The credit crunch provides a challenging opportunity to enquire into the construction of economic institutions, and whether the process is a rational one, undertaken by rational individuals. The role of financial institutions over the past few years is universally agreed to be disastrous. There is much less agreement, particularly among specialists, when it comes to explaining and understanding what has happened. Perhaps oddly, there is a fair amount of consensus among economists regarding what to do in the face of current problems. For the most part, this consists of propping up many of the financial institutions which seem to be near collapse with taxpayer’s money and commitments, and in various ways trying to head off deepening recession with monetary easing and running huge budget deficits. The expectation is that these deficits are to be corrected at some point in the future, and part of that correction will involve money supply contraction. Opinions differ as to how soon this process should be initiated and how long it will take to accomplish the task of restoring fiscal and monetary normality. It is interesting that there seems to be far more agreement as to what to do than there is about how and why we got into this mess. While there is much agreement in the popular press as to how we came to the present situation, within the economics profession there is considerable disagreement.

The popular press is more given to fables than to analysis. Gillian Tett of the Financial Times has a large following, especially among those with no knowledge of economics. It is disturbing to me that she successfully substitutes analogies and myth making — tales of leaking hoses, frenzy and greed, and denial in the face of grief — with explicit analysis. Many people who should know better seem to find this approach to understanding our current dilemma quite satisfying. Meanwhile, the economics fraternity verges ever closer to schism over the crunch. The Queen asks why no one saw this coming. Is this not a failure of economics? One Nobel Prize winner, Robert Lucas says firmly ‘no’, it does not represent a failure of economics. He bases his argument, wrongly in my view, on the complex issue of forecasting in social science. Another Nobel Prize winner, Paul Krugman, says equally firmly ‘yes’ it is a failure, and points to an alleged taste for formalism for its own sake and misrepresented macroeconomics.

*I am indebted to Michael Sheren for substantial comments, which I have unashamedly incorporated in this text, and also to Andrea Bagg and participants in the Workshop.
My own view, which changes day by day, tends to the position that the crunch was the perfect storm. (Shades of Ms Tett.) A number of things were building up together, no one of which would have been so dangerous to the economy on its own. Among these elements are the current wars. Popular wars can be financed through taxation, but governments have to borrow to finance unpopular wars, and this has been a problem for the US and the UK governments. Private debt has also expanded over recent decades, due in part to the long stretch of apparent prosperity and low interest rates. Then there is the housing debacle. House ownership has been encouraged by government policy to an unsustainable level both here and in the United States. Lenders did not care whether borrowers could pay or not. Off-balance sheet financing of mortgages through mortgage backed securities added to the incentive. Along with government encouragement, at one end of the chain, those proving mortgages felt that repossession would not entail loss due to rising house prices. This worked for a while, but of course came to an end.

A further contributing factor was the financial sector. The financial markets made changes in their activities, partly in response to deregulation. One would have thought that those responsible for pension funds and other similarly placed individuals whose job it is to monitor the activities of the financial sector would have acted. As it happened, they provided little check on the folly of much activity resulting from deregulation, derivative trading, leverage and related practices and innovations. Rather than casting a critical eye over the actions of fund managers, amateur decision making on the part of many pension fund administrators and other major players failed to provide any check. Part of the problem was probably that fund managers get paid when they invest, prompting a rush to investment.

Along with incompetence, a marked growth in outright dishonesty, and growth of near crookery, has led to large defaults. Much of the folly in many markets was able to continue without check because of the gigantic trade surpluses in China, and the use of substantial amounts of this surplus of buy American government debt and some corporate debt as well. The savings of the relatively poor have been used to finance the expenditure of the relatively rich. This has made possible a sustained period of excessive consumption in the rich countries, particularly the United States, accompanied by low or zero levels of saving.

One of the reasons why the economics discipline has had trouble coming to grips with all this is the high degree of specialisation that has developed over the years. Specialisation undoubtedly confers some benefits, but not everyone should go down that path. The high degree of specialisation in economics has contributed to the poor showing of economics as normally practiced in two ways. It has become a bit unfashionable to study the entire economy, the big picture, as against the workings of parts of the economy. It has also encouraged the analysis of fine tuning rather than the possibility of systemic failure.
Economic life is inherently problematic and uncertain. The coordination problem which the economy attempts to solve, however imperfectly, is immense. Investment decisions, crucial to the success of the economy, are often little more than leaps in the dark, and really cannot be anything else. Business firms are continually looking around for indicators as to which way the wind is blowing, and which way it will blow next year. Almost anything can be taken as a signal that bad times are coming or good times are approaching. Nothing could be easier to read as a sign of impending doom than the need for the taxpayer to bail out banks. This signal contributed to the recession. But this is not to say that it is all a matter of confidence. I reject the view that if only people acted in a more upbeat fashion, the problem would go away. Some problems would go away, but real factors are at work here which do not depend on confidence. Excessive borrowing is a real problem, and the pain of paying back the money owed is not something that can be handled through confidence.

Though I have argued that the current economic decline, almost world wide, has a number of causes. For the purposes of this discussion of irrationality, I will concentrate on the financial sector as one of the major influences leading to current difficulties. Rather than devoting attention to the recent speculative follies on the part of allegedly knowledgeable individuals, I will focus on the business as usual aspect of finance. This approach is more revealing of the workings of that sector, in good times and in bad.

In principle the financial sector is quite simple to understand. I will try to persuade you that there is a gross amount of misunderstanding about this sector of the economy, and this misunderstanding borders on irrationality. We have to concentrate on the basics. Like the education sector, the financial sector is a service sector. The service it provides is primarily offering a market place for shares, currency, commodities and other items, along with credit and insurance. A market economy allows individuals or other interests, if sufficiently endowed, to make purchases or sales, in other words to engage in transactions with other individuals and interests. But markets require some organisation, some structure, and some institutional framework. They do not just come about unbidden and without effort. The currency market is a useful example. Some institutional framework is required so that a centre or centres exist where individuals and other interests can buy and sell particular currencies without the complication of having to find other individuals wishing to make corresponding exchanges. It is often pointed out that without money a society is reduced to the huge inefficiency of barter exchange. But money in many cases is not sufficient to get around the problem of seeking out the person or interest who wants precisely what you have to sell, or will provide what you want to buy. What I am calling a market, and of course that is not my term, is the institution which greatly expands the scope for useful exchanges. I do not have to find someone who wants to buy pounds in exchange for dollars. The market makers stand by ready to accommodate all buyers and sellers.

This feature of market making is particularly productive when it comes to savers and investors. Individuals wishing to lend or invest money for a hoped
for return need not find on their own borrowers, or those needing capital. The banks, and other institutions, as market makers can offer a return to savers and take it upon themselves to find suitable use for these funds. The risk inherent in any investment, including holding cash with the risk of inflation and changing currency rates, has to fall somewhere. The market makers may bear this risk, and be rewarded for that. Alternatively, a saver who buys a share takes the risk on herself. The market maker in this case is a stock market, with some risk associated with default, but mainly the market simply provides a ready sale or purchase of shares in a company without the investor having to find a particular individual prepared to make the appropriate exchange. This is a valuable service, but not all that difficult to provide. For present purposes I am setting aside the insurance aspect of the financial sector.

These market making activities, sometimes referred to as normal banking functions, or the utility aspect of banking, are not the same as hedge fund operations, derivative trading, securitisation of mortgages and related activities. Most academic finance specialists, as well as most practitioners, would agree that the utility aspect of the financial sector does not require enormous ability. The practitioners tend agree that it is the other aspects which call for such a high degree of scarce talent. They may say what they like. I do not agree that these people not involved in the utility aspect of finance have any great abilities. While some advanced mathematics is involved, most of the money making activities involve sales, basic financial structuring abilities, and some research. This is important to my argument. The people in Goldman Sachs certainly make money. There is no denying that. But are these huge incomes rewards for exceptional skill, or simply a monopoly position to be exploited, or possibly something else which secures a gigantic cash income to those with little in the way of scarce ability?

In his book *The New Market Wizards*, Jack Schwager reports a fascinating discussion with the currency expert Bill Lipschultz. It is sufficiently important to my argument to warrant some substantial quotations from their exchanges.

JS. I've always been puzzled by the multitude of banks in the United States and worldwide that have large rooms filled with traders. How can all those trading operations make money? Trading is just not that easy. I've been involved in the market for nearly twenty years and know that the vast majority of traders lose money. How are the banks able to find all these young trainees who make money as traders?

BL. Actually, some of the large banks have as many as seventy trading rooms worldwide. First of all, not all banks are profitable in their trading every year.

JS. Still, I assume that the majority are profitable for most years. Is this profitability due to the advantage of earning the bid/ask spread on customer transactions, or is it primarily due to successful directional trading?

BL. There have been a lot of studies done on that question. A couple of years ago, I read a study on the trading operations of Citibank, which is the largest and probably the most profitable currency trading bank in the world. They usually make about $300 million to $400 million a year in their trading operations. There is always some debate as to how they make that kind of money. Some people argue that Citibank has such a franchise in currency trading that many marginal traders and hedgers in the currency market immediately think of Citibank when they need to do a transaction — and Citibank can earn a wide spread on those unsophisticated trades. Also, Citibank has operations in many countries that don’t have a central bank. In those countries, much or even all of the foreign exchange transactions go through Citibank. The study concluded that if Citibank traded only for the bid/ask spread and never took any position trades, they probably would make $600 million a year.

JS. That would imply that they probably lose a couple of hundred million dollars a year on their actual directional trading. Of course, that would help to explain the apparent paradox posed by my question — that is, how can all those traders makes money? Am I interpreting you correctly?

BL. Personally, that’s what I believe. However, the argument within Citibank would probably be: “We doubt that’s true, but even if it were, if we weren’t in the market doing all that proprietary trading and developing information, we wouldn’t be able to service our customers in the same way.”

This is a telling example of what I believe to be behind the profits of most of the participants in the financial sector. The exploitation of a monopoly position, which requires little in the way of special skills, generates most of the huge profits for the participants. We may ask why competition does not remove these profits. I believe there are answers to that question. For present purposes, I am taking it as read. The central point is that the key claim that the participants in the financial sector makes huge sums because of their talent is wrong. Many policy makers argue that if we were to tax these people and regulate their activities in ways that severely controlled profits, these able people would go elsewhere and we would lose out. This is wrong on three counts: they’re not particularly able; they will not go away; and even if they were to go away, that would not change their effects on society.

Apart from taking advantage of monopoly positions, simple dishonesty plays a role here. Undoubtedly there is a very shady side to much of the activity in the financial sector. Extreme cases have come to light in recent months of simple and outright fraudulent activity, often of a Ponzi scheme variety. Less dramatic unfair actions are commonplace. For example, if a large order comes in to a trader to buy a share, or a currency or some other asset, she can buy some for herself on her own account first. This is called front running. When the outside order is placed there is likely to be a rise in the value of that trader’s asset. The trader can then sell her share. This practice is illegal in some places and legal in others. With today’s highly mobile market, trades can be done anywhere. The trader in question has to be sure to choose one of the locations that allow this practice. The ability to select the right location hardly calls for genius.

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2 Ibid, pp. 55 – 56.
Another part of the return to participants in the financial sector comes from taking advantage of small differences in the price on an asset in different places and similar highly predictable anomalies. It would not be possible to profit from this activity if a trader had to pay normal commissions and the cost of borrowing money. The financial sector generates certain positions where large sums can be made through being in the position to avoid most of those costs. There are various reasons why competition cannot effectively remove these advantages. No less an authority on market matters than Warren Buffet is on record suggesting that the rewards for moving money around are incommensurate with the skill and effort required.

Some further thoughts are needed in support of the view that many of the highly paid participants in the financial sector do not have scarce skills. No doubt some extremely able and well trained Ph.D.s work there. Indeed, it can be argued that among the costs to society of the financial sector is its drawing people in who could make a far more significant contribution in other work. But many participants in the financial sector are not particularly skilled or able. In the book referred to above, Jack Schwager asks Victor Sperandeo, “Was there any correlation between intelligence and success at trading?” Sperandeo replied, “Absolutely, but not in the way you think. For example, one of the people I picked was a high school dropout, whom I am sure did not even know the alphabet. He was one of the five who made me a great deal of money.” Sperandeo is referring to his personal training programme. “Over a five year period, I trained thirty-eight people. Each of these people spent several months by my side while I taught them virtually everything I knew about the market. Of these thirty-eight people, five made money.” Note that it was a matter of months to learn everything that the master trader knew. No doubt there are other features than intelligence and knowledge which are important for success in the financial sector. What I am questioning is whether these features are all that uncommon in the population. As the saying goes, more research is needed. But there is an apparent case that the reward goes with the job, and a highly organised rationing system limits entry to the job with fairly arbitrary criteria.

The next question we have to ask is, if the financial sector in the sense of market makers is hugely profitable, who is paying for this? No doubt market making has the potential to improve the allocation of capital and thus add to wealth. The company or individual who receives funds and eventually pays them back out of profits has added to wealth. And the savers who provided the funding have to be compensated. Apart from any reward for saving, there is bound to be competition for funds, and this competition generates returns to those providing funds. But what about the split between the three interested parties: the financial sector itself, and those who lend or invest money, and those who borrow or require equity financing? If the financial sector is very successful, there is only one place that money can come from, and that is the people who require their services. Market making provides a service which adds to wealth, or has that potential. But if the market making sector is sufficiently adept at charging the lenders and borrowers, it can in principal

cream off any gain at the expense of society. The most naive politicians seem to suggest that this sector creates wealth and that is a benefit to us all. On the contrary, they get rich by placing an excessive charge on society.

The basic point here is quite a simple one, but it seems to have eluded many people, especially policy makers in government. The financial sector does not produce goods that add to welfare. If it makes money, someone is paying for that, and is providing the funds that generate profits in that sector. Politicians and others seem to be persuaded that having people in our community who make this money is somehow good for us. We prosper as they prosper. But do we? Where do they get the funds from if not from us? Some observers of finance with a better grasp on reality assume that while the City rips us off, it massively rips off people in other countries, and so on balance we gain from that. Apart from the ethical question, again, do we benefit from their prosperity? Suppliers of very expensive goods may do a bit better by having high earners in the community. Does that compensate for their excessive charges on virtually all transactions? Probably not. And even if the activity were to go elsewhere to avoid paying taxes, the participants in that sector would still buy a good deal of their luxury goods in London.

There is widespread and in my view justifiable concern and indeed outrage at the money some market makers in the financial sector manage to pay themselves. What is rarely asked, and should be asked, is where does this money come from? If a software manufacturer makes money we can see where the money came from. A product was produced for less than the price to the consumer. The consumer also benefits because the software is worth more to her than she paid for it. What about a market maker in the financial sector? Where does her money come from? The answer is that the savers get less than they otherwise would, and so do the investors. The community pays. Are we paying the right amount, too little, too much? If we could get the same service for a lot less, and I believe this to be the case, we are paying too much. If we taxed their earnings and legislated to prevent more of the grossest excesses, and as a result many financiers went away, a London market would still exist. It could compete with Dubai or New York or wherever by offering the service for less. This would force the others to lower their charges, and be a benefit to us all.

A rather separate point is the risky activity banks are allowed to engage in. These are far away from traditional banking activity. Like selling puts, they tend to work most of the time, but when they go wrong, they go very wrong, and who bears the cost when that happens?

The often asserted view we all hear is that these market makers are very talented, and if we do not pay them these large sums, they will go to Dubai, or some other place, and do their market making there, and we will loose out. I am doubtful if they will go away, but I am convinced that if they do, they can easily be replaced with equally skilful market makers who could be paid a lot less. This is provided an appropriate policy for taxing and licensing the financial sector is adopted. This claim that people working in the financial sector are extraordinarily able is widely believed. In my view this is part of the
irrational attitude towards this sector. The discussion of currency trading at Citi bank lends some support to my position. There is a good deal of additional informal evidence. For example, the people working in this sector often express the view that they have no great ability.

It is no secret that most of the politicians in this country are persuaded that having a large and prosperous financial sector in London is a great asset to us all, not just those in the sector. Not only do they give them huge tax advantages, they turn a blind eye when the financiers direct their winnings to their wives living abroad and so pay no tax here, or there most likely. Why do the politicians do this? The corrupt answer is fairly obvious. Politics tends to be an uncertain career, and at the top, a short career. When it is over, how about a job in that sector the politicians have been so determined to favour? It is difficult to know how important this is as an incentive, along with potential contributions to party funds and the glamour of socialising with the very rich. I would not dismiss it. However, there is some informal evidence that many decision takers actually believe that the prosperity of the financial sector is good for all of us.

Before coming to the heart of my argument, I would like to address the question of whether these sums earned by the wealthy are truly significant for the rest of us. Some observers maintain that while the creaming off seems to be a lot, if we take in the big picture, it hardly matters. If they did not earn this money, we would benefit a little, but so little it hardly matters. Is this right? It is helpful here to remind ourselves about the big picture of income distribution. Every day we hear that some administrative figures in the BBC, for example, earn half a million. Does it matter, this culture of paying large sums to allegedly talented and hard working people in certain jobs, in the financial sector and in other sectors? I believe it matters greatly.

The income distribution figures I will quote are not entirely due to the financial sector. We have allowed obscene growth in income at the top in many activities. But I would argue that the enormous incomes of some in the financial sector has led the way to grossly inflated salaries of the few in top positions. Remuneration committees, in my view, should be made up of share holders, union representatives, community leaders and others, rather than the people themselves who are getting paid. When I read that individuals leave the room when their salary is being considered, that hardly inspires confidence. They fix their own salaries, and we watch them do it. But turning to the figures.

Does it matter to the majority that some people are getting what I feel are excessive salaries? Yes it does. In the Thatcher decade, the poorest fifth of the population experienced less than half a percent growth in income per year. The top fifth grew at four percent a year. Under New Labour, the rise of the super rich is staggering. Of course, what we observe here is going on in much of the rest of the world, particularly the United States. So what has been going on here? For one thing, the tax rate on much of city income has been dropped from 40 % to 10 %, and with tax havens, few even pay the lower figure. Thirty thousand people in the UK earn over half a million pounds
a year. The average income of this group is over one million a year. The top one tenth of one percent of the population receive four percent of national income. In the United States the top one tenth of one percent get six percent of national income. The top one percent in the US get over one fifth of national income. I agree this is not all due to the financial sector. But that sector plays a major part.

I have argued that the participants in the financial sector are not particularly skilled or able. Their presence in the community does not benefit the community. Yet they are given tax and other privileges. There is some talk at the moment of changing the institutional arrangements and the legal framework of this sector. I sincerely hope this is done. Those who argue that these changes have to be worldwide are dangerous people. Either they believe that such an agreement is possible, when clearly it is not, or they know their argument is an effective way of preventing any change. But note that most of the motive for change is the economic hardship the sector has brought on the rest of us over the past two years. I am not emphasising that. It is the normal operations of the sector that should be of concern. If I am right, there is either a self interested explanation on the part of politicians, or irrationality on their part and on the part of the community generally, or both. I opt for both. What accounts for the irrationality part?

I can remind us of some familiar explanations. The money changers were driven out of the temple, and making money out of money has been questioned in many religions. But there is a fascination here. These are magicians. If we do not think about where their money comes from, it seems as if they have found the cornucopia. Wealth adheres to them. They must be almost magical in their understanding of the way of the world. Do not forget the golden calf. We admire success. We go with the winners. That astute observer John Galbraith wrote,

“…nothing has been more remarkable than the susceptibility of the investing public to financial illusion and the like-mindedness of the most reputable bankers, brokers, and free-lance financial geniuses. Nor is the reason far to seek. Nothing so gives the illusion of intelligence as personal association with large sums of money. It is, alas, an illusion.” (The quotation is taken from Francis Wheen’s excellent book, How Mumbo-Jumbo Conquered the World.)

There are at least two important emotional reasons why we object to a realistic view of the financial sector. For one thing, we like to see the world as essentially fair, in spite of all the evidence to the contrary. It goes against the grain to concede that large and continuous exploitation has been going on. Along with a belief in fairness, the economics discipline has unwittingly played a part. Economics is a great achievement. Make no mistake about that. But some economic theory, carelessly and foolishly applied, tends to see the world as a rational outcome of a competitive process. It is useful to assume competitive conditions at times and be able to analyse interactions when they

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prevail. It is bizarre to assume that we can understand incomes in excess of a million pounds a year in terms of marginal productivity theory.

The second emotional factor is a great reluctance to admit we were wrong. Could it be that we have been so foolish as to allow ourselves to be ripped off? One of the reasons why the Nigerian we-need-a-UK-partner scam is rarely prosecuted is that victims are extremely reluctant to admit publicly that they have been had.

I believe we are left with something of a puzzle. Is the widespread misreading of the financial sector a valid case of irrationality? It is one thing to make a mistake. That is not the same as irrationality. In the early days, there was nothing irrational about belief in the ether theory in physics. Continued belief in the theory becomes irrational when new theory and evidence offer a solid refutation. Where do we stand with respect to the financial sector when it comes to irrationality as opposed to understandable misunderstanding? No doubt there is some pretty wicked self interest at work here. In addition, the financial sector employs a small army of public relations experts in a continuing programme to defend its position and make a case for the sums financiers earn. This is bound to have some effect on popular perceptions. But after all that, there remains an irrational element as well. In summary, we have an irrational acceptance of the wealth of the financial sector because of a fascination with magic, because we want to see the world as essentially fair, because we hate to admit mistakes, and for some who should know better, we succumb to a totally inappropriate application of market theory and ideology.