

PART I

# Overview of the Crisis

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## CHAPTER 1

# Leverage and Liberal Democracy

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Whenever something out of the ordinary happens that is destructive and menacing, the search for causes is almost always intense and prolific. That has certainly been the case with respect to the financial crisis of 2007–2009. Whether on CNBC, the pages of the *Wall Street Journal* and the *Financial Times*, the economic blogs, or even explanatory videos on YouTube, plenty of culprits have been put forward.

One reads and hears about greedy mortgage brokers and bankers whose pay structure encouraged them to cut ethical corners and undertake huge risks. Some point the finger at conflicted rating agencies that assigned Triple-A ratings to financially engineered junk. Free market skeptics cite an ideologically driven policy of *laissez faire* on the part of regulatory bodies. Defenders of free markets counter with the government's push to increase home ownership among the middle classes and the poor through Fannie Mae, Freddie Mac, and the Community Reinvestment Act. Economists speak of informational asymmetries arising from the enhanced opportunities for mortgage originators to unload credit risk onto the investing community as a result of securitization. Others note the dramatic expansion of complex securities like credit default swaps. Many have singled out the excessively low interest rates maintained by the U.S. Federal Reserve (Fed) between 2002 and 2005. But those who think the American central bank has been made a scapegoat refer instead to the Asian savings glut that kept long-term interest rates low even as the Fed subsequently endeavored to tighten monetary policy.

No doubt, whenever the definitive account of the crisis is written by future historians, it will have to integrate several of these factors. Yet it will need to go beyond these, if only because the story would otherwise be restricted to proximate causes. We would overlook the ultimate source of our difficulties, the larger historical forces that laid the foundation for the proximate causes that mainstream commentators have emphasized. Interestingly enough, it is the heterodox traditions of economics that have most acutely sensed the need to probe deeper. Marxists, for example, interpret the crisis as the culmination of the financialization of capitalism, a phenomenon manifest in the growth of debt that has been gathering force since the 1970s in response to the systemic dearth of investment opportunities.<sup>1</sup> Austrian economists, by contrast, blame that financialization, with all of its attendant ills,

on the political monopolization of money and credit creation rendered possible by the institution of central banking.<sup>2</sup>

Though these explanations rightly focus on the prevalence of debt—and more precisely the leverage that it reflects—they still do not get to the root of the matter. To reach that, we have to go back and familiarize ourselves with the original principles of the liberal democratic order within which our financial markets operate. That regime was founded on the recognition of leverage as a morally legitimate tool of economic life. Precisely because of tendencies inherent in liberal democracy, however, leverage was progressively freed from virtually all traditional moral limits. This has left present-day capitalist economies all too prone to financial calamities of the sort in which we now find ourselves.

By *liberal democracy*, what is meant here is not simply a particular form of government in which the ultimate authority for public decisions rests with a majority of the populace. Liberal democracy is more comprehensively understood as a mode of social organization that first arose in the seventeenth and eighteenth centuries in northern Europe—the very place and time, not uncoincidentally, when historians typically date the first great financial crises. Over the succeeding centuries, it spread globally such that its principal representatives now include the United States, Canada, much of Europe, Japan, Israel, Australia, and New Zealand, though it has also made significant inroads into Asia, Africa, and Latin America. The defining feature of the regime is its neutral stance about the meaning and purpose of human life. Accordingly, the state's role in a liberal democracy is limited to enabling individuals to pursue their fulfillment as they each see fit in an environment of freedom and equality, subject to the proviso that no harm is done to others in the process.

The early philosophic exponents of liberal democracy, such as John Locke and Adam Smith, well understood that this political vision implied freedom of commerce. They also realized that most people, once given the liberty to pursue whatever their hearts desired, would end up defining their happiness in terms of material affluence. Consequently, they saw that the chief occupation of governments in liberal democracies would become, as indeed it has, the promotion of economic growth, best accomplished through the establishment of a market society.

Among the biggest obstacles to this, however, was the long-standing moral inhibition against the lending of money with interest—originally known as usury. If the financial crisis has taught us anything, it has reminded us of the overwhelming importance of credit in market societies. Without loans—which few would obviously make without the provision of interest—individuals could not readily make large purchases to obtain appliances, cars, and houses. Firms would find it hard to manage the operational challenges posed by the level of receipts and outlays not being perfectly synchronized at each and every point in time. When those outlays happen to be for capital goods, firms must wait for a substantial period before generating a return on their investment. Of course, equity finance would still be an option, but it would be cumbersome to acquire shares in a person's future income stream. Though companies do issue stock to fund their activities, the rate of return that must be offered to investors has to be higher, given the risks entailed in being placed last in line to claim the firm's cash flows. Many with savings to deploy will shy away from such risks, while numerous capital projects with lower prospective rates of return, yet still above what a debt financing would cost, will go unfunded.

While denounced in biblical texts, the moral case against lending had its authoritative philosophic articulation in the writings of Aristotle and St. Thomas Aquinas. Aristotle, the Greek philosopher of the fourth century B.C. whose opinions on a wide variety of subjects were considered truth well into the seventeenth century A.D., insisted that money is naturally intended to be used in exchange for goods. But earning interest on loans is against nature precisely because it involves producing money from money.<sup>3</sup> In the thirteenth century, Aquinas elaborated and refined this argument by distinguishing between goods whose use consists in their own consumption and those in which the employment does not destroy the thing. Food is an example of the first, a house of the second. No moral problem is entailed in selling the use of the house for a period of time, as opposed to the house itself, as there would be a distinct item of value being exchanged. It would be unjust, though, to charge for both a hamburger and the use of the hamburger. These not being separable; one would be selling a good that literally does not exist. Aquinas held that money is more analogous to food than a house, in that its defining feature is for it to be used up in purchases of goods. Consequently, a lender that trades money now in return for anything more than that same amount of money later is essentially fleecing the borrower.<sup>4</sup>

By the time the architects of liberal democracy addressed the issue of usury, the Aristotelian-Thomist picture of money as a consumption item essentially incapable of reproducing itself had already been ruptured. In the sixteenth and seventeenth centuries, a few of the late scholastic thinkers noticed that money could be deployed so as to become productive of more money.<sup>5</sup> The budding of commerce in the Renaissance, with merchants and bankers adopting various stratagems to evade the usury laws, gave practical confirmation of money's generative aspects. Thus, in 1691, John Locke could almost take it as a given that money, by furnishing the means to engage in profitable trade, has productive uses and that interest is the price for securing this benefit.<sup>6</sup> Adam Smith would subsequently reiterate this point in *The Wealth of Nations* (1776), as well as observing that legal prohibitions on loaning at interest merely force borrowers to pay higher rates to compensate the additional risks to the lender of being prosecuted and not having the courts available to enforce their debt contracts. It was left to Smith's admirer, Jeremy Bentham, to give the coup de grâce to the traditional teaching on interest in his *Defense of Usury* (1787). His chief argument was that individuals, being the best judges of their interest, should be free to contract for loans at any rate they deem appropriate. Finance had finally found a home in liberal democracy.

With this, the use of leverage gained a decisive encouragement, insofar as individuals and firms could now take on higher debt-equity ratios without moral qualms. Initially, though, this acceptance of leverage was qualified. In coming to the moral defense of interest lending, Smith set the condition that rates not be permitted to go much above the market level for low-risk debt. Were it to go above that, Smith feared, a sizable portion of the credit available would end up in the hands of profligate consumers and Pollyannaish entrepreneurs. Much of the capital stock built up by society over generations would go to waste. Not only that, Smith promoted the virtues of prudence and frugality in his moral and economic writings, as did Benjamin Franklin, the eighteenth-century American statesman and inventor, whose counsel remained an influential part of the self-help literature well into the nineteenth century.

But the individual freedom that liberal democracy extols would ultimately act as an acid on these caveats. To a people attached to the ideals of personal autonomy and self-expression, deferred gratification will inevitably be felt as a harsh restraint. Plato presciently set down this feature of democracy two and a half millennia ago.<sup>7</sup> Time preferences thus changed, with present goods becoming more preferred to future ones. People saved less and willingly assumed more debt in pursuit of their life goals.

This additional debt had to come from somewhere. Critical in enabling this was the consolidation of fractional reserve banking in the nineteenth century. This institution arose out of the money warehouses run by goldsmiths, where people could deposit their gold and silver in return for warehouse receipts, which in turn functioned as currency in the marketplace. Within these depository establishments, it was soon noticed that there was no need to continually have every ounce of gold and silver available for potential redemption, since relatively few receipt holders demanded their metal on any given day. Even when they did, there were often others making new deposits to balance the outflow. Profits could be increased, it was figured out, by issuing more warehouse receipts than the stockpile of metals would cover.<sup>8</sup> The excess receipts could be lent and interest charged. To this day, this same operation continues, except that banks now extend loans on the basis of deposits of government-issued notes rather than precious metals. But the essence of fractional reserve banking remains in that deposits are only a proportion, and a slight one at that, of the loans outstanding.

That the morality of this practice elicits so little discussion is arguably the most astounding fact of modern finance. With the bulk of the money lent out having virtually no underpinning except for the creative powers of the banking system, the people exchanging actual goods and services for this currency are, for all intents and purposes, receiving nothing intrinsic in return. A profound injustice seems to be at work here. Then again, this would be to assume Aquinas's premise that money is to be understood in terms of its substance.

Bentham's critique of Aquinas' usury teaching provides the foundation upon which liberal democracy is built and tells us, instead, that money is to be viewed solely as a utility. If the economic success of liberal democratic economies since the nineteenth century is any indication, this utility must be acknowledged. What the currency manufactured out of the fractional reserve system effectively does is allow society to raise the level of investment beyond what its members, through the sacrifice of present consumption, have managed to save. For the borrower, it is less a matter of being entrusted with the stewardship of some portion of the capital stock and more about receiving some paper and electronic tokens. The borrower is then ordered to perform the following command: go out and harness the natural and human resources at your disposal so as to produce goods and services for which other people will be willing to trade at least enough paper and electronic tokens to pay off your loan. Finance has evolved to the point that it does not merely grease the wheels of trade and bring savers and investors together; it actually drives those wheels, its chief business having become to create a vast chain of obligations to generate more value out of the world.

The problem with this arrangement, of course, is that it places a lot more stress on getting the allocation of credit right. With all the leverage involved, all it takes is a slice of the loan portfolio to go bad for depositors to lose confidence and threaten

runs on the banks. When that prospect beckons, banks are forced to call in loans and restrict credit even to borrowers in good standing, wreaking havoc on the economy. As everyone knows, this is pretty much what has just happened as a result of the bad bet the financial system made on subprime mortgages.

Despite this risk, no growth-addicted liberal democracy could have ever been expected to morally question the extra economic torque that fractional reserve banking provides through its pyramiding of savings. As demonstrated time and time again, whenever the viability of the system was threatened in crises past, a fix has always been preferred, whether in the form of government-backed deposit insurance, the extensive regulation of financial institutions, or the formation of a central bank to serve as a lender of last resort to troubled banks. Needless to say, these are far from perfect solutions, since they encourage banks to be more audacious, secure in the knowledge that the government will extend them a lifeline should they run into difficulties.

What also explains the maintenance of fractional reserve banking is the power it confers on governing classes to manage the money supply, particularly when all of the commercial banks are overseen by a central bank. By changing the short-term rate of interest, adding or subtracting from commercial bank reserves, or modifying the required ratio of loans to deposits, governments can try to smooth the vicissitudes of the economy and hinder recessions. There was a time when this was not expected of governments, when the franchise was limited to a male, property-owning elite that could withstand downturns in the economic cycle. That changed in the twentieth century when the franchise was extended to every adult person. The upshot of all this is that a significant part of the responsibility of ensuring the optimal allocation of credit is shifted to the central bank. And no matter how much independence the latter might theoretically have, democratic political pressures will influence the central bank to err on the side of preventing recessions and, in the process, potentially setting up the next leverage-induced boom—precisely what the Fed did in keeping interest rates low for so long after the bust of the dot-com bubble.

None of this is to say that liberal democracy is fatally flawed. The political alternatives are surely worse on balance. What the financial crisis does help clarify, though, are the full terms of the bargain that liberal democracy made in originally according its moral stamp of approval to leverage.

## NOTES

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3. Aristotle, *The Politics*, trans. T. A. Sinclair (New York: Penguin, 1981), Bk. I. x.
4. Thomas Aquinas, *On Law, Morality, and Politics*, 2nd ed., trans. Richard J. Regan (Indianapolis: Hackett Publishing, 2002), 148–151.
5. Alejandro A. Chafuen, *Faith and Liberty: The Economic Thought of the Late Scholastics* (Lanham, MD: Lexington Books, 2003), 122–125.
6. John Locke, *Some Considerations on the Consequences of the Lowering of Interest and Raising the Value of Money*, <http://socserv.mcmaster.ca/econ/ugcm/3ll3/locke/consid.txt>.

7. Plato, *The Republic*, trans. Allan Bloom (New York: Basic Books, 1968), 561c–561e.
8. See Murray Rothbard, *The Mystery of Banking* 2nd ed. (Auburn, AL: Ludwig Von Mises Institute, 2008), 85–94, and George Cooper, *The Origin of Financial Crises* (New York: Random House, 2008), 47–50.

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