DID MORAL LAPSES CAUSE THE ECONOMIC CRISIS?

How Idolatry, Hubris, Greed and Injustice Led to the Financial Meltdown

We are now in the midst of the greatest global economic crisis since the Great Depression, the immediate cause of which was the meltdown of the global financial industry. But what caused the financial meltdown? Was it certain "bad actors" (greedy bankers, regulators asleep at the switch, low-income borrowers, etc) who overran the system's checks and balances? Was it the capitalist economic system itself, which gives so much power to the wealthy? Was it specific financial instruments—the collateralized debt obligations, credit default swaps and others—that were put into broad use before being properly understood? Yes, these all share the responsibility. Largely missing from the conversation, however, is the moral failure underlying and lacing together these other disparate roots. Basic to the financial crisis was a silencing of the crucial moral checks and balances embedded within the several American religious and philosophical traditions that ultimately make society possible and ought to underlie any economic system.

In the late 1980s I was working as an inner-city physician in an impoverished neighborhood in Washington, DC. Poor people had little access to health care; children had little access to a decent education; parents had little access to a violence-free neighborhood for their children; homeless people had little access to anything. A group of us started a 24-hour medical recovery shelter because homeless men had nowhere to recuperate from even serious illnesses. Our family eventually founded a home and community where we lived with homeless men dying of AIDS because there was no other place for them to get medical care or die among people who loved them. In our society's consumerism, our rush to affluence, and our embrace of an every-man-for-himself, radical free-market economics, our nation had not only marginalized but also abandoned the poor. At the same time I was just beginning to read the Old Testament prophets and to understand the profound moral imperative nations have to care for their poor. If, as was obvious to me, our nation was not caring for its poor, were there not going to be consequences for the nation? Should I not be speaking this truth as clearly as I could? My hesitance came from the facts that I did not trust the truth and power of the moral order deeply enough and I could not predict the particular way in which those consequences would work themselves out. (Certainly, the strength of the American economy at the time made collapse seem unlikely.) As I looked around at the strength of our country, I felt foolish preaching "The End is Near!" I regret now that I did not speak out more forcefully.

My intention in this essay is to look toward my own Judeo-Christian religious tradition and ask how it speaks to the financial meltdown that led to current economic crisis.[1] Jeremiah, Isaiah and the other Old Testament prophets believed that God had established a moral reality and that there were real-life, this-world consequences for neglecting that reality. There is an obligation to worship God, to care for the environment, to care for the poor, to live in harmony with each other, to counter greed, and so on. When the Kingdom of Judah, for instance, failed to worship God adequately or to care for its poor, then God (according to the prophetic interpretation of events) withdrew blessing and protection from Judah, allowing the Babylonian army to take the Jews into captivity where they learned to live according to God's law again, at which point they were able to return to Israel.

This concept of divine judgment is, of course, a particular understanding from the Judeo-Christian tradition. But I am not writing only to those within my tradition. A similar, coherent moral reality—with consequences for obedience and disobedience—exists within other spiritual traditions and among many with no professed spirituality. As we have wrestled with the concrete issues of our times, however, we have too often pushed those understandings to the side. Moral reality, however, offers us an interpretive lens that must undergird the usual political, social, and economic analyses of our time. In particular, interpreting the current economic crisis as result of moral failures helps us see more deeply into the true nature of the causes and gives us better tools for responding to it.

To understand this complementary relationship, however, some understanding of the usual economic analysis of the recent financial meltdown is necessary, which, because of its length and detail, I am including as an appendix to this essay. Analyzing the causes of the economic crisis through the lens of objective,

[1] A wider moral analysis of many other factors that contribute to the economic crisis is critical but beyond the scope of this essay, which will confine itself primarily to the crisis in the financial industry.

dispassionate, economic analysis, we can understand much about how it happened and how to prevent something similar in the future. Subprime mortgages need to be carefully evaluated; lenders should not be off the hook for mortgages they write; the financial industry should not be allowed to so highly leverage itself; complex, opaque derivatives need to be tightly controlled, and so on. These are all important understandings.

But they are incomplete. Many of the decisions that led to the collapse cannot be fully understood unless one looks through the lens of moral reality. Some of these decisions were not just ignorant or careless or lacking in data; many were also based in attitudes that must be judged on their morality.

The Sins of the Nations

Morality!? Here we stand on uncertain ground. Given the pluralism of our post-modern society, consensus about the nature of moral reality (or even whether there *is* a moral reality) is unlikely. To avoid that ultimately paralyzing discussion, therefore, I'm going to arbitrarily follow my own Judeo-Christian tradition and look at four sins from the Hebrew Bible—idolatry, greed, hubris, and injustice—for which God judged the nations. My defense for this shortcut is that similar prohibitions are found in Islam and (in very different form and emphasis) in Buddhism, as well as in other major spiritual traditions. I recognize that other writers might choose a different list of transgressions. My point is not so much to argue that these four specific transgressions are the unique and primary causes of the current economic crisis; rather, my point is that the current crisis can be traced to our society's increasing willingness to ignore the moral reality that it knows (or should know) to be the underpinnings of even the economic system.

Idolatry is the worship of a god unworthy of worship. People rarely recognize their own idolatry, yet American worship at the temple of affluence is obvious from any outside perspective. Americans' well-documented consumerism[2] has placed material well being above all other values, putting our culture at risk.

Beyond some level of basic sufficiency, increasing affluence does not seem to increase our level of happiness. The standard of living in the 1950s was roughly half of what it is now, yet the reported level of happiness in the United States has not increased with this doubling of our standard of living. Our worship of consumption has led us to work longer hours in order to increase income, even as family life has suffered from it. (Since the 1970s the average number of hours worked has increased by 20%; in Germany, France and Italy, by comparison, the number of hours worked has *declined* by twenty percent.)[3]

This worship of affluence and consumption has had several direct effects on the current economic meltdown. First, in the last fifteen years we have mortgaged ourselves past any common sense in the struggle to maintain an ever-higher standard of living. American personal debt (largely home mortgages, credit card debt, and auto loans) has skyrocketed to approximately $10 trillion (or more than $33,000 per person) so that the US personal savings rate has been hovering around zero for several years. This certainly has larger structural causes, for instance, an advertising milieu in which the next new thing becomes indispensable for happiness and credit-buying is expected. But the American consumer has also happily gone along. Apparently, we have to possess all the stuff to feel worthwhile. This enormous debt has had several direct consequences for the financial meltdown.

- The debts themselves have become the basis for the financial derivatives at the heart of the crisis. As more investors have wanted to buy the mortgage-backed derivatives (increasing the supply of loans available and thus driving down mortgage interest rates), American would-be homeowners have been increasingly willing to take out the loans even if they have no obvious way of paying them back.
- With their credit maxed out and no savings, many Americans have had no reserves to cover themselves when the value of their newly purchased homes has fallen below their mortgage principal, leading to the defaults that are the immediate cause of the crisis.
- In part due to the enormous financialization of our economy (50% of American corporate profits are from the finance industry, triple what it was a generation ago[4]), we no longer manufacture what we consume,

[2] By "consumerism" I mean the equating happiness with the purchase and consumption of material possessions.
[3] Wolff, Rick, "Capitalism Hits the Fan", *Dollars and Sense*, November/December 2008, p 16.
[4] Vasudevan, Ramaa, "Financialization," *Dollars and Sense*, November/December 2008, p 27 (as detailed in the appendix)

forcing us to import over two billion dollars *a day* more than we export. This buildup of US dollars in Japan, China, Russia, the oil exporting states, and elsewhere is a primary source of the dollars foreign investors use for buying the derivatives that have now collapsed. In other words, the easy credit at the center of the financial collapse is fueled by our idolatry of a level of consumption we cannot afford. And the consequences of this enormous foreign debt, we can be sure, will not be positive for long-term economic recovery.

Second, the American sense of entitlement to a home of one's own has led directly to the subprime mortgage crisis as Americans took on mortgages that they could have afforded only if the housing bubble had continued indefinitely … which bubbles never do. We were so focused on raising our standard of living by purchasing a home that we did not consider the likelihood of complications, such as the deflation of housing values. (By "we" here I mean not only the homebuyers but also the entire financial industry including the Federal Reserve that encouraged the bubble.)

Third, it was society's preoccupation with an ever-rising standard of living that led Alan Greenspan, then chairman of the Federal Reserve, to encourage the housing bubble in 2001 by reducing interest rates essentially to zero, sparking the explosion of adjustable-rate mortgages, teaser rates, and zero-down financing that encouraged home buying by those who could not afford it. Traditional economic theory understands the importance of allowing a mild recession to follow an economic bubble. But following the dot-com collapse of technology stocks in 2000 and the terrorist attacks of 9/11, Greenspan was apparently afraid of the ramifications of even a mild recession in a society accustomed to an ever-rising standard of living and, therefore, intentionally encouraged the rise of home prices, (incorrectly) believing that a housing bubble was not possible (see "hubris" below).

Idolatry is rarely mentioned as a cause of economic phenomenon, but we neglect it at our peril.

Greed is another helpful lens through which to understand the behavior of the financial industry and investors that made the dangerous subprime loans possible.

It is certainly true that for capitalism to function properly investors must receive enough to make their investment worthwhile, some reasonable rate of return. But in the last thirty years, society has released itself from those limits. As in other previous empires, investors have turned away from the real economy of manufacturing and commerce to the higher returns of the financial industry. The greed of investors for the highest possible returns and of brokers in the investment bands for the highest possible fees led directly to the "innovations" of the complicated derivatives and blinded otherwise intelligent people to concepts that should have been obvious:

- Allowing primary lenders to sell mortgages to financial institutions that sell them to investors relieves both sets of institutions of any incentive to scrutinize the ability of borrowers to repay, a prescription for disaster.
- Seducing borrowers with "teaser rates" encourages the irresponsible.
- Risky, subprime loans cannot be made safe by repackaging them.
- Economic bubbles *always* collapse.
- A society cannot borrow indefinitely.
- The finance industry must be regulated,[5] and so on.

Greed is usually defined as the "excessive" desire to acquire material wealth and possessions beyond the need of the individual, especially when this accumulation of possession denies others' legitimate needs for those resources. But "excessive" is a relative term that has loses all meaning within free-market capitalism. Indeed, it feels hypocritical to call investors (which includes many of us) looking for the highest returns "greedy." Isn't that what everyone does? Indeed, the bedrock theory of capitalism assumes that the economic system works

[5] While deregulation has been the rage for the past generation (especially since President Reagan re-popularized free-market economics), the need to regulate the financial industry had been obvious to previous generations because the unregulated financial industry has been a repeated cause of severe economic crisis, most clearly and recently in the Great Depression.

best if people pursue their own selfish good, specifically avoiding concern for others' needs; it further assumes that the purpose of any economic transaction is profit. But what is this but a practical definition of greed: obsession with self-interest, ignoring the impact of one's wealth on others, and living for the sake of profit? Greed as a traditional *vice* disappears; within capitalism it becomes, if anything, a virtue. Once the free-market, capitalist economic system becomes the theology guiding the culture, the concept of greed no longer has meaning.

Nevertheless, the prophets would be clear that by deifying the free market (see "idolatry" above and "hubris" below), the powerful within the culture have succumbed to a deep greed. Indeed, one must look at the bazaar of financial derivatives and ask if some of them are not, in themselves, primarily expressions of greed. It is true that within any economic system investors must be encouraged to make capital available if other people are to get mortgages or if companies are to get started and to expand. The mortgage-backed securities, including the collateralized debt obligations, reduced risk for some investor (by increasing it for others) thus encouraging more investors to make their money available, a worthy goal. And it is necessary for the broker (whether local bank or national investment bank) to make a reasonable salary (from fees) for arranging investor money to flow to borrowers. The process of securitization (ie creating simple derivatives) was, for instance, especially important during the Great Depression for connecting investors with prospective homebuyers and entrepreneurs who needed the investment. But the financial industry has become the dominant American industry over the last generation for three major reasons: the slicing and dicing of loans into the various complex secondary and tertiary derivatives, the lucrative fees charged by the industry, and the absence of meaningful regulation of the industry. Since the higher order derivatives cannot be effectively rated, since they destabilize the economic system, and since they are so difficult to regulate, the real question is whether or not they are primarily manifestations of greed … as I suspect the Old Testament prophets would have decided.

Hubris (or arrogance) is another attribute we modern Westerners would like to forget is a sin. For the Greeks, Wikipedia informs me, hubris was actually considered the worst sin and classified as a crime. Unfortunately, hubris is *built into* Enlightenment thinking and its dangers neglected: We have come to believe that we—in our amazing knowledge and skill—can rationally arrange the world however we want it without acknowledging the rules of mercy, love and justice woven into the fabric of the universe. We believe that our knowledge is so comprehensive and our ability to manipulate the real world so evolved that we can outwit the moral consequences of our decision making. What is lacking is wisdom. Indeed, having discounted a Supreme Being, we have also discounted that there may be deeper moral truths binding the web of life together. This is obvious in our willingness to despoil God's creation for the sake of profit, but it is also embedded in our acceptance of the "rules" of capitalism as the final arbiter of economic decisions.

- We have told ourselves that self-interest is all that is necessary and that if everyone would just act out of simple self-interest, it would be better for everyone."
- We have convinced ourselves that the "efficiency" of the market compensates for its amorality.
- We have pretended that free-market capitalism is best for the poor, too.

The real sin was hubris. Besotted by their greed, large swaths of our elite believed that the old moral limits were no longer relevant. They could concentrate only on making money without concern for anything else, and it would not backfire on them. There were no rules except those of the market.

At a more prosaic level, hubris reached its apogee, perhaps, with the eager willingness to buy the third-level collateralized debt obligations and credit default swaps based on sub-prime mortgages and other debt. Financial "experts" arrogantly trusted their computerized mathematical models that suggested that they could loan money to poor credit risks and still create safe investment securities backed by them. Common sense be damned! If as a broker you questioned the safety of these investments, you found yourself losing business to those who accepted it in blind trust. It should not have taken a financial genius to figure out that you cannot take a bunch of bad loans, break them up into pieces, switch them around, and come up with safe securities at high rates of interest. But in their hubris that their financial tools could turn dross into gold, the geniuses apparently believed their own stories.

Some have argued that most of these elites knew that there would be disastrous consequences to these shenanigans, that the culprit is fraud and not hubris. In some cases that may be true … but not very often. In the world of high finance, it is possible to "sell short,"[6] in essence to bet on disaster. If the elites had known what was going to happen, large numbers of them would have been short-selling these fancy financial derivatives, but almost none did (although the few who did became very wealthy). The rest trusted the computer creations and, in their hubris, neglected the moral limits of greed.

Hubris, of course, is closely bound to idolatry. The combination leads to ignorance, in this case ignorance of one fundamental moral understanding: the need for **justice**. But care for the "widows, orphans, and strangers" is central to the ethics of the Israelites' covenant with God. John Rawls, the pre-eminent American moral philosopher of the twentieth century also made care for the poorest fundamental to his (completely secular) conception of justice. The reality is that we are all part of a common society, and the destitution of any one of us damages the well-being of all of us.

As a tool of a just society, regulated capitalism promises rewards to both workers and owners, who share jointly in the increased productivity made possible by technological changes, increased efficiency, and hard work. Workers must be paid enough to live happy and productive lives with adequate food, shelter, health care, education, retirement benefits and a reasonable degree of leisure. Managers should be fairly compensated so that executive salaries remain some reasonable multiple of the lowest paid workers.[7] Owners (including investors) must receive enough to make their investment worthwhile, some reasonable rate of return.

But over the last generation the income of the bottom 90% has stagnated while the wealthy have become much wealthier. We tend to forget that there is a direct connection between the increasing wealth of the wealthy and the impoverishment of the working (and even middle) class. But workers' wages have stagnated as they are forced to compete against low-wage foreign workers in order to maintain high corporate profit levels. Retirement funds are raided by legal maneuvers that cheat retirees of benefits they were promised for work they have already done. Benefits (especially health care and defined-benefit retirement plans) are slashed or disappear. Responsible companies that "play it safe" with low levels of debt and higher-paid workers become targets for take-over and dismemberment. Companies with already high profit levels consolidate to squeeze out more profits through oligopoly pricing.

The end result of all this has been that almost nothing of American industry's productivity gains over the past generation has gone to the workers. Low-wage jobs have seen a decline in wages over that time. The desire for the highest profits (accruing almost exclusively to the wealthy) has been at the expense of the working class … again, within the religious tradition, the very definition of injustice.

Part of the free-market ideology of the last twenty-five years has been the argument that these results have been the inevitable consequences of impersonal market forces. No one is responsible; that's just the way it is. In fact, however, political decisions have been made at all levels to boost profits and reduce working-class wages.

- Politicians, the media, and other corporations have whittled away at union protections so that workers are all but helpless against their gigantic employers.
- The push at the top for free trade has forced workers here to compete with low-wage workers abroad.
- Government unemployment and retraining benefits for those who lose their jobs are vastly inadequate.
- Public secondary education is in many locales in ruins.

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[6] One way to bet against a stock works like this: I "borrow" from you a stock or other financial instrument that you own, agreeing to return it to you in, say, six months. I then turn around and sell the stock to a third party at the current rate. At the end of the six months, I have to buy the stock back on the open market in order to return it to you. If the company has done well and the stock's price has risen during the six months, I have to buy it back at the more expensive price and lose out. But if the stock has done poorly or even become worthless, I can buy it back very cheaply, pocketing the difference between the price six months ago and the price now. (How this is different from gambling—still illegal in most states—is not clear to me.) Selling short was prohibited by the Securities and Exchange Commission (SEC) for a short time during the height of the financial crisis because it is essentially an attack on a company that can, in itself, cause the stock price to fall.

[7] Marxist theologian Dorothee Sölle suggested seven as the upper limit of a reasonable multiple, *far* below the usual CEO income of something over 400 times his lowest paid worker.

- Higher education—highly or completely subsidized in other industrialized nations—is too expensive for the poor and, increasingly, for the middle class.
- Health care is not guaranteed. And so on.

These are all essentially political decisions (that could be made differently) that guarantee that the wealthy will benefit at the expense of the poor.

Pure, free-market economics has no way to provide for (or even think about) those who do not or cannot earn money, so it is tempting to forget that we are to care for the poor, too. For the last thirty years, our nation has been in the process of forcing the poor increasingly to fend for themselves. Education in poor neighborhoods is inadequate; health risks in poor neighborhoods are high; the poor are usually hidden away in their (white or black or brown) ghettos. Our social safety net has been shredded. We have convinced ourselves that since fewer people are on the welfare rolls, they are doing better. And so on. The poor have gotten poorer.

How has our abandonment of the poor impacted the financial meltdown? It is fascinating to read Kevin Phillips's accounts in his *Wealth and Democracy* of the arcs of the three empires prior to ours—Spain, Holland, and Great Britain. In each case prosperity was built up by investing in manufacturing or commerce that provided both goods and jobs, thus increasing equality within the society. But as the country became rich and powerful, the wealthy stopped investing in infrastructure, training, or even manufacturing. Rather, they turned to investments with the highest possible returns, which were usually in finance or foreign investments. Without local investment, however, the infrastructure collapses; without support education falters leading to less innovation and fewer skilled workers. And a country that invests primarily in making money ignores the manufacturing and commerce that made it strong. The rich continue to do well (for a while), but high rates of unemployment and low salaries impoverish many. These consequences of investment in finance rather than the "real economy"—plus a high military budget as the state tries to maintain its dominance—lead to the state's demise as an empire. If a society is to be strong, it must invest in the structures that allow *everyone* to share in the wealth. That is simply a moral given. We have forgotten that, and it has come back to haunt us.

There are, then, direct consequences of idolatry, greed, hubris and injustice that have led to the financial crisis. A moral perspective offers a deeper perspective for examining economic catastrophe.

The Interpretive Lens of Moral Assessment

How does this moral understanding of the financial crisis complement the scientific in analyzing the causes responsible for the crisis? One broad category of analysis popular within the financial industry itself is to blame the crisis on the poor judgment and/or ignorance of one or another of the actors in the drama.

- The regulatory process broke down, and regulators were unprepared for the chaotic consequences of financial globalization.
- The lenders who developed their complicated derivatives trusted their formulas too much.
- Then-chairman of the Federal Reserve Board Alan Greenspan didn't recognize the housing bubble, so he continued to stimulate the economy when he should have applied the brakes.
- The development of mortgage-backed securities gave the primary lending institutions less incentive to evaluate the capacity of prospective homebuyers to make their mortgage payments, and so on.

The "bad judgment/ignorance" model *is* helpful in understanding specific causes so that the industry does not make the same mistake next time. During the Great Depression, for instance, the federal government refused to support local banks, thousands of them shut down, and depositors lost their savings, deepening and prolonging the depression. We learned from that, developed federally administered deposit insurance, and have weathered some severe crises (like the S&L debacle of the late 1980s and early 1990s) since then. The problem with this way of understanding of the crisis is that it provides only limited help in the future. We learn not to make *those particular* mistakes again, but the next crisis will have different immediate causes.

A second broad category of analysis leans heavily on the moral culpability of a few bad actors and blames them for the crisis. We look for scapegoats, some small number of egregiously guilty people whom we can blame for the crisis. Let's blame especially greedy Wall Street brokers, or the venal politicians for dismantling

the regulatory system, or corruption at Fannie Mae and Freddie Mac, or unethical lenders who encouraged low-income people to take out complex mortgages they could never pay, or stupid low-income people who did not understand what they were getting into. Such "scapegoat analysis" may help us rein in certain corrupt practices, but it misses the big picture. It is a comfortable analysis we gravitate toward because it places the blame squarely on some other, usually "evil," entity and absolves the rest of us of complicity. It, also, is of little value in deterring future crises since again the specific, immediate causes will usually be different.

The third lens I am proposing combines the scientific and moral to identify the relatively constant underlying problems of these crises that are often ignored because they depend upon moral assessments that our post-modernist society is loathe to make.[8] This lens makes use of the tools of financial analysis to understand how, in objective, descriptive terms, the economic meltdown occurred, but then goes a step further to identify a deeper, more consistent causation: moral reality. The contention of this essay is that this moral analysis adds a dimension to our understanding that is not present in the purely scientific understanding. There are moral laws in the universe and breaking them has consequences.

Values are identified:

- Trusting that a theory (like capitalism) or a computer model allows us to ignore moral reality is hubris.
- Consumerism is idolatry.
- Greed is toxic
- The marginalization of the poor is unjust.

The causes of the economic meltdown are not merely poor economic judgments and decisions that a wiser person would have made differently; the causes involve ignoring moral limits that religious and philosophical traditions perceive as embedded in the universe.

Adding this moral dimension assigns a level of responsibility to human agents. They *should have* known better, not because they should have understood the complexities of collateralized debt obligations better but because they chose to ignore what moral reality makes plain: that hubris, idolatry, greed and injustice are not only wrong but also eventually lead to disaster. This is not only a question of being able to judge our guilt in retrospect; it also offers us a framework for decision making in the future that goes beyond sophisticated technical judgments about the wisdom of a particular action. We can look on an economic system that assigns all of the increased productivity to the wealthy and holds back the wages of the working class and say, "That's wrong, and there will be consequences!" (even though we may not be able to predict exactly what those consequences will be).

A moral assessment is a call to future repentance and action. It reminds us that if we do not correctly interpret the moral warning signs inherent in the current economic crisis, if we do not respond in a radical enough way to change things, then there will be another day of consequences in the future. For instance, a moral analysis suggests that if we continue to allow the wealthy to take all the benefits from increases in productivity or if we continue to borrow heavily from other countries to finance our lifestyle or if we continue to allow the poor to sink into penury, there will be even more painful consequences for our nation. There is a powerful call to action.

The moral analysis, for instance, warns us that the economic stimulus plan just passed should not aim merely to restore our economy but to *correct* it. How should the bailout be structured to encourage a *smaller* economy with less use of non-renewable resources? What should be the balance between bailing out the carmakers and investing in public transportation? What gas mileage should be required of carmakers who accept bailout provisions? How can the bailout increase the power of unions (which will raise workers' salaries)? How should the bailout encourage alternate sources of energy? What should the bailout do to assist the poor? The answers to these questions involve highly technical economic theory, but they need to be

[8] As noted above, this is not the place to engage in the important discussion of moral relativism. Clearly, moral principles differ to some degree from culture to culture, spirituality to spirituality. This essay does not try to defend the assessment of idolatry, greed, hubris, and the marginalization of the poor as sins; rather, it asks whether such an assessment gives us an interpretive handle that might otherwise be missing.

fundamentally based in moral considerations. We do not need to be able to predict the particulars of how the consequences will play out in order to know that future transgression *will* play out.

There are two obvious objections to this moral analysis. The first is that many elements within pure, free-market capitalism (eg using the free market to distribute necessities) would fail any moral test. The response to that, I would suggest, is not to devalue the moral analytic approach but to look more carefully at the consequences of the radical free-market economics that we have embraced over the last generation (which I hope to do in a future essay).

A second objection is that such a moral analysis is overly simplistic and does not capture the complexity of economic reality. Is it *really* the immorality of higher level derivatives that led to the crisis or is it enough just to fix the computer models? Is it really the immorality of American consumerism that contributed to the financial free fall? Those are questions, it seems to me, that welcome further study. The moral analysis does need to become much more sophisticated; people with a greater understandings of economics than I need to draw the direct lines from the morally objectionable elements of the system to the system's failure. But at least we need to ask the questions. If economics is as deeply tied to moral behavior as I'm suggesting, perhaps some decisions are less complicated than they appear.

At this point in our response to the economic crisis, there has been little moral analysis. We are all about better regulation, economic stimulus, perhaps eliminating some of the riskier derivatives. There has been little talk of idolatry, greed, hubris, or injustice. It must be said clearly, however: We can do all we want to fix the technical problems with the economy, but unless we respond to the moral crisis of our country, it will be just a matter of time to the next set of consequences … whatever they are. There are consequences to breaking the moral order. We had best pay attention.

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APPENDIX: An Economic Analysis of the Global Financial Meltdown

The American (and global) economy is moving deep into recession. While the length and depth of this recession are as yet unknown, economists do understand that the major immediate cause of this *economic* crisis is the meltdown in the *financial* industry that has led to a severe tightening of credit on which the economy depends. The financial meltdown itself was a combination of:

- the reckless development of a broad category of securities called "derivatives" (defined and discussed below);
- the "housing bubble" that raised home prices to an artificial and unsustainable level; and
- the willingness of lenders to offer (and consumers to accept) risky "subprime" mortgages that the borrowers were unable to repay.

The broad function of the banks, mortgage brokers, investment institutions, stock market, and others that make up the financial industry is to connect people or institutions who need money with people or institutions who have it (and want to invest it). Banks, for instance, take in depositors' money, offering them a certain interest rate, and lend it back out in the form of loans or mortgages at a higher rate of interest, charging fees for their services keeping the difference between the rates of interest in return for their services. Other institutions arrange the sale of bonds[9] to investors in order to raise money for corporations or governments, charging a fee for their services. Still others manage the sale of stocks[10] to raise money from investors in order to start or expand a corporate enterprise, again charging a fee for their services. Traditionally, the financial industry has been a relatively small part of the economy intended primarily to service the "real economy" that provides the usual goods and services. In 1981, for instance, profits from the financial sector were only 14% of total corporate profits.[11]

Over the last generation, however, the financial industry has invented and aggressively sold new, often exotic, financial "derivatives," which are bonds that *derive* their value from traditional loans and bonds; that is, the financial industry uses the mortgages, corporate debt, credit card debt, and other debt that it holds as assets to guarantee the value of these new derivatives they sell that promise interest and principal repayment to the investor (explained in more detail below). This process of "securitization" dates back to the Great Depression and has been a useful way to bring investors' money to the people who needed loans. But many of the newer derivatives have reached a level of complexity and abstraction from the actual borrowers that they have endangered the real economy. While their nominal purpose is to encourage more investment in the mortgage market, their capacity to generate fees for the financial industry and opportunities for speculation by risk-minded investors has dominated the practice. These have grown so quickly that—instead of acting as an adjunct to the economy (facilitating the production of goods and services)—the financial industry now dominates the US economy, generating 50% of all corporate profits.[12]

Housing Bubble

A primary source for these financial derivatives has been American home mortgages, which makes it important to understand the "housing bubble"[13] that began in various places as early as the late 1990s raising prices for homes much faster than inflation. One cause was the derivatives themselves, which made credit too easily available (see below), prompting fall in interest rates and a rise in demand for homes that led to increases

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[9] Bonds are "debt instruments"—certificates promising that the corporation or government selling them will pay a certain rate of interest and eventually pay back the principal. They are essentially loans from investors to corporations or governments.

[10] Stocks are "equity instruments"—certificates giving the buyer an ownership share in a corporation. Like bonds, they are a way of borrowing money from investors, but make no promises about rates of interest or paying the money back. Their value rises or falls with the perceived value of the corporation.

[11] Vasudevan, Ramaa, "Financialization," *Dollars and Sense*, November/December 2008, p 27

[12] Ibid

[13] A financial (or "speculative") bubble is a rise in the prices of a particular kind of asset (houses, stocks, or even tulip bulbs) above their real value. They occur because investors believe—always on the basis of some rationalizing doctrine—that the price of a particular asset that *has been* rising in the recent past *will continue* to rise. This demand stimulates further rises in prices and the repeating cycle pushes prices ever higher until something (usually a modest return to sanity) causes the bubble to burst.

in prices. With the bursting to the dot.com bubble in 2000, investors seeking a safe place for their money turned to the historically safe American housing market, further fueling the rise in housing prices. As usually happens in financial bubbles, many (both homebuyers and speculators who bought the houses intending to resell them rapidly) were seduced by the fantasy that prices would continue to rise indefinitely. (In fact, prior to the housing bubble, inflation-adjusted average home prices were remarkably constant since 1890 (with the exception of a significant dip around the Great Depression),[14] suggesting that economists should have recognized the widespread increases in home prices after 2000 as an ordinary speculative bubble that would eventually pop. Indeed, many did. But others within the financial industry (including chairman of the Federal Reserve Bank, Alan Greenspan, the country's top regulator) considered a nationwide housing bubble impossible and developed economic justification for the idea that "things are different this time." They discounted the possibility of a significant nation-wide crash in housing prices.

Prospective homebuyers began *counting* on the rising value of their homes in calculating whether they could afford the mortgage payments. They took out mortgages that were too expensive for them believing that as their houses' values rose they could renegotiate their mortgages and use their increased equity to get better terms (lower interest rates or longer repayment times), lowering their payments to what they could afford. Eager to earn the fees, lenders (local banks, mortgage companies, and others) were happy to make loans for the same reason: Rising prices meant that even if a homeowner defaulted on the mortgage, the lender would be able to repossess the house and sell it for more than the price of the mortgage. Borrowers and lenders all believed they could not lose.

Lenders could make only so many loans, however, because federal banking regulations require that lenders maintain a certain percentage of their loans in cash reserves so as to be able to repay depositors in the event of some mortgage defaults. That's where the investment banks and their derivatives enter the picture. The cash reserve requirements are different (or nonexistent) for these newer financial institutions, so, beginning in the late 1980s and early 1990s, they began offering to buy entire pools of mortgages from the lenders. The cash from the sales of the mortgage pools increased lenders' reserves and allowed them to turn around and offer other homebuyers mortgages and still have enough cash to cover their depositors, thus bringing in more fees. As the housing bubble heated up, this device allowed the lenders to keep up with demand. Indeed, the abundant cash available forced lenders to lower mortgage interest rates, further fueling demand.

Lenders soon realized, of course, that by selling their mortgages to investment banks (who repackaged them and sold them to investors), the lenders had transferred to the investors the risk in the event of homeowner default, so there was little need for local bankers to be careful in evaluating the risk of default, contributing to the rise of much riskier loans. To encourage home purchases, lenders began offering "adjustable rate mortgages" (ARMs) at interest rates several percentage points lower than the usual fixed-rate, long-term mortgages, but the rates were tied to index interest rates.[15] These index rates were very low at the time, so the ARM rates were also low; however, as interest rates rose, so would the ARMs (unlike the usual long-term, fixed-rate mortgage). So eager were lenders that they eventually began issuing ARMs at unrealistic "teaser rates" so low they were difficult to for prospective homebuyers to refuse; the rates, however, were set to increase a year or two later, which (according to later surveys) borrowers frequently did not really understand. Lenders offered these "subprime" loans without requiring much in the way of proof that homeowners would be able to afford the payments after the teaser rates were reset. The lenders then turned around and sold those mortgages to investment banks, too, getting themselves off the hook and continuing the cycle. [Jump back to "housing bubble" in main essay]

[14] See graph of average American home prices divided by the consumer price index at http://mysite.verizon.net/vodkajim/housingbubble/

[15] Investors interested in owning a house only a short time had long used these adjustable-rate mortgages because ARMs were cheaper than long-term mortgages, but these had previously not usually been offered to homebuyers.

Derivatives[16]

First level: mortgage-backed securities

The purpose of the various classes of mortgage-backed securities within the "real economy" is to encourage investors to make their money available to prospective homebuyers. This *could* be done if lending banks were simply to sell the actual mortgages to investors and then loan that money out again. But investors like to diversify their loans in order to reduce the risk of losing much of their money in the event of default. An investor *could* diversify by buying many different mortgages from home buyers with different levels of income and from different parts of the country, but that would require any single investor to have a lot of money to invest. So investment banks created and sold "mortgage-backed securities" (MBSs). The banks buy large numbers of mortgage from various lenders, combine them into diversified pools, and sell "shares" of these pools (as "securities") to investors, who now get the desired diversification and a share of the principal repayment and interest charged to homeowners; in return they have to pay fees to the investment banks for originating the deal and for handling the mortgage payments. The MBSs play an important (although, as we shall see, double-edged) role in the "real economy" by making credit more available to the general economy, which lowers mortgage interest rates for homebuyers. But, of course, investors also had to take on a *pro rata* share in the risk that some of the mortgages in the original pool would default.

Second level: collateralized debt obligations

Suppose, however, that an investor wanted to get in on the deal but couldn't afford to take even the risk from the diversified mortgage pool (for instance, mutual funds have legal restrictions on the degree of risk they can take in their investments). To encourage these investors, an investment bank buys a pool of mortgage-backed securities from another bank (or uses its own) and creates second-level securities called "collateralized debt obligations" (CDOs). But instead of all investors who buy these getting a *pro rata* share of the returns and the risk, the bank determines that certain groups (or "tranches") of CDOs get first claim on the returns, while others line up behind them and absorb most of the losses (in the event of defaults). In return for the increased safety, the tranches with first claim take a lower rate of interest, while those that will absorb potential losses get a higher rate of interest. (Suppose, for illustration, that the average return on the mortgages was 10% and the average return [after the investment banks' fees] on the MBSs was 8%, the returns on the various tranches of CDOs could range, say, from 20% [for those who would take the first losses] to 4% for those who were last in line to lose out.) Creating the CDOs makes more money available to homebuyers because now investors are more likely get a ratio of risk to return with which they are comfortable.

A big problem, of course, is how to rate the risk and returns on MBSs, especially since the actual brokers who made the loans (and have met the homebuyers face-to-face) are no longer involved. Statistical computer programs were developed to assess the risk and returns of the pool of mortgages and then rate the MBSs. Investment banks had to engineer vastly more sophisticated computer models to calculate the differential risks of the CDO tranches on the basis of mortgages that are now at least two levels removed from anyone actually involved in the mortgage. To assure investors of the risk levels, investment banks paid companies like *Moody's Investors Services* and *Standard and Poor's* to assign ratings to CDO tranches based on their risk of default. It is now clear, however, that both the investment banks' computer models and credit rating companies severely underestimated the risks. But since American mortgages were considered generally safe bets in themselves, institutional and international investors were happy to buy these CDOs, the best of which were rated only marginally more risky than US Treasury bonds.

Third-level: CDO-Squared

It turned out that risk-averse investors were happy to buy the safe, low-interest CDOs and speculators were eager to buy the riskiest, high-interest CDOs but the mid-range tranches were not so popular. So other financial institutions bought these mid-range tranches and—using even more sophisticated computer modeling programs, the mathematics of which virtually no one now understood—created *new* securities which they then broke into

[16] I am indebted to economist Dennis Farley (personal communication) for much of the analysis here.

further tranches also lined up by risk, and sold them as "collateralized debt obligations-squared" (CDO^2s). What seems bizarre in retrospect is that the computer models predicted that even from a pool of mid-rated tranches, layers could be developed that could receive the highest credit ratings. Again the tranches were structured so that in the event of defaults the investors with the highest rated securities would be paid first. The raters believed that the lower levels would protect the higher levels. At this level, however, almost no one actually knew the details (and thus the risk) of what was in an individual CDO^2. The investment banks and financial companies, of course, took both originator fees (every time they performed one of these steps) and ongoing management fees.

At least one financial institution took it a step further to create a CDO-Cubed (CDO^3) that was backed only by CDO^2s. Understandably, investors could not begin to evaluate for themselves their safety (if, indeed, anyone could).

Fourth Level: credit default swaps

If investors wanted to play it even safer, insurance companies were also willing to issue insurance policies[17] (that they called "credit default swaps") on these various derivatives in the event of default. But they were not just insurance; these credit default swaps (CDSs) could also be sold and traded as securities. Since the underlying derivatives were rated highly by the Moody's and S&P, insurance companies offered and investors bought the CDSs with confidence that the underlying derivatives would hold their value and no insurance would have to be paid out. As noted above, the reality was that the actual risk of the CDOs, CDO^2s, CDO^3, and credit default swaps could not be reliably evaluated. The eventual value of all these mortgage pools, mortgage-backed securities, various CDOs, credit default swaps and other instruments were leveraged to something over $50 trillion although it was all based on mortgages worth about $3 trillion, about 20% of which were high-risk, subprime mortgages.

But investors were eager for these derivatives and brokers were eager for the fees, so there was increasing pressure to create mortgages on which the industry could be based, leading lenders to offer increasingly risky subprime mortgages,[18] which of course made the derivatives even riskier. A $50 trillion house of cards was constructed on a very shaky base. One of the implications of this mass of interweaving derivatives was that all of the major financial institutions were included in the web. While the web made individual investors safer, it endangered the whole: A major problem anywhere would be a problem everywhere. (jump back to "derivatives" in main essay)

Why did Moody's, S&P, and other credit-rating companies give these increasingly risky financial instruments the high ratings that enticed investors? The answer to that is apparently still unclear. The biggest problem was the opacity of these instruments. It's probable that most brokers and probably many credit-raters did not really understand the advanced math to know what was going on underneath the hood. But the larger question comes from the credit-rating companies' conflict of interest: The ratings companies were paid by the financial institutions whose derivatives they were rating. The rating agencies, of course, deny that this influenced their ratings, but it remains an open question. As Upton Sinclair once said, "It's hard to get a man to see the truth when his livelihood depends on him not seeing that truth." In any event, investors bought these financial instruments without really understanding how risky they were.

Ultimately, of course, the housing bubble collapsed, and home prices fell (about twenty per cent on average across the country). Owners of recently purchased homes discovered that their homes were now worth less than they owed on their mortgages, in some cases far less. Suddenly the increased equity that so many had counted on to be able to afford their new homes no longer existed. For many of these "homeowners," it made more sense to simply default on the mortgage than to try to make payments they could not afford, especially if the "teaser rates" of the adjustable-rate mortgages were now resetting to much higher interest rates.

[17] Although these were in every sense insurance policies, the financial industry didn't call them that because it wanted to avoid the regulation to which insurance is usually subject.
[18] One group of sub-prime mortgages, so-called "Alt-A" mortgages required little or no documentation of ability to repay.

Quickly the default rate on mortgages skyrocketed and homes were foreclosed. Suddenly the mortgage payments on which the huge financial house of cards depended were being delayed or not paid at all. Because the financial institutions were so highly leveraged (that is, they had virtually no cash to support their obligations in the event of default), they could not pay investors trying to redeem their mortgage-backed securities. Financial companies that had been holding pools of lower rated tranches of (CDOs) were especially hard hit. Insurance companies that had insured some of the CDOs through credit default swaps were forced to pay out huge sums of money, leaving them in peril or, like AIG (American International Group), sinking.

As financial institutions saw how much trouble they were in, they became less able (and even less willing) to loan out funds to institutions in the larger economy for fear that they would never be paid back; therefore, credit was less available in the general economy for all the institutions that rely on it for everything from expansion to meeting payroll or to homebuyers trying to renegotiate their mortgages to prevent default. The wider economy began to sink.

[*Click here to return to essay*]

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