

Freedom, Markets, and Wealth Creation: Setbacks Threatened by Economic Crisis

Economic Freedom of the World Project

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It is my pleasure to acknowledge the invitation of my fellow Kansan, Jim Gwartney, to participate in this distinctive celebration of his ongoing path-breaking Economic Freedom Project. I wish also to thank Peter Wong of Lion Rock Institute and Fred McMahon of the Fraser Institute for hosting the arrangements. And, finally, I would like to acknowledge my wife and companion, Candace.

Lovers of freedom, like the many members of the Economic Freedom of the World Network, have just cause to believe that liberty forms the mainsprings of the worldwide growth in human economic welfare. This is because freedom nurtures innovation, the key component in all economic activity. The evidence has long made it plain that the greater a country's liberty, the greater is its per capita creation of

wealth and the smaller is its gap between rich and poor. Even more important, and not easily measured, is the fact that freedom expands people's opportunities, and this is central to human betterment. But these ideas are not widely shared nor understood. Many do not grasp that people do not have to *consciously* understand the socioeconomic principles at work in their society in order to be effective agents whose can-do knowledge is silently coordinated with that of others to advance human betterment. F.A. Hayek has articulated these principles, and has most effectively restated for our time the genius of Adam Smith, the 18th century Scottish philosopher and economist, most famously tagged as the 'father of economics based on his well known book, *The Wealth of Nations*. (1776) demonstrating the great coordinating power of markets. But Smith's first book, *The Theory of Moral Sentiments*, (1759; extensively revised in 1789 and therefore essentially his last book) contains neglected lessons for all of us today, especially in articulating the role a few of human sociality in the emergence of the property right foundations of markets.

Although ignorance of these principles does not prevent people from responding creatively to their guidance, that ignorance becomes damaging when it is aligned with public policies that mistakenly target particular short-sighted immediate outcomes, rather than solidifying the rules that facilitate long term wealth creation. The problem with targeting particular outcomes is that the opportunity cost in reduced wealth creation is unknown. When those costs show up as unforeseen unintended consequences, it is often too late to return to the status quo and make a fresh start. And sometimes the status quo has been redefined by what seemed like a brush fire that has become a forest fire.

We have had two such major conflagrations in 80 years—The Great Depression and the ongoing current Great Recession. Both have been huge, but ultimately I hope temporary, setbacks for freedom in the U.S. and elsewhere where the rule of law governs. The first led to a heightening of class warfare marked by the heaping of demonic blame on business and on the abstract “rich.” Regretfully, the same forms of demonization have returned in the current crisis, with our troubles also

blamed in-discriminatively on deregulation. Policy discussions have been riddled with finding blame rather than finding solutions, a human characteristic well-known to, and articulated by, Adam Smith.

In this talk I will first mention a few key ideas of Adam Smith using his own words in order to frame my discussion of the current economic crisis as it developed. I will then use the crisis to illustrate freedom's most important challenge: that over and over again human kind generally takes two steps forward 1.5 backward.¹

I don't begin with 1997, the year that house prices began their unsustainable credit financed ascent, because that is not the place to begin. The place to begin is with Adam Smith, the central Scottish Enlightenment figure associated with modern concepts of freedom, who was so important in defining how we think about and have benefited from freedom. Smith and his friend David Hume were pioneering thinkers and part of the birth of the 'idea revolution' which became the bedrock that underlay and foreshadowed the phenomenal growth in per

¹ I will supplement and draw liberally on my joint work with two co-authors, Smith and Wilson (2011) and Gjerstad and Smith (2009, 2010) This final text version of my original talk has benefited much from the editorial suggestions of Candace Smith.

capita income and human opportunity during the past 200 years. In anchoring with Adam Smith, I hope that what I say about the financial crisis will seem more pertinent and will offer a new way of looking at ourselves and the crisis itself.

The Scottish Enlightenment figures, particularly Smith and Hume, became the mouthpiece for a revolution in ideas, ideas which were defined and united by a common scientific thread: 1) keen observation of the order around them, and 2) the use of reason in forming socioeconomic models to reconstruct the postulated rules hidden beneath the surface of observation. In my view Smith and Hume's immediate intellectual forbearer was Isaac Newton who, to the astonishment of the scholarly world, had explained their natural physical environment with a handful of predictive laws of motion that were invisible to their *conscious* awareness but which brought order to sensible experience.²

² Sometime prior to 1758, Adam Smith had written a draft of his "History of Astronomy" in which he stated that: "... (Newton's) followers have, from his principles, ventured even to predict the returns of several... (comets), particularly of one which is to make its appearance in 1758 (Smith, 1795, p 103). Subsequently, he added in a footnote that: "... the return of the comet happened agreeably to the prediction." Smith is referring to Halley's Comet which has returned on schedule about every 76 years since 1758. It is difficult for us today to even imagine what a mind-transforming event was this prediction and its miraculous verification. The significance of Newtonian science was captured at the time by Alexander Pope: "Nature and Nature's laws lay hid in night, God said let Newton be, and all was light."

The important consequence for us today, and for those of us here in this very room, was that the inspired Scottish geniuses asked the key question: “What other laws lay hidden from human view?” They launched the search for new thought models that could improve our understanding of the social, economic, legal and political framework whose order—like the greater order discovered by Isaac Newton—surrounded them to greater or lesser degrees. This order was later described by Adam Ferguson, as “the result of human action, but not the execution of human design.” The acknowledgement of this unseen order is at the heart of understanding wealth creation and human betterment.

Although Smith revolutionized the way we see the world and created modern economics, he would have been disheartened by the utterly vulgar distortions of his enduring message. Smith opposed slavery seventy-five years before it was outlawed by the British Parliament; opposed mercantilism, colonialism and empire, when such opposition was unpopular; championed the principle that a common street porter was not in his nature intellectually inferior to a philosopher;

and developed the insight that the rich, with all their preoccupation with what he called the trivia of “baubles and trinkets,” were the custodians of society’s wealth, preserving the ‘seed corn’ against private and public forms of current consumption thereby assuring the improvements that would create a better future even for the poorest. These principles would nourish 200 years of growth and, as we have come to understand, Smith’s “improvements” were not to be found only or even primarily in producer goods—tools and machinery—but in innovation, the tools of the mind, as economist Deirdre McClosky (2010) has taught us.

Smith’s views are agreeable and complementary with the incredible economic accomplishments of Hong Kong. However, everywhere, the current policy debate is laden with the language of regulation, and a demonizing of the bipartisan deregulation movement associated first with the Carter, and subsequently the Reagan, administrations.³ This language is a distortion and a mistake. We here at this Gala Event should be clear that the real subject is property rights as

³ It was in the Carter administration that a bipartisan coalition came to see that airline regulation was not benefiting the passengers, and it was brought to an end, spreading from this origin to railroads, trucking, electric power, and, under Reagan, to the natural gas industry..

there is no such thing as a market unrestricted by rules defining what constitutes foul play.

It was the genius of David Hume, who gave us the right language when, in 1739 he published his first book, *A Treatise of Human Nature* wherein he states the property right foundations of social order. His voice echoes the spirit and even the language of Newton:

WE have now run over the three fundamental laws of nature, *that of the stability of possession, of its transference by consent, and of the performance of promises.* 'Tis on the strict observance of those three laws, that the peace and security of human society entirely depend; nor is there any possibility of establishing a good correspondence among men, where these are neglected. Society is absolutely necessary for the well-being of men; and these (laws) are as necessary to the support of society. Whatever restraint they may impose on the passions of men, they are the real offspring of those passions, and are only a more artful and more refin'd way of satisfying them." (Hume, 1739, p 319)

But why do we restrain ourselves in the matter of property? It is not because of reason for we also learn from Hume the important maxim

that “The rules of morality,..., are not conclusions of our reason.”

(Hume, 1739, p 285)

The fuller answer would come from Adam Smith. The central idea is that we learn to discipline and restrain our actions out of our experience of human sociality. “We endeavor to examine our own conduct as we imagine any other fair and impartial spectator would examine it.” (*Sentiments*, III.1.2, p 110)

In Smith’s impartial spectator is found a metaphor for the judgments we apply to others as we endeavor to exchange, mirror-like, our perspective with that of others, and, in the words of Bobby Burns, whose statue in Edinburgh is just down High Street from Smith’s, “To see ourselves as others see us.”

Smith did not use the word ‘fair’ in the sense of fair outcomes, as it is commonly used today. For Smith the socioeconomic game was entirely about the rules of fair play. The opposite of ‘fair’ was not ‘unfair’ but ‘foul.’ Moreover, this social discipline does not arise

consciously. It arises by a guiding hand, an order invisible to our awareness:

“Our continual observations upon the conduct of others, insensibly lead us to form to ourselves certain general rules concerning what is fit and proper either to be done or to be avoided.” (*Sentiments*, III.4.7, p 159)

So what is Smith’s first punch line? It is that

“If he would act so as that the impartial spectator may enter into the principles of his conduct...he must...upon all...occasions, humble the arrogance of his self–love, and bring it down to something which other men can go along with.” (*Sentiments*, II.ii.2.1, 83)

Smith uses the phrase; “go along with” 41 times in his book, and by this repetition brings home to us the manner in which we govern each other’s actions by defining our own boundaries, and by discovering and interacting within the social boundaries of propriety.

It is out of our sense of propriety that we fashion the rights of property—the individual rights to take action in civil society—otherwise known as the rule of law, by which we limit destructive transgressions and enable freedom to do the world’s work. I will refer to Smith’s key concept here as his

Injustice Proposition: “Actions of a hurtful tendency, which proceed from improper motives, seem alone to deserve punishment; because such alone are the approved objects of resentment, or excite...sympathetic resentment... Resentment seems to have been given us by nature for defence, and for defence only. It is the safeguard of justice and the security of innocence.” (*Sentiments*, II.ii.1.4, p 78-79)

Smith explicitly argued that property rights under modern civil government originate from human resentment of the violation of justice:

“Among equals...and antecedent to the institution of civil government, (each individual is) regarded as having a right both to defend himself from injuries, and to exact...punishment for those which

have been done to him. (p 80). And, “As the greater and more irreparable the evil that is done, the resentment of the sufferer runs naturally the higher...”(p 83-4)...

And finally,

“The most sacred laws of justice, therefore, those whose violation seems to call loudest for vengeance and punishment, are the laws which guard the life and person of our neighbour; the next are those which guard his property and possessions; and last of all come those which guard...what is due to him from the promises of others. (84)

For Smith that which safeguards justice and innocence are the rules for punishing injustice. It is essential to the fundamental concept of liberty, and to the essence of the rule of law, that we do not, nor should we attempt to, reward acts of justice. Rather our business is to discourage, or punish, acts of injustice! This is because *justice is what is left over after suitable sanctions are used to control and limit injustice.* You do not get a reward for driving through a green light—innocence is

your duty; rather, you get a citation for driving through a red light.

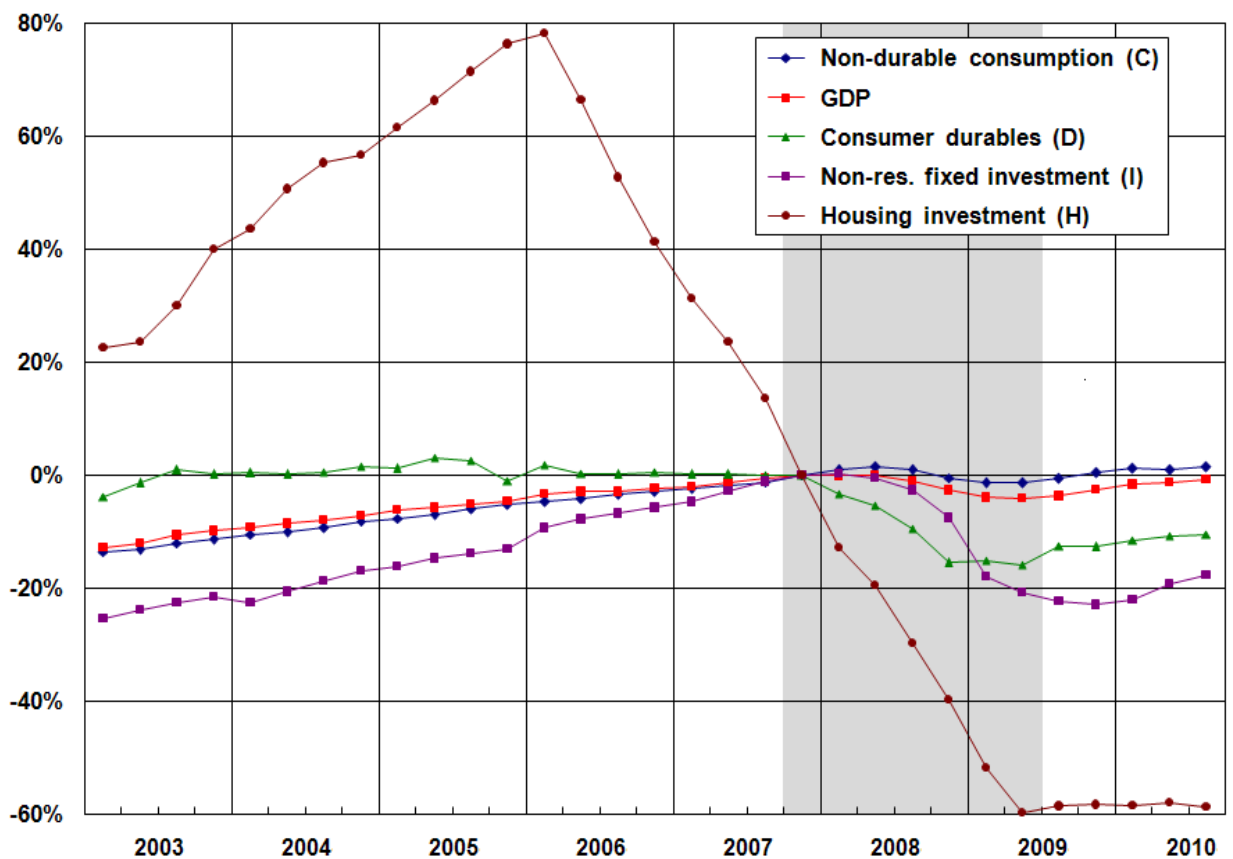
Freedom is maximized by focusing only on the boundaries that constrain it in the interest of other people's freedom, but otherwise leaving people free to define the infinity of ways in which their own space of action can be legitimately expanded; this is the mainspring of innovation.

The boundary that constrains us in protection of the freedom of others is not, however, fixed for all time, but requires continuous reexamination in the light of changing experience and technology. Only in this way can freedom for all be continuously refreshed and stay focused on the extension and expansion of human opportunity, and the principle that ultimately we must take responsibility for ourselves.

Moreover, Smith's argument in *Sentiments* is that civil law quite naturally encodes the emergent social rules found to be effective in preventing those actions that are intolerable—what people cannot go along with. Rules do not determine what is right; rather rules emerge out of what people discover to be right. (Cf Hayek, 1988, p 162)

Your patience as I have developed this property right background enables me to now ask: How do we apply these insights to better understand what went wrong in the Great Recession, which was essentially a replay of what went wrong in the Great Depression?

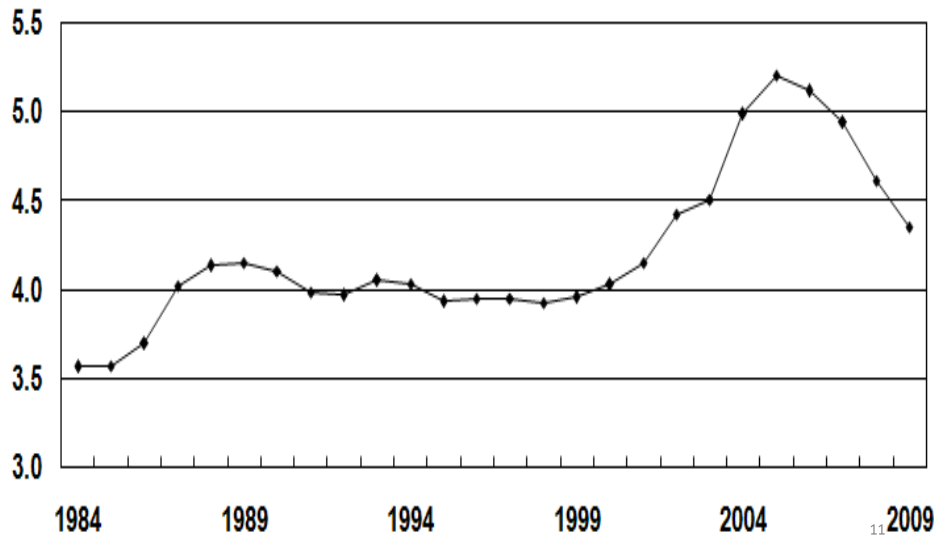
To see the answer, in the following chart, let us first look at the behavior of key components of the US national accounts leading up to the 2007 downturn in GDP.



Each component is measured in percentage deviations from its level in Q4, 2007 when the recession officially began. The recession period is in grey. Observe in particular two features: the towering volatility of new housing expenditures, and the dramatically opposing stable behavior of non-durable consumption expenditures, C. Not shown in this chart is that the latter is not only stable but massive, accounting for 80% of gross private product. For this vast sector the rule of law, as Smith would have described it, has served us well. Leave it alone as there is nothing in broad outlines that needs fixing. All the instability in the national economy derives from the 20% of private products that are durable goods, and of these, by far the most unstable is housing. Why?

The answer is implicit in the next chart showing the ratio of median house price to median family income. House prices rose far faster than income; this price-income disparity—the bubble—is another way of showing that it was entirely fueled by credit. Indeed, it is nothing short of astounding that, according to the National Association of Realtors, in 2005, 45% of first time home buyers paid no money down—

Ratio of median house price to median family income



zero. Here is how Adam Smith surely would have characterized the problem with these home buyers:

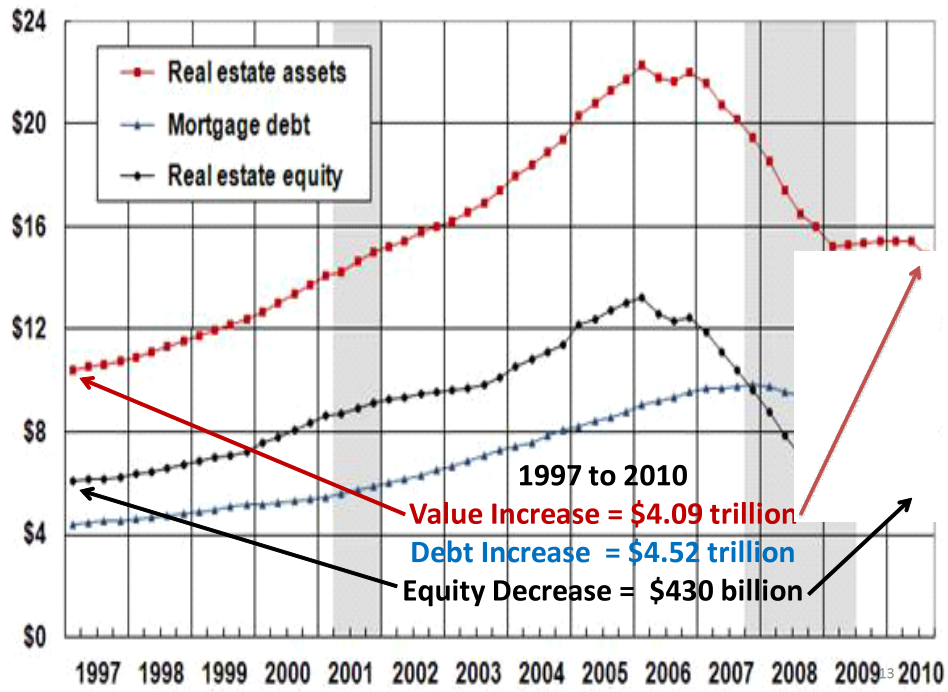
“...being the managers rather of other people's money (OPM) than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which...(they) frequently watch over their own.” (*Wealth*, II, p741)

Although they may have been entirely unaware of it, home buyers were playing a win-win game for themselves: if home prices rose their capital gains went to their bottom line—tax free up to half a million dollars, thanks to the politically popular bipartisan tax law change under Bill Clinton in 1997—while if home prices fell the buyer’s incentive was to walk away from the mortgage and cede the loss to their bank.⁴

If this had been an independent private event, placing a private lender’s single loan voluntarily at risk, the lender would have alone borne the cost of this downside risk. This would be the case, say, if it was your mother that used her cash savings to provide the down

⁴ It should be noted, however, that in most states, banks can legally file deficiency judgments against a borrower whose foreclosed home brought insufficient proceeds to cover the mortgage principal balance owed.

payment on your first home—not the bank that is the custodian of other people’s deposits. That it was credit created by the banks, had dramatic consequence for the US economy: in the third quarter of 2007 we entered into the second major balance sheet crisis in 78 years. The credit inflated housing boom was reversed and household equity collapsed as asset value fell against fixed mortgage debt obligations, placing all bank balance sheets and the economy at risk As of 2011 over 22% of households are in the Black Hole of negative equity, with many more on its grey edge. Since banks hold the mortgages, they face comparable negative equity problems and insolvency. The former are not in a mood to spend and the latter are reluctant to lend. The dramatic and rapid collapse of household equity against fixed mortgage obligations is shown in the next chart.



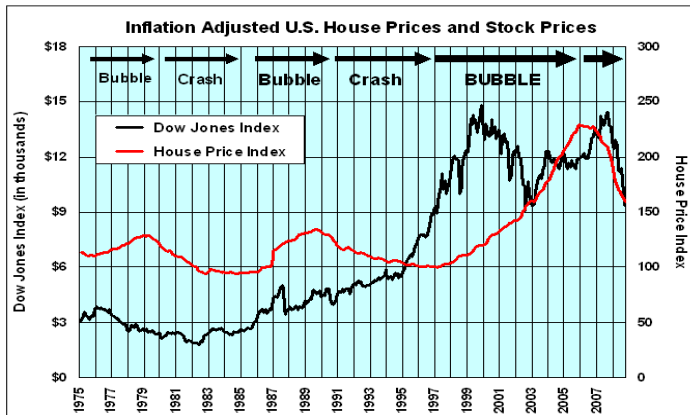
From 1997 through 2010 the incremental total gain in the value of the stock of all U.S. homes was just over \$4 trillion, but we incurred over \$4.5 trillion worth of added debt, ending with an equity loss of \$430 billion. Every nickel's worth of home value we created was borrowed from future growth in demand—the world's most gigantic Ponzi scheme. Is it any wonder that this black hole is absorbing the nation's economic light? We have seen similar patterns worldwide.

The central importance of Smith's "other people's money" problem cannot be better illustrated than in contrasting the effect of stock and housing bubbles on the economy. Here is a chart of inflation adjusted housing and stock prices.

STOCK VS HOUSING BUDDIES

Ten trillion \$ came off the value of stocks in the dotcom crash, 2000-2002, with hardly a dent in bank balance sheets; and only a mild recession, 2001. Similarly, the crash, Oct 19, 1987 yielded no recession.

Three trillion \$ came off the value of homes, 2006-7, the banks buckled; economy tanked; Fed intervened massively.



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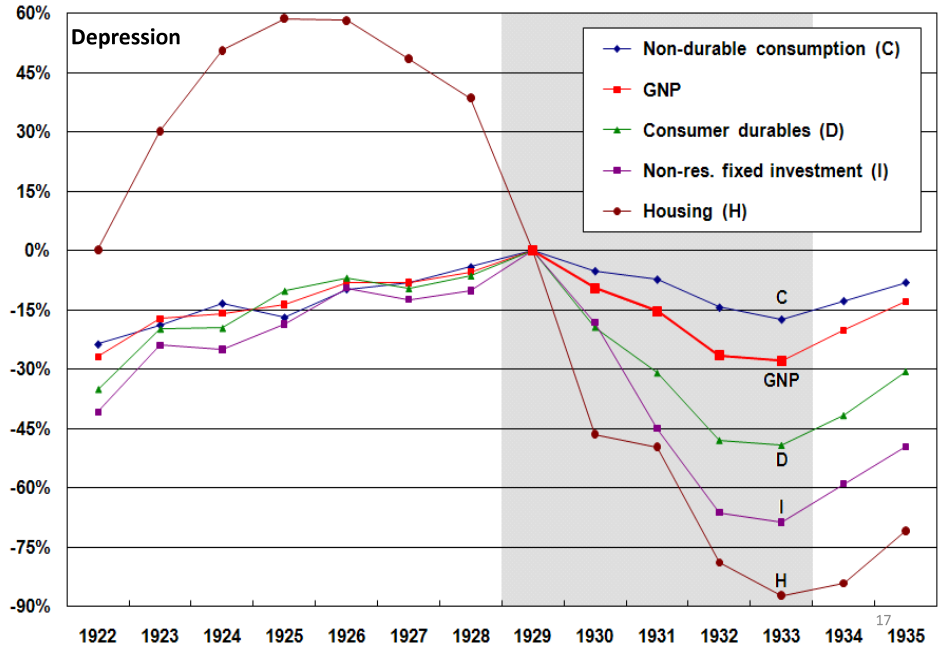
The 10 trillion dollar decline in the value of shares in the dotcom crash from 2000 to 2002 did no damage to household and bank balance sheets. But a mere 3 trillion dollar decline in the housing market, 2006-2007, ushered in the household-bank balance sheet crunch that quickly escalated into the Great Recession. Why this fundamental difference between stock and housing market crashes? The answer is to be found in differential property rights, and requires me to go back to securities market developments from 1928 to 1934.

Already, a year and a half before the stock market crash of October, 1929, private brokers and their bank lenders were cranking up margin requirements for stocks—from 25% to 50% for DJ stocks, and much more for riskier stocks. Then, in 1933, for the first time in its history, the NYSE required all its members to impose margin rules on their customers. Finally, in the SEC Act of 1934, Congress codified this private sector institutional learning into the securities laws. This evolution from private experience and practice to civil law is precisely the way Adam Smith would say property right traditions should change

and develop in response first to private experience and then, as needed, embodied in civil law. These original securities market rules, once found, have been retained. They will not prevent stock market bubbles, but they do confine and internalize the primary effect of stock market crashes to investors. This severely limits any collateral damage to the banks and to the economy.

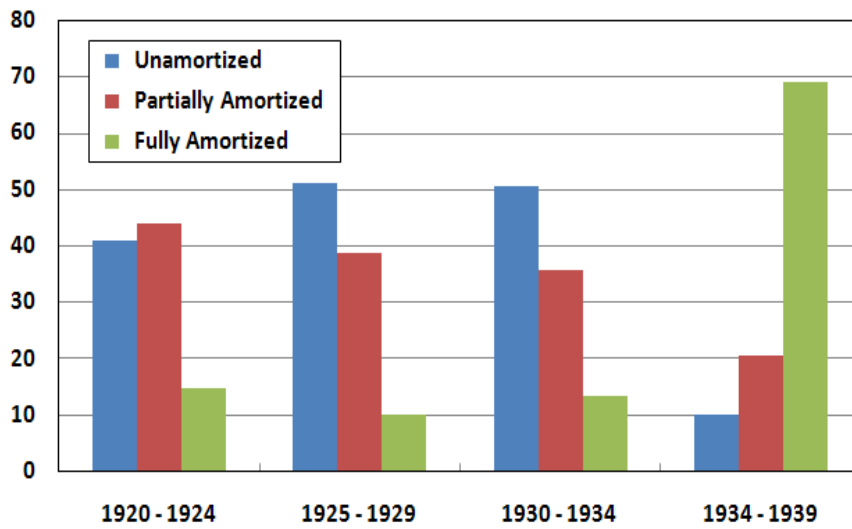
Here is a chart showing the movements in the national accounts from 1922 to 1935. A five-year housing market investment boom from 1922 to 1926 paralleled our nine year boom from 1997 to 2005; its collapse beginning in 1927 paralleled ours starting in 2006. From 1922 to 1925 new housing expenditures surged 59 percent, held steady in 1926, then, in 1927, 1928 and 1929, plummeted back to its 1922 level. The boom was not only credit-financed but the flow of mortgage funds did not immediately decline as new housing investment plummeted; it continued unperturbed all through 1927 and 1928 before dropping precipitously in 1929 and 1930. This explains the bank crisis that followed.

Changes to Housing, Investment, Consumption, and GNP
(relative to their 1929 levels)



Ultimately these developments led to corrective measures in the mortgage market that were very similar to what happened in the reform of securities market rules. Just as the securities rules were modified by experience in the 1920s and 30s, so also were the property rights governing housing and mortgage markets. Throughout this period, 85% of commercial bank mortgages were 3-4 years term and not fully amortized, with balloon end-payments dependent on refinancing. The same practices dominated insurance company mortgages; only Savings and Loans made longer term fully amortized loans. Not until the latter half of the 1930s did strong public and private traditions emerge to support bank amortization of mortgage loans, but also 30% down payments, and due diligence in mortgage originations. For the commercial banks the change in amortization traditions is shown in the next slide.

Commercial Bank Mortgage Loans, 1920-1939
Data for Chart from Grebler et al (1956, p 231)



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The delay in strengthening mortgage property right standards was caused by the public outcry against home foreclosures, just as in our own day.

To our long lasting regret, these housing-mortgage rules and traditions eroded badly in the 1980s and 1990s, and set the stage for the housing crash. But there were other complications.

- For example, the separation of mortgage origination from lending led to the spectacle of upfront fees for mortgage origination.
- A rushed and incompetent institution, yielded the unstable chain:
Mortgage Origination => Securitization (MBS) => Agency Rating
=> Derivative (CDS) “insurance.” Each link was self justified and fueled by expectations of rising house prices!

So what is to be done?

My greatest concern is that too much will be done, that too much will be “fixed; that secondary rather than fundamental issues will be addressed. Nothing in my view can be done to prevent bubbles. They are of ancient origin and part of the human condition; perhaps an inevitable

part of the process of price discovery for long lived durable items with uncertain future values. But we can limit or contain their external damage. Property right restraints on access to OPM in the form of credit have served this role in securities markets.

Housing-mortgage markets also have been plagued by incentive incompatibilities. A prominent example was up-front mortgage origination fees that caused mortgage originator incentives to diverge and disconnect from those of the remote lender. The fix is a property right rule in which the originator's compensation simply mimics the time profile of the borrower's principal payments. If it's a 20% down payment loan, then 20% of the originator's fee is in cash, and the remaining 80% is escrowed in proportion to principal payments over the life of the loan. Thus, if it's an interest-only loan with a 10 year balloon payment, then no fee is paid until year 10, if and only if the loan is paid. Note that in this argument the market determines the level of the fee for valuing loan origination services, not the rule. The rule simply seeks to assure that the originator shares the same risk profile as the lender. The

rule leaves it open for the market to determine whether lending and origination are combined in joint supply or separated into distinct enterprises with a transfer price, or fee level, shared under the rule. Origination and lending cannot now fly off in different uncoordinated directions with the bank and its depositors bearing all the risk for a bad loan.

There are other issues like the problem of the uncollateralized Credit Default Swap markets, but my time is limited.

What have not been fixed are the bank balance sheets. We have one well-practiced institution for fixing damaged balance sheets: it's called bankruptcy. Shelia Bair over at the FDIC has put some 360—and counting—banks through balance sheet restructuring. Investors take their hit and the system gets rebooted to give new lending an opportunity to restart. The large banks have market equity values much below book value indicating uncertain, potentially fake, profits carved out of inadequate reserves for bad loans. Bank balance sheets need repair and

they should not be arbitrarily protected, as “too big” from needed balance sheet restructuring.

In closing keep in mind that our mentor, Adam Smith, in his two classic books taught that individual freedom must be constrained in the interest of other people’s freedom.

- Control is not about arbitrary and uniformed “regulation” but propriety rights, or consensual rights to take action, that are imbedded in the concept of property in free societies.
- The focus must be on rules that enable the creation not only of measured wealth, but of human opportunity.
- Stability in financial networks requires constraints on the use of other people’s money (OPM) particularly that of bank depositors. We learned this in the 1920s and 30s for securities and mortgage markets—two steps forward—then forgot it in mortgage markets.

- If downside risk is to be contained and internalized, each node in the financial network must be buffered by liquidity, or cash margin rules, and by solvency, or equity margin rules.
- Only experience can guide rule development.
- There are no easy answers.

Thank you ladies and gentlemen, and may peace be with you.

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