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LIBERTY AFTER LEHMAN BROTHERS

By Loren E. Lomasky

I. Introduction

Like a motor that stutters, deceptively jerks back to life, and then entirely seizes up, the engine of world finance was thrust into crisis by events of the weekend of September 13, 2008. The New York Federal Reserve Bank had called a meeting of potential suitors to see if troubled Lehman Brothers might be reclaimed in its eleventh hour by an arranged marriage to some fiscally more robust firm. On this occasion, however, potential rescuers were less ardent than they had been six months previously when JPMorgan Chase swept in to snatch Bear Stearns from the financial abyss. They had been chastened by the intervening cascade of discouraging news in housing markets and throughout the financial industry. Nor would the Fed sweeten the dowry enough to persuade the reluctant to commit. Lehman Brothers would be allowed to sink or swim on its own. And sink it quickly did; when the new business week dawned, Lehman Brothers filed for bankruptcy.

Perhaps government officials would not have been so keen to subject the company to the disciplinary forces of the market if it had comprehended how severe and broad the reaction to the fall of Lehman would be. This had been a firm with creditors among the world's financial elite, and these counterparties were interlocked with innumerable other firms in a web of delicate trust relationships. Once doubt arose concerning who could pay and who could not, the rational course for each firm was to build up its own cash balances by selling marketable assets and by calling in loans. What was individually rational, however, proved to be collectively disabling. Firms that had been solvent just the day before found themselves unable to meet demands they had not expected. Like one domino striking the next and that the one after, contagion spread beyond all accustomed bounds. First Bear Stearns, then Lehman: who would be next? Answers came discouragingly quickly: insurance giant AIG, quasi-governmental mortgage leviathans Fannie Mae and Freddie Mac. Iceland's banking industry went into receivership, taking most of the country with it. The pathology of finance bled profusely into other sectors. Legendary titans of American industry Chrysler and General Motors sought bankruptcy protection, and numerous other American, British, and European firms were put on financial life-support by panicking governments. GDP everywhere plummeted as unemployment soared. Was it to be Great Depression II?

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The cautious answer is: Not yet. Indeed, as I write a year after Lehman sank beneath the waves, a majority of the pundits seem to be emerging from their foxholes and offering some hope that, although no robust recovery is to be expected anytime soon, the worst may be behind us. There are still more bankruptcies to weather, more firestorms to be put out by harried public officials, more broken balance sheets to be painstakingly mended. Yet even while crisis-management mode remains very much the order of the day, this may also be an apt time to step back from the day-to-day tremors and perturbations and to consider what enduring lessons are to be learned from the Crunch of 2008.[1] Not since the 1930s has there been an occasion to think so intensely about the adequacy of accustomed modes of economic interaction. Like hangings, financial panics wonderfully concentrate the mind. The technology to contain bank failures, we had been told, was well established; global markets for financial instruments had promoted a spreading of risk that fortified not only the various players in the investments industry but also the system as a whole. Yet over a few days in September these assurances were shown to be hollow. The Great Machine was not the reliably self-correcting mechanism its savants and caretakers had advertised. How was it to be brought back into good repair?

Early responses were variations on: *Round up the usual suspects!* To what should have been no one's surprise, the word from the Continent, especially Paris, was that Anglo-Saxon market fundamentalism had been discredited once and for all in favor of the more prudent and humane dirigisme of the technocratic planners. Before the corpse of Lehman Brothers was cold, French president Nicolas Sarkozy was heard to declare, "Self-regulation as a way of solving all problems is finished. Laissez faire is finished. The all-powerful market that always knows best is finished."[2] Government had meekly stepped aside so as to allow the unfettered market its dizzying rise and yet more dizzying collapse. The indicated remedy was a reversal of the preceding two decades' abdication of responsibility to rampaging capitalism and a move to place business firmly under regulatory wraps. In one way or another, this verdict was seconded by numerous other politicians, business moguls such as George Soros, and Nobel prize-winning economists Paul Krugman and Joseph Stiglitz.

A very different tune was heard from the right. What had brought on the debacle? Government! How are future crises to be avoided? Less governmental intrusiveness! Should deregulation be reversed? No, it needs

[1] A word about nomenclature: The events of 2008 remain too recent for a consensus on terminology to have emerged. My preference is "Crunch." "Crash" overemphasizes the fall of asset prices as opposed to the sheer breaking down of markets and is too much an echo of 1929. "Recession" is too mild and "Depression" too tendentious. "Panic" might be acceptable but suggests something more temporary and subjective than what transpired after the fall of Lehman Brothers.

[2] Nicolas Sarkozy, quoted at http/www.csreurope.org/news.php?type=&action=show_news&news_id=1727.

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to be accelerated! Libertarian and conservative critics pointed to political pressures on Fannie Mae and Freddie Mac to extend housing loans to a wider, less financially capable range of borrowers. Special scorn was held out for the 1977 Community Reinvestment Act which, in the words of the Federal Reserve, "intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound operations."[3] The problem was, of course, that the imperative to provide mortgages to those previously deemed not creditworthy was blatantly in tension with the "safe and sound operations" qualifier. Congressional representatives were solicitous of low-income constituents, President George W. Bush pushed his model of the "ownership society," and an already excited real estate market was set on a course to explosion.[4]

The great virtue of these "explanations" is that they afford one the comfort of preserving ideological convictions unchanged—no new thoughts required. Indeed, the Crunch can be displayed as decisively confirming prior warnings that, take your pick, buccaneer capitalism/ubiquitous government is brewing the apocalypse.

To be sure, rational individuals do not summarily abandon what they take to be well-attested theories when confronted with an anomalous instance or two. However, it is also a part of rationality to reflect critically on one's beliefs in the hope of securing yet better ones. When ideologies ossify, they render themselves impervious to the significance of new data. With regard to the Crunch of 2008, there is ample reason to believe that the instant analyses from both the left and the right are, at a minimum, incomplete. Broadsides against so-called laissez-faire capitalism conveniently fail to observe that institutional failures were less a matter of market deregulation than misregulation. Traditional commercial banks, for which overseers are thick on the ground, suffered worse breakdowns than did the more lightly regulated hedge fund industry. Nor does quantity of regulation translate into quality of regulation. Short-term interest rates are closely controlled by the Federal Reserve (and other central banks), yet one of the most frequently cited factors alleged to have generated the Crunch is an easy money policy pursued too long and too lavishly by the Fed. As quasi-governmental agencies, Fannie Mae and Freddie Mac are subject to scrutiny by their political controllers, yet their failures were no less catastrophic than those of the great investment banks. And although not directly contributive to the Crunch, the fecklessness of piling up new boards of governmental supervisors is underscored by the massive Bernie Madoff fraud, the most ruinous Ponzi scheme ever perpetrated by a private party. It simmered for more than a decade under

[3] The Federal Reserve Board, "Community Reinvestment Act," http://www.federalreserve.gov/dcca/cra/.

[4] See, for example, Stan J. Leibowitz, "Anatomy of a Train Wreck," *National Review* 60 (October 20, 2008).

what should have been but emphatically was not the watchful eye of the Securities and Exchange Commission. Foresight is devoutly to be wished, but it can never be as acute or reliable as hindsight. It is fatuous to suggest that the events of 2008 can be attributed to a scarcity of bureaucrats.

No less fatuous, however, are complaints from the other side of the political spectrum that the Crunch was primarily or simply a governmental failure. The unsatisfactoriness of this response should be especially troubling to friends of free markets, among whom I count myself. Yes, it's true that policies pursued by Congress, the various regulatory authorities, and semigovernmental entities introduced distortions into real estate (and other) markets, but state actions *always* introduce perturbations into perfect free-market models. It isn't a surprise when opportunists or wide-eyed idealists grasp the levers of political control in order to serve their various ends; what would be truly surprising is if they ceased to do so.[5] No doubt rent-seeking and the like impose costs, but they do not typically drive the economy off the cliff. These costs tend to be less than they might otherwise be because prudent actors anticipate their direction and take intelligent measures to counteract them. Sometimes they do so by opposing politicking with counter-politicking—the dance of dueling lobbyists—but they also do so through voluntary exchange. The primary virtue of the market is not that it works efficiently on frictionless surfaces but rather that it tends to respond effectively to exogenous disturbances: those generated by governmental action just as much as acts of God. Entrepreneurs make money by seizing opportunities that dubious governmental undertakings create. In 2008, however, friction won. It does seem that market participants en masse lost their heads. To be sure, some financial institutions were under pressure from their political masters to write mortgages of dubious creditworthiness, but that does not explain why other investors not under such pressure then snapped these up, yet others decided that these were assets fit for securitization, rating agencies evaluated as AAA what soon proved to be toxic treacle, and final purchasers leveraged themselves to dizzying heights in order to expand their share of the action. That is not how the textbooks—I mean the textbooks written before the demise of Lehman Brothers—tell us that rational profit-maximizers are motivated to behave. Yet they did so, at costs now well into the trillions of dollars and rising. Because that is the case, it especially behooves friends of markets to reevaluate our creed. Did we miss something that now needs to be added to the standard textbook presentation? Or if not absent, were there some aspects of capitalistic exchange that were under- or over-emphasized? Those who saw it all coming and took appropriate measures, thus generating proud records of predictive success and personal fortunes, need not review the events of 2008. I, alas, am

[5] The obverse diagnosis lays the blame for the Crunch on the "greed" of speculators. When haven't the money men been in it for the money?

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not among them.[6] This essay is a first reflection on the legacy of Lehman Brothers. What are the implications of the Crunch for the political economy and philosophy of liberalism?

II. Two Metaphors

Two metaphors dominate the theory of voluntary interchange among independent actors each acting with exclusive concern for his own self-interest. The first is that of the *invisible hand.* Although assuming its canonical form in the work of Adam Smith, it appears only once in *The Wealth of Nations* (1776) and once in his other great book, *The Theory of Moral Sentiments* (1759). Counting occurrences, however, radically understates the impact of the controlling idea. Smith's system of political economy over and over again provides instances of individuals' self-regarding behavior which, when pursued within the context of a "system of natural liberty," generates results that benefit not only the party in question but also other members of the social entity. Private interest is midwife to the common good. Smith's invisible hand should not be interpreted theologically or mystically. Rather, it is a reliable mechanism via which benign outcomes spontaneously emerge as the unintended consequence of the activities of the various actors. Central controlling authority is not required, and indeed is inconsistent with the optimal working of the invisible hand.

Smith is not the first important social theorist who advances an invisible-hand model. He is preceded by Bernard Mandeville, who contends in *The Fable of the Bees* (1714) that private vices generate public benefit (while private virtue would enfeeble the hive). Their accounts differ in important respects, especially with regard to the underlying moral philosophies, but the implications for political economy are very similar. The twentieth century's great theorist of the grip of the invisible hand was Friedrich Hayek, 1974 Nobel laureate for economics, who simultaneously punctured the pretensions of central planners to achieve an effective top-down ordering of the economic realm and demonstrated the power of spontaneous orders to facilitate coordination. It is only a slight exaggeration to say that the invisible hand is the dominant motif of all free-market theorizing since Smith.

The other commanding metaphor is the *prisoner's dilemma.* As with the invisible hand, it refers to a scenario featuring interaction among independent self-interested agents. Unlike invisible-hand cases, results are

[6] Nor was Alan Greenspan. Critics have pilloried his rueful admission to Congress in October 2008 that "[t]hose of us who have looked to the self-interest of lending institutions to protect shareholder's equity—myself especially—are in a state of shocked disbelief" (http://oversight.house.gov/documents/20081023100438.pdf). Without wishing either to affirm or to deny Greenspan's considerable culpability for the Crunch and its aftermath, I find the candor of this declaration refreshing. It marks a greater personal integrity than that possessed by certain previously effusive admirers-turned-critics.

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baleful. The strategy that each party adopts leaves it worse off than would have been the case had all parties followed the contrary strategy. What makes the prisoner's dilemma appear strikingly paradoxical is that by each acting rationally in his own self-interest, they are collectively worse off than had each acted against self-interest. Uncoordinated activity here leads to disaster, but the prospects for the affected parties to escape this result are dismal because each has an incentive to defect from the strategy that would evade it.

The label "prisoner's dilemma" goes back only to the mid-twentieth century, but the concept has long been known to political philosophers. Most famously, it is the structure that governs the behavior of denizens of Thomas Hobbes's state of nature, whose lives, consequently, are solitary, poor, nasty, brutish, and short. For Hobbes, the moral is undeniable, and he develops it in *Leviathan* (1651) with unequaled brusqueness: in order to survive, the parties must contract away their primal freedom. Uncoordinated choice is the problem to which the state is the solution. The Hobbesian interactive scenario is anticipated as far back as Book II of Plato's *Republic* in a thought-experiment advanced by the character Glaucon.[7] For Plato, as with Hobbes, the way out of the trap is a directive central authority.

Two controlling metaphors and two diametrically opposed equilibria: the Pareto-superior invisible hand and the Pareto-inferior prisoner's dilemma. Which is the one to be credited? The consensus among theorists is that *both* obtain. The traditional liberal synthesis holds that central direction is required to break out of the prisoner's dilemma–like state of nature, but then, under the discipline of the minimal (or in later incarnations, not-so-minimal) state, independent agents suitably constrained by the rule of law will reap the rewards of the invisible hand. Anarchists demur, arguing that the invisible hand itself is sufficient to undo the grip of the prisoner's dilemma, perhaps through sequences of iterated games. For the anarchist, then, it's invisible hand all the way down. The paradigmatic model of traditional socialism is similarly monistic, but with centralized authority taking the place of individual self-directedness on all levels. Market socialism/social democracy attempts to carve out niches somewhere in between.

There exist vast literatures on prisoner's dilemma strategies, the alleged impossibility of socialist planning, the feasability of rational anarchism, and related concerns. For purposes of this essay, I am going to assume that some version of the liberal synthesis is correct. If my assumption is mistaken, if either unbridled anarchism or thoroughgoing socialism is capable of bringing about tolerable levels of peaceful coexistence and prosperity, then that is how political life should be. My view is that

[7] It can be argued that Plato also anticipates invisible-hand dynamics in the *Republic*'s account of the "city of pigs."

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neither theory nor practice renders either of the monisms plausible, but that will not be argued here. Liberalism is a more delicate structure than either of its rivals because it acknowledges that the uncoordinated activity of diverse parties is sometimes to be welcomed but sometimes to be combated. The trick is to work out which is which.[8]

As a first approximation, it can be agreed that, all else equal, it is good that individuals be unimpeded in exercising their liberty in accord with their own conceptions of the good. Those who disagree, either on grounds of paternalism or as friends of virtue in its constant vigilance to root out vice, may have a point, but, again, it is beyond the ambit of this essay.

The first approximation is sorely in need of a second. Individuals are self-directed agents of their own ends in invisible-hand scenarios, but so too are they in prisoner's dilemmas. The difference is that in the former they bear the lion's share of the costs of their own goal-directed actions, while in the latter they impose costs on nonconsenting others. Moreover, those costs exceed *in toto* for each agent the benefit she secures from her own choice. That is the sense in which prisoner's dilemmas are negative-sum games. What the centralized authority of the Sovereign does in Hobbes's telling of the story is to thwart individuals' pursuit of their own advantage—a negative—but to secure for them liberation from external costs imposed by the choices of others—a decisive positive.

Only in the most stylized examples of invisible-hand interactions (e.g., two-party exchange without externalities) is it strictly true that individuals fully bear the costs of the benefits they secure for themselves. To take the most obvious example, markets with open entry allow competition that can and does drive less-capable parties to the wall. The rise of the automobile spelled doom for buggy-whip manufacturers. (The recent humbling of General Motors can be viewed as a tardy sacrifice to the god of the buggy whip.) To constrain the liberty of actors with the proviso that they not impose external costs on any nonconsenting party would be intolerably demanding in a world with non-zero transactions costs. A functional system of private property rights will, however, go a long way toward countenancing only those exchanges that generate benefits in excess of the external costs thereby imposed and—this is crucial if the structure is to be deemed both reasonably efficient and just—will tend over time to spread benefits and costs in such a way that almost all persons will enjoy an ex ante expectation of thereby being rendered better off than if such exchanges were blocked. Conversely, activities that generate excessive external costs—and, most especially, those tending to set off cascades of costs—are to be restrained. This is a tolerably simple set of dicta for political institutions, but of course it is not as simple as one that

[8] For all the brilliance and rigor of his political logic, Hobbes ultimately places himself outside the perimeter of what is recognizably liberal in virtue of allowing the necessity of avoiding prisoner's dilemmas to occupy nearly all the political space there is.

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recognizes only one variable, e.g., "The government is best that governs least." To the contrary, sometimes less government is better than more—and sometimes it isn't.[9]

I propose instead a normative structure with two parameters. The first of these is the *Personal Choice variable:* more scope for self-directed choice is better than less. The second is the *External Cost variable:* less imposition of unconsented costs on others is better than more. A moment's consideration reveals these variables to be in permanent tension. The greater the scope of permitted choice, the greater the likelihood of interfering with the designs of others. Which of the variables captures our conception of personal liberty? Both do. As the scope of permissible choice expands or contracts, liberty waxes and wanes. Similarly, the greater one's liability to bear unconsented costs, the less free one is to live according to one's own lights rather than those foisted on one by others.

Hobbes's state of nature is a condition in which individuals have a right to all things, notoriously even to the bodies of others.[10] Rights so understood are not claims that impose duties of forbearance on others but rather naked choice that constrains no one. In the state of nature so conceived, the personal-choice parameter is maximized. This is, Hobbes claims, a condition of perfect liberty. He would be correct if liberty were only a function of the scope of personal choice, but it is not. At any rate, it is not the liberty that we have reason to care about. The other extreme might be a traditional society in which external interference is absent but the only option open to each person is to adopt the same social role as that formerly held by one's same-sex parent. This too falls short of full-bore freedom. The indicated moral is that there is an irreducible duality to liberty. Therefore, there is an irreducible complexity to social life: the two parameters are in permanent conflict, and all reasonable principles of permissibility will incorporate strategies for trading off one against the other.

This is vague. To render the structure operational, it is necessary to answer the question: How much does a gain in choice of magnitude M_1 outweigh costs of magnitude M_2? I do not believe that there exists a programmatic metric to resolve such conflicts. Rather, particular applications of the structure require case-by-case estimation of the gravity of the personal-choice interest at stake and the severity of associated external costs. For example, one central chapter of the history of liberty in the West involves the growth of a strong consensus that the choice of a preferred mode of religious expression is a very weighty interest, one to be secured even when it causes acute psychic externalities. Assessment of the weight of a choice to smoke cigarettes has taken an opposed trajectory, being routinely trumped in public

[9] Similarly, Ronald Reagan's statement in his First Inaugural Address that "government is not the solution to our problem; government is the problem" is approximately 88 percent correct. That's a splendid result for a practicing politician, but it isn't adequate as the foundation for political philosophy.

[10] Hobbes, *Leviathan,* chap. 14.

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practice by even minimal external impositions. Is there an alternative possible world in which the ordering would have been reversed: great attentiveness to the external costs of religious belief and little to those of burning tobacco? That seems entirely plausible. Indeed, there are corners of the world in which, for better or worse, it is actual.

Where the weight of either variable is taken to be very great, the discourse of liberalism often speaks in terms of *rights.* Rights appear on both sides of the choice/cost calculus. If you have a right to open a McDonald's franchise next door to my sandwich shop, then the fact that your choice to do so will be exceedingly costly to me does not afford me standing to block your enterprise. I may, however, bar you from crossing through my establishment on the way to yours even though the cost to me of your trespass is slight and the inconvenience to you of having to detour is substantial.[11]

If I were a *natural rights theorist*, I would not speak in this way. Rather, I would reverse the order of implication. According to a natural rights account, it is not the costliness to others of a particular kind of activity that renders such behavior a rights violation. Rather, what makes the imposition of a cost a matter of considerable gravity is the fact that it constitutes violation of a (natural) right. The metaphysical foundation of natural rights discourse is obscure, especially within theories that eschew theological underpinnings.[12] This is a theoretical burden natural rights proponents deem worth bearing because the alternative of (merely) conventional rights is judged to be too frail a barrier against predation: what the state giveth it also taketh away. The concern is legitimate, and I sympathize to some extent with a tactic of natural-rights-as-Noble-Lie. One problem with it, though, is that it makes rights more mysterious than they need be, more mysterious than if they are understood as derivative from the two parameters. A second problem is that it casts doubt on the legitimacy of an *evolutionary technology of rights.* Illustrating that point is the burden of the following section.

III. The Evolution of Conventional Rights

Rights can be conventional without being *merely* conventional. They will not be shallow constructions if they are solidly grounded on the two

[11] It is, however, too great a stretch to conclude that all real rights are *absolute,* inviolable come what may. If to flee from an assassin, you run across my private property—even property displaying a large *No Trespassing* sign—you have not acted improperly (although you may subsequently owe compensation for damages inflicted). Rights can be robust without being infinitely stringent. I address these issues in "Compensation and the Bounds of Rights," in *Compensatory Justice: Nomos XXXIII* (New York: New York University Press, 1991), 13–44.

[12] John Locke in *Second Treatise of Government* explicitly grounds rights in Divine provenance; Thomas Jefferson in the Declaration of Independence is slightly more coy. Robert Nozick in *Anarchy, State, and Utopia* (New York: Basic Books, 1974) is content to leave unspecified the status of the so-called Lockean rights he invokes.

parameters. I offer three examples of unarguably conventional practices that are now woven almost everywhere into the economic fabric of free societies.

A. Personal bankruptcy protection

In virtue of a voluntary undertaking, negligence, or plain bad luck, a person can find herself mired in debt from which she is unable to extricate herself. Failure to make good on the debt constitutes a nonconsensual imposition of costs on the creditor. He has been deprived of property that is rightfully his. Several responses suggest themselves. First, the failure to repay can be adjudged a *crime,* on a par with assault and theft. Given that conception, the indicated response is *punishment.* Sending debtors to prison or shipping them off to labor in Van Diemen's Land is adequate expressively as a response to the perceived wrongness inherent in trampling on the property rights of others.

More responsive to the harm done to the injured party would be to transform the claim on unavailable financial assets into a claim on the labor of the transgressor. Such bondage need not be perpetual, but it might be. John Locke in the *Second Treatise* advances an argument like this for the propriety of slavery. A somewhat gentler remedy than making the debtor the personal property of the creditor is to give the latter a lien of indeterminate duration on any assets that may subsequently be acquired by the debtor. If the amount owed is large enough, and if the debt compounds at the going rate of interest, the obligation may very well not be discharged prior to death. This approach is maximally responsive to people's concern not to be victimized by external cost impositions, but, especially in the slavery variant, it comes down quite hard on the offending party's choice interest.

Compared with either of the preceding options, personal bankruptcy protection is markedly less "natural." Rather, it is a convention through which individuals can be absolved of indebtedness and then make a fresh start unencumbered by the residue of prior obligation. Because of our familiarity with the bankruptcy convention, the extent to which it distorts what would otherwise be the rights and obligations of the concerned parties may not be readily observable. In a world without the bankruptcy convention, a creditor's right to full repayment may be *violated,* but that right does not thereby *cease to exist.* However, in a world with bankruptcy protection, an individual possessing a strong right to repayment may, through no fault of his own, not only lose the repayment but also lose the right to be repaid. This is a moral phenomenon curious enough to deserve some comment. In terms of the model sketched in the preceding section, overwhelming indebtedness sets the interest of the creditor in not bearing unconsented costs against the unencumbered choice interest of the debtor. There is no necessity written in the stars that the conflict be addressed

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after the fashion of contemporary bankruptcy law. From an *a priori* theoretical point of view, both the punishment approach and the bondage approach are at least as plausible. It has, however, been judged over the course of the history of responses to indebtedness[13] that an available but not-too-available mechanism for relieving obligations strikes a better overall liberty balance between the parameters than do alternatives. Of course, it is an imperfect mechanism. Like other forms of insurance, it generates moral hazard. Probably it raises the cost of funds to debtors. These defects, however, are outweighed by the liberation brought to incautious or unlucky debtors. And because potential creditors know that one possible outcome of making a loan is default, they can rationally appraise the likelihood of being repaid in full, and can price accordingly, thereby self-insuring against what they take to be excessive risk.[14] Alternatively, they can purchase credit default swaps on the open market. (More on this later.) Bankruptcy law is something of a kludge, but it is one that works.

B. Limited liability corporations

Nothing is more clearly an artifice than the status of corporations as legal persons standing at a remove from their stockholders. Between Adam Smith's time and ours, the corporation has emerged as the dominant form of economic organization. Factors spurring this transformation are clear. When individuals pool their resources as partners in an enterprise, their joint and several personal liability is, this side of the bankruptcy court, unlimited. Therefore, they have reason to be cautious in such undertakings. Prudent investors will carefully vet potential business partners and agree to share risk only with those known to be of sterling probity and impeccable financial credentials.[15] This means that firms will tend to be small. In the wake of the Industrial Revolution, however, it transpired that a growing number of initiatives that people wanted to pursue in order to improve the material conditions of their own lives (and those of their transactors) required enterprises of larger scale than had ever previously existed. Invention of the limited liability corporation prompted vastly increased capital investment, which in turn afforded individuals enhanced means to pursue their old ends and develop some new ones. For would-be entrepreneurs and their transactors, the personal-choice variable is significantly enhanced. It was not only advances in industrial technology that spurred the nineteenth century's revolutionary trajectory of production; innovations in financial technology were hardly less crucial.

[13] Including its ancient history. The Hebrew scriptures' institution of a sabbatical year in which (some) debts are canceled is an early variation on the bankruptcy theme.

[14] This capacity holds to a lesser extent in the case of tort damage.

[15] Corporations similarly have a prudential interest in avoiding liability for debts incurred by their shareholders. I am grateful to David Ciepley for making me aware of this symmetry.

Corporate ascendancy was not, however, pure gain from the perspective of liberty, for it lessened the capacity of parties on whom external costs had been imposed to recover full damages. To put it another way, when a partnership turns into a limited liability corporation, all those who either voluntarily or inadvertently transact with it are placed at greater risk. Their possibilities for recovering costs imposed on them have been lessened. For example, holders of General Motors bonds will do less well than they would have done if the debts of the company passed through as claims on the personal funds of its owners. In that case, though, there would have been no General Motors. It is because we deem ourselves to be benefited on balance by the corporate form that we welcome its presence in market arrangements. Things could have been otherwise. Once they were.

C. Intellectual property

Intellectual property rights that impose duties of non-trespass on others are intensely troubling to traditional natural rights theories. There are two reasons why this is so. First, the sort of thing that an intellectual property right encompasses may seem metaphysically occult. It is not a concrete object that can be held in one's hands like an apple, walked across like a field, weighed, transported, or chopped to little bits. The property right is to an abstract object, what philosophers call a *type* rather than a *token.* Scarcity does not work in the same way for types as it does for tokens. If I appropriate your apple, then you have one apple fewer. If, however, I build a widget of a type over which you hold a patent, then my having this particular widget does not mean that the quantity of widgets you own has diminished. If there is no particular thing of yours, no spatiotemporally individuated entity against which I trespass, then in what sense can I be said to have intruded on any property that is yours?

Even more troubling is the time-delimited status of intellectual property rights. Suppose that the term of patent duration in this jurisdiction is twenty years from the date of filing. This means that the mere passage of time can render something—assuming that abstract types are indeed something—to which one had a strong, enforceable property right an item that instead is the property of no one. Ownership of concrete property does not work that way. In the Lockean paradigm, one mixes one's labor with an object and renders it one's own—period. Unless it is abandoned, one's tenure over it is indefinite. And if it is abandoned, then some other person is at liberty to claim it, thereby having exclusionary rights against all other people in the world. Intellectual property is altogether different. The extent of the term of protection is a matter of arbitrary fiat. It could have been shorter, could have been longer, could have been zero, could have been infinite. And once the term of the right expires, the abstract object is owned by no one.

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The critic of intellectual property errs in confusing what is *conventional* with what is *arbitrary.* A system of patents under which they last twenty-one years rather than twenty would have been in virtually every respect as manageable as what in fact obtains (although the attractiveness of round numbers should not be underestimated). However, patent durations of either twenty days or twenty decades would undermine the purpose of the intellectual property system. That purpose is, law-and-economics scholars contend, wealth maximization. Although in a broad sense that may be right, it is too undiscriminating a rendering. There are at least two routes to increasing wealth. One is to enhance the choice capacity of individuals to engage in activities they value, and the other is to discourage impositions of external costs. As has been noted previously, these often run at cross purposes. Limited-term protections of intellectual property represent a balancing between these two parameters such that a tolerably good result is achieved. (Only in the economists' fantasies is it a social optimum.) In the absence of intellectual property rights, non-innovators could free-ride on the efforts of those who innovate, thereby depriving them of what would otherwise have been the fruits of their labors. The result would be less innovation, rendering everyone worse off with regard to their capacity to better their lives by making effective choices. However, if intellectual property rights were of indefinite duration, then the liberty of non-innovators would be permanently trammeled. (We are all of us, even the most prolific artists or inventors, non-innovators with regard to the vast preponderance of goods we enjoy.) Limited-term intellectual property rights split the difference. It is, of course, legitimate to call into question how well they do so. Perhaps the conventions we now have are not the very best conventions we could have; perhaps they are not even nearly good enough. What is much less defensible, however, is to suppose that the purity of the free market is sullied by the existence of rights that are thoroughly conventional. These conventions are themselves grounded on interests that are not matters of artifice: the interest in directing one's life in accord with one's own lights, and the interest in not being forced to bear costs externally imposed.

The aim of rehearsing these familiar stories about the development of personal bankruptcy protection, limited liability corporations, and intellectual property rights is to underscore the fact that there is no such invariant species as the "free market." At one time, markets lacked these practices, just as they lacked antitrust legislation, regulatory oversight commissions, lenders of last resort, and dozens of other time-bound bits of institutional apparatus.[16] Individuals transact with willing others in a variety of institutional contexts that evolve in response to changing technologies of production and distribution. The great classical theorists of liberalism were writing about an economic world radically different from

[16] To forestall possible confusion, this is not to be taken as an endorsement of all or any of these constructs.

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our own. John Locke knew nothing of Chapter 11 bankruptcy, nor Adam Smith of the World Trade Organization's TRIPS agreement.[17] That does not render works in the liberal canon less relevant. Although most of their specific policy proposals are now obsolete,[18] the underlying theory of what it is for human beings to live well among others continues to speak to the contemporary condition. Indeed, the record of adaptability of the liberal conception to new vistas (as contrasted, for example, with the progressively more pronounced sclerosis of socialism) shows that it possesses greater universality than might have seemed to be the case in its infancy. But although the reasons that free markets are desirable remain essentially unchanged, what constitutes the conditions of a free market, one suitably responsive to the two parameters, does not remain fixed. The Industrial Revolution gave cause for reconsideration. So too does the Crunch of 2008.

IV. The Lessons of the Crunch of 2008

In the days after Lehman Brothers hauled up the white flag, the entire world of finance took on the likeness of a paradigmatic prisoner's dilemma. Chastened by the demise of Lehman (and the earlier close escape of Bear Stearns), each firm saw its interest as shoring up its balance sheet. That meant calling in loans, unloading vendable assets, and conserving cash. By doing so, each was worsening the liquidity of all the others. The spiral threatened to descend to an equilibrium in which the quantity of lenders' assets and the economy's money supply were drastically lower than pre–Lehman Brothers. When and how it would have bottomed out we will never know, because the central banks of the United States, Europe, and other key economic players rushed to restore liquidity to the system. That we didn't find out is almost surely a fortunate thing.

Note that the hypothesis entertained by each bank that its counterparties were dangerously likely to be overstretched was not false. That is because it became self-fulfilling. If, however, they had acted instead on the assumption that the others were solvent and capable of meeting their obligations, that too would have been largely self-fulfilling. Those market participants that were truly insolvent could have been dealt with via an orderly liquidation process (or at least as orderly as the process can be in times of financial stress). Others, no longer bogged down by weaker hangers-on, would have gotten back to doing the business of business. The resultant equilibrium then would have been achieved at a higher

[17] TRIPS is the Agreement on Trade-Related Aspects of Intellectual Property Rights, signed in April 1994.

[18] Some are not. For better or worse—mostly worse—the need to make and remake Adam Smith's case for free trade across national borders is perennial.

level of wealth than if each distrusted all the others. This disparity is the defining structural feature of a prisoner's dilemma.

The most important lesson of 2008, then, is that sometimes financial markets are aptly self-regulating, but sometimes they are not. The term of art for the latter condition is "systemic failure." Roughly, what this means is that each party, in pursuing its own interest (in the aftermath of September 2008, shoring up vulnerable balance sheets), thereby imposes external costs on others to whom it is tied by the web of relationships that constitute twenty-first-century finance. Each is acting in keeping with individual rationality, but the result is collective disaster. In this as in other prisoner's dilemmas, when a strategy of defection becomes dominant, there can be a long way to fall.

In principle, the rush for liquidity could have been addressed through voluntary arrangements among the participants. Because they understood that each had an interest in the maintenance of an unconstricted flow of credit, they could have agreed, conditional on the like performance by others, to keep their cash drawers open to those with whom they had a history of transacting. Something like this occurred during the Panic of 1907, when J. P. Morgan assembled in his Madison Avenue mansion the aristocracy of Wall Street and forged with them a pact to restore liquidity to besieged financial institutions.[19] It is beyond expectation, however, that any similar rescue operation by market participants could be effected a century further on. Not only is there no single commanding figure comparable to Morgan, but there also no longer exists a tidy coterie of individuals or institutions that constitute the U.S. banking industry. Not only has finance gone global, it has spawned a wide array of near-banks, quasi-banks and bank-substitutes generically known as the shadow banking industry. What they have in common is that they intermediate between borrowers and suppliers of funds. Their operations are too multifarious, occasional, and impersonal to provide the basis for an agreement such that each could have justified confidence that all others would comply. Even if, beyond all expectation, the potential parties to a pact could be identified and then signed up, the means to monitor their performance would be inadequate. Should this be described as a "market failure"? A less misleading locution is "market limitation." The picture of fully informed parties seamlessly transacting among themselves in a world of zero transaction costs and self-enforcing bargains is and always has been a fairy tale. It becomes dangerous when taken to be either a depiction of or a normative standard for actual markets.

The trades of butchers, brewers, and bakers would be grossly impeded, if not altogether scuttled, in the absence of (i) generally recognized prop-

[19] See Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Grove Press, 1990). Milton Friedman and Anna Schwartz also recount this episode in their magisterial *A Monetary History of the United States* (Princeton, NJ: Princeton University Press, 1963).

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erty rights, (ii) transactions that are mostly peaceful and undisputed, and (iii) a reliably authoritative enforcement mechanism that can be brought to bear when parties find themselves unable to resolve their own differences. No less are these primary structures of a liberal order required for the business of buying and selling money. Bank stability, however, requires further background conditions.

To the best of my knowledge, there exists no history of brewer panics. If one batch of beer is bad, the issue gets resolved between its maker and purchasers. At the extreme, the brewer loses custom and goes out of business. This is not bad news to other venders. To the contrary, the externalities are positive. They have gained a welcome opportunity to pick up additional custom. Once they do, thirsts are quenched and stability is restored. However, banks (and near-banks) are interconnected in webs where the assets of some are the liabilities of others. Failure by one firm, or even rumor of its fiscal unsteadiness, redounds to the harm of others in the network. Minor slips cascade into major panics. This is, then, the opposite of the dynamic in which the misfortune of one competitor is the good fortune of another. Rather, everyone is made worse off.[20]

The peculiar character of the money business has been familiar since the first bank panic.[21] In some respects, the events of 2008 repeated the pattern of earlier busts: highly leveraged speculators extend themselves in a bull market; eventually the bubble bursts; they and those who have lent to them come a cropper. In other respects, however, 2008 is distinctive and so provides a basis for learning new variations on old tricks. The particular wrinkles of Lehman Brothers and its aftermath can be expressed as the product of three paradoxes:

A. The paradox of efficient markets

Suppose one believes that markets are efficient in the sense that prices reflect all the knowledge that is available to participants. It then follows that investment in research to determine whether pricing is fair is largely wasted. At most, it will supply at the margin a tiny increment to the knowledge that the thousands or millions of other market participants have already incorporated into the valuing of the asset under review. A rational agent will, then, choose to free-ride on the cognitive undertakings of others. The greater the confidence in the overall efficiency of the market, the greater the incentive to take a free ride. At the extreme,

[20] I hereby follow the usual philosophical convention in which "everyone" means *those parties the writer is choosing to take into account so as to advance a particular theoretical point.* To set that useful convention aside for the moment, I acknowledge that when banks fail, short sellers, investors rich with cash who have been sitting on the sidelines, Marxist revolutionaries, and misanthropes may thereby be advantaged.

[21] The story is informatively and entertainingly told in Niall Ferguson, *The Ascent of Money: A Financial History of the World* (New York: Penguin, 2008).

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everyone is free-riding on everyone else, and no one is actually monitoring the condition of the underlying assets. Well before that stage is reached, however, serious informational distortions will have been introduced.

To believe in the informational efficiency of markets requires bold and sustained leaps of faith. The global stock market crash of October 19, 1987 ("Black Monday"), Long Term Capital Management's sudden and dramatic demise in 1998, and the turn of the millennium's dot-com bust certainly gave the appearance of an excess of excitement over efficiency. Theories, though, especially when purveyed at a high level of mathematical abstraction by acclaimed savants, are as hard to kill as Rasputin. Nothing better sustained the efficient-markets hypothesis than the extraordinary string of profits that the financial industry accrued during Lehman Brothers' final decade. Looking is good but leaping is better. Or in the words of Citigroup CEO Charles Prince that perhaps best expressed the period's sentiments, "As long as the music is playing, you've got to get up and dance."[22]

The proposition that markets are efficient tends to be self-refuting. The more it is believed, the less accurate it becomes. The more skeptical market players are of its truth, the more effort they will invest in monitoring their potential investments, the overall effect of which is to enhance efficiency. That will then create conditions under which those who subscribe to the efficient-markets proposition will do better than the skeptics. And the merry-go-round takes another spin.

B. The paradox of reduced risk

Over the period that roughly coincided with the term of Alan Greenspan as Fed chairman and the early days of his successor, Ben Bernanke, it appeared to many investors that markets were safer than they had ever been before.[23] The recent slaying of the dragon of inflation had put to rest one chief concern of investors,[24] and wondrous growth in the formal theory of risk assessment had eased another. As far as the eye could see, interest rates were low and gently dropping. Moreover, many of the innovations of the period were explicitly addressed to making risk easier to hedge. For example, credit default swaps allow those holders of securities who are reluctant to bear the risk of default to insure against that eventuality with those who are willing, for a price, to assume the risk. Collateralized debt obligations allow those who are in the business of making loans (mortgages especially, but also credit card debt and other

[22] Charles Prince, cited in http://dealbook.blogs.nytimes.com/2007/07/10/citi-chief-on-buyout-loans-were-still-dancing/.

[23] Greenspan was appointed Fed chairman by Ronald Reagan in 1987 and was succeeded in 2006 by Bernanke.

[24] See Robert J. Samuelson, *The Great Inflation and Its Aftermath: The Past and Future of American Affluence* (New York: Random House, 2008).

assets) to pass along the contract to other parties. They, in turn, package it into products of differing degrees ("tranches") of riskiness and then sell them on to yet other parties whose situations are consistent with assuming that particular degree of chanciness. Firms that possess tools to scientifically assess their assets at risk, and then hedge against those risks deemed significant, are less likely to fall victim to the vagaries of the economy.

The single most important component of risk-reduction via diversification was the increasing globalization of world finance. It is risky to be a lender whose exposure is predominantly in one locale. An economic downturn specific to that region could generate defaults that swamp the capital standing behind those assets. It is much less likely that holdings spread out nationally and internationally will simultaneously undergo distress. Rather, peaks and crests will tend to balance each other out. Common knowledge during the Greenspan years was that housing markets may be locally vulnerable but do not undergo collapse on a national level. Most conspicuous among those affirming that homily was Greenspan himself.[25] Americans became enthusiastic buyers of foreign financial assets, and foreign concerns with even greater enthusiasm snapped up products of the vibrant American market—including those securitizing mortgages of less-than-prime quality.

If assets had become less risky than the equivalent products of ten or twenty years earlier, then the capital levels necessary safely to secure those assets had become lower. Especially in an environment in which interest rates were low, the path to significant profits led through increased leverage. In the aftermath of the collapse of Lehman Brothers, innumerable sermons have been preached on the lunacy of 30-to-1 or 50-to-1 debt-to-capital ratios. However, if it is known—or rather, "known"—that risk has been put to rest, then what is irrational is to bear the cost of additional equity when debt is more remunerative. From the perspective of each participant, the enhanced safety of the market provides reason to accept bets that would be rejected as too dangerous in a less well-managed environment. However, each firm's counterparties—and the counterparties of the counterparties—are thereby rendered more vulnerable to its losses. This is, then, another aspect of externalizing costs.

It can be objected that the costs are not externalized in the relevant sense but rather voluntarily assumed by those who choose to make loans to or purchase credit default swaps from inadequately capitalized firms. In a formal sense, that is correct. However, if all parties believe that overall risk levels are lower and then act on the basis of that belief, they will systemically undermine the conditions that generated the belief in the first place. In an era of breakneck financial innovation in which new and untested products are constantly being marketed, it will be especially

[25] Alan Greenspan, cited in http://realtytimes.com/rtpages/20041021_bubbleburst.htm.

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difficult to judge the financial soundness of the firms with which one deals (whereby I mean both ultimate solvency and current liquidity). Given the prevalence of the hypothesis of efficient markets, the general belief will be that these products are fairly priced. Observe also that in a densely interconnected financial services web, the status of one's transactors is in large measure a function of the status of those with whom they are dealing, and so on until it comes around full circle. I am unsure whether in theory this problem is mathematically resolvable, but in fast-moving markets where billions of dollars may be lost to those who tarry (or, to use Prince's expression, who sit out the dance in order to catch their breath), relevant externalities are largely unsuspected.

The paradox, then, is that the more markets are believed to be safe, the riskier they become. This perhaps helps explain one of the most baffling components of the Crunch of 2008: the utter failure of ratings agencies such as Standard and Poor's, Moody's, and Fitch accurately to judge the likelihood of default of the new financial instruments being peddled by the vanguard of the finance industry. There has been much remarking in the literature about the prima facie conflict of interest posed by rating agencies who are paid by the issuers of the securities to which they attest soundness. In retrospect, that does indeed seem to be a curious way to police the players. It does not explain, however, why the structure worked reasonably well until just before 2008 and then was overwhelmed by a hemorrhage of AAA defaults. Nor does it explain why purchasers of securities did not seem to be much chastened by the potential conflict. The paradox of reduced risk suggests that raters had developed an understanding of the overall environment in which finance was conducted that led them systematically to underestimate the likelihood of any particular security going belly-up. Probably this fed on itself; if one enormous collateralized bundle is deemed safe, then others put together more or less on the same model will be judged similarly. This was largely uncharted territory that the credit rating agencies were entering, and so both they and those who relied on their evaluations might be supposed to have had reason to be vastly more cautious. However, the paradox of efficient markets had led them to believe that they could accurately assess the value of an instrument by observing its pricing,[26] and the paradox of reduced risk reinforced the efficiency supposition.

C. The paradox of hard-won knowledge

It can hardly be denied that the science of economics and the practice of financial intermediation have grown by leaps and bounds since the days of J. P. Morgan (the person, not the eponymous institution). No episode was

[26] "How many financial analysts does it take to screw in a lightbulb?" Answer: "None. The market has already done it."

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of greater instructive value than the experience of the Great Depression. The moves made by all the key players in the catastrophe both inside and outside of government have been minutely examined by numerous scholars, not least Milton Friedman and Anna Schwartz in their *Monetary History of the United States.*[27] Although much controversy still obtains concerning causes and responses to the Depression, macroeconomists have since World War II increasingly gained confidence that they know how recessions can be stopped in their tracks before they pose significant threats to the integrity of the financial system as a whole. Central bankers need only lubricate the wheels of a creaking economy with an infusion of money to ensure that landings are smooth and that growth quickly resumes. The further lesson of the "Great Moderation" is that they can do so without thereby engendering any inflationary eruptions.[28] In a November 2002 tribute to Milton Friedman on his ninetieth birthday, Ben Bernanke concluded with this confession that is also a boast:

> Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.[29]

A few months later in his presidential address to the American Economics Association, Robert Lucas observed:

> Macroeconomics was born as a distinct field in the 1940s, as a part of the intellectual response to the Great Depression. The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: Its central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades.[30]

If the best and the brightest representatives of the profession concur in pronouncing that the problem of macroeconomic instability has been

[27] See note 19.

[28] "Great Moderation" refers to the two decades between the conquering of double-digit inflation in the mid-1980s and the demise of Lehman Brothers. According to the *New York Times,* the expression originates in a paper by Harvard economist James Stock and is given widespread currency in a 2004 speech of Ben Bernanke. See "Origins of 'The Great Moderation'," http://www.nytimes.com/2008/01/23/business/23leonside.html.

[29] The speech is available at http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021108/default.htm. "Anna" refers to Anna Schwartz, coauthor with Friedman of *A Monetary History of the United States.*

[30] Robert E. Lucas, Jr., "Macroeconomic Priorities" (January 10, 2003), available at http://home.uchicago.edu/~sogrodow/homepage/paddress03.pdf.

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solved once and for all, it would take an unusually brave or foolhardy person to demur.

Knowing how to avoid the awful mistakes of the past is indeed a wonderful achievement. It may, however, lead one to suppose that new challenges will be resolvable by just those means that have worked in the past. This is a reliable inference when addressing inorganic phenomena: the astronomical regularities that generate prediction of the next lunar eclipse will be exactly like those that predicted the last one. However, when the phenomenon in question involves human institutions and expectations, the possibility that some seemingly negligible variance will profoundly affect outcomes is not to be dismissed. The paradox of hard-won knowledge is that by coming to understand what had previously been mysterious, one is thereby rendered more prone to believe that one understands what in fact still is mysterious.

I believe that this paradox played itself out in the United States during the early years of the new century. The dot-com collapse and, especially, the attacks of September 11, 2001, had put crimps in the long economic expansion. The Federal Reserve acted to keep interest rates very low, even though the United States was running an enormous trade deficit, federal fiscal policy was also generating large and growing deficits, and a few people were starting to use the word "bubble" in the context of real estate and stock markets. Chairman Greenspan and his successor both held that so long as inflation remained thoroughly in check, there was no justification for raising interest rates. They had also learned (or "learned") that when markets are not distorted by intrusive government policies, they can be relied on to be self-correcting. That did not, of course, mean that the regulators themselves could relinquish the levers of monetary policy and hoist golf clubs instead, for they had absorbed the greatest lesson of all: it is the special function of the central bank to lean against both inflation on the one side and deflation on the other. (The Japanese "lost decade" of the 1990s underscored the importance of the latter.) Therefore, the regulators would keep all their constituencies happy for as long as they could by leaving the money faucet open. If inflation indicators began to nudge upwards, they would have adequate lead time to stanch the flow before it became worrying. And should economic growth measures turn lethargic, a well-timed further monetary infusion would restore them to vitality. This was the hard-won knowledge of postwar macroeconomic practice.

When you believe that you already know how to do something, it is irrational to invest resources in relearning how to invent the wheel. However, if the next great economic disruption coming along is significantly unlike recent recessionary episodes, then tried and tested habits may prove unavailing. And if the global economy were to seize up to an extent that it had not done since the 1930s, but the dynamics of the current crisis proved to be crucially different from those of the Great Depression, then

a little knowledge could indeed prove to be a dangerous thing. The aftermath of Lehman Brothers showed that neither the Federal Reserve nor the Treasury was prepared for what had befallen. Apparently they had not taken advantage of the previous months' intimations to run simulations of a steep decline in housing prices, massively increased foreclosure rates, and ensuing stresses on lenders and their counterparties. Had they been a bit less confident in their own expertise, they might have done so. They would, then, have avoided the clumsy lurching about of a Troubled Asset Relief Program (TARP) that first told the country that it would restore the banking system by buying up and sequestering toxic assets and then admitted that it didn't know how to do that and so would instead directly provide capital to reeling institutions. Most of all, they would have brought to the weekend of September 13, 2008, a clearer idea of the likely consequences of a Lehman Brothers default.[31]

The Crunch of 2008, then, was of the genus of other busts that had gone before, but it was also specifically distinct. The vaunted efficiency of post-millennium markets, their capacity to spread and absorb risk, and the scientific progress of their overseers combined to engender a unique degree of false confidence. When the storm was brewing—a perfect storm—regulators were ill-equipped to spot it on the horizon while it was still of a size smaller than a man's fist. When it assumed more ominous proportions, they were clumsy in their initial measures to blunt its force. Lehman Brothers was neither the first nor the last ship to capsize, but it was central to the catastrophe.[32]

[31] Best of all, as numerous post-Lehman critics aver, would have been a campaign several years earlier to put a foot firmly down on the brake of monetary expansion, thereby popping the real estate bubble before it expanded to dangerous proportions. Simultaneously, authorities should have imposed legislative or regulatory barriers to lax lending practices. See, for example, John B. Taylor's critique of Fed policy, *Getting Off Track* (Stanford, CA: Hoover Institution Press, 2009). Alan Greenspan responds to Taylor and other critics in "The Crisis," Brookings Institute paper, April 15, 2010, available at http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2010_spring_bpea_papers/spring2010_greenspan.pdf. Taylor takes another bite of the apple in "Getting Back on Track: Macroeconomic Policy Lessons from the Financial Crisis," *Federal Reserve Bank of St. Louis Review* 92 (May/June 2010): 165–76.

In the glare of hindsight, these reflections are incontestable. Was there ever a realistic chance that they might have been taken up? It is difficult enough for the Fed to step up interest rates when the Consumer Price Index is beginning to climb; powerful political interests are more attached to easy money than to low inflation. In a period of stable consumer prices, the howls that would confront the (unelected and so democratically suspect) monetary authorities would be unendurable. At least that would have been so prior to Lehman; we now possess new hard-won knowledge. As for tightening up mortgage lending, it had been for many years the settled policy of both political parties, whether in Congress or the White House, to encourage greater rates of home ownership. (Recall George W. Bush's abortive "ownership society.") Holders of risky mortgages vote too.

[32] Suggestions in this section that the causes of the Crunch were largely endogenous to the workings of the financial system were anticipated by the work of the mid-twentieth-century economist Hyman Minsky. See his "The Financial Instability Hypothesis," Jerome Levy Economics Institute of Bard College, Working Paper 74 (May 1992), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=161024. On Minsky's relevance to the Crunch, see Janet

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V. Regulation After Lehman Brothers

Analysts will, no doubt, contend for many decades concerning the causes and therapeutic regimens applied to the Crunch of 2008. Debates about the Great Depression and the New Deal still bubble, and contemporary events cast them in a new light. (For example, reruns of the John Maynard Keynes/Milton Friedman clash sometimes are declared to have a different winner.) With greater insight will come greater clarity concerning appropriate policy measures. I believe, however, that the Crunch has confirmed the proposition that financial markets are susceptible to prisoner's dilemma configurations of an especially virulent form.[33] To believe that these will invariably prove to be self-correcting at tolerable cost requires a leap of faith less supportable now than it was pre–Lehman Brothers. Tamping down the imposition of external costs is one of the twin directives of liberal institutions; liberty consists not only in an entitlement to choose one's path in accord with one's own lights but also to be protected from fallout from others' activities. The indicated conclusion is that liberty after Lehman Brothers will best be served by new institutional structures designed to prevent financial meltdowns from occurring and to halt contagions before they spread. Some of these structures will be created by market participants themselves. Others will have a governmental provenance. One sort of change concerns rules[34] to be impersonally enforced on the various parties. The other concerns grants of heightened discretionary powers. I take these up in turn.

Yellen, "A Minsky Meltdown: Lessons for Central Bankers," *FRBSF Economic Letter,* Number 2009-15 (May 1, 2009), http://www.frbsf.org/publications/economics/letter/2009/el2009-15.html#5; and "Minsky's Moment," *The Economist* (April 2, 2009), http://www.economist.com/businessfinance/displaystory.cfm?story_id=13415233. My understanding of Minsky is that he offers a model alleged to apply to all business cycles. The intended application of the analysis of the preceding section is more modest, expressly limited to the Crunch of 2008.

[33] It is a proposition affirmed by Adam Smith in *The Wealth of Nations,* Book II, chap. 2, "Of Money Considered as a Particular Branch of the General Stock of the Society":

> To restrain private people, it may be said, from receiving in payment the promissory notes of a banker, for any sum whether great or small, when they themselves are willing to receive them, or to restrain a banker from issuing such notes, when all his neighbours are willing to accept of them, is a manifest violation of that natural liberty which it is the proper business of law not to infringe, but to support. Such regulations may, no doubt, be considered as in some respects a violation of natural liberty. But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments, of the most free as well as of the most despotical. The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty exactly of the same kind with the regulations of the banking trade which are here proposed.

[34] I do not distinguish here between *legislation* and *regulation,* although these would have to be separated in a more sophisticated normative account.

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A. Rules of the game

An obvious flaw in the pre–Lehman Brothers system was seriously inadequate capital requirements for banks and quasi-banks. The Basel international conventions on capital adequacy[35] proved to be inadequate protection against default risk, and national strictures did not plug their gaps. In retrospect, it is easy to see why capital cushions were likely to prove too slim. It is costly for banks to carry inert reserves. Insofar as they seek to secure impressive profits and to ring up returns that are at least no worse than those of their competitors, they will angle to skirt capital requirements and to increase leverage. Financial institutions' own Value at Risk (VaR) models were probably not deliberately designed to present an unduly rosy picture of overall exposure, but it is perhaps asking too much of executives that they be very skeptical of profit engines that are decked out in state-of-the-art mathematical sophistication. We have learned post–Lehman Brothers that reserve requirements need to be raised.

Raised how far? This is not a question appropriate for philosophers to hazard an answer—at least not this philosopher. Capital adequacy standards should, though, be at a level substantial enough to shift costs away from external parties who will be caught up in the backwash of bank failures and place them instead on those banks and their clients.[36] Banks will, of course, point out that increasing equity and meeting higher reserve requirements impose significant burdens, and they will be correct. The central guiding principle in allocating risk here and elsewhere is that the onus should lie on those who are directly participating in the business of financial intermediation and securing its benefits, rather than on the public at large. If that makes the life of bankers less interesting—as in the saying "May you live in interesting times"—so be it.

Second, Lehman Brothers has taught us that if it walks like a bank and quacks like a bank, then whether or not it is technically a bank, it needs to be regulated as if it were one. This should have been apparent at the time that relics of the New Deal such as Glass-Steagall[37] were sent into retirement. There were too many players in the finance market of a heft and concomitant dangerousness to subject some to minute agency scrutiny and others to a much less restrictive regulatory regime. Again, I beg off from stipulating the extent to which oversight ought to be applied and who the regulating party or parties should be. I content myself instead

[35] See http://www.bis.org/publ/bcbsca.htm.

[36] An aptly countercyclical way to do this might be to encourage financial institutions to issue during good times special debt securities that automatically convert to equity when specified emergency situations arise. See Raghuram G. Rajan, "The Credit Crisis and Cycle-Proof Regulation," *Federal Reserve Bank of St. Louis Review* 91 (September 2009): 397–402.

[37] Glass-Steagall is the 1933 act that, among other things, separated ordinary commercial banks from investment banks. After an extended period of whittling away, it was repealed in 1999. Again to forestall misinterpretation, I am not claiming that the repeal was unjustified.

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with citing Aristotle's dictum that like cases are to be treated alike. In the 1990s and beyond, Aristotle was too little heeded.

Third, there ought to be more transparent advance indication of just which parties are deemed "too big to fail." Part of the problem that beset governmental functionaries in the pre–Lehman Brothers period is that they were uncertain in their own minds who was to be protected against ultimate collapse and who could be allowed to go to the wall. The only given was that depositors in federally insured financial institutions would not be allowed to lose their funds.[38] Beyond that, ad hoc ruled. If relatively little Bear Stearns was shepherded to a soft landing (albeit one exquisitely painful to shareholders), then could it not be inferred that larger entities such as Lehman Brothers would secure a like solicitude? In the event, it could not. Were nominally private corporations Fannie Mae and Freddie Mac really governmental agencies in drag? The answer was not completely revealed until they were hastily put into receivership. It seemed clear that the Federal Reserve's mandate to be lender of last resort applied to member banks but not to insurance companies such as AIG. However, through its credit default swap business, AIG was deeply implicated in every avenue of global banking. Were it to be allowed to fail, the repercussions would be incalculable, and so it was spared Lehman's fate.

It is asking too much to demand complete precision in distinguishing those parties that are too big to fail from those that are dispensable. Nor is the locution quite right; the operative variable is "too interconnected to fail." Size matters only to the extent that it indicates the number and thickness of tendrils growing through the financial network. However, it is not too much to ask of regulators that they distinguish with some reasonable degree of specificity those firms to which they will lend, in whole or in part, the full faith and credit of the United States (and who, therefore, will be subject to more stringent precautionary rules) from those which, when seas get rough, will be allowed to founder. Such advance notice will not only inform the decisions of investors; it will inform the regulators themselves so that their own perceived uncertainty does not add a further toxin to distressed markets.

Fourth and most speculative, there may be sufficient grounds to block the formation through merger or internal growth of unduly massive financial concerns. If magnitude makes their possible failure too grave a risk to be prudently borne, then they may justifiably be cut down to size. A variation on the size test as such is that those firms that are deemed to be too interconnected to be allowed to fail will be subject to special constraints such as higher reserve standards or additional disclosure requirements. Conversely, their smaller and more nimble brethren will be allowed

[38] Even here, there was some residual uncertainty as to the extent of the protection. Prior to 2008, the maximum insured amount per account per bank was $100,000. When rumblings of bank reserve shortfalls were heard, it was then raised to $250,000.

to bear greater, perhaps unlimited levels of risk, but with the proviso that if and when they fail, they truly fail. I say that this is speculative because it is not clear that regulators have adequate means to determine in advance for which firms failure is tolerable and for which it is not. Perhaps even more important, there is serious doubt that governmental bureaus can precommit to keeping their hands off of failing enterprises when all those who stand to lose considerable sums are wheedling for relief. Nonetheless, some mechanism seems necessary to avoid a repetition of 2008's massive socialization of the losses of the financial industry. One prong of the strategy will be to extend public insurance only to those entities that agree to operate conservatively. Against complaints that this will bring back the stodginess of banking during the Glass-Steagall era, the response must be that we have been well reminded that stodginess is not the worst vice that bankers can display. The second prong is to allow innovative entrepreneurship and conspicuous risk-bearing among players who internalize cost externalities.

Some will argue that any such regulatory gap between central and peripheral market participants is inefficient. The reason that firms become very large, they will say, is that there exist economies of scale that favor giant banks over smaller ones; otherwise they would not be induced to grow. What this argument fails to account for are the probability-weighted costs of bailouts. If the reason that the cost of funds to megaliths such as Citigroup is smaller than it is to pygmy banks is that suppliers are confident that they will be protected in the event of a severe downturn, then risk has been socialized to the public at large. Not only is this inefficient, it is inequitable. In a first best world, all players in the financial market fully bear the cost of their own profit-seeking activities. However, in a world of second best, a prohibition of unlimited growth can be justified.

There are dangers attached to all these measures. Some dangers are "merely economic," but others raise deep concerns of justice. In attempting to shield third parties from impositions of external costs, the regulatory regime may erect roadblocks to entrepreneurial innovations which, if left unimpeded, would allow individuals to pursue their ends more effectively. The problem is endemic; the two parameters of liberalism are in tension, and there exists no algorithm for arriving at the optimal trade-off. I confess that with regard to financial regulation the difficulties are greater than usual. Given the extraordinary sums at stake, rent-seeking by interested parties is likely to tip resolutions away from what an impartial spectator would commend. And because the scale on which twenty-first-century regulation must be pursued is largely global, political frictions are exacerbated. Only someone exceedingly optimistic will predict that governing authorities are likely to hit on measures that are optimal or nearly so. The more pertinent question, however, is: Do we have a reasonable expectation of improving on the status quo pre–Lehman Brothers? There, I think, we do indeed have some reason for optimism. It

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would be quite extraordinary if we have altogether failed to learn something from the events of 2008, and it would be thoroughly depressing if that knowledge cannot be put to some good use. I concede, though, that in the political realm the extraordinary and the depressing do have a tendency to go hand-in-hand.

B. Discretionary authority

I turn now to the exercise of regulatory powers. Perhaps the single clearest lesson of the collapse of Lehman Brothers is that it should not have been allowed to happen. Governmental officials could have arranged a financial cocoon for the firm, but chose not to do so. Perhaps their concern was the aggravated moral hazard that piling a Lehman Brothers rescue on that of Bear Stearns would generate. The worry is not in itself inappropriate, but the very worst time to indulge it is just as the sky is beginning to fall. Either much earlier or much later would have been preferable. I cannot supply figures for how much a rescue of Lehman Brothers would have cost in September 2008, and I am prepared to concede that the sum would have been considerable. However, that amount is dwarfed by those that subsequently were expended to address the Crunch that ensued. If Ben Bernanke and Treasury Secretary Hank Paulson supposed that they were being prudent, they were very much mistaken.[39]

A further lesson of Lehman Brothers is that timeliness is next to godliness. By waiting until the world of finance was in freefall, American (and not only American) officials exacerbated what had to be. This is not to maintain that as late as September 2008, a clean escape could have been made; almost certainly that is not the case.[40] However, what turned into a catastrophe might instead have been merely a disaster. (Or is it the reverse?) The moral is that decisive action is much to be preferred to indecisive waffling. At least that is the case when it is the *right* decisive action. If not (if, for example, the action undertaken is to preempt possible employment of weapons of mass destruction when in fact there exist no such weapons), then the cost calculus is quite otherwise. These are problems that analysts will almost never get wrong—provided they are allowed to address them in the light of hindsight. I am not without sympathy for those who are not afforded this luxury.[41] However, no one is forced to be a cabinet secretary or governor of the Federal Reserve. Their job is to get things right, or at least not to get them terribly wrong. That did not

[39] A contrary view was offered on the one year anniversary in Joe Nocera, "Lehman Had to Die So Global Finance Could Live," *New York Times,* September 11, 2009, http://www.nytimes.com/2009/09/12/business/12nocera.html.

[40] A similar verdict is offered by Kenneth Rogoff, "The Confidence Game," http://www.project-syndicate.org/print_commentary/rogoff59/English/.

[41] I am a tenured professor of philosophy. In my discipline, the scope of hindsight is centuries if not millennia.

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happen in 1929, and it did not happen in 2008. Few things can be more important for the prosperity and freedom of citizens than that comparable errors not recur anytime soon.

Lovers of liberty must always be made uneasy by writs permitting to their governors scope for discretion. "A government of laws and not men" is the preferred dictum. I heartily concur. However, it is too much of a good thing to infer that the optimal mix is 100 percent rule of law, 0 percent discretion. I do not see how, in a world of imperfect knowledge in which the future resembles the past only imperfectly, all exercise of state powers can be ordained in advance in accord with general and universal laws. But if discretion cannot be avoided, then its worst excesses can be countered by a regime of transparency and accountability. Perhaps if the Bush administration had not been in lame duck mode in the autumn of 2008, it would have been more vigilant in spotting little fires before they became conflagrations. This is speculation, but it may account for some of the fiddling that went on while the contemporary version of Rome was burning. Of no less explanatory value is the paradox of hard-won knowledge. Because authorities believed that they knew what to do and how to do it, they failed to put in the intensive thought that might have led them to safer ground.

These sorts of reflections are of value, but it is limited value. The sad truth is that we are much better at plotting strategy for the last war than the next one.[42] Just as authorities were fully primed to prevent a recurrence of 1929, the next time around they will be vigilant to head off another 2008. So too will be private parties. Even if no elevated reserve levels are mandated, counterparties are liable to insist on enhanced security prior to transacting. Similarly, they will demand and be willing to pay for greater transparency. Does this mean that new governmental measures are unnecessary? That is to take a step too far. They may be valuable simply to assure market participants that those with whom they deal (and those with whom these parties in turn deal, and so on) have taken what are generally agreed to be prudent measures. The costs of making private contracts are decreased by the parties' confidence that, if something breaks down, enforcement will be forthcoming from the ruling authorities. Similarly, the costs of bringing about greater financial stability will be minimized by governmental assurances that counterparties have behaved prudently.

That we can learn something from the collapse of Lehman Brothers does not mean that we will learn all and only the right lessons. In the next and concluding section, I turn to possible educational failures.[43]

[42] The Maginot Line was an excellent strategy for holding back the Kaiser's troops. It worked decidedly less well against the Wehrmacht.

[43] As final revisions of this essay were being prepared, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 made its passage through Congress and to the pen of the president. I would be claiming more for myself than is justified if I professed to under-

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VI. Conclusion

The single most dangerous reflection on the Crunch of 2008 takes the form, "The bankers got their bailout, so why shouldn't the builders/distressed homeowners/auto manufacturers etc. get theirs?" The second most dangerous is from Rahm Emanuel, President Obama's chief of staff: "You never want a serious crisis to go to waste." Combined, they wedge open the Treasury's gates. Of course, so did the original bank bailouts. I have contended that, although clumsily handled, these bailouts represented the least bad alternative at the time. It is, however, a serious error to conflate bank rescue with the various spending packages that followed Lehman Brothers' demise.

The reason for infusing the banks with capital was not a humanitarian concern for harried bankers; no group on earth has a weaker claim on grounds of distributive justice for relief. Rather, it was to prevent further pain from engulfing those who rely on access to credit. Directly or indirectly, that includes almost everyone. Although on one level it would have been supremely gratifying to see the proximate causes of financial distress go down in flames, consumed in the ashes of their own cupidity,[44] spite is a dubious basis for policy. The realistic alternative is to shore up battered institutions until they can stand on their own. Policy authorities did not do this smoothly, they did not do it in a manner that inspired confidence, and they certainly did not do it in a timely fashion. However, before everything fell apart, the financial landscape was refashioned so as to avoid a second Great Depression. Perhaps not even two cheers are merited, but an honest appraisal should acknowledge that as bad as the aftermath of Lehman Brothers was, it could have been worse.

Other bailouts are more questionable. Clasping a bankrupt General Motors to the federal bosom was economically unjustifiable, although for a newly elected Obama administration it may have been politically irresistible. To be sure, when an ordinary industrial firm chalks up a steady stream of losses, it does externalize costs over the whole economic landscape. General Motors' slow dying negatively impacted its many suppliers, dealerships, employees, and the municipalities dependent on them. However, if it goes into liquidation, its productive assets do not suddenly disappear. Rather, they are available to be put in the hands of those who are better able to generate value from them. Plants, skilled workers, and technology will be reallocated. In the process some will lose out, but others—Ford, Toyota, possibly holders of senior debt and U.S. taxpayers—

stand the text of this legislation (available at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.4173:), let alone to pronounce on the likelihood that it will improve the financial environment. At any rate, a thoroughly globalized financial industry does not take all its cues from the United States.

[44] This is meant metaphorically. There are many Americans who would endorse it literally. I'm not sure that I couldn't be talked into becoming one of them.

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will be gainers. Unlike bank meltdowns, this destruction is genuinely creative. I admit that this is a conceptually difficult point. Losers from a General Motors liquidation are clearly identifiable, especially by themselves and the politicians for whom they vote. Gainers, however, are dispersed and largely anonymous. This is the stuff of a Principles of Economics course, but most Americans weren't A students in their econ class.

State ownership inevitably conduces to state management and then to state micromanagement. Is it really the task of the White House to decide when to sack the CEO and with whom to replace him? Or to determine salary levels and bonuses of executives who work for companies in which the government has a stake? The politically indicated answer is yes. A central precept of foundational liberal theory is state neutrality concerning citizens' (rights-respecting) activities, but ownership precludes neutrality. What the government chooses not to prohibit, it thereby chooses to allow. Many of these determinations will benefit some citizens at the expense of others. The political constellation of forces rather than narrow economic rationality will determine how they work themselves out. Other decisions engage the passions: for example, "obscene" AIG bonuses paid out only a few weeks after the firm's rescue.[45] It is unrealistic to suppose that policymakers will be able simultaneously to heed the legitimate concerns of their constituents (not to mention heeding some concerns that are a good deal less than legitimate) while prudently managing enterprises that have fallen into their lap. This is true of banking as much as it is of automobile manufacturing, but entry into the latter field was chosen, not forced. The next choice should be to exit as deftly and as soon as possible.

Once the banks were cosseted, governments of the United States, the United Kingdom, and, to a more limited extent, Europe turned to stimulus packages. Debates over their efficacy go back generations, and this is not the place to attempt an independent assessment. It is undeniable that the pace of economic transactions slowed dramatically in the wake of Lehman Brothers and that governmental purchases and transfers counteracted the slowdown to some extent. It is also undeniable that the national deficits of these countries will be massively greater a decade from now than they are today. (In fairness, it should be noted that deep recession would have bloated deficits even in the absence of explicit stimulus.) Addressing deficits will involve some level of higher taxation, inflation, or both. (In theory, it could occasion spending decreases, but that would be to let the crisis go to waste. Expanded health care coverage, green energy, and educational subsidies may or may not be justified in their own right, but they are not compatible with a decrease on the expenditure side of the budget.) Financing a larger deficit means higher

[45] See Andrew Samwick, "AIG Bonuses: Some Perspective," http://www.capitalgainsandgames.com/blog/andrew-samwick/817/aig-bonuses-some-perspective/.

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interest rates, crowding out of some private borrowers, and concomitantly reduced rates of growth. Programs created or expanded in the name of temporary stimulus create constituencies that will be loath to relinquish their largesse. Even if the gravity of the emergency did indeed justify passage of stimulus measures, one of the hardest to learn lessons of Lehman Brothers will be how to reverse the expansion. Democracies are simply not very adept at destimulating.

The task for liberals/libertarians in the post–Lehman Brothers environment is to continue to remind those who can be persuaded to listen that invisible hands really do direct market relations, and that interference with their workings is generally counterproductive. For example, as unemployment rates jump and then remain discouragingly high, protectionist impulses predictably rear their head. Adam Smith was aware that those who succumb to the blandishments of beggar-thy-neighbor also beggar themselves. That seems, however, to be a message impossible to impart once and for all. Programs such as paying people large subsidies to junk functional vehicles and purchase new ones that are more fuel efficient ("Cash for Clunkers") need to be described as what they are: silly. Nothing new here.

I am sure that some of those who read this essay will conclude that there is nothing new, period. Verities are as they were in the mid-1930s when Hayek debated Keynes. I respectfully disagree. Liberal enthusiasm for invisible-hand interactions should not blind one to the fact that this is not the universal form taken by interaction, not even in markets. Prisoner's dilemmas are real, and they are lethal. They can be engendered (or, conversely, overcome) by innovations in law, technology, or common practice. An enthusiasm for liberty that shows itself oblivious to the imposition of external costs is an enthusiasm that is, at best, incomplete. A more adequate understanding will recognize the need from time to time to develop new institutional structures, both private and governmental, to secure better trade-offs between the two parameters. Liberalism requires not only a creed but wisdom. If Dr. Johnson is correct in claiming that the prospect of hanging concentrates the mind wonderfully, then perhaps the near-death experience of September 2008 will indeed have left us a bit wiser.

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