II. Financial Principles for Fun and Profit

David Korten [2] says, "I first encountered economics in college when I chose it as my undergraduate major. I soon found it mechanistic, boring, and detached from reality, so I switched to the study of human behavior and organization. I've since come to realize that economic systems are the dominant systems for organizing behavior in modern societies and are most appropriately studied as behavioral systems." Economics as a "social science" means it involves people, and that it strives to be considered a scientific discipline. But "people" is a notoriously complex concept to bring under supposedly objective and predictive scientific scrutiny. Therefore, certain abstractions have been used to simplify the process. These abstractions have become principles and, finally, beliefs. These beliefs, or more accurately, myths, are what drive the financial system because they are used to make real people act, unquestioningly, in the best interests of the financial system itself.

A. Homo Economicus: The Sanctification of Greed

The most important abstraction basic to contemporary economic theory is that of *Homo economicus*. The chief feature of the abstract *Homo economicus* is extreme individualism combined with the insatiability of total wants.

There are explicit underlying assumptions about this abstract *Homo economicus*:

- Humans are motivated by self-interest, which is expressed primarily through the quest for financial gain.
- The action that yields the greatest financial return to the individual or firm is the one that is most beneficial to society.
- Competitive behavior is more rational for the individual and the firm than cooperative behavior; consequently, societies should be built around the competitive motive.
- Human progress is best measured by increases in the value of what the members of society consume, and ever higher levels of consumer spending advance the well-being of society by stimulating greater economic output.

To put it in harsher language, these ideological doctrines assume that:

- People are by nature motivated primarily by greed.
- The drive to acquire is the highest expression of what it means to be human.
- The relentless pursuit of greed and acquisition leads to socially optimal outcomes.
- It is in the best interest of human societies to encourage, honor, and reward the above values.

I, among many others, think this picture of human beings is profoundly erroneous and conclusions drawn by economists about the real world from this model must be deeply suspect. On a very personal level, is this the real you? People almost everywhere, when asked about the essential elements of a good life come up with much the same list:

- A secure means of livelihood that provides for our basic material needs while earning us a place of respect in our community;
- A strong, nurturing family, friends, and a supportive, peaceful, and secure community that allows us to explore and develop our capacity for loving relationships;
- The opportunity to learn and to give expression to our awareness and understanding of ourselves and the world around us both intellectually and artistically;

- Good physical health and the opportunity to engage in athletics, dance, and other forms of physical expression that make our bodies tingle with life's energy;
- A sense of belonging to place, community, and life, yet with the freedom to make personal choices-and sometimes to wander and explore without the obligations of place;
- A clean and healthy environment vibrant with the diversity of life; and
- An assurance that our children will have an opportunity for the same.

B. The Invisible Hand: Is It Picking Your Pocket?

So why do many economists use this model? Because they believe *Homo economicus* is close enough to reality to support their theories. And because they have a nearly religious belief in the "free market." Morality and community have been replaced by Adam Smith's "invisible hand." In 1776, Scottish scholar Adam Smith published his pathbreaking book, *An Inquiry into the Nature and Causes of the Wealth of Nations*. Modern economics may be dated from that historic year, which was also notable for the Declaration of Independence.

Smith's message was clear. Private markets should be liberated from the tyranny of government control. In pursuit of their private interests, individual producers would make the goods that consumers want. It is not, said Smith, "from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest." There is an "invisible hand," he wrote, that causes the producer to promote the interests of society. Indeed, "by pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it." In general, said Smith, the government should be cautious in interfering with the operations of the private market. According to Smith the best policy is *laissez faire* – leave it alone. George Soros [14] has termed this philosophy *market fundamentalism* (akin to religious fundamentalism). This economic theory has become the ingrained philosophy/mythology of the financially powerful and is being accepted uncritically by the media and the people. All you need to do is strive to become rich yourself and all good things will automatically come to society and the world!

But in reality, *market theory,* as articulated by Smith and those who subsequently elaborated on his ideas, developed into an elegant and coherent intellectual construction grounded in *carefully articulated assumptions* regarding the conditions under which such self-organizing processes would indeed lead to socially optimal outcomes. For example,

- Buyers and sellers must be too small to influence the market price.
- Complete information must be available to all participants and there can be no trade secrets.
- Sellers must bear the full cost of the products they sell and pass them on in the sale price.
- Investment capital must remain within national borders and trade between countries must be balanced.
- Savings must be invested in the creation of productive capital.

Herein lies the catch: the conditions of what we currently call a *capitalist economy* directly contradict the assumptions of market theory in every instance. Bear in mind that the optimally efficient market exists only as a theoretical construction. No economy has ever fully satisfied its assumptions and probably none ever will. The challenge facing those who would create an economy that approximates the market's promised outcomes of fair but modest returns to capital, full employment at a living wage, and socially-optimal allocation of society's productive resources is to establish a framework of rules that create as closely as possible the conditions that market theory assumes. Korten [3] attempts to do this with his concept of "mindful markets" discussed later.

C. The Free Market: Greed as Religion

Doug Henwood in his book Wall Street [9] points out that:

> "Studying economics also seems to make you a nastier person, not surprising based on the definition of *Homo economicus* given above. Psychological studies have shown that economics graduate students are more likely to "free ride" in classroom simulations - shirk contributions to an experimental "public goods" account in the pursuit of higher private returns - than the general public. Economists also are less generous than other academics in charitable giving. Undergraduate economics majors are more likely to defect in the classic prisoner's dilemma game than are other majors. And on other tests, students grow less honest, expressing less of a tendency, for example, to return found money after studying economics, but not after studying a control subject like astronomy."

The beliefs espoused by free-market ideologues are familiar to anyone who is conversant with the language of contemporary economic discourse [2]:

- *Sustained economic growth,* as measured by gross national product, is the path to human progress.
- *Free markets,* unrestrained by government, generally result in the most efficient and socially optimal allocation of resources.
- *Economic globalization,* achieved by removing barriers to the free flow of goods and money anywhere in the world, spurs competition, increases economic efficiency, creates jobs, lowers consumer prices, increases consumer choice, increases economic growth, and is generally beneficial to almost everyone.
- *Privatization,* which moves functions and assets from governments to the private sector, improves efficiency.
- The primary *responsibility of government* is to provide the infrastructure necessary to advance commerce and enforce the rule of law with respect to property rights and contracts.

A number of valid ideas and insights have become twisted into an extremist ideology that raises the baser aspects of human nature to a self-justifying ideal. But economic efficiency is not synonymous with social desirability. Although this ideology denigrates the most basic human values and ideals, *it has become so deeply embedded within our values, institutions, and popular culture that we accept it almost without question*. It exists all around us and plays a critical role in shaping nearly every aspect of public policy.

In a self-justifying twist of moral logic, market fundamentalists commonly argue that *rich countries best help poor countries by increasing their own consumption* to increase demand for the exports of poor countries, thus stimulating their economic growth and lifting their poor up from poverty. Denying or ignoring the existence of environmental limits, they maintain that there is no moral or practical basis for reducing the consumption of the rich to relieve the deprivation of the poor. To the contrary, they argue, *it is the moral duty of the rich to consume more to create more growth to provide more opportunities for the poor* - a convenient rationalization for tax breaks for investors and the colonization of ever more of the world's resources to support self-indulgent consumption by those who can afford it. *The Economist* magazine argued that it is *a moral duty of the rich countries to export their pollution to poor countries* because this provides poor people with economic opportunities of which they would otherwise be deprived.

In a more despicable example, a brief segment in a television documentary from some years ago on overpricing in the drug industry illustrates the extent to which some academic economists are revising economic theory to defend monopoly pricing. The documentary looked into a case in which a drug company was charging a price far above its costs for a patented drug that a small number of desperate patients depended on for their lives. *An economist who was invited to comment argued that because the patients who used the drug had no alternative, the drug company had a fiduciary responsibility to its shareholders to raise the price to the highest level the users considered their lives to be worth*. Because the drug's current high price was clearly below this amount, the company was in fact underpricing the product. Adam Smith, a staunch foe of monopoly pricing, must have been turning in his grave. (And you can believe the drug company was lobbying to have government and private health insurance help pay for the drug.)

Benjamin Barber [7] states:

> "There is today a disastrous confusion between the moderate and mostly well-founded claim that flexibly regulated markets remain the most efficient instruments of economic productivity and wealth accumulation, and the zany overblown claim that naked, wholly unregulated markets are the sole means by which we can produce and fairly distribute everything human beings care about, from durable goods to spiritual values, from capital investment to social justice, from profitability to sustainable environments, from private wealth to the essential commonweal. This second claim has moved profit-mongering privateers to insist that goods as diverse and obviously public as education, culture, penology, full employment, social welfare, and ecological equilibrium be handed over to the profit sector for arbitration and disposal."

But even one of the most respected and successful capitalist investors in the world, George Soros, believes we are in a crisis of global capitalism [14]:

> "There are people who question whether the collective interests of society exist at all. Society, they maintain, consists of individuals, and their interests are best expressed by their decisions as market participants… The functions that cannot and should not be governed purely by market forces include many of the most important things in human life, ranging from moral values to family relationships to aesthetic and intellectual achievements. According to market fundamentalism, all social activities and human interactions should be looked at as transactional, contract-based relationships and valued in terms of a single common denominator, money. Activities should be regulated, as far as possible, by nothing more intrusive than the invisible hand of profit-maximizing competition. Market fundamentalism has become so powerful that any political forces that dare to resist it are branded as sentimental, illogical, and naïve. Yet the truth is that market fundamentalism is itself naive and illogical. To put the matter simply, market forces, if they are given complete authority even in the purely economic and financial arenas, produce chaos and could ultimately lead to the downfall of the global capitalist system."

Markets don't tell people with substantial incomes to consume no more than their rightful share of ecosystem resources. They don't tell retailers not to sell guns to children. They don't tell producers that their wastes must be recycled. They don't give priority in the allocation of scarce resources to the basic needs of those with little or no money before providing luxuries for those who have great wealth. Indeed, in each instance, they generally do exactly the opposite. There is no substitute in a complex modern society for the market as an efficient mechanism for setting most prices, motivating productive activity, and processing routine economic transactions. However, although markets are useful institutions for *implementing* public priorities, they are inappropriate institutions for *setting* them.

Assumptions for a Perfect Free Market

- All participants have equal access to perfect information.
- There is perfect competition.
- Prices are absolutely accurate and up-to-date.
- Price signals completely reflect every cost to society.
- There is no monopoly (sole seller).
- There is no monopsony (sole buyer).
- No individual transaction can move the market and prices.
- No resource is unemployed or underemployed.
- There's nothing that can't be readily bought and sold.
- Any deal can be done without "friction" (no transaction costs).
- All deals are instantaneous (no transaction lags).
- No subsidies or other distortions exist.

- No barriers to market entry exist.
- There is no regulation.
- There is no taxation (or taxes don't distort resource allocations).
- All investments can be uniformly traded and exchanged.
- At the appropriate interest rate, capital is available to everyone.
- Sole motivation is maximizing personal "utility" (wealth).

D. Free Trade: Ricardo's Comparative Advantage Debased

Many economists use David Ricardo and his concept of "comparative advantage" to support the concept of unfettered free trade. Ricardo showed how free trade could be mutually beneficial for countries even where there were dramatic one-sided differences in how expensive it would be to produce the same goods in each country. Consider his example of England and Portugal in the eighteenth century. It was cheaper to produce both wine and cloth in Portugal, in absolute terms, than in England. But it was also true that England's cloth industry was - relative to its wine industry - significantly more efficient. England's disadvantage relative to Portugal in cloth production was less than its disadvantage relative to Portugal in wine production. England had a comparative advantage in cloth, Portugal a comparative advantage in wine. Ricardo showed that each country would be better off specializing in the product in which it had a comparative advantage and trading for the other, regardless of absolute advantage. Free trade between the countries, and competition within each country, would lead to this mutually beneficial result.

Modern economists seem to have forgotten one of Ricardo's basic premises. Ricardo was very careful to base his comparative advantage argument for free trade on *the explicit premise that capital was immobile between national communities*. Capital, as well as labor, stayed at home, only goods were traded internationally. It was the fact that capital could not, in this model, cross national boundaries that directly led to replacement of absolute advantage by comparative advantage. Capital follows absolute advantage as far as it can within national boundaries. But since by assumption it cannot pursue absolute advantage across national boundaries, it has recourse to the next best strategy, which is to reallocate itself within the nation according to the principle of comparative advantage. Among other required conditions, trade must be balanced between the two countries, both countries must have full employment, and investors must not be able to transfer their production facilities from one to the other.

Ricardo's reasoning is quite straightforward. If trade between countries is balanced, labor is fully employed, and investors are unable to transfer their assets abroad, the investors who find they cannot compete against foreign imports in one industry will shift their investment and the related jobs to another industry in which their country has some natural comparative advantage. For example, if for reasons of climate Portugal has an advantage in growing grapes and producing wine, and if for reasons of climate, technology, cheap energy, and labor skills England has an advantage in growing wool and producing woolen cloth, both countries stand to benefit if Portuguese woolens producers shift to wine production and English wine producers shift to production of woolen cloth, and the products are then exchanged through trade. Workers and capital remain fully employed in both countries, the British are able to enjoy more wine, and the Portuguese are able to enjoy more woolen clothing.

It's an entirely different matter if both investments and goods are free to flow where they will - which is the goal that the new global capitalists are advancing through international trade and investment agreements and organizations with names like NAFTA, GATT, WTO, OECD, APEC, and the MAI. Negotiated without public discussion and ratified by legislative bodies with limited debate and no opportunity for amendment, these agreements are used to eliminate economic borders and regulatory restraints on the power of the institutions of capitalism to move goods and capital freely, without regard to national interests or trade balances, wherever they see prospects for quick profit.

Assume under a regime of completely open borders that Portugal has both a more favorable climate and a substantial labor surplus that keeps wages deeply depressed, and that the retail prices of both cloth and wine

tend to be higher in England. In this instance British investors will find it profitable to move their looms and wine presses to Portugal and ship both cloth and wine back to England.

Unable to compete with the lower-cost imports, the remaining British wine and textile producers will likely be driven out of business - depressing wages, increasing unemployment, and ultimately substantially reducing the British market for Portuguese wine and cloth. In the meantime, the Portuguese may find their economy increasingly controlled by British investors intent on keeping Portuguese wages low and repatriating as much profit as possible back to England to finance purchases of Portuguese textiles and wine by the remaining elite. This may result in additional wage employment in Portugal, but with wages low and much of the output exported to a narrow market, Portuguese workers may find they are unable to afford to buy the products of their own labor. The only winners are the investor classes, who point out that the Portuguese workers should be happy to have any kind of job at all given the sad state of both the British and Portuguese economy. It is toward this latter world that economic globalization has moved us.

For Ricardo it is the capitalist's attachment to his national community that keeps capital at home. Adam Smith held the same view, and, interestingly, it is in the context of his discussion of the international immobility of capital that the famous “invisible hand" passage occurs. As Smith put it:

> “By preferring the support of domestic to that of foreign industry, he (the capitalist) intends only his own security; and by directing that industry in such a manner as its produce may be the greatest value, he intends only his own gain, and he is in this, as in many other cases led by an invisible hand to promote an end which was no part of his intention.”

As Daly points out [1]:

> “*When the self is constituted by internal relations in community it is not so surprising that pursuit of self-interest should promote the community welfare*.”

Ricardo emphasized that he would be sorry to see these feelings of community weakened. But of course they have in fact been greatly weakened, in no small part by the globalist ideology ironically justified by misunderstandings of Ricardo's own comparative advantage argument. Nowadays, in the twentieth century's globally integrated view of free trade, it no longer makes sense to think of national teams of labor and capital - both become global. Formerly national capitalists in the United States now communicate with their former domestic workers by mobile telephone in the manner of the following conversation imagined by David Korten [2]:

> “Sorry, old Union Joe Six-Pack, but we live in a global economy - I can buy labor abroad at one-tenth the wage your union wants, and with lower environmental and social taxes, and still sell my product in this market or any other. Your severance check is in the mail. Good luck.... What do you mean, "bonds of national community"? I just told you that we live in a global economy, and have abandoned all that nationalistic stuff that caused two world wars. Factor mobility is necessary for maximum efficiency, and without maximum efficiency we will lose out in global competition.... Yes, Joe, of course there will be a tendency to equalize wages worldwide, but profits will also equalize.... Well, yes, of course wages will be equalized downward and profits equalized upward. What else would you expect in a global economy that reflects world supply and demand? Don't you want the Chinese and Mexican workers to be as rich as you are? You're not a racist, are you, Joe? Furthermore, economists have proved that free trade benefits everyone. So be grateful.... Now that you have some extra time, Joe, sign up for Economics 101 at your local community college. You'll learn about comparative advantage. It'll help you feel better.”

E. Moral Hazard: Uncle Melvin's Problem

Moral hazard in financial markets is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) from the lender's point of view because they make it less likely that the loan will be paid back. Frederic Mishkin gives a simple example of moral hazard. [19]

> "Suppose that you made a $1000 loan to a relative, Uncle Melvin, who needs the money to purchase a word processor so that he can set up a business typing students' term papers. Once you have made the loan, however, Uncle Melvin is more likely to slip off to the track and play the horses. If he bets on a 20-to-1 long shot and wins with your money, he is able to pay you back your $1000 and live high on the hog with the remaining $19,000. But if he loses, as is likely, you don't get paid back, and all he has lost is his reputation as a reliable, upstanding uncle. Uncle Melvin therefore has an incentive to go to the track because his gains ($19,000) if he bets correctly may be much greater than the cost to him (his reputation) if he bets incorrectly. If you knew what Uncle Melvin was up to, you would prevent him from going to the track, and he would not be able to increase the moral hazard. However, because it is hard for you to keep informed about his whereabouts - that is, because information is asymmetric (economic jargon for the borrower knowing something the lender doesn't) - there is a good chance that Uncle Melvin will go to the track and you will not get paid back. The risk of moral hazard might therefore discourage you from making the $1000 loan to Uncle Melvin, even if you were sure that you would be paid back if he used it to set up his business."

The greatest recent example of the sanctification of greed creating a moral hazard was the savings and loan debacle in the United States. Who were the Uncle Melvins of that disaster? As a *Wall Street Journal* piece on the thrift disaster noted, the list of malefactors is "so long that some observers conclude there is something profoundly wrong with the country's political and financial systems, which appear easily undone by feckless and reckless behavior." In fact, they say, "the behavior of this legion calls into question the performance of this nation's professional class itself".

As Doug Henwood notes [9]:

"Every institution that was supposed to watch the S&Ls botched the task. Topping the roster of failures are the regulators, federal and state, in the grip of the early-Reagan-era euphoria, who failed to supervise the institutions - often run by dim provincials - that they had just set free to enter businesses they'd never been in before. Congress had long been in the industry's pocket. Even a president's son, Neil Bush, helped drive an S&L into the ground, Denver's Silverado. The administration with the complicity of an uncurious press successfully kept Silverado out of the 1992 campaign, no doubt helped by equal Democratic political and financial collusion in the disaster.

> But it's wrong to blame only the government, despite the American habit of doing so. Virtually every high-end profession around was involved. Auditors repeatedly certified fictitious financial statements, lawyers argued on behalf of con artists and incompetents, investment banks bilked naive S&L managers, and consultants testified as character witnesses for felons. One of these character witnesses was Alan Greenspan, then an undistinguished economist from whom "you could order the opinion you needed." Greenspan praised thrift-killer Charles Keating's "seasoned and expert" management team for rescuing a "badly burdened" thrift through "sound and profitable" investments. Every word of this was untrue. Greenspan's reputation, however, survived intact (just as it did his earlier demented jottings for Ayn Rand's *Objectivist* newsletter).
>
> Deregulation was the proximate cause, but moral hazard was the engine of destruction. The laws and regulations governing the thrifts had long been written by industry lobbyists, and their regulators were in thrall to the S&Ls as well, but this cozy relationship became particularly dangerous, as they were free to go wild. That wildness, as everyone knows by now, included

> showering money on superfluous shopping centers in the middle of nowhere, windmill farms, prostitutes, speculative housing, speculative office buildings, cocaine, junk bonds, art for the CEO's house, the Nicaraguan contras, and yacht parties on the Potomac. Hot for funds to get into these pursuits, and subsequently hotter for funds to cover losses, thrifts pushed up interest rates to attract deposits from Wall Street and other investors."

The price of the S&L bailout, paid by US taxpayers in another transfer of wealth from the middle class to the rich, would have funded the presence of 10 full-time bank examiners in every thrift in the country for close to 200 years. Extend this concept to the present global movement of trillions of dollars a day and tell me not to worry! Tell me that the "invisible hand" will protect what's left of the rain forests!

You would think some people would have learned their lesson, but the financial crisis of 2008 would prove you wrong.

The collapse of Lehman Brothers, a sprawling global bank, in September 2008 almost brought down the world's financial system. It took huge taxpayer-financed bail-outs to shore up the industry. Even so, the ensuing credit crunch turned what was already a nasty downturn into the worst recession in 80 years. As with the savings and loan crisis, taxpayers paid a huge price for other people's greed.

Per the Economist in 2013:

> "With half a decade's hindsight, it is clear the crisis had multiple causes. The most obvious is the financiers themselves—especially the irrationally exuberant Anglo-Saxon sort, who claimed to have found a way to banish risk when in fact they had simply lost track of it. Central bankers and other regulators also bear blame, for it was they who tolerated this folly.
>
> Start with the folly of the financiers. The years before the crisis saw a flood of irresponsible mortgage lending in America. Loans were doled out to "subprime" borrowers with poor credit histories who struggled to repay them. These risky mortgages were passed on to financial engineers at the big banks, who turned them into supposedly low-risk securities by putting large numbers of them together in pools.
>
> Low interest rates created an incentive for banks, hedge funds and other investors to hunt for riskier assets that offered higher returns. They also made it profitable for such outfits to borrow and use the extra cash to amplify their investments, on the assumption that the returns would exceed the cost of borrowing.
>
> When America's housing market turned, a chain reaction exposed fragilities in the financial system. It became difficult to sell suspect assets at almost any price, or to use them as collateral for the short-term funding that so many banks relied on. Trust, the ultimate glue of all financial systems, began to dissolve in 2007—a year before Lehman's bankruptcy—as banks started questioning the viability of their counterparties."