MY VETERANS DAY

Viet Nam. Iraq. Afghanistan. Service

WHAT HAPPENED TO THE CULTURAL ELITES: CHANGES IN THE CONDITIONS OF PRODUCTION

The production of culture is largely under the control of corporations and institutions. Brain workers do not control their own production.

LESSONS FROM THE FCIC FINAL REPORT IN FHFA V. NOMURA

The ruling of Judge Denise Cotes in Federal Housing Finance Administration v. Nomura Holding America, Inc., is a 361 page description of the fraud and corruption that went into just one group of real estate mortgage-backed securities. FHFA was formed after the Great Crash to oversee Fannie Mae and Freddie Mac. These two entities were the actual buyers of the RMBSs offered by Nomura Securities International, Inc., and RBS Securities, Inc., then known as Greenwich Capital Markets, Inc. The Court finds that a number of statements in the offering materials were false at the time of the offering, in violation of Section 12 of the Securities Act of

1933. It awarded a judgment in the amount of $806 million, and required FHFA to tender return of the securities.

This Reuters story is typical of the coverage of the decision, in the "we knew that" mold. Peter Eavis of the New York Times wrote a clearer explanation, pointing out that this decision undercuts any argument that Wall Street banks did not break the law in the sale of RMBSs. This is the first paragraph of the decision:

> This case is complex from almost any angle, but at its core there is a single, simple question. Did defendants accurately describe the home mortgages in the Offering Documents for the securities they sold that were backed by those mortgages? Following trial, the answer to that question is clear. The Offering Documents did not correctly describe the mortgage loans. The magnitude of falsity, conservatively measured, is enormous.

In this post, I'll look at several aspects of the case: 1) the legal framework; 2) the discussion of the due diligence tracks the findings of the Financial Crisis Inquiry Commission in its Final Report; 3) the individual liability holdings; 4) the role of the Credit Rating Agencies; and 5) loss causation.

!. The Legal Framework.

The main theory of liability in this case is the Securities Act of 1933, 15 USC § 77a et seq., specifically Section 12. The operative language says that a person who

> offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce

> or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission

is liable to the purchaser for any loss arising from the misrepresentations. The plaintiff has to prove that the offering materials contained an untrue statement of a material fact, and that the purchaser did not know about the falsehood. Sellers can defend by proving that they did not know and "in the exercise of reasonable care could not have known" of the falsehood. Sellers can also reduce their damages to the extent they bear the burden of proving that the losses of the buyer were not caused by the falsehood. The defendants did not claim that Fannie Mae and Freddie Mac knew that the offering materials were full of falsehoods. Thus, the main focus of the decision is the falsehoods in the offering materials.

2. The Due Diligence Defense and The Final Report of the FCIC

If the Defendants exercise reasonable care in preparing the offering materials, they are protected from liability. In fact, the risks of failing to exercise due care are so great that investors believe that financially strong sellers of securities wouldn't take the risk of selling unless they had done good due diligence. Of course, our dominant ideology, neoliberalism, preaches that markets, whatever they might be, police themselves, and securities laws are unnecessary. Here's a lovely example from John Spindler, now a business law professor at the University of Texas (it's not on his CV). The

Final Report also calls out this bizarre idea, beginning at P. 171 (.pdf page 198).

The Final Report looks at the due diligence across the universe of securitizers in Chapter 9, page 156 (.pdf page 184). It says that the securitizers did little or no due diligence themselves. Instead, they farmed it out to third parties. These vendors examined a sample of loans from a pool, and reported whether the loans met the guidelines that the originators claimed to follow, whether they complied with federal and state laws, and whether the valuations of collateral were reasonably accurate. They also looked for compensating features that might outweigh the defects. The sample loans were graded, and the securitizers could use these grades to kick out loans, or they could waive the defects, and in either case, they could use the information to negotiate the purchase price for the pool.

The Final Report says that vendors reported very high defect rates, and that securitizers waived in a high percentage of the defective loans. The originators then put the kicked-out loans into other pools proposed for sale. Disqualifying defects were discovered in 28% of the loans examined by one vendor, Clayton Holdings, for the 18 months ending June 30, 2007. Of those, 39% were waived in, so that 11% of defective loans were included in purchased pools. The samples were small, as low as 2 or 3%. There seems to be little effort to find the defective loans in the non-sampled portion, so it’s reasonable to assume that a similar or higher percentage of loans in the entire pool are defective.

Judge Cote follows a similar pattern. Nomura had no written procedures for evaluating loans. P. 48. After it won a bid for a pool, it conducted a review of the loans, relying on the information contained on the loan tape provided by the originator of the loans in the pool. The loan tape is actually a spread sheet containing information about the loans, including FICO scores, debt to income ratios, loan to value ratios, owner-occupancy status and other important data. P. 31. Nomura sent the loan tape to its vendors to conduct reviews for credit, compliance with originator's stated underwriting guidelines, and valuation. The due diligence was done on a sample, in the range of 25-30%, but it was not a random sample, so the results could not be extended to the entire loan pool.

Of the loans submitted beginning in 2006 and the first quarter of 2007, one vendor graded 38% as failing to meet the originator guidelines. Nomura waived in 58% of those. It also had very high kickout rates for the pools it purchased. That means that of the examined loans, about 22% had major defects, again not counting the unexamined loans. With high kick-out rates, the number of defective loans remaining would be much higher.

The offering materials for these RMBSs all claimed that the loans met the originator guidelines with some exceptions. Judge Cote says this was a false statement, and that there was no showing that the defendants had done the kind of investigation required to avoid liability.

3. Individual Liability.

The Judge looks at the liability of the five individual defendants in part IV.b.3. P. 234. These are the officers, directors and signatories of the entities responsible for the filing of the offering materials. The ruling is harsh:

> All five Individual Defendants testified at trial. The general picture was one of limited, if any, sense of accountability and responsibility. They claimed to rely on what they assumed were robust diligence processes to ensure the accuracy of the statements Nomura made, even if they did not understand, or, worse, misunderstood, the nature of those processes. Not one of them actually understood the limited role

> that due diligence played in Nomura's securitization process, and some of them actually had strong reason to know of the problems with the diligence process and of the red flags that even that problematic process raised.
>
> Each Individual Defendant made a point of highlighting the aspects of Nomura's RMBS business for which he claimed to have no responsibility. None of them identified who was responsible for ensuring the accuracy of the contents of the Prospectus Supplements relevant to this lawsuit, and, as this group of Individual Defendants furnished the most likely candidates, the only logical conclusion is that no one held that responsibility.

A detailed explanation of this summary follows. Apparently securitizers have terrible memories.

4. Misleading The Credit Rating Agencies

FHFA did not claim the ratings were false, but that the ratings were not based on accurate information about the actual collateral for the RMBSs. The Court found that the defendants gamed the credit rating agencies models by submitting only the loan tapes prepared by the originators, even when they knew that the loan tapes were full of errors that would affect the final rating. Page 202. The Court found that the ratings depended on factors like the loan to value ratio and the debt to income ratio. The Court found that the LTV ratios were lower than represented by Nomura in 18-36% of the loans, and that many LTV ratios were above 100%, which skewed the models of the credit rating agencies and bought Nomura undeserved AAA ratings. This is a nice piece of lawyering by the legal team at Quinn Emanuel.

The FCIC is not so forgiving towards the Credit Rating Agencies:

> The Commission concludes that the credit rating agencies abysmally failed in their central mission to provide quality ratings on securities for the benefit of investors. They did not heed many warning signs indicating significant problems in the housing and mortgage sector. Conclusion to Ch. 10 at .pdf 240

But there's no point in shooting at the credit rating agencies. They have a get out of jail free card from the judiciary, which says that they are just giving opinions and are protected by the First Amendment.

5. Loss Causation.

The defendants argued that they didn't cause the loss. They claimed that it was the housing market crash. Judge Cote cites a recent decision from the Second Circuit, Fin. Guar. Ins. Co. v. Putnam Advisory Co., LLC, – F.3d –, 2015 WL 1654120 at 8 n.2

> … there may be circumstances under which a marketwide economic collapse is itself caused by the conduct alleged to have caused a plaintiff's loss, although the link between any particular defendant's alleged misconduct and the downturn may be difficult to establish.

Judge Cote tells us that the Second Circuit cited the Final Report of the FCIC for the proposition that the housing crash was linked to the "shoddy origination practices concealed by the misrepresentations" in the Nomura offering materials. Those shoddy practices contributed to the housing bubble, and were factors in the Great Crash. Crucially, she writes at 332:

> Defendants do not dispute this. They do not deny that there is a link between the securitization frenzy associated with those shoddy practices and the very macroeconomic factors that they say caused the losses to the Certificates.

> This lack of contest, standing alone, dooms defendants' loss causation defense, which, again, requires them to affirmatively prove that something other than the alleged defects caused the losses.

6. Conclusions

The legal team at Quinn Emanuel did a nice job of preparation. The people who prepared the testimony of the expert Dr. William Schwert deserve a special mention: that was really smart. See page 204 and previous material.

It looks like the Quinn Emanuel team and the Judge were deeply informed by the Final Report, and used it as a road map to digging up and presenting evidence of the fraud and corruption in the securitization process. It's a terrible shame the spineless prosecutors at the Department of Justice couldn't grasp the point of the Final Report. That is, unless the prosecutors did understand, and the decision was made by the neoliberals at the top, Lanny Breuer and Eric Holder, and the bankster's best friend, Barack Obama.

PIKETTY GETS A LAUGH AT MANKIW'S EXPENSE

I'm not a fan of the former Bush economics adviser and Harvard economics professor N. Gregory Mankiw, so I was delighted to see Thomas Piketty make a joke about him at the recent meeting of the American Economics Association. Chuck Collins of the Institute for Policy Studies was there, attending one of the panels on Thomas Piketty's Capital in the Twenty-First Century. One of those panels, packed with right-wing economists, was set up by Mankiw, who used it as a stage to attack Piketty. He and his fellow ideologues decided unanimously that the best thing to do is to impose a consumption tax, presumably as part of a package to lower taxes on the top earners and to keep capital gains taxes low and corporate taxes at their lowest level in decades.

> Mankiw, at another point in his presentation, had still more embarrassing comments to make. Piketty, he intoned, must "hate the rich." Piketty's financial success with his best-selling book, Mankiw added, just might lead to self-loathing.

This is what passes for right wing humor in the economist class, though Collins reports that the obviously prepared bon mots "fell flat". Then someone asked Piketty what he thought about the consumption tax idea. Collins reports his reply:

> "We know something about billionaire consumption," Piketty observed, "but it is hard to measure some of it. Some billionaires are consuming politicians, others consume reporters, and some consume academics."

Sweet. A correspondent tells me that one of his friends was there and that this jibe brought the house down. Too bad more people don't laugh at Mankiw and other toadies for the rich.

A PROPOSED DEFINITION OF MARKET ECONOMY

In this post, I give a proposed definition of the term "market":

> A market is the set of social arrangements under which people buy and sell specific goods and services at a specific point in time.
>
> Social arrangements means all of the things that constrain and organize human action, including laws, regulations, social expectations, conventions, and standards, whether created or enforced by governments, institutions or local traditions.

With this definition in mind, how should we define the term "market economy"? To start with, my definition is meant to contrast with other definitions discussed in this post, and particularly that of Samuelson and Nordhaus, *Economics*, 2005 ed. p. 26.

> A market is a mechanism through which buyers and sellers interact to determine prices and exchange goods and services.

That definition forms the basis for their definition of the term "market economy":

> A market economy is an elaborate mechanism for coordinating people, activities, and businesses through a system of prices and markets. It is a communication device for pooling the knowledge and actions of billions of diverse individuals. P. 26.

The terms market economy and free market economy are used by people to describe the economic system in the US. Many people are committed to the belief that free and untrammeled markets are intricately and intimately bound up with political and personal liberty. Milton Friedman is one such: here is a link to a short 1961 essay in which he explains his views. Friedman contrasts capitalism with socialism. He tries to imagine how such a socialist country might convert to capitalism. In such a country, he explains,

> The first problem is that the advocates of capitalism must be able to earn a living. Since in a socialist society all persons get their incomes from the state as employees or dependents of employees of the state, this already creates quite a problem.

Presumably Friedman is talking about the Soviet Union. From this we should conclude that his target is the command and control economy which the Soviet Union and the Socialist Republics of the USSR implemented. Friedman sees the capitalist or free market system as the opposite.

> Fundamentally there are only two ways in which the activities of a large number of people can be coordinated: by central direction, which is the technique of the army and of the totalitarian state and involves some people telling other people what to do; or by voluntary co-operation, which is the technique of the market place and of arrangements involving voluntary exchange.

So, it turns out that the definition of a market economy is any economy except a command and control economy. The details about the level of organization and constraint provided by various actors, including but not limited to governments at each level, are details worked out in each society in accordance with local desires. I'm not sure Friedman would approve of my pair of definitions, though.

This essay is a fascinating glimpse into early neoliberalism. Friedman gives a history of liberalism similar to the one I give here. He contrasts what we call liberalism, associated with the New Deal, with his views which he calls new liberalism, "a more attractive designation than 'nineteenth century liberalism.' " He denounces what he calls “democratic socialism” as a contradiction in terms. He explains that his form of liberalism is like the 19th Century form with its emphasis on “freedom”. He says that 20th Century liberals put the emphasis on “welfare”, meaning the well-being of the members of society, not like Great Society welfare programs. His 20th Century liberal might ask what the point of Friedman’s freedom is, since it apparently isn’t the well-being of the members of society.

I take this to be his central thesis:

> It is important to emphasize that economic arrangements play a dual role in the promotion of a free society. On the one hand, “freedom” in economic arrangements is itself a component of freedom broadly understood, so “economic freedom” is an end in itself to a believer in freedom. In the second place, economic freedom is also an indispensable means toward the achievement of political freedom.

For example, if you are forced to participate in Social Security, you have lost a portion of your personal freedom. But, he says, that’s what you expect of pointy-headed liberal intellectuals:

> They tend to express contempt for what they regard as material aspects of life and to regard their own pursuit of allegedly higher values as on a different plane of significance and as deserving special attention.

I promise you that I consider my creature comforts more important than my intellectual pursuits, such as they are. Friedman then explains that economic power is a natural opponent of concentration of power in governments. Economic freedom is a necessary but not sufficient condition for political freedom. The rest of the essay is a surprisingly shallow explanation of these ideas. You might have thought that he would at least recognize the danger of concentrated capital for democracy. After all, he wasn’t that far removed from the Great Depression, the Palmer Raids, and the horrifying treatment of workers beginning with industrialization. But no. Instead we get this:

> If I may speculate in an area in which I have little competence, there seems to be a really essential difference between political power and economic power that is at the heart of the use of a market mechanism to preserve freedom.

This is where he gives his hypothetical about a Soviet Republic that wants to switch to capitalism. It can’t happen according to his discussion; but, of course it did. Then he explains how the Hollywood Blacklist was an infringement of the right of suspected communists to earn a living, and how it was destroyed by the demands of the market. Both of these arguments show how right Friedman was to claim little competence. Or perhaps Friedman hadn’t focused on the way his ideology limited his conceptualization of complicated issues; a problem every thinker must guard against.

In any event, it seems that we don’t need a complicated definition of the term market economy. All it means is any economy that isn’t a command and control economy. Anything else is just metaphor, like the communication device conjured up by Samuelson and Nordhaus.

A PROPOSED DEFINITION OF MARKET

Over several posts, I have criticized standard economic textbook definitions of market, here and here. I neglected to mention one, the idea that markets are an emergent phenomenon; here's a discussion of that lunatic definition. Here's my proposed definition:

> A market is the set of social arrangements under which people buy and sell specific goods and services at a specific point in time.
>
> Social arrangements means all of the things that constrain and organize human action, including laws, regulations, social expectations, conventions, and standards, whether created or enforced by governments, institutions or local traditions.

The point of this definition is that it focuses attention on the actual attributes of our intuitive understanding of the term.

1. All buying and selling is done in a social setting. The image of the lone white male creating a business all by himself in the face of monolithic government resistance is just as brainless as the image of the perfectly free individual moving in a consumer wonderland picking and choosing the things that will provide the greatest happiness. All businesses are social activities with social ramifications, and all require the actions of others than the towering ego of one person.

2. Each act of buying and selling is a separate act, done separately in time and space. The act of aggregating purchases and sales is thus left out of the definition. That is a political act, and by separating the definition from the aggregation, we force the statistics users to state their principles of aggregation. That puts us into a position to evaluate both principles and purposes behind the statistics, and to judge the success of the endeavor.

3. The principle constraints on buying and selling are set up by people. They don't evolve out of the mists of time, or come to life in the mind of someone contemplating the natural order

of things, or emerge from the underlying acts of buying and selling, and they don't have to stay the same from time to time. We don't have to live with the rules inflicted on us by the people who create the monopolies, oligopolies, patent restrictions, right-wing courts, captured agencies, and all the other tools of neoliberalism for making the rich even richer at our expense.

4. In the definition, I purposefully chose to insert the words "conventions" and "standards". These words expose the fact that people have expectations about how things are supposed to work, and are angered when they don't. In our neoliberal world, we aren't supposed to notice that the CEO class takes all the rewards of the hard work of thousands of other people. We're supposed to be cynical and say that society isn't entitled to such expectations. We're supposed to call the screwing of the public in the Great Crash greedy but not illegal. We aren't supposed to be angry. But, as Whiner-In-Chief Jamie Dimon has dimly noticed, the anger is white hot, and isn't going away, even as bank profits and greed go through the roof.

I think the most important thing this definition does is to demonstrate what markets can't do. They won't solve any of the important problems facing our society. Mainstream textbooks talk about several kinds of market failure: externalities like pollution and noise and fracking water dumped into the aquifers that provide irrigation and drinking water; monopolies and oligopolies sanctioned by the courts and administrations of every neoliberal variety, for example. These are different from market imperfections, for example, where there are large economies of scale, or high barriers to entry. See Samuelson and Nordhaus, *Economics*, Ch. 9, 2005 ed. Economists offer some vague and unimpressive government solutions to these problems, but the neoliberals reject them, saying that only markets can solve our problems, and us idiots need to step aside and let them work.

As my definition shows, markets operate on a case by case basis. They make no provision for the future. To the extent that they do, it’s because individuals themselves give some thought to their future. This point did not escape the sharp mind of William Stanley Jevons, who devotes a section of his discussion of utility to dealing with the obvious fact that an individual’s ability to enjoy pleasure and escape pain requires a regular and continuing supply of various commodities. He gives a clever illustration of using the available resources when future supplies are uncertain. Jevons, *The Theory of Political Economy* III.47-49, 59 et seq.

In this post I try to show that there is no reason to think that markets even meet the limited test of utility maximization set up by Jevons; and we haven’t even discussed the problems with his definition of utility. With my definition of market we can see why. Each transaction happens in a moment. At most, it can come close to maximizing utility for that point in time for the persons transacting. It says nothing about the future.

Perhaps some of the people buying or selling are thinking about their future needs closely and carefully. But the point is that they only are maximizing their personal utility at a point in time. Jevons makes this clear in his definition of utility when he adds this qualifier:

> This perfectly expresses the meaning of the word in Economics, provided that the will or inclination of the person immediately concerned is taken as the sole criterion, for the time, of what is or is not useful.

Let’s remember that for Samuelson and Nordhaus, modern economics as taught to college students flows from Jevons and other neoclassical economists. See the back inside cover of *Economics*, 2005 ed. Neoclassical economics is the foundation of neoliberal economic theory as well, and the latter is nourished by both the training given in college to non-economics majors and all of the public discussion of economics by trained and untrained people. Again, the claim is that markets will solve any and all problems.

But they obviously won’t. Whatever else we know about markets, and it isn’t much beyond a few obvious general ideas, we know that markets are reactive, responding to news or immediate needs. They have nothing to do with long-term problems. They have no predictive capacity. Which market predicted that the oceans would fill up with plastic crap? Which market predicted that the earth would warm up to the point that it became uninhabitable to humans? What fixes do these wizard markets offer?

They offer nothing. In the end, the only thing these ideological markets do is give the richest people control over the outcomes. The Koch brothers with their John Bircher background hate democracy, and use their money to influence the social arrangements that create and constrain buying and selling to benefit themselves. In the end, they and their ilk are the people who decide how we will deal with poisoning the oceans, the aquifers, the fresh water lakes and the atmosphere. And they’ll do it with their markets. And they’ll do it with the praise of the majority of citizens who believe in their foolish theories of markets. And the only people, if any, who will benefit are the filthy rich.

That’s why we need to stop talking about the markets in the terms defined by the rich and their pet academics, and start focusing on reality.

THE PROBLEM WITH MARKET DEFINITIONS

It is an article of faith in the US that the free market system is the best possible system for allocating scarce resources. Samuelson and Nordhaus have a long explanation of the glories of this kind of allocation. *Economics* 2005 ed. P. 26. One source for this idea is the early neoclassical economist William Stanley Jevons. He offers a mathematical proof that competitive markets will automatically generate the greatest utility for all participants in the market. The key words here are market and utility, and Jevons has a careful definition for both. His proof doesn't work for non-competitive markets, but there is no such thing as a competitive market in the real world. Therefore, the proof doesn't support the proposition that markets in the real world will produce the best possible allocation of scarce resources even in Jevons' limited sense.

In his 1871 book, The Theory of Political Economy, available online here. Jevons taught that economics had to be based on physical sciences to achieve respectability.

> But if Economics is to be a real science at all, it must not deal merely with analogies; it must reason by real equations, like all the other sciences which have reached at all a systematic character. IV.38

This was the view of the major neoclassical economists, including Léon Walras, Francis Edgeworth, Irving Fisher and Vilfredo Pareto, all of whom were trained in science, math and/or engineering. It is still the dominant view today, whether it's Krugman with IS/LM, the Dynamic Stochastic General Equilibrium crowd scattered across the economic landscape, or any of the rest of the academic and business economists who dominate all discourse on the economy. All of them think math is the important thing. Thomas Piketty and his colleaguges, and the MMT group are notable exceptions.

The first step in a math-based program is definitions. Jevons is careful to define his terms, starting with the term “utility”, which is the subject of Chapter III. He quotes Jeremy Bentham’s definition from his Introduction to the Principles of Morals and legislation:

> ”By utility is meant that property in any object, whereby it tends to produce benefit, advantage, pleasure, good, or happiness (all this, in the present case, comes to the same thing), or (what comes again to the same thing) to prevent the happening of mischief, pain, evil, or unhappiness to the party whose interest is considered.”
>
> This perfectly expresses the meaning of the word in Economics, provided that the will or inclination of the person immediately concerned is taken as the sole criterion, for the time, of what is or is not useful.

A commodity is a physical thing or service that embodies utility. Jevons explains at length the “fact” that the more you have of any commodity the less utility you derive from the last unit. Jevons uses the logic of the Riemann Integral to generate a downward sloping smooth curve based on the utility of the last unit. See III.17 and III.21. These figures depict the downward slope of the utility curve as more units of the commodity are acquired by the person.

Now suppose there are two people each with a supply of a single commodity. Jevons derives the following to show the conditions that determine the amount each will exchange with the other:

$$\frac{\phi_1 (a - x)}{\psi_1 y} = \frac{y}{x} = \frac{\phi_2 x}{\psi_2 (b - y)}.$$

Here, the symbol φ is the utility function for one commodity and ψ is the utility function for the other. The subscript 1 is for one person, and the subscript 2 is for the other. He says that each person will exchange until they reach the point point each person values the balance of their own commodity more than that of the other. Jevons is focused on straight up exchanges, corn for beef, but his equations work with money as well.

Finally, Jevons gives a careful definition of market in Chapter 4.

> By a Market I shall mean much what commercial men use it to express. Originally a market was a public place in a town where provisions and other objects were exposed for sale; but the word has been generalised, so as to mean any body of persons who are in intimate business relations and carry on extensive transactions in any commodity. … The central point of a market is the public exchange,—mart or auction rooms, where the traders agree to meet and transact business. In London, the Stock Market, the Corn Market, the Coal Market, the Sugar Market, and many others, are distinctly localised; in Manchester, the Cotton Market, the Cotton Waste Market, and others. IV.15

For other definitions, see this post. In today's language, we would call the people who make up Jevons' market merchants. Here's Jevons' formal definition, my bold.

> By a market I shall mean two or more persons dealing in two or more commodities, whose stocks of those commodities and intentions of exchanging are known to all. It is also essential that the ratio of exchange between any two persons should be known to all the others. It is only so far as this community of knowledge extends that the

> market extends. Any persons who are not acquainted at the moment with the prevailing ratio of exchange, or whose stocks are not available for want of communication, must not be considered part of the market. **Secret or unknown stocks of a commodity must also be considered beyond reach of a market so long as they remain secret and unknown.** Every individual must be considered as exchanging from a pure regard to his own requirements or private interests, and there must be perfectly free competition, so that any one will exchange with any one else for the slightest apparent advantage. **There must be no conspiracies for absorbing and holding supplies to produce unnatural ratios of exchange.** Were a conspiracy of farmers to withhold all corn from market, the consumers might be driven, by starvation, to pay prices bearing no proper relation to the existing supplies, and the ordinary conditions of the market would be thus overthrown. IV.16

Jevons connects his utility and market definitions through his Law of Indifference:

> …[W]hen two objects or commodities are subject to no important difference as regards the purpose in view, they will either of them be taken instead of the other with perfect indifference by a purchaser. Every such act of indifferent choice gives rise to an equation of degrees of utility, so that in this principle of indifference we have one of the central pivots of the theory.

The connection is that in a perfect, or what we would call a competitive, market when dealing with commodities that are utterly alike, we can predict that people will exchange commodities to increase their utility, and will continue to exchange until further exchanges would decrease their total utility.

After some examples, and acknowledgement of various problems with his equations, Jevons draws the following conclusion:

> But so far as is consistent with the inequality of wealth in every community, all commodities are distributed by exchange so as to produce the maximum of benefit. Every person whose wish for a certain thing exceeds his wish for other things, acquires what he wants provided he can make a sufficient sacrifice in other respects. IV.98

This conclusion springs directly from his definitions of market and utility. There are serious questions as to whether either definition is a good one, but the definition of market must describe some alternative planet. At the time Jevons was writing, financial markets and commodity markets were infested with fraud and corruption. Jevons acknowledges the problems of availability of information to participants, and the unfairness associated with speculators. IV.18. The average consumer bought in street markets, which probably match his definition fairly well for everyday items.

No one really thinks commodity and financial markets are much better today than they were in Jevons’ day. For consumers, the problem is worse. There is no bargaining in grocery stores or department stores or with Amazon. There is no bargaining with cable companies or health care providers or insurance companies or banks or any provider of necessary items. The consumer is the price taker, and with the purchase takes all the legal limitations the seller can impose. Even for savers, there is no protection from stock brokers who owe no fiduciary duty to anyone but themselves.

Samuelson and Nordhaus use language very similar to Jevons to explain utility and marginal utility and to explain consumer behavior, to the point of quoting him. *Economics*, 2005 ed. Ch. 5. It's reasonably true that individual consumers try to maximize their utility from the goods and services they buy, subject, of course, to their ability to understand the transaction, and to determine correctly the utility of the goods and services, as compared to other choices, including the choices to save or pay down debt. Samuelson and Nordhaus don't claim that consumers always make good choices. P. 89. They do claim that consumers make reasonable choices and learn from their errors, and that's close enough for their theory, they say. I wonder how many billions of dollars fall into that web of cracks in the market façade.

But Samuelson and Nordhaus separated their definition of market from their definition of utility, so it isn't obvious to the student that the markets themselves are inadequate tools for determining price/utility ratios that consumers face. In fact, the problems with those markets means that consumers can only maximize their utility to a certain level, and the people and firms that control the markets will always suck up the rest of that utility for themselves. We don't trade in utility, so that means they suck up more consumer money.

To be clear, most economists probably have a more sophisticated view of markets than we see in Jevons and in Samuelson and Nordhaus, and probably understand the limitations of the notion that the market system produces the best possible allocation of scarce resources.

But that sophisticated view is saved for grad students. The public, even the college-educated public, is fed on Jevons. That is why I think the definition of market matters. If economists had to teach the imagined better theory in Econ 101, the cracks and strains of the current system would be apparent.

WHAT IS THE DEFINITION OF A MARKET?

The US economic system is based on what we've all agreed to call free markets. The entire system is often called the free market system instead of the capitalist system. I've been looking for a definition of the term market.

1. Textbook Definition. Samuelson and Nordhaus define markets early in their textbook Economics (2005 ed.):

> A market is a mechanism through which buyers and sellers interact to determine prices and exchange goods and services. P. 26.

Markets consist of buyers and sellers interacting to determine prices? I'd call that moderately descriptive. Is it interacting when you go to the grocery store and decide to buy one brand of crackers rather than another? Is Macy's is running an auction? You get into an accident and your car needs body work. The insurance company negotiates with your body shop. Is that interacting? You need to see a doctor. There's no interaction over prices. This definition implies that as far as ultimate consumers are involved, a market is an arrangement where prices are set by sellers, and buyers get to pick whether or not to buy and from whom among the reasonably available sellers. It is a reasonable description for transactions among merchants. There isn't really a mechanism, and the whole thing doesn't constitute a mechanism, and the term interacting seems inaccurate. There is, of course, exchange of goods and services.

They also define the term "market economy"

> A market economy is an elaborate mechanism for coordinating people, activities, and businesses through a system of prices and markets. It is a communication device for pooling the knowledge and actions of billions of diverse individuals. P. 26.

Again we see the word “mechanism”. It must be a metaphor, and not a definition. These descriptions lead you to think a market is a circuit on the motherboard of a computer that is running the market economy program. You’d think a market economy operates by formal laws and in accordance with mechanical rules. You’d think it was a permanent thing, to be studied in the same way you’d study galactic movements or steel balls rolling down an incline. That seems completely wrong.

And anyway, the term mechanism doesn’t tell us anything about what a market is. The other terms are vague and unconnected to anything. It’s hard to see how this definition could serve as the basis for an economic system.

2. Markets as defined by early neoclassical economists. One of the first neoclassical economists was William Stanley Jevons, a mathematician and philosopher. His principle contribution to economics is his book *The Theory of Political Economy*, published in 1871. The book includes an early effort to apply the new Riemann Integral to the field of economics. Compare the drawings in III.17 and III.21 with the graphics at this link. Here’s his definition of Market:

> By a market I shall mean two or more persons dealing in two or more commodities, whose stocks of those commodities and intentions of exchanging are known to all. It is also essential that the ratio of exchange between any two persons should be known to all the others. It is only so far as this community of knowledge extends that the

> market extends. Any persons who are not acquainted at the moment with the prevailing ratio of exchange, or whose stocks are not available for want of communication, must not be considered part of the market. Secret or unknown stocks of a commodity must also be considered beyond reach of a market so long as they remain secret and unknown. Every individual must be considered as exchanging from a pure regard to his own requirements or private interests, and there must be perfectly free competition, so that any one will exchange with any one else for the slightest apparent advantage. There must be no conspiracies for absorbing and holding supplies to produce unnatural ratios of exchange. Were a conspiracy of farmers to withhold all corn from market, the consumers might be driven, by starvation, to pay prices bearing no proper relation to the existing supplies, and the ordinary conditions of the market would be thus overthrown.
>
> The theoretical conception of a perfect market is more or less completely carried out in practice. IV.16-17

This is an excellent description of what we call a competitive market, you know, the kind that doesn't exist in the real world today, if it ever did. Jevons thinks the model is close enough to reality to allow him to create equations, which he thinks this is crucial.

> But if Economics is to be a real science at all, it must not deal merely with analogies; it must reason by real equations, like all the other sciences which have reached at all a systematic character. IV.38

3. Post WWII economics. Neoliberal economists of the Chicago school updated the metaphor of the

early neoclassicals. Bernard Harcourt in his excellent book *The Illusion of Free Markets* explains that neoliberal theory extolling marvels of markets rises from 18th and 19th Century theories that markets are part of the natural order of things. One branch, related to the ideas of Friedrich Hayek, springs from Adam Smith’s metaphor of the invisible hand of the market, a form of spontaneous order, updated with “new models from computer science.” Chapter 8.

Harcourt describes another strand of thought about markets, this one closely linked to Gary Becker and Richard Posner of the Chicago school of economics. He says it focuses on the alleged economic efficiency of the market economy, and he traces its roots to French Physiocrats who believed that markets were the embodiment of a natural order. Just as we perceive order in the physical universe (more or less, depending on how you understand quantum behaviors), so markets reproduce that efficiency. Efficiency is set up as the chief goal of the economy. With this step, we incorporate a determinative model of the economy, one that can be represented by equations.

But there is still no definition of the term market.

4. Contemporary works. Now, as in the past, economists raid the physical sciences for new ideas. Here’s a fascinating example: *The Market as a Creative Process*, available starting at page 378 here [huge .pdf] by James M. Buchanan and Viktor J. Vanberg. They discuss an early book on complexity theory by Ilya Prigogine and Isabelle Stengers; Prigogine won a Nobel Prize in chemistry, and later turned to the study of complexity. His book is about the role of chaos theory in the self-organization of more complex forms.

Buchanan and Vanberg discuss a very old problem arising from Newtonian physics. That system is thought to be deterministic, in the sense that if you knew the position and motion of every particle in the universe, you could predict the future. Nobody has actually thought that was true for decades, at least. As far as I know, economists don't think that markets are deterministic. Buchanan and Vanberg point out that lurking in a system of equations based on the idea of general equilibrium, there is a kind of determinism lurking. They explain that Prigogine's book should bring an end to ideas about determinism in economics, and presumably an end to the idea of equilibrium in the economy.

Ideas about chaos theory were cutting edge in the mid-80s. Chaos theory is a mathematical field, so I'm not sure it's the best argument Buchanan and Vanberg could have made. There has been much progress since then in both complexity theory and ideas about self-organization. This seems to me to be a very elegant solution.

Buchanan and Vanberg's paper is in a book titled *Philosophy and Economics*. Therefore, you'd expect a bit of formalism, like a definition of market. But no. We learn that standard economic teaching is based on the "self-organizing nature of markets." 383. That doesn't accord with Samuelson, which I have set up as standard economic teaching, but it seems to be at the heart of the Austrian School; you can see it in this paper by Friedrich Hayek. This school preaches that markets are self-organizing and automatically compute the proper allocation of resources without resort to any centralized apparatus. Hayek explains that the "price system", which seems to mean the market system, "evolved without design". H.24. He doesn't cite any evidence for this proposition, and surely no one really thinks the bread markets in 18th Century France evolved without design, any more than the Chicago Board of Trade did. See Harcourt's The Illusion of Free Markets.

I've got a lot of stuff to look at, but so far, I don't see a formal definition of "market" that will bear any scrutiny. Why it matters is the subject of a future post.

THE NEOLIBERAL INHABITANTS OF MONT PELERIN

In this post, I talked about the intersection of neoliberalism and neoclassical economics. There is a lot of talk on the left about neoliberalism, and a number of ideas about what it is. For me, neoliberalism refers to the general program of a group of economists, lawyers and othes loosely grouped around the Mont Pelerin Society. This description is used by Philip Mirowski in his book, *Never Let a Serious Crisis go to Waste*. Mirowski did a Book Salon at FDL, here; the introduction gives a good overview of the book, and Mirowski answers a number of interesting questions.

The writer Gaius Publius provides an historical perspective here. Classical liberalism is based on the idea that property rights are central to the freedom of the individual, an idea espoused by John Locke, as the Theologian Elizabeth Bruenig explains here.

> John Locke's 1689 discussion of property in his Second Treatise on Civil Government establishes ownership as a fundamental relationship between the self and the outside world, with important implications for governance. In Locke's thought, the justification for private property hinges upon one's self-ownership, which is then applied to other objects. "Every man," Locke writes in the Second Treatise, "has a property in his own person: this no body has any right to but himself." Through labor, Locke continues, the individual mixes a

> piece of herself with the outside world. Primordial self-ownership commingles with material objects to transform them into property.

In this view, property is the central element that structures individual lives and then society as a whole. Those who have it are entitled to total control over it, just as they are over their own person. Perhaps they should even be in charge of operating the state. When you think about that era, you can see why that formulation would be popular: it solved the problem facing newly rich merchants and others under a monarchy. They were in constant danger that royalty would seize their property from them without fair compensation. Locke's argument provides a framework to limit the power of the monarch. It also explains the relation between slaves and owners, and women and men. And, as Bruenig points out, it can be extended to justify protection of property with the same force allowed in self-protection.

The defense of property from interference by the State leads directly to the idea of small government. Government shouldn't interfere with markets any more than it should interfere with any other use of property. The combination of these ideas leads to the principles of classical liberalism: nearly absolute personal freedom for those with property, and a tightly limited sphere of government action. This is the classical formulation of liberalism.

It lasted until the Great Depression and the New Deal. Franklin Roosevelt was faced with the rich on one side, and with angry and miserable workers on the other. These workers and unemployed people, and most of the citizenry were looking at the massive damage done by capitalists and their capitalist system, and saw that the system did not work for them. They were listening to the leftists of the day, socialists and communists; independent smart people like Francis Townsend; and powerful speakers and populists like Huey Long and Father Coughlin.

The elites were frightened of the power of these people to inform and structure the rage of the average citizen, and FDR was able to force them to capitulate to modest regulation of the rich and powerful and their corporations, including highly progressive tax rates.

FDR and the Democrats embraced the term liberalism, and the meaning of the term changed to include a more active state, to some extent guided by Keynesian economic theory. In this version of liberalism, the government becomes a tool used by a society to achieve the goals of that society. People who stuck with the old definition of small government coupled with massive force in the protection of property and rejected all Keynesian ideas were labeled conservatives.

The reformulation of the definition of liberal did not sit well with a segment of the conservatives. Friedrich Hayek and his rich supporters launched the Mont Pelerin Society in 1947. The point of the MPS is to preserve and extend classical liberalism, in an effort to prevent FDR-style liberalism from turning the US and other countries to socialism or something even worse. It is a diffuse group, not secretive, but it doesn’t seek publicity. It seems to content itself with publishing papers and having meetings at which like-minded people can talk to each other and feel good about their brilliance.

The name neoliberal comes from their desire to recapture the glory of small government capitalism. This is from a speech delivered by Edwin J. Feulner, the outgoing president of the group, in 1998:

> But with the onset of Progressivism and the New Deal, many Americans became attracted to a political philosophy that was diametrically opposed to Jefferson’s. The new statist philosophy had great faith in public man, but was deeply distrustful of private man. It maintained, quite incorrectly, that the

> uncoordinated activities of ordinary individuals were bound to culminate in economic catastrophes like the Great Depression, and it looked to an all-good, all-wise and increasingly all-powerful central government to set things right. In the view of these statists — who brazenly hijacked the term "liberal" to describe their very illiberal philosophy — what we Americans needed was more government, not less.

The FDR socialists and communists brazenly hijacked the term "liberal" to cover their assault on the principles of small state property protection. That gives you some idea of the ressentiment of the neoliberals. They have a strong sense of entitlement, and they cling to grudges for decades. Hayek was perhaps most famous for his book *The Road to Serfdom*, written in the wake of World War II, a screed warning against socialism. That wasn't going to happen, but it fit neatly with the ressentiment of the filthy rich capitalists who never forgave the Class Traitor FDR.

The Statement of Aims of the MPS is here. It describes a limited choice: Communism or Free Market Capitalism This stark choice has

> … been fostered by the growth of a view of history which denies all absolute moral standards and by the growth of theories which question the desirability of the rule of law. It holds further that they have been fostered by a decline of belief in private property and the competitive market; for without the diffused power and initiative associated with these institutions it is difficult to imagine a society in which freedom may be effectively preserved.

This statement shows why the filthy rich love neoliberalism: it feeds there sense of self-glorification. That it lends itself to exploitation for their cash benefit is a lovely side benefit.

NEOLIBERALISM AND NEOCLASSICAL ECONOMICS

I'm new here as a poster, so I'll start by describing my interests. As you may know from my work at Firedoglake under the name masaccio, I'm interested in the way the economy actually works. That's why I like the work done by Thomas Piketty and his colleagues on wealth and income inequality: he has collected, refined and organized huge piles of data and made both that data and his analysis public. Piketty's book, *Capital in the Twenty-First Century*, tells us that we can and should insist on data as a source of analysis, not the enormous array of cute stories mainstream economists like to tell us from their armchairs. Trickle-down, life-cycle consumption, pay based on marginal productivity, free markets, and most of the neoclassical economics taught in Econ 101 to pretty much the entire college population for decades, all of them are clever, easily explained in sophomore level calculus, and wrong.

The two parties cooperated to implement self-regulating financial markets, both through the gradual abolition of Glass-Steagall, and to gut regulatory agencies. They laid the groundwork for the Great Crash, and the cheats and thugs on Wall Street did the rest. Then the elites and their pet economists insisted that the solution lay in pumping money into the banking system with no thought of criminal investigation, let alone prosecution, and only the weakest forms of re-regulation, insuring that the criminals would not be deterred and would have plenty of ways to bring on the next disaster.

US voters were angry about the bailouts, but their wrath turned onto the victims of the fraudulent lending schemes and the interest rate swaps and the other financial innovations that the Alan Greenspans and Robert Rubins enthusiastically supported. Does your city or your school district have an interest rate swap? I live in Chicago, and our school district has a bunch. The Chicago Tribune estimated they will cost us $100 million that should be going to education but instead is going to the con artists on Wall Street. The cuts to education here are painful and unnecessary. The same is true all over the country

But it was bad luck homeowners who really got cheated. First, there were knowingly fraudulent loans, then knowingly fraudulent foreclosures, and now possibly knowingly fraudulent delinquency claims.

The vast majority of the public thinks this is just fine. Screw the victims, help criminal banks is a strange goal, but the worst part is that victims of this economic system frequently do blame themselves.

This outpouring of hostility towards the losers in the economic struggle should be seen as a natural consequence of neoliberalism. In that worldview, the market is an indifferent referee, doling out rewards to the successful, and pushing the losers off the playing field into the outer darkness. Everyone is required to be the entrepreneur of themselves, investing their money or their parents’ money or borrowed money in their own human capital in the hopes of beating out some other poor bastard for some bad job that pays poorly. If they win, they might get to retire. If they lose, there’s always bankruptcy, except for taxes and student loans, and they are trash. It’s a bleak world.

Neoclassical economic theory is the linchpin of neoliberalism. It provides a theoretical underpinning for the harsh world it envisions. In this world, humans are seen solely as consumers and producers. These calculating creatures are rational optimizers, constantly using the markets to achieve their own personal highest utility. It’s an evil, reductive idea, but notice how well it corresponds to the self images of the people described by Jennifer Silva in her book *Coming Up Short*, which I discussed here. The encouraging thing about the people Silva talked to is that they see themselves as having agency, they see themselves as having problems, but they are convinced they can do something about those problems.

The middle class is shrinking. Social class mobility is falling. But no one seems interested in the possibility that the economic system is the problem. The Republicans love it, and the Democrats do too, only not quite as much: they offer timid solutions like Elizabeth Warren’s suggestion that we reduce the interest rate on student loans, or increase the minimum wage to $10.10 per hour. These are not the kinds of changes that will make a significant difference in anyone’s life. They will do nothing to dilute the power of the richest 16,000 US families. And yet these represent the extreme left in politics.

In the 1920s, there was widespread intellectual ferment around alternatives to capitalism, socialism and communism, and that forced questions about capitalism to the surface. As the Great Depression deepened, the rich and politicians were afraid that the working class and the unemployed would find those ideas superior to capitalism. Eventually they were forced to compromise a tiny bit, creating a more or less regulated system of markets. Even the conservative hacks on the Supreme Court (the Court is full of conservative political hacks almost all the time), bent to the will of the people, and allowed a range of FDR’s initiatives to stand. In some cases, for a while, the hacks even enforced those laws, though that ended years ago.

Partially regulated capitalism was a major force for the creation of what Piketty calls the Patrimonial Middle Class. This group, 40% of the population, roughly the 50^{th} to 90^{th} percentiles of wealth, at one time had enough wealth to live comfortably in retirement and leave an inheritance to their children. That group is dwindling. The bottom 50% of the population has little or no net worth. Piketty calls them the Lower Class. The top 10% he calls the Upper Class and the top 1% he calls the Dominant Class. The Upper class is taking all the money produced by the economy. These are the people who can make major donations to politicians and thus acquire influence they can turn to their cash benefit.

The Lower Class is becoming more and more angry as the recovery stomps their faint hopes into the dirt. The Middle Class is shrinking, and I hope is beginning to think that maybe it’s not their fault. Things won’t change until enough people figure out the connection between the economic myths they’ve been taught and the social and political institutions that enforce those myths, and structure their understanding of their place in the world. If Silva’s people are right, if Middle and Lower Class people do have agency, and if they learn to see through the smoke and mirrors of the neoliberals and their academic lapdogs, they can enforce demands that will actually improve their lives.

I like to think of this process as the way you’d peel an octopus off an aquarium wall: one tiny sucker at a time. Eventually it comes off, but it’s a lot of work, and the octopus resists with all its strength.

which is Piketty’s actual term