



A Silver Lining to the Financial Crisis: A More Realistic View of Capitalism

By Jeffrey Friedman and Wladimir Kraus

There is little evidence that deregulation or banks' compensation practices caused the financial crisis. What did seem to cause it were capital regulations imposed on banks across the world. These regulations explain why bankers who are commonly seen as having recklessly bought risky mortgage-backed bonds in order to boost earnings—and bonuses—actually bought the least-risky, least-lucrative bonds available: those that were guaranteed by Fannie Mae or Freddie Mac or were rated AAA. These securities were decisively favored by capital regulations, raising the question of whether regulation actually increases systemic risk. By definition, regulations aim to homogenize the otherwise heterogeneous behavior of competing enterprises. Since one set of regulations has the force of law, it homogenizes the entire economy in that jurisdiction. But regulators are fallible, and if their ideas turn out to be wrong—as they appear to have been in the case of capital regulations—the entire system is put at risk.

A BBC poll conducted in twenty-seven countries found last month that only one in four Americans thinks that capitalism works well—and that this is the highest proportion of any country in the world. Only in America and in Pakistan, of all places, do more than 20 percent of the respondents think that capitalism works well; the average across the twenty-seven countries polled was only 11 percent. And 23 percent of those polled “feel that capitalism is fatally flawed, and a new economic system is needed.” Majorities want their governments “to be more active in owning or directly controlling their country’s major industries in 15 of the 27 countries.” But “the most common view is that free-market capitalism has problems that can be addressed through regulation and reform—a view held by an average of 51 percent of more than 29,000 people polled.”¹

Jeffrey Friedman is the editor of the journal *Critical Review* and of *Causes of the Financial Crisis* (University of Pennsylvania Press, forthcoming in 2010). Wladimir Kraus is coauthoring, with Friedman, *Engineering the Perfect Storm: How Reasonable Regulations Caused the Financial Crisis* (University of Pennsylvania Press, forthcoming in 2011).

This is a measure of the intellectual toll taken by the financial crisis. But it is good news, in a way. As opinion researchers have long known, terms such as “capitalism” are dimly understood by most people (even by intellectuals), so the best way to interpret these results is as a repudiation of the status quo, which most people (inaccurately) call “capitalism” or “the free market.”

Key points in this Outlook:

- Two familiar scapegoats for the financial crisis—deregulation and bankers’ bonuses—do not, in fact, appear to have been responsible for the disaster.
- Powerful evidence suggests that the recourse rule, and other variants of the Basel regulations on commercial banks’ capital, caused the crisis.
- As they did in this case, regulations may tend to increase systemic risk by homogenizing otherwise heterogeneous, competitive economic behavior.

In this light, the real problem lies not in the fact that so many people would like to see an entirely new system—a reasonable demand, once we understand what caused the crisis—but rather in the fact that a majority thinks that the remedy for the inadequacies of the status quo is “regulation and reform.” The status quo can best be characterized as hyperregulated capitalism, and it was the regulatory elements, not the capitalist elements, that caused the financial crisis.

It is one thing to say that corporate America’s compensation systems are flawed. It is quite another thing to say that this flaw caused the financial crisis.

In short, people are right to be dissatisfied with prevailing economic arrangements. But they have been persuaded by their intellectual leaders—including, unfortunately, most defenders of “capitalism”—to think that the status quo is capitalism, rather than a system in which the most fundamental feature of capitalism—competition—has been seriously undermined by a thick layer of regulation laid over capitalism during the last 150 years. There is no better example of how misleading it is to blame “capitalism” for the resulting problems than in the case of the financial crisis, which was in fact a regulatory failure par excellence.

What Did Not Cause the Crisis

There are currently three points of consensus about what caused the crisis, one of which is indisputable, one of which is dubious, and one of which is incorrect. The incorrect and the dubious need to be cleared out of the way if we are to understand what really went wrong. So here are the three points of consensus, arranged from wrong, to probably wrong, to right:

Claim One: Financial Deregulation Caused the Crisis.

This piece of the conventional wisdom is false. The indefatigable Peter J. Wallison has pointed out in an *AEI Financial Services Outlook* that the two aspects of financial deregulation that have been blamed for the crisis are mythical, not factual.²

First, the Gramm-Leach-Bliley Act of 1999,³ which amended the Glass-Steagall Act of 1933,⁴ did not erase the distinction between commercial banks, which take deposits and make loans and investments, and (the somewhat confusingly labeled) investment banks, which underwrite and trade securities. The 1999 act merely allowed both commercial and investment banks to be subsidiaries of a common holding company, but they remained subject to the same restrictions on the nature of their activities as before. These restrictions were loose in the case of investment banks but tight for commercial banks—and as we shall see, the crisis took place within the commercial banks. It is therefore crucial to recognize that, contrary to the claim many prominent economists and commentators have made, the 1999 act did not “repeal” Glass-Steagall, whose heavy regulatory framework on the activities of commercial banks remained on the books, as potent as ever.

The second part of the “deregulation” myth concerns credit default swaps, which truly were, and remain, unregulated. But as Wallison has shown in yet another *AEI Financial Services Outlook*,⁵ subsequently expanded into an article in *Critical Review*,⁶ credit default swaps did not mysteriously “interconnect” banks and increase systemic risk.

In essence, a credit default swap is a loss-protection insurance contract. This risk is swapped (for a fee) by the lender to a “counterparty”; the amount of the risk remains the same but has merely been transferred from the lender to the counterparty. This transfer no more increases overall risk levels than does a car insurance policy, which transfers risk from the driver to the insurance company. A credit default policy is often traded from one counterparty to another, so on a flow chart that followed the policy from hand to hand, all the counterparties might appear to be “interconnected.” But this interconnection is historical only: past counterparties do not remain on the hook when they pass a policy to a new counterparty. There remain only two meaningfully connected parties—the ultimate insurer and the insured. Not surprisingly, then, Wallison demonstrates there is no evidence that credit default swaps contributed to the crisis.

Claim Two: Executive Compensation Systems at the Banks Caused the Crisis. This part of the conventional wisdom is doubtful at best. It is true that many publicly held American corporations, including banks, pay performance bonuses that may encourage excessive risk

taking. The reason for this is a topic that cries out for exploration, as does any instance of manifestly irrational behavior by large numbers of businesses. An explanation that we find credible builds on the historical research of Amar Bhidé, who points out that starting in the 1930s, regulations issued by the Securities and Exchange Commission (SEC) made the close supervision of corporations by “insiders” who financed these companies—the dominant practice before the SEC regulations—impossible.⁷ Since the 1930s, therefore, equity investors in most corporations have, by definition, been “outsiders” who have had to use publicly reported information to infer what is going on inside. In making these inferences, they rely on short-term, legally mandated heuristics for long-term performance, such as quarterly earnings reports. This gears publicly held corporations toward short-term gain, even at the price of long-term risk.

It is one thing, however, to say that corporate America’s compensation systems are flawed, whether because of securities regulations or for some other reason. It is quite another thing to say that this flaw caused the financial crisis.

To date, there have been only two studies of the matter, the first of which found that the banks whose executives held the most stock in the bank lost the most money in the crisis—indicating that the executives did not engage in deliberate risk taking motivated by a quest for higher bonuses, as they would have been risking their own money.⁸ A more recent study, however, by Ing-Haw Cheng, Harrison Hong, and Jose Scheinkman finds a positive correlation between risk taking and large bonus packages,⁹ although this study has been criticized on the grounds that most of the risk taking found by the authors was among insurance companies, not banks.¹⁰

These two studies are important, regardless of their conflicting findings, because their authors recognize that different banks operated differently. But at the aggregate level, there is decisive evidence against the thesis that incentives to take risks caused the financial crisis. The evidence is this: 93 percent of all the mortgage-backed securities held by American banks either were issued by Fannie Mae or Freddie Mac, and were thus implicitly guaranteed by the U.S. Congress (as the American taxpayer soon found out), or were issued by investment banks and rated AAA by one of the three rating agencies: Moody’s, Standard and Poor’s, or Fitch.¹¹

Never mind that these three private corporations had had a legally protected oligopoly since 1975, thanks to another SEC regulation.¹² Never mind, in short, that,

protected from market competition, these companies’ AAA ratings may have been so sloppy or so deliberately skewed that they understated the risk associated with mortgage-backed bonds. That aside, the oligopoly’s ratings produced a concrete result: as is true of all bonds, AAA-rated bonds paid less than lower-rated (AA, A, BBB, etc.), supposedly riskier bonds. Bond investors always trade risk against returns. A high rating connotes safety and therefore always pays lower returns than lower-rated bonds pay—and there is no higher rating than AAA. If bankers were being lured by their banks’ compensation systems into acquiring risky but *lucrative* assets—on the basis of which the bankers would have gotten bigger bonuses—then they should never have bought AAA bonds. Instead, they should always have bought higher-paying AA-, A-, or BBB-rated bonds, but they did so only 7 percent of the time.

Claim Three: The Fed’s Low Interest Rates from 2001 to 2005 Financed the Housing Bubble That Led to the Crisis.

This is the only element of the conventional wisdom that seems to rest on solid ground.¹³ But when it is cut loose from the other two elements of the conventional wisdom, it generates a puzzle: why did the bursting of the housing bubble cause a *financial* crisis, that is, a banking crisis?

This might not seem so puzzling at first: commercial banks made many of the mortgage loans that were financed by the Federal Reserve’s low interest rates. But the financial crisis was not caused by mortgage defaults directly: it was caused by a sharp drop, in September 2008, in the market price of mortgage-backed bonds, in anticipation of their declining value as the bubble deflated. The first victims of the falling price of mortgage-backed bonds were Fannie and Freddie; in quick succession came the investment bank Lehman Brothers; and finally came the commercial banks—because they held so many mortgage-backed bonds, *not mortgages*. The question, then, is why the commercial banks held so many mortgage-backed bonds. If deregulation or the quest for high earnings, hence high compensation, did not cause the banks to buy these bonds, what did?

Regulatory Roots of the Financial Crisis

To answer this question, we have to turn in a direction that has been overlooked by the conventional wisdom: an obscure regulation called the recourse rule. The recourse rule was enacted by the Federal Reserve,

the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Office of Thrift Supervision in 2001.¹⁴ It was an amendment to the international Basel Accords governing banks' capital holdings, and all over the world, these regulations appear to have contributed significantly both to the housing boom and to the financial crisis.

A bank's capital reserve represents funds that are not borrowed—funds that, therefore, need not eventually be paid back to someone, such as a bank's depositors. Thus, an important source of a bank's capital reserve is funds from selling shares of stock in a bank. These funds can be costly to acquire, as one expert has pointed out:

For corporations (including banks) not eligible for Subchapter S earnings pass-through treatment, the after-tax cost of equity capital, say 12 to 15 percent, is substantially greater than the after-tax cost of debt, which is generally in the 3 to 5 percent range.¹⁵

By reducing their capital holdings, banks can, at least in principle, increase their profitability.

But under the recourse rule, "well-capitalized" American commercial banks were required to spend 80 percent more capital on commercial loans, 80 percent more capital on corporate bonds, and 60 percent more capital on individual mortgages than they had to spend on asset-backed securities, including mortgage-backed bonds, as long as these bonds were rated AA or AAA or were issued by a government-sponsored enterprise (GSE), such as Fannie or Freddie. Specifically, \$2 in capital was required for every \$100 in mortgage-backed bonds, compared to \$5 for the same amount in mortgage loans and \$10 for the same amount in commercial loans.

One can readily see that the recourse rule was designed to steer banks' funds into "safe" assets, such as AAA mortgage-backed bonds. The fact that 93 percent of the banks' mortgage-backed securities were either AAA rated or were issued by a GSE shows that this is exactly what the rule accomplished.¹⁶ Unfortunately, these bonds turned out not to be so safe. Without the recourse rule, however, there is no reason for portfolios of American banks to have been so heavily concentrated in mortgage-backed bonds.

No other category of investors except investment banks (which packaged mortgages into mortgage-backed securities, and thus were caught with huge inventories of both), no matter how highly leveraged—not hedge

funds, not bond funds, not pension funds, not insurance companies—was as decimated as commercial banks by huge holdings of mortgage-backed bonds. But that is because the recourse rule covered commercial banks, not hedge funds or anyone else. If not for the recourse rule's privileging of mortgage-backed bonds, the burst housing bubble almost certainly would not have caused a banking crisis. The banking crisis, in turn, froze lending and caused the Great Recession.

If not for the recourse rule's privileging of mortgage-backed bonds, the burst housing bubble almost certainly would not have caused a banking crisis. The banking crisis, in turn, froze lending and caused the Great Recession.

Indeed, the recourse rule may have been a significant factor in pumping up the housing bubble itself. In 2001, \$2.2 trillion in mortgages were originated; the figure leapt to \$2.9 trillion in 2002, when the recourse rule took effect, and to \$3.9 trillion in 2003 before declining to \$2.9 trillion in 2004, \$3.1 trillion in 2005, and \$3 trillion in 2006, after which the bubble began to deflate.¹⁷ Was there a connection between the recourse rule and the housing bubble?

Each mortgage-backed bond promised, to the bond holders, principal and interest payments drawn from thousands of mortgages. The more mortgage-backed bonds were bought, the more mortgages had to be written. The artificial demand for mortgage-backed bonds created by the recourse rule may therefore explain why, as the decade wore on and the pool of credit-worthy borrowers who made traditional down payments dried up, banks and mortgage specialists lowered their lending standards and made the terms of their mortgages more generous. The resulting mortgages would soon be sold to Fannie, Freddie, or an investment bank for securitization into bonds. (Between the middle of 2001 and the beginning of 2002, mortgage securitization jumped from about \$20 billion to \$50 billion per

quarter, peaking at nearly \$150 billion per quarter in 2006.)¹⁸

The recourse rule did not apply outside the United States, but the first set of Basel accords on bank capital, adopted in 1988,¹⁹ included provisions for even more profitable forms of “capital arbitrage” through off-balance-sheet entities such as structured investment vehicles (SIVs), which were used extensively in Europe. Moreover, in 2006, a second set of bank-capital accords, “Basel II,” began to be implemented outside the United States. Basel II took essentially the same approach as the recourse rule, encouraging foreign banks to acquire mortgage-backed securities, just as in the United States.²⁰

Here, then, we may have the genesis of the global financial crisis. If so, it turns out to have been caused by the very device—regulation—to which most people now, as they did throughout the twentieth century, look for the “reform” of capitalism. But is it really capitalism when it is so heavily regulated?

Regulation as a Source of Systemic Risk

It is true that capitalists—bankers—who took advantage of the recourse rule turned out to be making a grievous mistake. But not all capitalists made this mistake, and that is where the story gets interesting.

Recall the findings of Cheng, Hong, and Scheinkman, who detected more risk taking among individual banks that paid high bonuses. We contrasted this finding against the aggregate behavior of (commercial) banks, which chose the less-lucrative, less-risky GSE-issued or AAA-rated mortgage-backed bonds favored by the recourse rule 93 percent of the time. The aggregate finding suggests that executive compensation practices did not cause the crisis and that the recourse rule did. But the findings by Cheng et al. remind us that aggregate figures obscure differences in behavior among individual business firms. Indeed, there is a word for “differences in behavior among individual business firms”: competition.

Consider the contrast between Citigroup and one of its main competitors, JP Morgan Chase. Citi jumped into mortgage-backed bonds with both feet, putting them on its balance sheet through the recourse rule but also buying them off-balance-sheet through SIVs, of which Citi created seven of the sixteen in the United States (there were forty-one in Europe). Citi even established a separate unit to securitize its own

mortgages. Meanwhile, JP Morgan lost billions of dollars in potential revenue for years in order to avoid mortgage securitization.²¹ JP Morgan’s Jamie Dimon was among those who recognized the danger; Citigroup’s Chuck Prince apparently recognized the danger but calculated the odds of disaster as lower than the profits to be made from taking advantage of Basel I (which sanctioned SIVs) and the recourse rule.

What explains this diverse behavior is that the individual bankers in question had different perceptions of the magnitude of the risk. In unregulated markets, that kind of diversity of viewpoints is precisely what makes capitalism work. One capitalist thinks that profit can be made, and loss avoided, by pursuing strategy A; another, by pursuing strategy B. The heterogeneous strategies of different capitalists compete with each other, and the better ideas produce more profits than losses.

That, from an analytical perspective, is competition. From the same perspective, competition is at the core of any rigorous definition of “capitalism.” Competition is what gives capitalism its only conceivable economic advantages, as compared either to regulation or to the “whole new economic system” that many people have tried to envision ever since capitalism—with its inequalities, its waste, and its many other inadequacies—burst into public consciousness during the Industrial Revolution. To ask why we need competition, then, is to ask why we need capitalism.

Our answer is as follows. In a complex world like ours, nobody really knows what will succeed until it is tried. Competition, which pits entrepreneurs’ divergent ideas against each other, is the only way to test these ideas through anything but the highly unreliable process of verbal debate (in which the debaters’ competing ideas cannot be simultaneously tested against each other in the real world, instead of in the imaginations of their audience).

Competition among capitalists sorts out which of their ideas actually please real-world consumers and which of them are displeasing—however appealing the ideas might have seemed on the drawing board. And competition among capitalists also sorts out which ideas for how to avoid loss are good ones and which ideas for avoiding loss are bad. Thus, competition has the net effect of spreading society’s bets among different, fallible ideas about where profit—and loss—might be located and of testing them against reality. For this reason, herd behavior among capitalists is a genuine threat to its “competitive advantage.” If capitalists stop acting

heterogeneously—if they compete through imitation, rather than innovation—the risk of systemic failure increases, unless all of the capitalists happen to be placing their chips on the right idea.

Regulations, by their very nature, align the behavior of those being regulated with the ideas of those doing the regulating. Regulations are like mandatory instructions for herd behavior, *automatically* increasing systemic risk.

Capitalism will probably always be prone to asset bubbles and other manifestations of homogeneous behavior, but only because it is part of human nature for people to go along with the crowd. This is a risk that can be mitigated but not eliminated. But capitalism has a unique feature, competition, that does mitigate it by both encouraging and taking advantage of heterogeneous behavior, that is, innovation.

Homogeneity, on the other hand, is the ineradicable curse of socialism, in which the community as a whole, through its elected (or self-appointed) representatives, decides on the allocation of resources. One plan is imposed on all, as thoroughly as if everyone spontaneously decided to join a herd.²² And we maintain that homogeneity is also the problem with regulation. Regulations, by their very nature, align the behavior of those being regulated with the ideas of those doing the regulating. Regulations are like mandatory instructions for herd behavior, *automatically* increasing systemic risk.

The recourse rule, Basel I, and Basel II loaded the dice in favor of the regulators' ideas about prudent banking. These regulations imposed a new profitability gradient over all bankers' risk/return calculations, conferring 80 percent capital relief on banks that bought GSE-issued or highly rated mortgage-backed bonds rather than commercial loans or corporate bonds, and 60 percent relief for banks that traded their individual mortgages for those "safe" mortgage-backed bonds. Only bankers with the most extreme perceptions of the downside, such as JP Morgan's Jamie Dimon, escaped unharmed.

Bank-capital regulations inadvertently made the banking system more vulnerable to the regulators' errors. But this is what all regulations do. Whether by forbidding one activity or encouraging a different one, the whole point of regulation is, after all, to change the behavior of those being regulated. And the direction of change is, obviously, the one the regulators think is wise.

Perhaps, then, we do need a new economic system: capitalism. The Basel rules, the recourse rule, the oligopoly-conferring regulations of the SEC—these regulations cover a tiny fraction of the millions of pages of the Federal Register and its state, local, and international counterparts. And each of the hundreds of thousands of regulations filling those pages chips away at the heterogeneous competitive behavior that constitutes the best reason for capitalism. If one is looking for the cause of a systemic failure in our highly regulated economy, it makes more sense, at least initially, to look to the laws that govern the whole system, rather than reflexively blaming what has now become "capitalism" in name only.

How Conservatives Get Capitalism Wrong

If our argument has been correct, then the Great Recession was a regulatory failure, not a failure of capitalism. But it is also an occasion for a rethinking of capitalism—by both its conservative defenders and its liberal critics.

Let us start with conservatives, many of whom make the mistake of extolling the brilliance, wisdom, or heroism of capitalists. They forget that for every Jamie Dimon, there is a Chuck Prince. Capitalists are as fallible as anyone else. Collectively, they possess no superior powers; their lucky guesses, no matter how well informed, are still guesses. Everyone can see this in the wake of the crisis. Paeans to capitalist genius will no longer do.

Seventy-three percent of the successful entrepreneurs recently surveyed by the Ewing Marion Kauffman Foundation said luck was an important factor in their success.²³ These successful capitalists' own assessments happen to track the standard liberal view. The main point made by John Rawls—the great philosopher whom conservatives love to loathe but hate to read—was that good luck, including even the good luck to develop a strong work ethic, confers no moral claim. Winners of the genetic lottery, Rawls said, are not thereby entitled to be rewarded. Liberals are right to notice that good

luck explains many capitalists' success, and that bad luck—accidents of birth—condemn millions to lives of misery. Conservatives who close their eyes to the accidental element in wealth and poverty make themselves appear both heartless and clueless.

If our argument has been correct, then the Great Recession was a regulatory failure, not a failure of capitalism. But it is also an occasion for a rethinking of capitalism—by both its conservative defenders and its liberal critics.

In addition to their unfortunate romanticizing of capitalists, conservatives have erred by adopting the economists' standard explanation for the success of capitalism: self-interest. Self-interest is supposed to provide the "magic of the market," but we can safely assume that Chuck Prince was every bit as self-interested as Jamie Dimon. Both of them had equally strong incentives to save their banks, but that did not help Citigroup. Armen Alchian, an economist at the University of California, Los Angeles, showed in 1950 that capitalism would succeed even if capitalists were not motivated by self-interest. And the fact is that many successful capitalists, such as the founders of Google and Whole Foods, were *not* motivated by self-interest.²⁴

Unfortunately, economists have only grown more obsessed with self-interest—that is, "incentives"—since 1950. This has led many conservatives to embrace the idea that "greed is good"—a woeful misreading of Adam Smith. Smith's parable of the baker, to whose benevolence we do not appeal when we buy our bread, is actually a lesson in unintended consequences, not in the wonders of greed. Even if the baker intends merely to make money, he can do so only by providing his customers with bread. In his case, greed is indeed good. But that does not mean that greed is *always* good and benevolence bad, nor that all bakers are in it solely for the money. Nor does it mean that greed accounts for the success of capitalism.

How Liberals Get Capitalism Wrong

Liberals are right to see through the usual conservative defenses of capitalism, but they are wrong on the big picture. They fail to notice that there is more to capitalism than luck and greed: there is competition—the saving grace of the whole system; the device that turns good luck to social advantage; and, when undisturbed, the source of capitalism's systemic strength.

Competition is the engine that turns the talents of the lucky to the service of all. A baker who offers moldy or bland bread can be driven from the field by a competitor offering a better product. *That* is the message of Adam Smith. The successful baker, no matter how greedy his motive for baking bread, must unintentionally mimic the very actions an altruistic Rawlsian philosopher would prescribe. The reason is the competitive nature of the capitalist system; the motives of individual capitalists are irrelevant. Competition puts capitalists' different motives, like their different ideas, to the acid test of consumer satisfaction. This tends to give consumers what they want—or at least what they think they want—and it diversifies a capitalist society's investment portfolio. Capitalism thus mitigates both human greed and human fallibility. This is an amazing achievement, but there is nothing magical about it.

Now consider again the alternatives liberals tend to favor—either the regulation of capitalism or its replacement by something more democratic, like an idealized socialism. Since regulators' or citizens' ideas would then be imposed on the whole economy at once, they could not be put to the competitive test—any more than the conflicting arguments of debaters, the conflicting promises of politicians, or the conflicting forecasts of budget analysts can be tested. If the citizens' or the regulators' ideas happen to be good ones, we all gain; if they happen to be bad, we all lose.

The whole system crashed when the financial regulators' ideas about prudent banking backfired, but such failures are inevitable unless modern societies are so simple that the solutions to social and economic problems will be self-evident to a generalist voter, or even a specialist regulator. That modern societies really are that simple is, in truth, the hidden assumption of modern politics. This is why political conflicts get so ugly: neither side can understand why their adversaries oppose what "self-evidently" should be done, so both sides ascribe evil motives to each other. But the financial

crisis has exposed this simplistic view of the world for what it is. In the wake of the crisis, nobody can plausibly deny anymore that modern societies are bafflingly complex. The solutions to social and economic problems are thereby unlikely to be self-evident. The theories that seem so obviously true to voters or regulators may turn out to be disastrously false—unless regulators or citizens are infallible.

That surely would be magical. But there is no more magic to politics than there is to markets. The question raised by the ongoing intellectual contest between socialism and capitalism, and the ongoing practical battle between regulation and competition, is how best to guard against human frailties: By putting all our eggs in one politically decided basket? Or by spreading our bets through the only practical means available: competition?

Notes

1. BBC World Service Poll, “Wide Dissatisfaction with Capitalism—Twenty Years after Fall of Berlin Wall,” November 9, 2009, WorldPublicOpinion.org, available at www.worldpublicopinion.org/pipa/articles/btglobalizationtradera/644.php (accessed January 8, 2010).
2. Peter J. Wallison, “Deregulation and the Financial Crisis: Another Urban Myth,” *AEI Financial Services Outlook* (October 2009), available at www.aei.org/outlook/100089.
3. *Gramm-Leach-Bliley Act of 1999*, Public Law 106-102, U.S. Statutes at Large 113 (1999): 1338.
4. *Banking Act of 1933*, Public Law 73-89, U.S. Statutes at Large 48 (1933): 162.
5. Peter J. Wallison, “Cause and Effect: Government Policies and the Financial Crisis,” *AEI Financial Services Outlook* (November 2008), available at www.aei.org/outlook/29015.
6. Peter J. Wallison, “Credit-Default Swaps Are Not to Blame,” *Critical Review* 21, no. 2–3 (2009): 377–88, available at www.aei.org/article/101074.
7. Amar Bhidé, “An Accident Waiting to Happen,” *Critical Review* 21, no. 2–3 (2009): 211–48.
8. Rüdiger Fahlenbrach and René M. Stulz, “Bank CEO Incentives and the Credit Crisis” (manuscript, Ohio State University, July 2009).
9. Ing-Haw Cheng, Harrison Hong, and Jose Scheinkman, “Yesterday’s Heroes: Compensation and Creative Risk-Taking” (second draft, manuscript, Princeton University, October 2009).
10. Steven N. Kaplan, “Should Banker Pay Be Regulated?” *The Economists’ Voice*, December 2009.
11. Viral V. Acharya and Matthew Richardson, “Causes of the Financial Crisis,” *Critical Review* 21, no. 2–3 (2009): 195–210, table 1.
12. See Lawrence J. White, “The Credit-Rating Agencies and the Subprime Debacle,” *Critical Review* 21, no. 2–3 (2009): 389–99.
13. John B. Taylor, “Economic Policy and the Financial Crisis: An Empirical Analysis of What Went Wrong,” *Critical Review* 21, no. 2–3 (2009): 341–64.
14. Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, “Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations; Final Rules,” *Federal Register* 66, no. 59614 (November 29, 2001).
15. Bert Ely, “Bad Rules Produce Bad Outcomes: Underlying Public-Policy Causes of the U.S. Financial Crisis,” *Cato Journal* 29, no. 1 (Winter 2009): 93–114.
16. We have been unable to find aggregate figures for commercial banks’ holdings of AA-rated mortgage-backed bonds. Whatever the number turns out to be, it should be added to the 93 percent of these bonds that were either GSE-guaranteed or were privately issued and rated AAA—driving up the proportion of mortgage-backed securities that gained “capital relief” under the recourse rule even closer to 100 percent.
17. Viral V. Acharya and Matthew Richardson, eds., *Restoring Financial Stability: How to Repair a Failed System* (New York: Wiley, 2009), chapter 1, table 1.
18. Viral V. Acharya and Matthew Richardson, “Causes of the Financial Crisis,” figure 1.
19. Basel Commission on Banking Supervision, “Basel Capital Accord, International Convergence of Capital Measurement and Capital Standards,” July 1988, available at www.bis.org/publ/bcbbsc111.pdf (accessed January 8, 2010).
20. Basel Committee on Banking Supervision, Bank for International Settlements, “Overview of the Amendment to the Capital Accord to Incorporate Market Risks,” January 1996, available at www.bis.org/publ/bcbs23.htm (accessed January 8, 2010).
21. Gillian Tett, “Leveraging Lunacy,” in *Fool’s Gold* (New York: Free Press, 2009), 129–142.
22. This Hayekian point has been best developed in Don C. Lavoie, *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered* (Cambridge: Cambridge University Press, 1985).
23. Ewing Marion Kauffman Foundation, “Experience, Management and Luck Are Keys to Entrepreneurial Success, Say Company Founders,” news release, November 17, 2009.
24. Armen Alchian, “Uncertainty, Evolution, and Economic Theory,” *The Journal of Political Economy* 58, no. 3 (June 1950): 211–21.