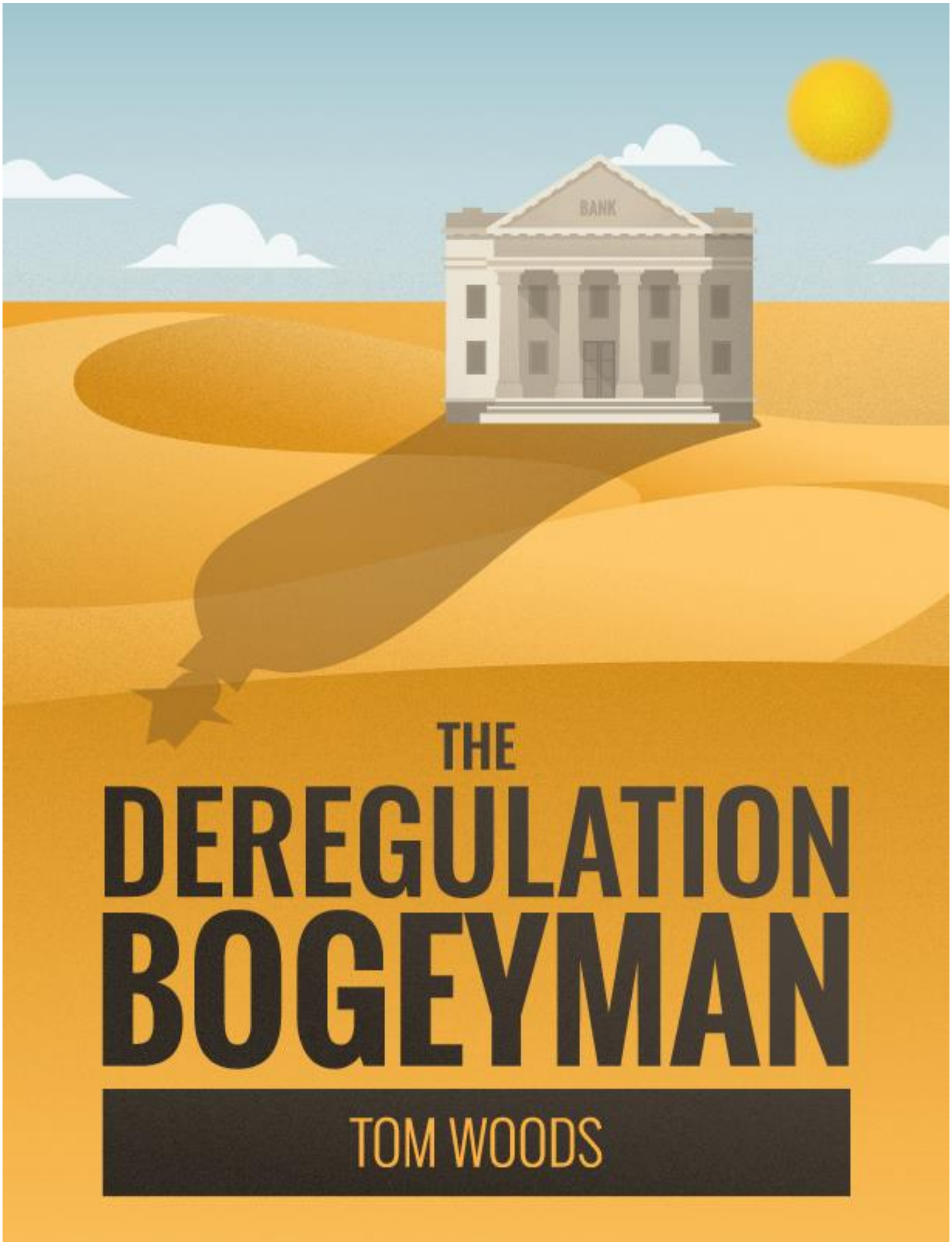
BANK
THE
DEREGULATION
BOGEYMAN
TOM WOODS

Introduction

The Wrong Lesson

In 2009 I published *Meltdown*, which was essentially the first book on the financial crisis to be published by anyone.

I wrote it because I could already see the conventional wisdom beginning to ossify: why, the economy blew up in 2008 because of capitalism run amok!

This is as wrong as wrong can be, yet it has reached the status of something "everyone knows."

The 2008 crisis has passed into history, but it remains important for us to study and understand. As F.A. Hayek observed, if we don't get history right, then we'll get the present dreadfully wrong.

In *Meltdown* I placed a great deal of emphasis on the role of the Federal Reserve System in causing the housing bubble and the subsequent bust. This eBook, which is focused on the more specific question of whether "deregulation" caused the crisis, spends less time on the Fed, so for that aspect of the question I refer the reader to *Meltdown*.

Now on to the myth busting.

Tom Woods
October 2018

Chapter 1

The Deregulation Myth

For some people the argument seems so natural that no real research is necessary: they just know deregulation must have caused our problems, even if they have no idea what deregulation is, what it consisted of, or what exactly our problems are. Countless Americans have permitted themselves to believe that there is no serious problem their wise overlords could not have prevented had they been able to crack a few more skulls. The possibility that our protectors may themselves be the source of the problem is unthinkable.

A review of the key planks of financial regulation over the past several decades reveals little that could account for the severity of the crisis that struck in 2008.

First, Regulation Q, which limited the amount of interest banks could pay on savings deposits, was mostly repealed under Jimmy Carter. That move seems unlikely to cause a global financial meltdown thirty years later.

Next, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 repealed restrictions on interstate branch banking. Far from destabilizing the banking system, that repeal presumably strengthened it by making portfolio diversification easier.

And finally, bank holding companies were allowed to underwrite corporate securities. That in itself is not particularly risky, and Columbia Business School's Charles Calomiris is right to note that we would be in much better shape today had these institutions been doing more corporate underwriting (similar to insurance) and less securitizing of bad mortgages.

There is nothing relevant that the banks did in the years leading up to the crisis that they could not have done in the absence of deregulation. Banks have always been free to hold or securitize mortgages, including the subprime and "no doc" varieties. There is no repealed regulation that would have prevented them from doing these things.

The one specific act of deregulation that is sometimes pointed to as a contributor to the crisis is the partial repeal of the 1933 Glass-Steagall Act by means of the Gramm-Leach-Bliley Act in 1999. We heard less about it once proponents of this theory realized that future vice president Joe Biden had supported it while in the Senate, and Bill Clinton had signed it into law.

The Glass-Steagall Act of 1933 consisted of four basic provisions that combined to erect a wall between commercial and investment banking. First, it prohibited banks from underwriting or dealing in securities, apart from essentially riskless government-issued or government-backed securities. The prohibition on "dealing" in securities meant that banks could not acquire securities for the purpose of selling them, but they could acquire them to hold because they believed them to be good investments; banks could later sell them when they concluded they were no longer good investments or when they simply needed cash. Second, securities firms could not take deposits. The remaining two provisions prevented banks even from being affiliated with firms whose main function was to underwrite or deal in securities.

Gramm-Leach-Bliley repealed only this last part of the earlier legislation, thereby making it possible for a commercial bank and an investment bank to coexist under the umbrella of a common holding company. It did not repeal the provision preventing banks from underwriting or dealing in securities. Commercial banks continue to operate under the same Glass-Steagall restrictions that have existed since 1933.

The financial condition of the banks, and the financial crisis itself, had nothing to do with the "repeal" of Glass-Steagall. The problem occurred because banks made bad loans and investments – in other words, banks did a poor job at traditional banking activities, not some newfangled activity that "deregulation" had made possible. Many commercial banks held large portfolios of mortgage-backed securities, but it wasn't some "repeal" of Glass-Steagall that allowed them to accumulate those portfolios. They were always allowed to do so.

But did the repeal of two provisions of Glass-Steagall allowing affiliation of commercial banks with securities firms through their control by the same holding company contribute to the losses and risk that permeated the system? Certainly not. For one thing, commercial banks bought mortgage-backed securities for their AAA rating, their attractive return, and the minimal capital requirements associated with holding them; they did not acquire these assets because they were connected to investment banks that were trying to unload them. Moreover, severe regulatory firewalls essentially prevent this kind of affiliation from contributing to losses or increased risk on the part of the commercial bank involved.

The reverse problem, that affiliation with a commercial bank might bring down an investment bank, is exceedingly unlikely, given the relative magnitudes of assets held by each institution. The commercial banks' assets were only a tiny fraction of those held by the investment banks they were affiliated with. These banks were in no position to cause the investment banks any serious problem, much less their complete downfall.

Meanwhile, the record of the Federal Reserve – the chief regulator of the banking system – was less than impressive. During the boom years the Federal Reserve boasted of its unique ability to foresee and prevent financial crises. In January 2007, on the verge of the crisis, Federal Reserve Chairman Ben Bernanke told a gathering of academics:

> Together with the knowledge obtained through its monetary-policy and payments activities, information gained through its supervisory activities gives the Fed an exceptionally broad and deep understanding of developments in financial markets and financial institutions....
>
> In my view, however, the greatest external benefits of the Fed's supervisory activities are those related to the institution's role in preventing and managing financial crises.
>
> In other words, the Fed can prevent most crises and manage the ones that do occur.
>
> Finally, the wide scope of the Fed's activities in financial markets—including not only bank supervision and its roles in the payments system but also the interaction with primary dealers and the monitoring of capital markets associated with the making of monetary policy—has given the Fed a uniquely broad expertise in evaluating and responding to emerging financial strains.
>
> Later that year, the housing bubble burst.

Of course, the Fed failed to prevent the current crisis – and, as I argued in *Meltdown*, itself bears much responsibility for what went wrong. Did that make the political class re-examine the Fed's claims about its wondrous abilities? To the contrary, in the wake of the crisis the Fed was given still more regulatory authority.

It seems to be a general rule: no matter how badly regulators fail, every crisis brings calls to empower them further. There appears to be nothing regulators could do to make the public consider the excluded possibility that mere "regulation" of a flawed system doesn't make the system at root any less flawed.

Our talking heads who thoughtlessly call for "more regulation" as a panacea are attributing quasi-magical powers to people who in the real world tend to be unworthy of these exaggerations. As Robert Higgs puts it, "Had they been given even greater powers, budgets, and staffs, what enchantment would have transformed the regulators into smart, dogged champions of the public interest, rather than the time-serving drones and co-conspirators with the regulated firms that they have always been?"

The case of Bernie Madoff comes readily to mind. Madoff ran a scheme in which wealthy if gullible individual and institutional investors wound up losing $50 billion.

Madoff, his clients thought, was extraordinarily skilled at beating the market. In fact, all he was doing was taking later clients' money and using it to pay earlier clients, a scheme that required the addition of a greater and greater number of new clients over time – the definition of a Ponzi scheme.

The immediate and predictable response ran as follows: the Madoff fiasco shows what happens when you cut funding and personnel for the Securities and Exchange Commission (SEC), which (critics said) suffered under George W. Bush. Additional regulators and more funding would solve the problem.

Back on planet Earth, George W. Bush hadn't cut funding or personnel for anything at all – SEC funding increased at an 11.3 percent annualized rate, as compared to 6.8 percent under Bill Clinton, and its staff grew at 1.0 percent per year, as compared with negative 1.2 percent under Jimmy Carter. So we have to entertain another theory: perhaps for all its employees and wealth, the government had simply failed. The SEC had been warned about Madoff for at least ten years, and perhaps as many as sixteen. Madoff even boasted of his family ties at the SEC. Even though it had the largest budget and largest staff in its history, it still failed to act. By contrast, Harry Markopolos, one of Madoff's competitors, simply examined the options strategy Madoff told his clients he was using and concluded that his alleged results had to be fraudulent. (An alert competitor has a powerful incentive to be a good regulator.)

Well, it may have taken them at least a decade of warnings, but at least the SEC finally wised up and nabbed him, right? Actually, the SEC had nothing to do with it. Madoff's own sons turned him in after he came to them and explained what he had done. And he felt compelled to approach them with the real story in the first place only because his financial situation had begun to deteriorate so badly. Catching him had nothing to do with the SEC at all.

The very existence of the SEC lowers investors' natural alertness – e.g., if such-and-such investment outlet were in fact a criminal Ponzi scheme, people assume the SEC would have done something about it. A private certification agency that made an error of this magnitude would be finished, never to be heard from again. Would you, dear reader, continue to rely on it? Meanwhile, other institutions would quickly gain market share at the incompetent firm's expense. The SEC, on the other hand, is going to get more money.

As it turns out, spending and personnel have increased dramatically, not just on the SEC, but throughout the whole arena of financial regulation: the 12,190 people in Washington, D.C., alone who are charged with overseeing American financial markets would probably have something to say about the "unregulated" American financial system. Adjusted for inflation, spending on the regulatory agencies in charge has tripled since "deregulation" began in 1980. Boston University economist Laurence Kotlikoff came up with a tally of 115 regulatory agencies for financial services; are we supposed to believe things would improve with 116?

But the presence of more regulators doesn't need to translate into more genuine oversight. According to Nobel Laureate George Stigler's capture theory of regulation, firms in a regulated industry tend to "capture" the regulatory body, such that they and their concerns dominate the regulatory agenda, and that agenda becomes an instrument of the further aggrandizement, rather than the genuine supervision, of the industry. If Stigler is correct, then we have here another reason to consider it simplistic, even childish, to foist major tasks of economic stabilization onto regulatory bodies in the superstitious hope that this race of supermen will identify and act upon problems before anyone else perceives them, and always with an eye to the public interest. At a Federal Reserve conference in 2008, economist Willem Buiter spoke of "cognitive capture," a phenomenon in which regulators eventually become incapable of thinking about the relevant issues except in the way the regulated industry thinks about them.

And that is not to mention the revolving door that often exists between the regulatory agencies and the private sector. "SEC Lawyer One Day, Opponent the Next" ran a *Wall Street Journal* headline in 2010. Observing the traditional common-law treatment of fraud and bad dealing would be much more effective than still more layers of rules, which would have results no different from what they have always had. According to Gerald O'Driscoll, a former vice president of the Dallas Fed, "The idea that multiplying rules and statutes can protect consumers and investors is surely one of the great intellectual failures of the 20th century. Any static rule will be circumvented or manipulated to evade its application."

Regulators failed to identify the growing problems in the U.S. economy that culminated in the crash. To the contrary, we were told things were fine and that the economy was robust. For one thing, regulators made the mistake of relying heavily on the risk assessments of a small cartel of government-approved ratings agencies that were not subject to competition. Beyond that, they either grossly misread the condition of the housing market or they simply misled the public. Alan Greenspan said in 2005 that conditions in the housing market were actually "encouraging." Ben Bernanke, who became chairman of the Fed the following year, declared that "our examiners tell us that lending standards are generally sound and are not comparable to the standards that contributed to broad problems in the banking industry two decades ago. In particular, real estate appraisal practices have improved." Bernanke admitted that a "slower growth in house prices" may be possible, but then added that he would simply lower interest rates if that were to occur.

But suppose regulators had been able to perceive the problem. Would they know how to fix it, or even have the courage to try? "A regulatory crackdown on loose mortgage underwriting standards in 2004," writes economist Russ Roberts, "would have meant taking away a punch bowl filled with more home ownership – particularly among minorities – as well as expansion and profits in the businesses of home building, real estate brokerage, mortgage origination, and Wall Street financial engineering." Not too likely, in other words.

And to put it bluntly, how many business school or other graduate students aspire to become regulators? The brighter students go on to become successful businessmen and entrepreneurs, and the slower ones wind up in the regulatory agencies. We expect a kid who graduated number 505 out of a class of 508 not to get his clock cleaned by a kid who graduated number 12?

The Dodd-Frank Financial Regulations Act, the financial reform bill passed in 2010, proposes to solve the problem of financial instability, but perhaps financial instability might have been avoided in the present case had the federal government and the central bank not distorted the housing market in the first place. Not a word in the bill mentions the Fed's role in financial bubbles; bubbles, once again, are assumed to be spontaneous events that come from nowhere, and against which we need rafts of regulators to focus their watchful eyes. As I argued in *Meltdown*, in discussions of financial crises the Federal Reserve is the elephant in the living room everyone pretends not to notice.

No one quite knows what the bill's full impact will be. Its text contains over one hundred references to "The agency shall set," "The agency shall determine," and so on. It will be years before its full significance becomes clear. What we do know is that as of November 2010, financial lobbyists had met with regulators 510 times over the Dodd-Frank Act. The bill's 2,300 pages still leave enormous discretion in the hands of regulatory agencies, and the usual suspects are angling to get things to go their way. "Frank-Dodd has created huge powercenters at these agencies," writes economist Robert Wenzel. "And it is real expensive to get access. Try calling up [Federal Deposit Insurance Corporation chairwoman] Sheila Bair and see if you can get a meeting with her the way [J.P. Morgan's] Jamie Dimon did."

It is interesting to note, though, how the bill addresses admitted regulatory failures. According to Congressman Barney Frank, the Fed "has a terrible record of consumer protection." Consumer protection duties are therefore to be transferred to a new regulator. That'll show 'em! Except no Fed employee previously responsible for consumer protection is actually being fired. They're all being hired by the new regulator, as called for in Section 1064 of the bill: "All employees of the Board of Governors identified...shall be transferred to the Bureau for employment."

The bill abolishes the Office of Thrift Supervision, diverting its responsibilities to the Office of the Comptroller of the Currency. That'll show 'em! Except (need we even say it?) no one is actually being fired. Says Section 322:

"All employees of the Office of Thrift Supervision shall be transferred to the Office of the Comptroller of the Currency" or to the FDIC. (By the way, the Office of Thrift

Supervision was created as the alleged solution for the economy in the wake of the Savings and Loan collapse in the 1980s.)

What's more, the kind of prudential regulation that we are assured will prevent future crises wound up contributing to the present one. The capital requirements under which banks operated rewarded them for holding mortgage-backed securities by permitting them to hold fewer reserves against them (thereby freeing up more money for loans). For every one hundred dollars it held in standard loans, a bank needed ten dollars in capital. For every hundred dollars in mortgage loans, the amount was five dollars. But for every one hundred dollars of AAA-rated mortgage-backed securities they held, banks were required to have only two dollars in capital. This advantage naturally encouraged an artificial rush into this particular kind of asset.

On a free market, institutions are likely to hold a wide variety of assets. But when government regulation artificially fosters one kind of asset over another, as it did in this case, the favored asset will be more widely held than it would otherwise have been, and if it declines in value the economic effects will be that much more severe. "Regulations," say economists Jeffrey Friedman and Wladimir Kraus, "are like mandatory instructions for herd behavior, *automatically* increasing systemic risk."

To be sure, we encounter much hand-wringing about poor management at major financial institutions. What we do not hear so much about is that the current regulatory environment makes it essentially impossible for professional and institutional investors to do anything about it. Institutions like insurance companies, pension funds, mutual funds, and banks are not permitted to hold more than a very small stake in any particular company. Hedge funds and private equity investors are restricted by regulations that prevent them from acquiring a controlling interest in a bank holding company. But it is these kinds of institutional investors who have a direct stake in the firms in question that are best positioned to keep wayward management in line. Hoping that "regulators" will perceive such problems, when they have none of their own money at stake, and when (as in the present crisis) they have a track record of identifying problems as virtues, holds out much less promise.

Because of this government policy, stockholders of these institutions are artificially disorganized and scattered, and cannot discipline bank management properly. Management, meanwhile, enjoys an artificial protection that would not exist on the free market. When bank managers feather their nests under such a system, our commentators then react with surprise.

Investment bank "leverage" was too high, say critics. In other words, these institutions were looking to multiply their gains by using money borrowed at low interest rates to purchase long-term assets they expected to increase in value. These institutions may well have engaged in too much of this, but we should pause to consider why they might have done so. Why would equity ratios be so low in the financial industry, and so much higher everywhere else? (And it is a contagion: once one firm starts borrowing short-term funds to buy longer-term assets, other firms feel compelled to follow suit if they don't want to be left in the dust.) Could it be that the financial industry, unlike the shellfish industry or the publishing industry, has a giant sugar daddy in the form of the Federal Reserve standing in the wings to provide "liquidity" at critical moments, with the federal government, on "too big to fail" grounds, standing ready to assist them in case of an especially serious problem? When Alan Greenspan made sure the Long Term Capital Management hedge fund was bailed out in 1998, Wall Street firms naturally concluded that if a hedge fund wasn't allowed to fail, then surely no investment bank would be permitted to go under. Even the International Monetary Fund admitted, in an April 2008 report, that big financial institutions were taking excessive risks in the expectation that their central bank would bail them out. They have grown "more complacent about their liquidity risk management systems and 'underinsure[d]' against an adverse liquidity event, depending more heavily on central bank intervention for their liquidity problems."

The Fed's interference with short-term interest rates, moreover, and what has been politely called its "overly accommodative" monetary policy, has much to do with the leverage employed by financial intermediaries. New York Fed President William Dudley observed in 2009 that "there is a growing body of economics literature on this issue that links monetary policy to leverage."

It is the system itself, in other words, that is the problem. According to economist Guido Hülsmann:

> The banks must keep certain minimum amounts of equity and reserves, they must observe a great number of rules in granting credit, their executives must have certain qualifications, and so on. Yet these stipulations trim the branches without attacking the root. They seek to curb certain known excesses that spring from moral hazard, but they do not eradicate moral hazard itself. As we have seen, moral hazard is implied in the very existence of paper money. Because a paper-money producer can bail out virtually anybody, the citizens become reckless in their speculations; they count on him to bail them out, especially when many other people do the same thing. To fight such behavior effectively, one must abolish paper money. Regulations merely drive the reckless behavior into new channels.
>
> One might advocate the pragmatic stance of fighting moral hazard on an ad hoc basis wherever it shows up. Thus one would regulate one industry after another, until the entire economy is caught up in a web of micro-regulations. This would of course provide some sort of order, but it would be the order of a cemetery. Nobody could make any (potentially reckless!) investment decisions anymore. Everything would have to follow rules set up by the legislature. In short, the

only way to fight moral hazard without destroying its source, fiat inflation, is to subject the economy to a Soviet-style central plan.

If we want to understand the source of banking instability, we might start there, instead of fooling ourselves into believing that another round of regulations, which as surely as night follows day will be gamed by the major players, will keep things stable.

One of the reasons deregulation is viewed with so much skepticism and even hostility is that disasters of various kinds have been falsely, even laughably, blamed on deregulation. For Americans over a certain age, deregulation recalls the presidency of Ronald Reagan, and in particular the sad story of the Savings and Loan institutions (S&Ls), in which 747 of those institutions failed at a cost of over $160 billion, most of which was paid by means of a federal government bailout. In the days before Reagan and his crazy deregulation spree, the story runs, everything worked fine. Then Reagan was elected, and he repealed all the laws. Society reverted to barbarism. Wolves ran free in the streets.

What actually happened was rather less cartoonish. First, so-called deregulation of the S&Ls began under Jimmy Carter, not Reagan. I say "so-called" because, as with most measures trumpeted as "deregulation," it was not really deregulation: all throughout the process of alleged deregulation, the S&Ls' deposits continued to be covered under government deposit insurance. Deregulation means the removal of government involvement and control. Does this sound like the removal of government involvement and control? To the contrary, it gave us the worst of both worlds – now the government-guaranteed institution was permitted to take greater risks while taxpayers remained on the hook for any losses. Not exactly the free market at work.

Under the government-established rules, the S&Ls could charge 6 percent on 30-year mortgage loans, and could offer depositors 3 percent. Since most depositors had nowhere else to go, they had to content themselves with a mere 3 percent return. But with the advent of the money-market mutual fund, ordinary people suddenly had the chance to earn higher returns than S&Ls could pay, and began pulling their money out of S&Ls in droves. Consequently, the S&Ls wanted permission to offer higher interest returns for depositors, so "deregulation" allowed them to do so. Had the original government requirements remained in place, the S&Ls would have gone under then and there.

A consensus began to form that in order to save the S&Ls, their government-established loan and deposit interest-rate requirements, as well as the kind of loans they could make, had to be modified in light of the impossible conditions under which these institutions were then being forced to operate. The S&Ls needed to be permitted to engage in riskier investments than 30-year mortgages at 6 percent. (Notice: it's the free market's fault when the government modifies the government-established rules of a government-established institution, while deposits continue to be guaranteed by the government. Got it?)

Maybe the S&Ls *should* have gone under in 1980. Perhaps they really did have an impossible business model. There is no non-arbitrary basis for deciding one way or the other, since the S&Ls were never genuinely subject to a market test. The government husbanded and cartelized the S&Ls, and stood ready to bail them out after that. Yet the string of failures continues to be blamed on "deregulation" and the market.

More recently, in the financial crisis that first gripped the world in 2007 and 2008, we have seen yet another crisis falsely blamed on the market. We have already discussed the American case, but Iceland, which was particularly hard hit, is supposed to be the classic case of the free market run amok. Before it was over, the country's stock market had fallen 90 percent, all major banks had gone under, and a severe recession and a shortage of consumer goods bore down on the public.

What remedy did our media class propose for Iceland? More regulation – what else?

Without having to know the first thing about that country, readers will already have surmised what a closer look at "free-market" Iceland will turn up: government interventions, guarantees, and moral hazard all over the place, particularly in money and banking. And that is exactly what we find.

Iceland, like the United States, experienced a gigantic housing bubble in the years leading up to the crash. And like the United States, the sources of that bubble were government and the central bank. Iceland's Housing Financing Fund, whose debt enjoyed an explicit government guarantee (in contrast to the only implicit guarantees enjoyed in the United States by Fannie Mae and Freddie Mac), artificially stimulated home purchases. Its low-interest loans were available to anyone without discrimination, and not just to those who fell below a certain income level. It was against this government-subsidized system that the "private" banks of Iceland had to compete. The predictable result was a race to the bottom in loan quality.

Add to this a very loose monetary policy: the Bank of Iceland, a creature of the Icelandic government rather than the free market, increased the money supply (M1) by between 20 and 30 percent per year from 2002 to 2007. This monetary expansion added fuel to the housing bubble, and gave rise to the structural distortions that Austrian business cycle theory describes. Unsustainable expansions in the aluminum, construction, and financial services industries were only the most obvious of these.

The Bank of Iceland also offered Icelandic banks an explicit guarantee that it stood ready to roll over their short-term debt if a liquidity crisis should arise. With that guarantee in their pockets, banks engaged in what would ordinarily be the risky practice of maturity mismatching, borrowing short term (and consistently rolling over, or renewing, those loans) in order to invest in long-term assets, pocketing the difference in interest rates between the two. Risk was practically removed by the Central Bank of Iceland, and thus the practice grew to levels it would never have reached on a free market.

When liquidity began to dry up in 2008, the Icelandic banks were stuck – and the Bank of Iceland, promise or no, could not help them. It could create additional supplies of the króna, the domestic currency, but it couldn't create yen and other currencies to help the banks pay off their foreign liabilities. And the banks had been piling up liabilities in other currencies, particularly the Japanese yen. Loans denominated in yen must be paid back in yen. The credit-induced mania ended in disaster, which – in spite of the fingerprints of the government and the central bank all over it – was promptly blamed on the free market.

The way the political and media establishments have addressed the claim that the housing bubble and resulting financial crisis might have been caused by something other than "unregulated capitalism" has been by pretending such a point of view does not exist. The academic world has been even worse. In 2009, Harvard University sponsored a conference called "The Free Market Mindset: History, Psychology, and Consequences." Its purpose was to try to figure out why, since everyone knows the financial crisis amounted to a failure of the market economy, the stupid rubes continue to believe in it. The promotional literature for the conference opened with Alan Greenspan's testimony before Congress in 2009, when he claimed in the face of all the arguments we have raised here that there was a "flaw" in the free market he hadn't noticed before.

Well, that does it, then. If our Soviet commissar in charge of money and interest rates says the free market doesn't work, who are you to disagree?

The promotional material continued: "If the current state of the U.S. economy makes clear that former Federal Reserve Chairman Alan Greenspan's faith in free markets was misplaced, the question remains: what was it about free markets that proved – and still continues to prove – so alluring to economists, scholars, and policy-makers alike?" Because if there's one guiding principle behind the largest government in history, it's *free markets*.

This conference, we were told, would bring together "leading scholars in law, economics, social psychology, and social cognition to present and discuss their research regarding the historical origins, psychological antecedents, and policy consequences of the free market mindset." So instead of trying to understand the free-market position itself, they prefer instead to study the twisted brains of those who advance it.

In short, the conference was about this: *Why do people still think the interaction of free individuals is a superior economic system to one directed by Harvard Ph.D.s? Why do people cling to the idea that being herded into a collective run by the experts isn't the best way to live? Why won't the proles just shut up and go along with what their betters tell them?*

So by assuming from the outset the very thing that needs to be proven—namely, that the current state of the economy just occurred spontaneously, as the result of wicked market forces—our betters relieve themselves of the need to consider their opponents' case. Their opponents do not have a case. They are deranged.

I wonder if anyone at the conference asked questions like this:

(1) When Alan Greenspan flooded the economy with newly created money and brought interest rates down to destructively low levels, thereby distorting entrepreneurial calculation as well as consumers' home purchasing decisions, was that the fault of the free market? Do you think the Fed's creation of cheap credit out of thin air makes market participants more careful or less careful in how they allocate borrowed funds?

(2) When Long Term Capital Management was bailed out in 1998, and Alan Greenspan made clear that the Fed's assistance would be forthcoming were he unable to lean on his friends in the financial industry, was that a "free market" phenomenon? Do you think the Fed thereby encouraged more or less risk-taking among other major market actors?

(3) *The Financial Times* spoke in 2000, in the wake of the dot-com boom, of an increasing concern that the so-called "Greenspan put" was injecting into the economy "a destructive tendency toward excessively risky investment supported by hopes that the Fed will help if things go bad." "All the insane dot-com investment we've seen, all this destruction of capital, all the crazy excesses of the past few years wouldn't have happened without the easy credit accommodated by the Fed," added financial consultant Michael Belkin. Did the free market cause that? Do lending standards decline for no particular reason, or could this phenomenon have a teensy bit to do with (a) government regulation aimed at increasing "homeownership" and (b) loose monetary policy by the Fed?

Questions like these could go on and on. Not one, you can be certain, was raised that day at Harvard.

Now if you really wanted to sponsor an event whose purpose was to try to understand why people continue to believe things that have been falsified by reality, you'd do much better to hold a conference on socialism, or on economist John Maynard Keynes and his school. It would be fascinating to learn the psychological motivation behind the persistence of Keynesian economics, whose popular version is a non-falsifiable, ersatz religion. Is Japan's economy still suffering? Why, that's because Japan didn't spend enough – even though it spent so much that it became the most indebted country in the developed world.

Have people spent so much that they're now burdened with debt they can't possibly repay? Then we need more spending. (But don't worry – p we'll repay it when the economy turns around, just as we always have in the past!)

Is the economy a distorted mess after an artificial boom? Then instead of letting the economy restructure itself along sustainable lines, let's instead "stimulate" the system just as it is, with the goal of bringing about more "consumption," more "labor" employed, and higher "income," without bothering to disaggregate any of these things and deciding what kinds of labor need to go where, what kinds of consumption are sustainable and what are figments of the bubble economy, or how the capital structure needs to be reassembled in order to cater to genuine consumer demand.

People who believe in the market economy support a social order in which free individuals make voluntary contracts with each other, and no one can initiate physical force against anyone else. Is that vision so obviously unattractive that we have to refer its supporters for psychological evaluation? We might instead wonder about the psychological condition of those who would denounce such a system: might they be motivated, for all their noble talk, by nothing but base envy of those with more material wealth than they, or by a pathological desire to dominate other people? Maybe that will be covered at next year's conference.

Notes

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3. Bill Woolsey, "The Crisis and Glass Steagall," October 2, 2009, available at http://monetaryfreedom-billwoolsey.blogspot.com/2009/10/crisis-and-glass-steagall.html

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Chapter 2

The Role of Government Housing Policy in the Financial Crisis

This chapter, featuring Peter J. Wallison of the American Enterprise Institute, is drawn from episode 561 of the Tom Woods Show (December 24, 2015).

WOODS: Let's start off with a couple of explanations that we've heard for the financial crisis and housing bust that are just not true, but which have seeped into the consciousness of the public to the point where it's hard to dislodge them.

The key one is that people were being sold mortgage packages that they just didn't understand. They were being scammed by bankers who were tricking them into mortgages that they couldn't afford. The poor public was put upon by these predatory lenders, and of course it all came to this bad result. What's wrong with that explanation?

WALLISON: Well, of course that happened in some cases, probably a limited number of cases. I was on the Financial Crisis Inquiry Commission, and one of the things I asked is that, well you know, there's been a lot of talk about predatory lending causing this problem; let's have some numbers on this. Why don't you find out how much of these loans were predatory? And of course, they couldn't find out.

The answer really is that there was much more predatory borrowing going on than predatory lending. More people were taking out loans that they knew they couldn't afford, because they were so cheap. These mortgages were being offered so inexpensively to people that they took them out even though when the mortgages reset so they were going to become more expensive, they couldn't pay them. They hoped that by the time the mortgages reset, they would be able to pay them, but by that time there was a financial crisis, mortgages had fallen in value, homes had fallen in value, they couldn't refinance the mortgages, and they defaulted. So I think the real answer is that there was much more predatory borrowing going on than predatory lending in the financial crisis.

WOODS: That's an interesting way to put it. Now, I also want to ask about, from the investor side, we hear that investors were dealing with these opaque financial instrument. And this just goes to show that the market economy yields you crazy investment decisions on the basis of financial packages and instruments that people don't know anything about, that are very complicated, and that can easily blow up. Is there anything to that?

WALLISON: No, actually. That's completely false. The reason we know that is that Fannie Mae and Freddie Mac bought the same kinds of instruments. Fannie Mae and Freddie Mac, of course, are the two major government-backed housing companies, mortgage companies, and they were very large financial institutions and had been doing this for years and years, buying mortgages from the private sector — that was their business. They bought the same mortgage-backed securities, they suffered the same losses, but they knew when they bought those securities exactly the mortgages that were in those securities. They were able to see the quality or lack of quality of those mortgages, and they bought them anyway. And one of the reasons they did so is that housing prices were going up. In part, they probably thought those were good investments. But they also had to buy them because they were required by the government to meet a quota of affordable housing loans that had been imposed on them in 1992 and got tighter and tighter until the mid to late 2000 years.

WOODS: Critics of yours might say that it's true that Fannie and Freddie had to comply with these affordable housing requirements and that they may have played some role, but they'll say people like you have wildly exaggerated that role, and they'll say there were totally private lenders who were not under nearly so much pressure to engage in affordable housing practices and yet they made these crazy housing loans as well.

Now, one thing that you can come back with is: the Community Reinvestment Act existed, and your application for a merger with another bank will be evaluated according to how well you live up to the affordable housing standards. But that doesn't seem like an overwhelming amount of pressure to make these loans, so how would you answer that? Like Countrywide, for example. What kind of pressures were on them for them to be so heavily involved in these mortgages?

WALLISON: Well, the reason Countrywide was doing it is the reason a lot of other banks were doing this: they had a ready customer in Fannie Mae and Freddie Mac. By 2008, more than half of all mortgages in the United States were subprime or otherwise risky mortgages. Of those — that was actually 31 million mortgages — 76 percent were on the books of government agencies, principally Fannie Mae and Freddie Mac. So Countrywide would make these mortgages because they knew they could sell them to Fannie and Freddie. And in fact Countrywide for eight years was either the top or the second-largest seller to Fannie Mae and Freddie Mac. The government was creating the demand for these mortgages. So banks and others were making the mortgages because they knew that Fannie and Freddie would buy them.

Now, there's another factor here, too, and that is that because Fannie and Freddie reduced their underwriting standards in order to take these poor quality mortgages to comply with the affordable housing goals, that built an enormous bubble, a housing bubble, between 1997 and 2007. Housing prices went up an unprecedented amount, about 10 percent a year for several of those years. As housing prices went up, many private lenders thought this was a good investment. We could make money if we made these mortgages, even if we made these mortgages to people who were not quality borrowers, because by the next year the house would be worth 10 percent more, and so our risk would be substantially reduced on some of these loans.

But the reason there was this bubble was that Fannie and Freddie had reduced underwriting standards. They had formerly only made prime loans — up until the affordable housing goals were imposed on them. They'd only made prime loans. But after the affordable housing goals were imposed on them, they started to reduce their underwriting standards.

And you can see how you could get a bubble from that. Let's assume that you had $10,000 in order to buy a house as a down payment. If the down payment is 10%, then you can buy a $100,000 house. But if Fannie and Freddie said they will now accept 5% as a down payment, you could then by a $200,000 house. Under those circumstances, of course, there was much more money chasing many houses, and that caused this gigantic bubble over time. So the bubble fooled the private sector to some extent — that's why many of them bought those mortgages — but the engine of this whole system was the government, particularly Fannie Mae and Freddie Mac, buying these mortgages in order to comply with the affordable housing goals.

WOODS: It's funny that in the years that followed, the government and its apologists just tried to claim that of course *it had nothing to do with us*, there's no way we could have caused something like this. But at the time and leading up to it, they were all too happy to take the credit for the increase in home ownership. And they said *it's because of our policies.*

And in fact, Andrew Cuomo, after there was some famous discrimination case that had been settled against a bank, said: now it's true that in the future to meet our affordable housing and our fair housing standards, there will be more nonperforming mortgages in these portfolios, but that's just the way it is. So he came right out and admitted it. Alan Greenspan years later, of course, admitted that, yes, of course there were going to be more risky mortgages made, but we felt like that was a good tradeoff to have in exchange for a higher homeownership rate.

So these people admitted it at the time, and then when the collapse came, they all pretend to scratch their heads like they had no idea what went on.

WALLISON: Yeah, isn't that amazing? Actually, the only person involved in this whole process who ever said anything in the way of an apology for having these policies was George W. Bush, who in his autobiography said he was very happy to see the increase in homeownership that was going on. What I didn't realize is all of the risks that we were creating for the economy. That's the correct story in a sentence.

WOODS: Well, I have to say I'm not a big George W. Bush fan, but that's about the most significant admission of ignorance or wrongdoing that I've pretty much ever heard from any president. Normally you circle the wagons and you defend yourself and that's it –

WALLISON: That's right. You won't hear any such confession from anyone else who was lower down in the government who was actually making these decisions. They have never apologized for what they did, or admitted – God knows the Left has been taking the position that any statement about the affordable housing goals is completely wrong. But in fact, that is the answer. The affordable housing goals forced on Fannie Mae and Freddie Mac in 1992 and continued until 2008 created the financial crisis. That's what the book is about.

WOODS: But isn't the whole point of these affordable housing requirements to make banks extend loans that they wouldn't have made otherwise? *Why wouldn't they have made them otherwise? Because they're bad loans.* It seems to me the logic of the thing is so obvious. That's precisely why they want these regulations: to make the banks do things they don't want to do. Why don't they want to do them? Because they're stupid decisions!

WALLISON: (laughing) Exactly. Well, the book contains a lot of the history of all of this. I don't want to make this into a partisan matter, because this occurred under both Democratic and Republican administrations. But in 1992, the Democrats were in charge of Congress, and the community activists were going to them and saying: homeownership in the United States has not increased for 30 years. It's still around 64 percent. And the reason is that these two big government-backed institutions, Fannie Mae and Freddie Mac, are imposing too-difficult underwriting standards. They are requiring prime loans, and a lot of low-income people cannot buy homes because of that.

That is what stimulated the adoption in 1992 of these affordable housing goals. It was to extend credit to people who didn't have good credit, because they were low-income and they couldn't afford mortgages, they couldn't afford down payments on mortgages, and by and large they didn't have good credit records. That is why the affordable housing goals were imposed on Fannie Mae and Freddie Mac. That was the major mistake.

If you wanted to help low-income people, you should have done it in a different way, perhaps some kind of government subsidy directly to those people, where the government would take the losses. But instead, what happened is they created this tremendous system in which banks and others were selling these terrible mortgages to Fannie and Freddie, who were delighted to get them in order to meet the affordable housing goals. And the machine that was created resulted in the financial crisis.

WOODS: How do you respond to the common argument that you are blaming this tremendous financial crisis on poor, vulnerable minorities, when the fact is that it was rich white guys in investment banks spinning out crazy investment products who were to blame, and they're laughing all the way to the bank?

WALLISON: The answer to that is that the government created the demand for those loans by insisting that Fannie and Freddie buy them. Now, the whole purpose of that was to enable more loans to be made to people of low income who were otherwise not able to buy homes. And so the answer is that actually worked: more people who were of low income were able to buy homes because of this system.

But the trouble is that because they were able to buy these homes, they created a huge bubble as a result of all of the money that was being poured into the homeownership system, and when that happened, we got this gigantic bubble. Many more mortgages were made that shouldn't have been made as a result of the view that it was not risky to make these very terrible mortgages, because home prices were going up, and the result of all of that, unfortunately, was a collapse in 2008 and the financial crisis.

WOODS: You write in the book about the Financial Crisis Inquiry Commission. Can you tell us what that was and what your role in it was, and what the result was?

WALLISON: I was a member of the Financial Crisis Inquiry Commission. Right after the financial crisis occurred, Congress voted to set up a commission to tell the American people and the president and Congress, of course, why we had a financial crisis. And the commission operated for about a year and a half in order to investigate the financial crisis and report on it.

Unfortunately, the way it was set up, there were six Democrats and four Republicans on the commission — I was one of the Republicans — and the Democrats were dead set on demonstrating that this was the fault of the private sector, that the government wasn't involved at all. They wouldn't accept any arguments about the role of Fannie Mae and Freddie Mac or the role of the affordable housing goals, and produced a report that I think was simply a basis for providing the new excessive regulation that came out from Congress in the form of the Dodd-Frank Act in 2010. So this, unfortunately, was a system that was set up for the purpose – inevitably – of demonstrating that it was the private sector that had created the problem and leaving the government untouched and uncriticized for its role in this whole process.

WOODS: What's wrong with Dodd-Frank, in your view?

WALLISON: Well, I think Dodd-Frank is what is responsible for the very, very slow recovery we have had from the financial crisis.

WOODS: Wow, that's a strong claim.

WALLISON: Oh, there's absolutely no question on that. This recovery is the slowest we have ever had compared to all other recoveries from recessions in the past or financial crises in the past. And the only thing that is different about this situation from what occurred in the past is simply enactment of the Dodd-Frank Act, which has suppressed the financial system to such an extent that it has been very difficult for small business in particular to borrow money. And without small business, we don't have the engine that usually gets our economy going.

WOODS: I knew it played some role. But what exactly is the big deal about it? There have been a lot of regulations imposed on small business over the years, and one way or another they surmount them.

WALLISON: Yeah, it's true, but this is really extraordinary. The Dodd-Frank Act is by far the most substantial regulatory law placed on the financial system since the New Deal, and it is much tougher than almost anything that was adopted in the New Deal. It has frozen our financial system in place, so that large banks as well as small banks are not able to operate as inexpensively as they did in the past. The regulations that had been imposed on them are very expensive, and in particular, for small banks – they now have to hire a lot of staff (lawyers and compliance officials and so forth) that they didn't have to hire before in order to operate under these new regulations. And when you do that, you have less money available to make loans to small business, and particularly the startup businesses that really get the economy moving.

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Chapter 3

Did Crazy Financial Instruments Bring Down the Economy?

This chapter, featuring Edward Stringham, President of the American Institute for Economic Research, Davis Professor of Economic Organizations and Innovation at Trinity College, and editor of the Journal of Private Enterprise, *is drawn from episode 783 of the Tom Woods Show (November 15, 2016).*

WOODS: Let's start off by having you describe the mainstream explanation of the events of 2008, or in particular, the explanation of how certain financial instruments performed, and so on.

STRINGHAM: The standard view is that Wall Street created the economic crisis, specifically advanced derivatives and advanced securities, such as credit default swaps, mortgage-backed securities, collateralized debt obligations. So a lot of people look at the market, they look at Wall Street, and they say: financial innovation occurred. Then they look at problems that manifested in society, and they say, see? Wall Street created it. The market created it. So there's a lot of finger- pointing done by politicians at the private sector, to at financial intermediation, and to lay the blame on them rather than – and we'll get to this in a second – looking at themselves in the mirror and saying, did government have anything to do with this at all?

WOODS: You mentioned collateralized debt obligations and mortgage-backed securities. I bet some people know what mortgage-backed securities are, but I also bet a lot of people the subject the way I treated the conflict in Bosnia in the mid-1990s.

STRINGHAM: (laughing)

WOODS: I was in graduate school. I had no idea what was going on. I figured someday I'd get around to figuring it all out. I'll bet a lot of people feel that way about these things. Can you explain what they are?

STRINGHAM: Sure. Even a lot of free-market people, well, they haven't studied it, and some of them say, something fishy must be going on; there must be some conspiracy with government behind these instruments. I actually disagree with that narrative, which is advanced by more like the Occupy Wall Street types, where these things are fake; they're some type of scam. I think they're legitimate financial innovations, and I'll talk about each of them.

Mortgage-backed security is the simplest to think about. It's similar to a mutual fund, where a mutual fund takes 100 companies, puts it together, and says you can buy this security, which is not going to have one stock in it, but it's going to have 100 stocks in it. A mortgage-backed security will take 100 loans and put them together and then sell them to an investor, who then says, okay, you know what? If one of these loans defaults or five of them default, I still have 99 left, or I still have 95 left. So it's basically a way of allowing people to extend credit to 100 people who want to take out a mortgage without requiring people to put all of their eggs in one basket.

So this is simply a way of diversifying risk. And we can talk about this in a few minutes. Just because people invest in a company or invest in a mutual fund, it's not a guaranteed success. And same thing with investments in mortgage-backed securities. If the loans that people are making are bad loans, then it's not a guarantee of success. But in and of itself, the mortgage-backed security is an amazing innovation. It expands the amount of loans available. It diversifies risk among many people. So that's the first one, that's fairly straightforward, and which I think is great.

The next one we can talk about is credit default swaps, and this one is also talked about very negatively in the press. A lot of people call it the bet that blew up Wall Street. Warren Buffett and other people refer to them as weapons of mass destruction. And I think they're actually unfairly maligned. I think they are a brilliant market innovation.

They're not technically insurance, but let's just think about these things as insurance. Suppose I own a mortgage – that I've lent some money to someone – but I'm worried that this person might default. Or suppose I've lent money to a corporation in the terms of a bond or any other loan, and I'm worried that that corporation might default. Well, I have to assume the counterparty default risk for this loan that I've given out. One way I can mitigate that risk is by going to a third party, someone who's selling insurance, someone who's selling credit default swaps, who says, you know what? If this party defaults, do you think you could insure this loan? That's a further step of mitigating risk. As you take out this insurance policy, you are mitigating the risk of default.

Now you still have to assume that your insurance company, or in this case the rider of the credit default swap, is going to pay. What if you have a policy and the insurance company says it doesn't have any money? People would actually take out insurance against the insurance company. So that is adding another level of protection.

And so in this market you had various levels of protection. In many cases people would require these riders of insurance, the riders of the credit default swap, to put collateral aside to say: in the event of default we will pay back, and we've even put this money in an entity which is already there, so you are assured that you're going to get payment. I think all of this is amazing. It's just like the insurance market.

Now, the mere existence of insurance doesn't eliminate disease. It doesn't mean storms or floods or any other thing are going to be eliminated. And what happened in the market was that a lot of the underlying securities turned out worse than people had predicted. Some of these mortgages turned out to be less safe than people thought, and in these cases people actually had to go to the sellers of the credit default swaps to say, would you pay me? But that's not a failure of the insurance market. It's just an existence of underlying problems in the economy.

I'm going to mention a huge set of credit default swaps, which functioned in an amazing way. Fannie Mae and Freddie Mac were nationalized, and the contracts for these credit default swaps said that that would count as a credit event. So anytime somebody owns bonds by Fannie Mae or Freddie Mac, they're then entitled to this insurance. Well, it turns out there's trillions of dollars of these contracts with this reference. And people said, what are we going to do? How are we going to have these huge payouts?

It turns out that there's a private association called ISDA, the International Swaps and Derivatives Association, and they basically figure out the value of the loans and default. They then figure out how much you're owed, so if your bond is supposed to be worth 100 cents, it's worth only 80 cents, well, now you're owed 20 cents. So they had this netting process and this huge amount of payment, and it all worked quite smoothly. So a lot of these things that people say – oh, it didn't work; it blew up – I actually argue that it made problems a lot less bad than they otherwise would have been.

WOODS: Well, I think you're right about the mortgage-backed security thing. The problem doesn't seem to have been with the instruments themselves so much as it was with the ratings. If people are told that they're AAA-rated, then they're going to have a certain assessment of the risk involved. But there was such a systemic overestimation of the value of these things that it seems hard to exonerate the private sector of major, major oversight or miscalculation. So how do you answer that?

STRINGHAM: I'm actually even going to slightly disagree with you here, Tom, so –

WOODS: Oh, please do.

STRINGHAM: I do agree that investors misestimated future profitability of certain instruments. Part of any market, including government-controlled markets or even centrally planned – is we don't know the future with certainty. So that's just a fact of the world under any imaginable circumstance. When you go back in the olden days and you had small credit union-style loans for mortgages, even then the people could predict the future with 100 percent accuracy. So sometimes they'll say, oh, well, John Smith looked like a good risk at the time, but I didn't realize he was going to lose his job. Or it turns out that a lot of the farms in the town go belly-up, and people can misestimate risk. So that's just a fact of the world.

In terms of the rating agencies, these rating agencies didn't do a perfect job. So they would say, okay, this one's AAA, and that one's fairly likely to pay back; this one is rated lower, and that's less likely to pay back. And it turns out they were a little too optimistic. However, I'm going to say that they were not widely off track. If you look at the loans that were more likely to be in default, it was the subprime-rated loans, the subprime-rated mortgage-backed securities, collateralized debt obligations, which we can chat about in a little bit if you want. But the ones where you had AAA-rated mortgages, there were not that many defaults in terms of the economy. They were much more reliable than the subprime ones.

People who invested in subprime loans knew what they were getting into. They knew that these were high-risk loans. That's why they had higher interest rates. But if you look at the interest rates for AAA-rated mortgages, they're actually pretty good. In any given quarter, bank foreclosure starts for prime fixed-rate mortgage comprised only 1% of loans. If you look at prime adjustable-rate mortgages, which are more risky, those are 2% of loans. And then once you start going to subprime mortgages, it goes up to 3%. And then when you get to subprime adjustable, it's much higher. So the mortgages that were rated to be more safe actually were more safe. So it's not perfect, but just because things turn out a little bit less good than expected, that doesn't mean the market has failed.

WOODS: Let me just read you one sentence here. This is from an article from 2008. "The over-the-counter credit default swaps market has drawn the world's major financial institutions and others into a tangled web of interconnections, where the failure of any one institution might jeopardize the entire financial system." This is what we heard throughout the period of the financial crisis, that we have institutions that are too big to fail or that there could be systemic risk, there could be a kind of poison, where one failure leads to another failure, which leads to another failure. And they point to credit default swaps as being at the heart of this looming risk over the whole system. What's the logic of that, and do you think there's anything to that case at all?

STRINGHAM: At one point in the movie *The Big Short* they have this, I forget what the game is, one of these tower puzzles, and if you take the things out from the bottom, every other piece collapses above it. And that's how they portrayed these things. And it's certainly possible that you could arrange a financial instrument that way. But it turns out they design them in probably exactly the opposite way.

If we can talk about collateralized debt obligations, these are basically combinations of these other instruments we're talking about, like mortgage-backed securities, and they would prioritize the income streams. So there would be one group, the AAA-rated tranche – or slice, we might call it – which was basically guaranteed payment first, and then below that there was someone else's guaranteed payment second, and then at the bottom was – actually, we should say at the top – are the people who are called the first-loss tranche. And so the people who assume the most risk, the people say if there's any problems, we agree to assume the losses first. And it's only at the very, very end do the safest tranches assume those losses. So that's actually quite the opposite of the description you're talking about. I know the quotation is about credit default swaps, and I'll get to that in a second, but a lot of these things were designed in such a way to actually mitigate these problems.

To get to the example of credit default swaps, the prudent firms – and I think Goldman Sachs, there are a lot of good reasons to criticize them for certain things they do with government, but I will praise them for the good things they did here. They were very prudent in terms of buying credit default swaps from many firms, including AIG, which historically was just a traditional insurance company that started selling these credit default swaps, the equivalent of insurance. And they not only bought some from AIG, but they made sure that they didn't put all of their eggs in one basket. So they bought credit default swaps from multiple companies, so they didn't have too much exposure to AIG or any one other firm. They also required a huge amount of collateral. I think, say, of the $10 billion in credit default swaps they had insured by AIG, they required AIG to put aside $7.5 billion in collateral. So even if AIG had gone bankrupt, which it didn't, firms like Goldman Sachs would have been in an okay situation. They also had bought insurance, the equivalent of insurance, against AIG in case AIG fell.

So the idea that firms' fates are interconnected, there's some truth to that. I totally get that and agree with that. But proper financial risk management means not putting too many of your eggs in one basket. If you are worried that AIG is not going to be able to repay your insurance, you can require collateral. In many cases, firms waived the collateral requirements. They said, oh, you know, AIG, you're good for it; you've got an AAA rating; don't worry about it. But those were risks that people were willing to assume. So I totally reject this whole notion that it's like a house of cards; you pull out the bottom card and then everything collapses.

WOODS: Let me read you a passage from Peter Wallison over at AEI – he's really pretty good on this stuff – just to get your comment. He writes:

"Even Lehman's credit default swap obligations, and the credit default swaps written specifically on Lehman by others, did not cause any substantial disruption in the CDS market when Lehman collapsed. Within a month after the bankruptcy, all of the CDSs specifically written on Lehman were settled through the exchange of approximately $6 billion among hundreds of counterparties, and while Lehman had over nine hundred thousand derivatives contracts outstanding at the time it filed for bankruptcy, these did not give rise to any known insolvency among those of its counter-parties that were protected by a Lehman CDS. In cases where Lehman's derivatives counterparties suffered losses, the counterparties filed appropriate claims in the Lehman bankruptcy proceeding, which are being adjudicated in the ordinary course. In other words, Lehman – a larger firm than Bear Stearns, which was bailed out, and one that had more 'interconnections,' had no significant effect in dragging down its counterparties. If Lehman's interconnections did not drag down its counterparties, Bear's certainly would not have done so."

I assume you agree with that passage?

STRINGHAM: Oh, it's brilliant. I mean, it's really amazing if you think about the levels of complexity of these things, and you mentioned hundreds of counterparties, so many people involved, how are you going to net these things. And in the olden days, we hear these stories of like, okay, there's going to be a run on the bank, and the first people are going to get these things first, and then that's going to cause everybody to go in. And I'm sure there were examples of this not working out for many people.

But in this market, if they can wind these things down in such an orderly fashion, when you have a group like ISDA overseeing the process to make sure that it's orderly, to say, okay, we're going to figure out who owes what, and we're going to net these things, and then once we figure out the value of who knows what, then we can ask people who are involved with the system to start doing payouts.

So within this market, you can make a contract over an exchange; that's one option. Basically you're dealing with a clearinghouse, like the Chicago Mercantile Exchange. And in those cases, exchanges are very good at managing counterparty default risk, making sure people get paid what they're owed. But miraculously, even with contracts which are made not over an exchange, which are called over-the-counter contracts, so just bilaterally between two people, even though you've got this very complicated network of those things, the fact that those things worked nearly as well as they did in this Lehman example, I think we should all be jumping up and down and celebrating Wall Street and having a parade for Wall Street.

WOODS: Well, that's not a very popular position to take, Ed Stringham.

STRINGHAM: (laughing)

WOODS: Just thought I'd let you know that. Well, what about –

STRINGHAM: I'm the official anti-spokesman for the – I'm the anti-Occupy Wall Street movement.

WOODS: In the wake of the crisis, the usual sort of people were scrambling around, trying to figure out how to regulate the system better, so as to prevent this type of crisis in the future. And it's your contention that – and I know this is a shock to a lot of people listening – regulation sometimes can do more harm than good.

STRINGHAM: Dodd-Frank right now, the stuff associated with it, it's not even completely finished being written. You've created tons of small regulator sub-bodies that have to fill in the details. But at present, it's 25 times longer than *War and Peace* – and I just finished *War and Peace*, and it was the best. But imagine 25 of those, not written by Tolstoy, but written by random, unelected bureaucrats. And imagine the number of constraints that's going to put on the banking industry. And so it turns out that regulations are extremely onerous. They're extremely costly. They are basically trying to micromanage the way that financial firms interact with each other. It's adding a tremendous amount of cost to the system.

And unfortunately, I was predicting this was going to happen a long time ago. Actually even when they did the Sarbanes-Oxley Act, people said: Enron, Enron. All we need to do is have this huge set of regulations called Sarbanes-Oxley, and that will solve all our problems moving forward. And I predicted, which is not a very hard prediction to make, that no matter how many regulations they add in Sarbanes-Oxley, it's not going to predict the next set of problems. And it turns out we have our next set of problems. And they said, ah! The problem was we didn't have enough regulation. All we need to do is have more next time. And I can predict now, this is what I'm 100 percent sure on, there are going to be some problems in the future, whether it's government-created or just a natural market change in prices, and people will say, see? It's because we didn't have any regulation. We just need to have Dodd-Frank times 25.

The more regulations you add to the economy, the less able banks are able to actually make choices based on assessment of risk, and letting different banks assess risk in the way is most proper. Instead you've got government mandating that banks assume risk in certain ways, value risk in certain ways, which, if anything, is going to increase systemic risk in the system when all banks are having to follow a certain set of government rules and regulations. And I think we could see this coming, unfortunately, where you've got politicians saying: we are going to rein in Wall Street. Well, when you have a bunch of bad news coming – the bad news which I'm calling future Dodd-Frank – that itself is actually going to depress stock markets. That's going to depress financial markets. When these people realize they're going to be hammered by a future set of bad regulations, that will be priced into current financial market prices.

So I actually think the economic downturn was caused by multiple factors, set off in large part by monetary factors – which one of my favorite books, called *Meltdown* by Tom Woods –

WOODS: How about that? Yeah.

STRINGHAM: And then you add on top of that this prospect of very harmful regulations, then it's no wonder that the financial markets are going to get hammered. It's like, all right, government destabilized us to begin with, and now we can't actually start sorting things out in a reasonable way. We've got to be dealing with tons and tons of onerous regulations. That's going to actually bring down markets, not help them.

WOODS: What would you say to somebody who says: all right, Mr. Smart Guy, is your approach then to say that we don't need any regulation of Wall Street whatever?

STRINGHAM: Historically I think the better solution than government regulation is private regulation, which I will call private governance, private rules and regulations that come through private entities, through things like the New York Stock Exchange, which historically was – it still does a lot of private self-regulation, but it had a much greater role before the creation of the Securities and Exchange Commission. It had listing requirements; it had disclosure requirements; it had membership requirements for brokers, traders, all that stuff. NASDAQ was a competing self-regulatory organization. Today we have the New York Mercantile Exchange, the Chicago Mercantile Exchange. And if you want to opt in to a more privately regulated market, you can. If you want to opt out to a less regulated market, so things like the pink sheets or any type of unlisted firm, you can. But the advantage of market regulation, of private regulation, of private governance, is you let the investor opt in.

I'll give you a cool example. With the hedge fund industry you've got basically a set of funds, which are similar to mutual funds, but they don't have to follow most of the mutual fund rules, so it's basically a completely unregulated market for the most part. And you need to figure out whether your money manager is doing what he's saying he is. And we see cases like, unfortunately, Ponzi schemes, like Bernie Madoff, where he says everything's great, and then investors say, Where's my money? And he says, trust me; don't worry about it. Well, most investors don't do that. Most investors who are investing in these "unregulated markets" demand private, third-party certification, custodian services.

So you've got a system of private regulation that's verifying whether there's money in that account. In many cases, the hedge fund manager doesn't even have control of the funds. Those funds might be sitting in an account of, I don't know, JP Morgan, for example. And so your hedge fund manager might say, I'm going to abscond with all this money, but he can't, because you've got a system of private rules and regulations to actually provide assurances to investors. So this is the alternative: not no regulation, but private regulation, effective private regulations that make markets work.

WOODS: You know, I happen to know a guy who has a book on how private regulations and private agreements can manage a whole lot of difficult topics, and –

STRINGHAM: It sounds amazing. Do you have any insight?

WOODS: (laughing) Yeah, I know a little something about it. It's called *Private Governance*, and it's by this guy Ed Stringham –

STRINGHAM: Ahh.

WOODS: — who, as it turns out, I found out today, is a fan of one of my books.

STRINGHAM: (laughing)

WOODS: So can you take a minute and say a little something about *Private Governance*?

STRINGHAM: Thanks, Tom, I love you. I do love *Meltdown* as well. *Private Governance* is my book that came out with Oxford University Press. I go throughout history and focus on some modern examples, but a lot of historical examples as well, and look at the emergence of the first stock markets in Amsterdam 400 years ago, England 300 years ago, New York 200 years ago. Most people have this basically fictional belief that you need government to create the rules of the market, you need government to come in and say, here's how we're going to enforce contracts, and only after government creates the rules of the game, only after government creates the framework, will you see the markets emerge.

Well, it turns out that is not the case at all. Markets emerge in what we might call a spontaneous way. There's individual actors making choices at all stages of the game, but it's not being planned by the government; it's being planned by various private parties. And you can actually read what they're doing, the challenges that they faced. And a lot of them said at the time: government rules are inadequate to deal with these complex markets, so we're going to create a system of private rules to deal with defaulters; we're going to create a system of private rules to deal with fraud and try and protect people from bad action.

And this is not just a small set of markets that happened for a year or two. This happened for hundreds of years. Government wasn't enforcing contracts in the early stock markets, so instead we have private rules and regulations, private governance creating modern society, creating modern capitalism without the hand of the Dodd-Franks or the Elizabeth Warrens of the day.

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Chapter 4

Did Deregulation Cause the Financial Crisis?

This chapter, featuring Peter J. Wallison of the American Enterprise Institute, is drawn from episodes 638 and 561 of the Tom Woods Show (April 12, 2016, and December 24, 2015).

WOODS: The Left approaches this question with the presumption that there must be some repealed regulation that would have prevented the financial crisis. If only the government could have cracked some more skulls, we wouldn't have had this problem, they think.

As you well know, they always settle on the Gramm-Leach-Bliley Act, the so-called partial repeal of Glass-Steagall. It's interesting to note that even *The Washington Post* had an interesting op-ed piece saying: *look, everybody, quit blaming the "repeal" of Glass-Steagall. This is a complete red herring.*

So let's start off with this Graham-Leach- Bliley Act and the partial repeal of Glass-Steagall. Tell us what Glass-Steagall was and what it was intended to do, and then let's talk about whether and to what extent it was actually repealed.

WALLISON: We've had deregulation in our economy, happily, over many years. We have deregulated transportation; we have deregulated security; we have deregulated broadcasting. All of these things have given us much lower prices for all of those services and much better services. We've had a lot more innovation as a result of that. The one thing we never deregulated was finance.

Glass-Steagall, passed in 1933, had had two provisions. One said that a bank could not engage in underwriting or dealing in securities. We're talking here about a commercial bank, an insured bank; it could not underwrite or deal in securities. The other part of

Glass-Steagall said a bank could not be affiliated with a company that engaged in underwriting or dealing in securities.

In 1999 the Graham-Leach-Bliley Act repealed the second provision; that is, banks could then be affiliated with firms that engage in underwriting and dealing in securities, but the first part of Glass-Steagall is still applicable to banks. They cannot underwrite and deal in securities.

Gramm-Leach-Bliley is the only law that anyone on the Left can point to that could have been seen as deregulation. That's why it gets mentioned all the time. But as I just noted, the only thing that law did was to allow banks to be affiliated with companies that engage in underwriting and dealing in securities. It did not allow banks themselves to do that.

Most people who talk about it don't even know what the Glass-Steagall Act did. And the simple way I talk about it is simply to say if the Glass-Steagall Act had remained in effect exactly as it was before it was changed in 1999, we would have had exactly the same problem. Our problem in 2008 arose out of troubling, low-quality mortgages in our financial system and had nothing to do with deregulation, if you can even call it that, of the banking system.

The banks, the non-banks that banks were then able to affiliate with, all got into trouble because they bought low-quality mortgages and held those low-quality mortgages because they didn't realize that they were in fact low quality. If the banks had actually sold them all off, then the banks wouldn't have been in trouble at all. But they didn't. They held on to many of them, because they believed they were actually good-quality mortgages. One of the reasons they believed that is that home values were going up 10 percent a year, and if that's happening, then a mortgage on a home is a pretty good investment.

WOODS: You say that even with the partial repeal of Glass-Steagall, banks may still not deal in securities. What does it mean to "deal in securities"?

WALLISON: What it means is that you buy a portfolio of securities, and you hold them for the purpose of selling them or buying them. It's sort of like thinking of them as a dealer in any product, let's say an iPhone, and if you're selling iPhones you also buy iPhones for resale. That is dealing in securities.

WOODS: So in other words, if a bank is sitting on a mortgage-backed security but it's just holding it, that's not "dealing" in it.

WALLISON: Right. If a bank is buying mortgage-backed securities, for the most part they are buying those for investment, to hold them, and that's in fact what they did. But at times, banks can also decide, just like any dealer in any product, let's say Exxon dealing in oil, that they no longer want to hold the product for investment, and they sell it. That's also permitted. So banks can buy and sell securities, mortgage-backed securities or other kinds of securities – debt securities of various other kinds; not equity securities but debt securities. They can sell those securities at any time if they decide they no longer want to hold them because the investment is not good.

WOODS: Now let me read you this paragraph. It says, "We've got Bear Sterns, Lehman Brothers, and Merrill Lynch, three institutions at the heart of the crisis, were pure investment banks that had never crossed the old line into commercial banking. The same goes for Goldman Sachs; the infamous AIG, an insurance firm; New Century Financial, a real estate investment trust. No Glass-Steagall there."

That is from *The Washington Post*, which is not known for being anti-regulation. But there's a column from the *Post* from several years ago saying that if you're trying to look for a boogeyman, this one's just not going to work. It doesn't match up with the financial crisis we just endured. We did not have a problem with institutions where we had a mingling of investment and commercial banking. That's not what happened.

WALLISON: That's entirely right. The whole Glass-Steagall issue is completely irrelevant to what happened in the financial crisis. People have to really understand what happened in the financial crisis to understand why that is true. And that is, everybody who got into trouble did so because they bought and held mortgage-backed securities or mortgages themselves. The issue of dealing and underwriting in securities was never a question in the financial crisis. AIG got into trouble by – actually, they insured mortgage-backed securities rather than actually holding them. Bear Stearns, Lehman Brothers, Goldman to some extent all got into trouble because they invested in – held, in other words – mortgage-backed securities or mortgages.

WOODS: So in other words, they were doing something they had always been allowed to do. There was no phantom regulation that was repealed that suddenly allowed them to do these things.

WALLISON: Exactly. In fact, that's a really good way to put it, Tom, because if Glass-Steagall had never been touched by the Gramm-Leach-Bliley Act in 1999, the financial crisis would have unfolded exactly the way it unfolded in 2008.

WOODS: Some of the more informed people who say we need a resurrection of Glass-Steagall seem to be saying: all right, it's not directly related to the financial crisis, but there's a connection between the partial repeal and the rise of institutions that were too big to fail, something that contributed to the creation of these gargantuan institutions. Is there anything to that?

WALLISON: No. There were three different kinds of institutions that failed. There were the AIGs, which was in fact an insurance holding company, but it also engaged in insuring, in effect with this so-called credit default swap, it was also insuring mortgages. That's one kind.

Another kind was an investment bank, like a Goldman Sachs or a Lehman Brothers or a Bear Stearns. They got into trouble because they bought and held mortgage-backed securities as investments.

And then there were commercial banks like Wachovia or Washington Mutual (known as WaMu) or IndyMac, three different kinds of commercial banks. They also got into trouble by holding mortgage-backed securities or mortgages themselves. So what we learned from all of that is that it doesn't matter what kind of institution it was or what kinds of laws applied to the way they carried on their business. The fact was that they got into trouble by investing in these very low quality mortgages.

WOODS: All right, so the cause of the crisis is quite mundane. It's that you have banks that extended mortgages that should not have been extended, and that's something that banks always had the power to do. They always had the power to make lousy mortgages.

WALLISON: Yes. Now, we're talking about Glass-Steagall, but if you want to know – and I'm saying to you that Glass-Steagall had nothing to do with the financial crisis, and no restoration of Glass-Steagall would have prevented the financial crisis, so let's leave that aside, because, in fact, there was a cause for the financial crisis that no one is talking about, and especially people on the Left are not talking about: it was government housing policy that caused the financial crisis. And in fact, I would argue that the whole Glass-Steagall idea was raised as kind of a smokescreen to prevent people from talking about the real problem, which was what the government did in housing policy.

WOODS: I read an economist named Bill Woolsey who said that the only reason he can think of – it might have been Alan Meltzer. But one of them said the only reason he could think of that anyone would point to Gramm-Leach-Bliley and the partial repeal of Glass-Steagall is that it's the only regulatory move and change of any kind that's even remotely connected to anything having to do with anything.

WALLISON: Actually, I said that, Tom (laughing).

WOODS: (laughing) Oh.

WALLISON: Maybe Alan Meltzer picked that up, too. I haven't read all his stuff, but I've been arguing that from the beginning.

WOODS: (laughing) Well, this actually confirms what I told you before we started recording. I said that people have been wanting to know about this Glass-Steagall thing and that I wanted you to talk about it because everything I know I learned from you – including your funny lines, apparently.

WALLISON: (laughing) Well, it is very, very frustrating, because people who know better have been talking about this as though they understand it. A senator from Massachusetts by the name of Elizabeth Warren has been saying on radio programs that I've been on with her that Glass-Steagall was responsible for the financial crisis. But then later on in candid discussions with other people, she has said, well, no, of course it really had nothing to do with the financial crisis, but it's important to understand that it was deregulation of some kind.

The important thingto understand about "deregulation of some kind" is that we've had a lot of deregulation, and it's been great for the United States. We've had deregulation in some parts of finance, like the elimination of regulated costs for trading securities. That's now all free market. We've had deregulation in communications. That has given us the Internet and iPhones and so forth. We've had deregulation in transportation. The one area where we have not had any deregulation is in the regulation of banks. That has only gotten tighter and tighter over time, with the exception of the partial repeal of Glass-Steagall, and that was not a deregulation of banks at all. It was a deregulation, if you want to call it that, of the companies that own banks. They could then own also firms that were engaged in underwriting and dealing in securities.

So the Left – and I'm sorry to say this and impugn their motives – but the Left has been looking around for some kind of deregulation that could have caused the financial crisis, and they hit on the Glass-Steagall Act. And since no one else knew anything about it, it's a complicated idea, they've been pumping that idea now for years, and people have fallen for it, but in fact, it had nothing to do with the financial crisis, and the Left unfortunately has to face the facts. And the facts arethat government housing policy, as I made clear in my book – and you were kind enough to talk about my book at one time – as I made clear in the book, the financial crisis was caused by government housing policy. Nothing more.

WOODS: Remind us of the full title of that book?

WALLISON: It's called *Hidden in Plain Sight: What Caused the World's Worst Financial Crisis and Why It Can Happen Again.*

WOODS: You know what's funny about the whole boogeyman story of Glass-Steagall: the same people who push that also tell us that in Canada they weathered the financial crisis better than we did here. Yet Canada had no Glass-Steagall in the first place. So they're contradicting themselves.

WALLISON: (laughing) Yeah, yeah, of course they are. And you can't really compare Canada's banking system to our own banking system. Canadian banks have different powers, and in fact, Canada did not have the government policies that created the very poor quality mortgages that suffused our financial system in the United States.

WOODS: What about the claim that, because of some form of deregulation, these investment banks were able to be much more highly leveraged than they'd been in the past, and this goes to show once again that deregulation leads to highly undesirable outcomes?

WALLISON: This had nothing to do with deregulation. Investment banks were never regulated, so there really wasn't any case for saying that deregulation caused it. The investment banks, organizations like Goldman Sachs and Morgan Stanley and even Merrill Lynch, were never regulated. The only part of that whole business that was regulated were broker-dealers, which are only the people who buy and sell securities for customers. But the holding companies of these broker-dealers, like Goldman Sachs and Morgan Stanley and Merrill Lynch and so forth, were never regulated. So it's inaccurate to say that there was something in Glass-Steagall that deregulated. There was nothing in Glass-Steagall that referred to them, or in any other regulation.

The problem was simply that the government had created through its policies this tremendous bubble that was larger than any housing finance bubble we have ever had in our history, and as housing prices grew – about 10 percent a year, as I said, in the 2000s – people looked at this and said, well gee, these are wonderful investments, these mortgages, because the next year a person would have a home that was worth 10 percent more. And so even if that person defaulted on the mortgage, we would probably be able to recover the value of the loan that was underlying that mortgage.

That, of course, didn't happen, and the reason there was a collapse, the reason that we had a collapse in 2008 was because we came to a point where homes had become so expensive that people couldn't buy them anymore, and the whole machine stopped running, so people could no longer refinance their homes when they couldn't meet their mortgage obligations and began to default.

WOODS: There's another issue I'd like to raise with you. When you get them on Glass-Steagall, then they come out with something that sounds even more complicated: the Commodity Futures Modernization Act of 2000. You've written about this, too. Tell me what that was and how it's connected to anything.

WALLISON: In the year 2000 – this was during the Clinton administration – the person who was the chairman of the Commodity Futures Trading Commission said that she wanted to regulate credit default swaps. I'll get to what those are in a minute. The chairman of the Federal Reserve, the chairman of the banking committees in the House and the Senate, the Secretary of the Treasury at the time, Rubin, all said that would be a terrible idea. Not only is it a terrible idea, but the idea that you are going to be regulating the credit default swap market is going to make that market very difficult to operate, because people are going to be afraid to get involved in the market if they think the Commodity Futures Trading Commission is going to come in and impose various kinds of regulations, making their investments weak or troubling or bad.

So they adopted in something called the Commodity Futures Modernization Act a rule that said the CFTC, the Commodity Futures Trading Commission, cannot regulate credit default swaps. That's what the Commodity Futures Modernization Act was about. There are other provisions in that act that did good things, but in this case they did a bad thing, according to the Left, and that is they restricted regulation of the credit default swap market.

Now, what are credit default swaps? Sounds very complex. They're not actually very complex. They are simply a kind of insurance product on a financial instrument. You can buy protection for your financial instrument – against its decline in value or its failure or whatever – by paying a premium to someone who will protect you. That transaction is called a credit default swap.

The same thing that happened with Glass-Steagall happened with credit default swaps: as soon as there was a problem in the market, various people, principally on the Left but also the government (and I will have to blame this in part on the late part of the Bush administration) began to say, well – this is particularly Henry Paulson, who was the Secretary of the Treasury at the time – the reason we had to bail out Bear Stearns is that these credit default swaps were going to make all of these companies fail. If one of them failed, it would drag down all of them, because they're all interconnected through these credit default swaps.

That idea was shown to be false when Lehman failed, because when Lehman failed, no other firm got into trouble because of Lehman's failure. And Lehman had been a big player in the credit default swap market. But the idea has lived on that it is necessary to regulate credit default swaps.

In the Dodd-Frank Act there was a very strong set of regulations or power to make regulations that was given to the CFTC in order to regulate credit default swaps, and they had now been thoroughly regulated. That to me is not a good idea. It has not produced anything good, and it did not save us from and will not in the future save us from anything bad.

WOODS: You mentioned Dodd-Frank; maybe your ears were burning today, because we were recording – I have another podcast; I do this show every weekday, but I also have a weekly show called Contra Krugman. We refute Paul Krugman every single week, my friend and I.

WALLISON: (laughing) Well, that's easy.

WOODS: Oh, it's great. We've got to get you on that show. We had Dan Mitchell from Cato on today –

WALLISON: Great. Great guy, Dan.

WOODS: Oh, yeah. We were talking about Krugman's column arguing that Obama's actually been a terrific president, and listing some of his accomplishments. Krugman gave financial reform as one of his accomplishments. And I cited an article you wrote maybe six months ago, connecting Dodd-Frank and the disproportionate burden it places on community banks, small institutions – and that's where small businesses, where a lot of the job growth was coming from, get their credit. And now suddenly we're not seeing job growth coming from small business anymore. You connected the dots very effectively in that column.

WALLISON: Yes, well, it is true. It is absolutely true that the reason that our economy has not recovered as smartly as it always recovers from steep recessions is because of the Dodd-Frank Act and the burden that it has placed not only on small banks, but also on the financial industry in general. It raised their costs tremendously, made them much more risk averse than they had been before. But the major problem with small business is coming from the burdens that have been placed principally on community banks by the Dodd-Frank Act and the behavior of the regulators after Dodd-Frank was adopted.

I really do think it has been a catastrophe for this country and one of the reasons that we have so many disaffected people in this country, because we have not had the economic growth that people are accustomed to since Obama came into office. And the principal reason for that – look, let's put it this way. There are only three major things that have happened in the financial world since Obama became president. One is the Fed cut interest rates down to virtually zero. There's Obamacare. And there is Dodd-Frank.

Now, those first two, Obamacare and the Fed cutting interest rates to zero should stimulate the economy, Obamacare because it added so much more government money into a major sector of the economy, which of course is health care. But we haven't had any growth. We've had the slowest recovery every since the 1960s. And why is that? It can only be one reason, and that is the Dodd-Frank Act.

And so people have not seen an increase in their salaries, their compensation. In fact, many of them have seen a decrease. The economy is growing very slowly. We do not have the kind of economic growth that has always made people confident about the future, and as a result we have a lot of people who are looking at this election as a way of stopping the terrible things that have happened over the last eight years. And yet it seems very unlikely that either of the candidates that are the frontrunners now will be able to do anything. One of them is of course just backing Obama's policies and promising to make them even worse for the economy, and the other doesn't actually seem to have a very good idea of how to handle the economy anyway.

Appendix A

If You're a Homeschooling Parent, You're Probably Working Too Hard

You're trying to do it all, and you're overwhelmed. You always feel you're falling behind. You may even have come close to throwing in the towel and sending your children to the government's schools.

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What's more, your students will learn more than ever, from instructors you can trust, in a curriculum endorsed by Ron Paul himself.

Who Am I?

I'm Tom Woods, the *New York Times* bestselling author of 12 books, including *The Politically Incorrect Guide to American History* and *Meltdown*, a book on the 2008 financial crisis, featuring a foreword by Ron Paul. I hold a bachelor's degree in history from Harvard, and my M.A., M.Phil., and Ph.D. from Columbia University. I'll be teaching government and Western civilization to your high school students.

I've worked closely with Ron Paul over the years. I've been his opening speaker at countless events (including his great Rally for the Republic in 2008), at Dr. Paul's invitation I testified before Congress on auditing the Fed, and Dr. Paul asked me to write the Mission Statement and Statement of Principles for Campaign for Liberty, the organization he created after his 2008 campaign.

I set up a special page of my own – RonPaulHomeschool.com – because I have some gifts to give you if you decide to join us – but only if you join through that page. More on that later.

A Great Education – and No More Struggles

The Ron Paul Curriculum is self-taught. Even before the junior high grades, parents don't have to teach. Students learn from daily videos, and from the Q&A forums in which students ask – and answer – questions.

What this means:

* Students learn at their own pace

* Students learn how to learn

* Students will be better prepared for college

This is Ron Paul's most important achievement, and it's what he dreamed of doing even during his congressional career. Now, it's here.

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1. No textbooks. Textbooks are a terrible way to learn. They're written by committees, they're bland, they reflect the conventional wisdom – which is often dead wrong – and they're expensive. Save money and give your students a better education by ditching them forever.

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2. We use a lot of primary sources. That means students will read some of the great thinkers and historical figures for themselves, without a textbook telling them what to think.

3. Video-based curriculum. Each full-year course consists of 180 videos – five videos per week for 36 weeks. Every single lesson will have a reading assignment and a video. Students learn much better with video instruction than with a bunch of readings alone.

4. Writing. Every course in the humanities and social sciences has a writing assignment every week. This will train your students to become good writers – a rare skill.

5. Review! Mountains of information won't do any good if your students don't remember it. Review is central to how we learn. So we begin every lesson with a brief review of the previous lesson, and every fifth lesson is a full review of what's been taught during that week.

Why is a self-taught, video-based curriculum better?

* Most people need verbal guidance to learn.

* Students can replay a video until they understand.

* A video boils down fundamental information.

* It reinforces reading assignments.

* It explains reading assignments.

* A good lecture livens up learning.

* It is more personal than reading.

* A good lecture is highly motivational.

* Images and outlines help us to remember.

* It is available at any time.

* Headphones reduce sibling distractions.

* A screen image helps students focus.

* Students learn how to take notes – a skill crucial for college.

In addition to the traditional subjects, our curriculum has courses your students won't be able to find anywhere else. For instance, imagine having your children take courses on:

* How to start a home business

* How to write advertising copy – a skill that practically guarantees them a job

* How to become a skilled public speaker

* Personal finance for teens (why is no one else teaching this?)

Even our traditional subjects are taught in an extraordinary way:

* Two full years of Western civilization, instead of the usual one year

* Two full years of Western literature, designed to run parallel to the Western civilization courses – there is nothing like this, anywhere

* Junior high science: building radios, robots, and more

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What Parents Are Saying

As a single parent with limited resources, I cannot adequately express how valuable RPC is to our lives. The increase in the standard and quality of our living is immeasurable.

Now that RPC has given me some confidence and freedom for homeschooling my kids, I am able to begin building and establishing a home-based business. – Justin Rash

My daughter loves this program. She thought the public schools were great, but once she started the Ron Paul Curriculum she never wanted to go back. – Robert Paul Spencer

This year, my 3rd, 4th, 6th, 8th graders began RPC.

It. Is. Incomparable. To anything else out there.

My little ones are immersed in quality, classic literature, and have loved the books they are blessed to be able to read each day. The elementary education is rock solid. I am learning just as much as the kids are!

My older children are even more spoiled. First, I love the self-learning concept. It's how they should be learning, and it best prepares them for college.

My 11-year-old loves the format. He feels in control of his own learning. Finally! He is excelling as I had only dreamed he would.

My home is more peaceful and structured. My kids are learning so much that I have no doubt they're surpassing all grade level expectations, and I am thrilled with the content and approach of RPC.

Make the switch now. It will change your life. – Alicia Thorson

The **Ron Paul Curriculum** has a 95 percent renewal rate – unheard of in this field. The parent testimonials you just read help explain why.

And here's the rest of the story: how a self-taught, video-based curriculum will make your life easier:

1. Homeschooling is not a good environment for live lectures.

2. Live lectures take enormous amounts of time to prepare.

3. Live lectures must be given in every course, every year.

4. Teachers soon abandon live lecturing...or never try.

5. A video can be reviewed for content by parents.

6. Advanced courses are taught by experts in the field.

7. No parent can match experts in every field.

8. Discipline problems disappear fast.

9. Student boredom disappears.

10. You do not have to nag as much.

11. You can see what each student is doing.

12. Making daily lesson plans ends forever.

How Much Does It Cost?

Whether you have one child or fifteen, an annual subscription to the **Ron Paul Curriculum** site is only $250 (if you choose renewable billing; it's $350 otherwise). Then it's just $50 per 180-video course – an incredible value.

Your $160 in Free Bonuses – Available Directly From Me Only!

If you join the curriculum via **RonPaulHomeschool.com**, you'll get these great bonuses!

FREE Bonus #1: A signed, personalized copy of my book *The Politically Incorrect Guide to American History* (retail price $19.95), featuring an endorsement by Ron Paul. This book spent 12 weeks on the *New York Times* bestseller list – to the consternation of the *Times* itself!

FREE Bonus #2: A ten-lesson bonus course, valued at $19.95, on the foundations of liberty. This course is suitable for students in the junior high grades and up, and it will prepare them for this liberty-based curriculum.

FREE Bonus #3: A one-year subscription to Liberty Classroom, my adult enrichment site that 's also been used by many homeschoolers. As of this printing we have 17 courses on history, economics, philosophy, and more, plus discussion forums, live events, recommended readings, and a great community of liberty learners. That's a $119 value – free!

These bonuses are available only when you join the Ron Paul Curriculum through my special site, RonPaulHomeschool.com.

"A student who goes through this curriculum, kindergarten through high school, will have a mastery of the foundations of liberty," says Ron Paul. "There is no other curriculum on the Web to match it."

Our Guarantee

We're so absolutely sure that the Ron Paul Curriculum is your best homeschooling option that we're offering an unconditional, no-questions-asked 60-day money back guarantee.

If for whatever reason the Ron Paul Curriculum does not satisfy you in any way, simply send us an email within 60 days from your purchase and we'll refund you right away!

So, if for any reason you're not happy, you can get your money back within 60 days. Simply contact us. No questions asked.

Pass on your worldview, and give your students the extraordinary advantages of the Ron Paul Curriculum by joining today – risk free!

P.S. Want to see a sample course outline? Here's my half-year, 90-lesson course on government, suitable for high school students.

Lesson 1: Introduction
Lesson 2: Natural Rights Theories I (High Middle Ages to Late Scholastics)
Lesson 3: Natural Rights Theories II (Locke)
Lesson 4: Natural Rights Theories III (more recent theories)
Lesson 5: Week 1 Review
Lesson 6: Locke and Spooner on Consent
Lesson 7: The Tale of the Slave
Lesson 8: Human Rights and Property Rights
Lesson 9: Negative Rights and Positive Rights
Lesson 10: Week 2 Review
Lesson 11: Critics of Liberalism: Rousseau and the General Will
Lesson 12: Critics of Liberalism: John Rawls and Egalitarianism
Lesson 13: Critics of Liberalism: Thomas Nagel and Ronald Dworkin
Lesson 14: Critics of Liberalism: G.A. Cohen
Lesson 15: Week 3 Review
Lesson 16: Public Goods
Lesson 17: The Standard of Living
Lesson 18: Poverty
Lesson 19: Monopoly
Lesson 20: Week 4 Review
Lesson 21: Science
Lesson 22: Inequality
Lesson 23: Development Aid
Lesson 24: Discrimination
Lesson 25: Week 5 Review
Lesson 26: The Socialist Calculation Problem

Lesson 68: Communism I
Lesson 69: Communism II
Lesson 70: Week 14 Review
Lesson 71: Miscellaneous Interventionism: Postwar African Nationalism
Lesson 72: Public Choice I
Lesson 73: Public Choice II
Lesson 74: Miscellaneous Examples of Government Activity and Incentives
Lesson 75: Week 15 Review
Lesson 76: Industrial Revolution
Lesson 77: New Deal I
Lesson 78: New Deal II
Lesson 79: The Housing Bust of 2008
Lesson 80: Week 16 Review
Lesson 81: Are Voters Informed?
Lesson 82: Is Political Representation Meaningful?
Lesson 83: The Myth of the Rule of Law
Lesson 84: The Incentives of Democracy
Lesson 85: Week 17 Review
Lesson 86: The Sweeping Critique: LeFevre
Lesson 87: The Sweeping Critique: Rothbard
Lesson 88: Case Study: The Old West
Lesson 89: Economic Freedom of the World
Lesson 90: What Have We Learned?

Grab this course a la carte:

http://www.TomWoodsHomeschool.com/government-1b

Get the whole Ron Paul Curriculum, including my $160 in free bonuses:

http://www.RonPaulHomeschool.com

Appendix B

Losing Debates With Leftist Friends?
That's Because Leftists Wrote Your Textbooks

Whether it's omissions, distorted history, or tendentious interpretations, your teachers and textbooks aren't exactly subtle when it comes to the opinions they expect you to hold.

Meanwhile, family, neighbors, and co-workers bombard you with left-wing platitudes they can express in a single sentence but that take paragraphs to refute.

And you fear your kids are having the same experience you did.

Well, you guessed it. I created the solution.

In 2012 I launched LibertyClassroom.com, a project separate from the Ron Paul Curriculum, out of frustration at the kind of history and economics people were generally learning in high school and college.

I wanted an adult enrichment site for people who'd like to learn the real thing, but don't really have time and lack reliable sources.

Liberty Classroom is for you if:

§ you've ever found yourself in an argument with friends or family, knew you were right, but just didn't have the command of history or economics to win;
§ you want your college student to have a lifeline to reliable professors;
§ you wish you'd gotten a more reliable education;
§ you're tired of haphazardly trying to fill in the gaps in your knowledge;
§ you're overwhelmed by many books you might read, and don't know where to start;
§ you want the self-confidence that comes from real mastery;
§ **you're sick of losing debates you know you should be winning.**

At LibertyClassroom.com, people can download courses that can be watched or listened to (we have both video and audio files for every lecture) on a computer or on mobile devices. We have Q&A forums in which you can ask faculty your questions. We also offer recommended readings, and host a monthly live video session with faculty. Every year we add several more courses to our offerings. Access to *everything we have* – 17 courses and counting as of this printing – costs less than a single credit hour at a community college.

The world's only hope:

About the Author

Thomas E. Woods, Jr., is a senior fellow of the Mises Institute and host of The Tom Woods Show, a libertarian podcast that releases a new episode every weekday. He holds a bachelor's degree in history from Harvard and his master's, M.Phil., and Ph.D. from Columbia University. Woods has appeared on CNBC, MSNBC, FOX News Channel, FOX Business Network, C-SPAN, and Bloomberg Television, among other outlets, and has been a guest on hundreds of radio programs, including National Public Radio, the Dennis Miller Show, the Michael Reagan Show, the Dennis Prager Show, and the Michael Medved Show.

Tom's 12 books include the *New York Times* bestsellers *Meltdown* (featuring a foreword by Ron Paul) and *The Politically Incorrect Guide to American History*. His critically acclaimed book *The Church Confronts Modernity* was released in paperback by Columbia University Press in 2007, and his book *The Church and the Market* won the $50,000 first prize in the Templeton Enterprise Awards.

Tom's books have been translated into Italian, Spanish, Polish, Lithuanian, German, Dutch, Czech, Portuguese, Croatian, Slovak, Russian, Korean, Japanese, and Chinese.

Tom's writing has appeared in dozens of popular and scholarly periodicals, including the *American Historical Review*, the *Christian Science Monitor*, *Investor's Business Daily*, *Catholic Historical Review*, *Modern Age*, *American Studies*, *Intercollegiate Review*, *Catholic Social Science Review*, *Economic Affairs* (U.K.), *Quarterly Journal of Austrian Economics*, *Inside the Vatican*, *Human Events*, *University Bookman*, *Journal of Markets & Morality*, *New Oxford Review*, *Catholic World Report*, *Independent Review*, *Religion & Liberty*, *Journal of Libertarian Studies*, *Journal des Economistes et des Etudes Humaines*, *AD2000* (Australia), *Christian Order* (U.K.), and *Human Rights Review*.

Tom also co-hosts Contra Krugman, a weekly podcast with economist Bob Murphy that provides a free-market response to Paul Krugman's *New York Times* column.

Tom created 400 videos on history and government for the Ron Paul Curriculum, a K-12 homeschool curriculum.