

CHAPTER ONE

The Anti-Entrepreneurs

Because the financial market crash of 2008, like the crash of 1929, followed a powerful prosperity it is often described as a crisis of capitalism, as if prosperity self-destructed. This is a primitive delusion, like believing drought and hailstorms are divine punishment on the inventors of crop rotation.

The crash of 2008 was driven by a betrayal of the most fundamental principles of capitalism, both in Washington and on Wall Street, by those often imagined to be capitalism's champions. This betrayal had little to do with the argument over whether government was too deeply, or not deeply enough, involved in the financial system. An unregulated financial sector is almost an oxymoron. In any modern state the government will always be the banks' biggest client and therefore will always make most of the rules, even if it pretends not to. The crash came not because we had too many regulators nor too few nor even because the regulators were incompetent. The crash came because both the regulators and the major players believed the same bad ideas.

The roots of the mortgage crisis, like the crash of 1987, the Long Term Capital crisis of 1998, and other market crises of our

PANIC

time are to be found in an ideology dominant in the financial establishment, on Wall Street and in Washington, through more than four decades. This ideology of modern finance replaces the capitalist's appreciation for *free markets* as a context for human creativity with the worship of *efficient markets* as substitutes for that creativity. The capitalist understands free markets as an arena for the contending judgments of free men. The ideologues of modern finance dreamed of efficient markets as a replacement for that judgment and almost as a replacement for the men. The most gloriously efficient of all, supposedly, were modern public securities markets in all their ethereal electronic glory. To these most perfect markets the priesthood of finance attributed powers of calculation and control far exceeding not only the abilities of any human participant in them but the fondest dreams of any Communist commissar pecking away at the next Five Year Plan.

Capitalism employs free markets as a proving ground, where the wise can be sorted from the fools, the good from the great. The ideology of modern finance calls only the market wise. As the Lord boasted to Gideon that he could make conquerors from cowards, the ideologues of modern finance offered to make any fool rich if only he renounced the first obligation of the capitalist, the burden of judgment.

The mortgage crisis and the crash of 2008 are sometimes described as problems of "liquidity": Too many of the nation's great financial institutions, we were told, lacked the cash to sustain their operations. Others say it was a crisis of insolvency, a fancy word for *broke*. Too many banks had invested in mortgages worth far less than the banks had paid. The banks were broke: they owed more than they owned.

These are half-truths. Like most grave financial crises, the mortgage crunch and the crash were crises of information. That's what panics are. Yes, the banks were short of cash but not because

cash was scarce generally. The Federal Reserve and the world's other central banks had been pouring cash into the banking system for more than a year. Yes, some of the great banks were probably broke. But the real problem was not that some of the banks were broke but that at the critical moment none of them could prove they weren't.

The banks could not prove they weren't broke because under the influence of modern financial theory they had abandoned basic tools of analysis and judgment. For these they substituted elaborate, statistically based insurance schemes that, with the aid of efficient financial markets, were assumed to make old-fashioned credit analysis and human judgment irrelevant.

These schemes failed to make good judgment irrelevant. But they did make it impossible when it mattered most. It became impossible for either executives or regulators to fully understand the financial condition of any great modern bank. Balance sheets once amenable to due diligence became impossible to assess accurately not only in practice but almost in principle. Deprived of information, investors were deprived of judgment. They panicked, not for the first time in recent years.

A crisis of capitalism? Compare the repeated disasters in securities markets over the past few decades with the astounding success in the "real economy" during the same time. The Great Reagan-Clinton Boom was driven by an explosion of entrepreneurial creativity, touched off by two coincident trends. In the first trend, very large cuts in tax rates—starting with President Carter's substantial reduction of capital gains taxes—combined with the end of runaway inflation to increase after-tax returns on investment several times over, drawing capital out of hiding to seek out new ideas. Happily, new ideas were abundant. At the time of President Carter's first capital gains tax cut, the microprocessor was just seven years old.

PANIC

The great boom was driven by inventors and investors whose good judgment connected suddenly abundant capital with suddenly abundant innovation. Relatively little of this connecting was done on Wall Street. The most important and innovative firms were launched far from public securities markets. What contribution there was from public markets often came from “wrong side of the tracks” neighborhoods like the junk bond market.

The men who launched the great boom were not gamblers. They did not make leaps in the dark. They brought light to the dark. They painstakingly turned hard-won knowledge into new wealth. Confronted with uncertainty they made their best judgments and then worked diligently to make those judgments come true. This process of confronting uncertainty and successfully resolving it usually by dint of hard work, diligent analysis, and sound judgment is the only source of what many economists have called “entrepreneurial profit” or sometimes “true profit.” Entrepreneurial profit is the new wealth created after all the routine costs of business, not just labor and materials, but management and capital have been accounted for. Companies can go along for many years using the customary methods of their industry, making good money for workers, managers, and investors alike, without ever creating a true entrepreneurial profit. Entrepreneurial profit is what happens when a company suddenly turns fewer inputs into more outputs, lowers costs but increases revenues. Getting more out of less or something out of nothing is an act of creation (cf. “Let there be light”). In the economic sphere we call that act of creation entrepreneurship.

The great boom was driven by entrepreneurs: outsiders, upstarts, and innovators. The great mortgage meltdown was an establishment game. The mortgage-backed securities market was created and driven by the largest, most well-established, most heavily regulated and government-subsidized players in mainstream financial markets.

The new mortgage market and the novel financial instruments traded on it were also innovations, in a sense. They were certainly the result of an effort to make more appear out of less, perhaps even something out of nothing. But the Wall Street men were conjurers not creators. Throughout the years when they were constructing the machinery of disaster, Wall Street men were repeatedly praised for the “creativity” of their new lending devices. But theirs was not the creativity of the entrepreneur but the bureaucrat. Their avowed goal, their most cherished dream, was to isolate money management from flawed human judgment, including their own. As with bureaucrats everywhere, they craved the cover of rules and systems. Like the servant who hid his silver talent in the earth, fearing his master more than he trusted his own judgment, the bankers buried the capital confided to them in structure and schemes rather than accept the responsibility it implied.

The great boom was driven by the insights, diligence, and judgment of a relatively small group of entrepreneurs. Underpinning the ideology of modern finance is the notion that the insight, judgment, and even diligence of the entrepreneur are irrelevant for investing in public securities markets. These markets, we are told, are special, too powerful, and too perfect to allow any entrepreneur’s judgment to matter.

Modern investment theory says that public securities markets—computerized, blazingly fast, effusively liquid—are as close as mankind has ever come to realizing the perfectly efficient market of classical economic theory. In such a perfect market, entrepreneurship is impossible. The entrepreneur’s profit comes from superior judgment, but in a perfect market no one’s judgment can be better than the market’s. In the ideology of modern finance, attempting to exercise ordinary human judgment when building a portfolio of publicly traded securities is considered not only futile but actually dangerous. Judgment is everywhere to be replaced

with structure and process. It is no accident that the various methods used to create the most complex mortgage-backed securities are comprised under the term “structured finance.”

To say, as so many did in the wake of the crash, that the bankers were reckless, heedless of risk, is exactly the opposite of the truth. They were so obsessed with risk that they became terrified to live by their own judgment. If the ideology of modern finance had a motto, it might be “thinking doesn’t work.”

In the manner of ideologies, this one captured many who actually rejected its founding assumptions. The efficient market hypothesis—the notion that financial markets get prices more “right” than any investor can—is indispensable, logically, to modern investment theory. Yet by the time of the crash the efficient market hypothesis was far less widely accepted than it had been twenty years earlier. The tech wreck and other market catastrophes had left few money managers willing to swear their undying allegiance to the all-knowing market. Yet, even as specific notions underlying the reigning ideology were discredited, the ideology itself grew stronger. Ideologies are like that; it is part of their power. When a set of ideas becomes an ideology, the ideas can themselves all but disappear into the background, like air or gravity.

It was not bad theory alone that caused the crisis. A clutch of the top executives of our greatest banks joined with fly-by-night mortgage brokers and august agencies of the government in an unspoken conspiracy of fraud, with their own institutions among the ultimate victims. While the fraud was happening it was winked at and even encouraged by nearly every relevant regulatory and political authority, with a few ineffectual exceptions.

The ideology was essential to the deception, especially the self-deception. It gave cover to temptations that, had they appeared in their raw and rabid form, might have been resisted. Tempters everywhere seek the cover of respectability, and nothing was more

respectable, more impeccable, even scientific and statistical, than the contemporary theory of investment. The bankers fervently believed their new structures and systems would better ensure the soundness of their loans than old-fashioned credit analysis and human judgment, fraught as ever with human error. Having crafted a system that seemed to relieve them of responsibility for making good judgments, they naturally proceeded to make an enormous number of bad loans. Similarly, the government did not know the banks' financial condition not because the banks were hiding it but because the banks themselves did not know. Believing that statistical systems could transcend the need for human judgment, the bankers created and the regulators encouraged financial institutions with balance sheets no one could judge.

Finally, when the fraud began to be revealed by its consequences, the government turned crisis into catastrophe. It was the government that actually collapsed stressed credit markets, largely by treating fraud as mere misfortune. Transfixed by the same ideology of irresponsibility, the government coddled those who perpetrated the fraud and concentrated its ire on those who exposed it, especially short sellers. (Short selling is to financial markets what free speech is to political markets.)

The ideology of modern finance tears capitalism in two, and then abandons the half beyond the ken of bureaucrats and the professors who train them. Capitalism demands free markets because it needs free minds. Modern investment theory says efficient markets can moot the minds entirely. The entrepreneur cherishes freedom including the freedom to fail. The bureaucrat of capital dreams of a world in which failure is impossible. Confronted with demons of uncertainty, the entrepreneur wrestles them till dawn. The bureaucrat of capital crafts idols of ignorance and worships in the dark.

Prevailing in Washington as on Wall Street were the most vile



PANIC

and self-destructive assumptions of anti-capitalists everywhere who imagined they could wield capital even while abandoning the principles that created it; that systems could substitute for the moral standards they once embodied; or that men who lost trillions of dollars of other people's money might somehow recover it if only the government would give them trillions more. Crony capitalists on the right and socialists on the left united as always behind their most fundamental belief, that wealth is to be captured by power and pull rather than created in the minds of men.