic selling any more than a football rule against roughing the passer assures that quarterbacks will not be injured. What is necessary is strict enforcement and certain penalties for breaking the rule, breaching the limit, especially when it involves private groups or public agencies.

Nevertheless, just as quarterbacks are injured even with strict enforcement, so too financial markets sometimes will dysfunction even under a strict enforcement regime. Because human beings including those who practice moderation in their everyday affairs make mistakes and do no know and fully understand how markets change with new financial products and new global connections, enforcement can limit the damage but cannot prevent every serious dysfunction.

Economic history teaches us that the one thing the market system cannot do is assure the financial security of everyone.

> **For more on this crisis see Edward Kane's August 2008 paper *Ethical Failures in Regulating and Supervising the Pursuit of Safety-Net Subsidies* available at:**
> **http://www2.bc.edu/~kaneeb/Ethical%20Failure%20in%20Regulating-8-8-08.doc**
> **Kane holds an endowed chair in finance at Boston College, is a former president of the American Finance Association, and has been consulted widely on problems of failure and dysfunction in financial markets. In his paper Kane describes the current financial mess as "a scandal of the highest order."**

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