How would Adam Smith fix the financial crisis? Transcript

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THINKING ABOUT THE CRISIS
How Would Adam Smith Fix the Financial Crisis?

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The works of Adam Smith are habitually oversimplified. But in this piece, the author takes a deeper journey into the meaning of Smith to draw interesting lessons about the current economic crisis and future reforms.

Though the principles of the banking trade may appear somewhat abstruse, the practice is capable of being reduced to strict rules. To depart upon any occasion from those rules, in consequence of some flattering speculation of extraordinary gain, is almost always extremely dangerous, and frequently fatal to the banking company which attempts it.

-Adam Smith, Wealth of Nations ([1776] 1976), vol. 2, 279

THIS ARTICLE USES ADAM SMITH's ANALYTICAL CATEGORIES in explaining sources of the financial crisis and conjectures what solutions Smith might prescribe in our present circumstances. The legitimacy of such an endeavor deserves remark. Much of the commentary about the current crisis stresses the role played by financial transactions such as adjustable rate mortgages and collateralized mortgage obligations that are, in either their nature or scale, distinctively features of the twenty-first century without historic parallel. It thus may appear both unwarranted and unfair to charge an eighteenth-century writer with the task of explaining a present he could not have imagined.

There is indeed much about the present that Smith cannot explain, especially because most of his writings on money and banks assumed the context of paper currency convertible to metallic coin. [1] Despite such contextual differences, one of my goals is to show just how relevant Smith's perspective remains.[2]

If my effort is convincing, there are important implications for thinking about ultimate sources and prospective solutions to this most recent crisis. To the degree that Smith still illuminates our present, this suggests that, beneath complex developments in finance over the last thirty years, we need to examine more deeply rooted business practices that created problems in Smith's time and in ours. Until those practices are transformed, we will likely see the repetition and intensification of such crises.

The second broad goal of this exercise is to rehabilitate Smith from the neo-liberal economists that today lay claim to his legacy.[3] The conventional view of Adam Smith is as the father of laissez-faire economists, the great proponent of self-organizing free markets.[4] This is, however, to confuse Adam Smith with Friedrich Hayek.[5] In fact, throughout Wealth of Nations, Smith continually emphasizes the importance of sovereign institutions in creating the infrastructure to underpin capital accumulation. Hence Smith conceptualized economics as 'a branch of the science of a statesman' in pursuit of the enrichment of the state and its citizens ([1776] 1976, vol. 1, 449). Although a secondary source, it is evident that the extreme libertarianism embedded in prevailing economic orthodoxy contributed to the regulatory environment that made this crisis possible. In its wake, the economic philosophy that has recently under-girded public policy needs its pretense to the disciplinary tradition exposed. This is a necessary step in creating an atmosphere conducive to a shift away from that economic discourse to those more prudent.

Unfortunately, despite the change in presidential administrations, the policies currently being proposed will compound rather than resolve the problems this crisis offers an opportunity to address, in no small part because those in charge of the bailout remain faithful to neo-liberal concepts. The injection of money into banks by the Federal Reserve and Treasury is a new instance of old trickle-down economics. In the context of a recession, banks and their privileged clients receiving the money will be able to acquire assets at a discount, representing a redistribution of income from taxpayers who may or may not be beneficiaries of the monies.

In what follows, I will lay out three responses to the current situation that I believe reflect the spirit of Smith.[6] These policy proposals concern institutional problems with our current system and point in the direction of fundamental fixes. Throughout I will discuss major facets of Smith's writings, particularly those that concern money and banking. I conclude by reflecting on why, culturally speaking, the current and inadequate response to the financial crisis so matters to us and would to Smith.

Narrow Banking

To restrain private people . . . from receiving in payment the promissory notes of a banker . . . when they themselves are willing to receive them; or, to restrain a banker from issuing such notes, when all his neighbors are willing to accept them, is a manifest violation of that natural liberty which it is the proper business of law, not to infringe, but to support.

. . . But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole of society, are, and ought to be, restrained by the laws of all governments. . . . The obligation of building party walls in order to prevent the communication of fi re, is a violation of natural liberty, exactly of the same kind with the regulations of the banking trade which are here proposed. -Smith ([1776] 1976), vol. 1, 3457

In 2003, the World Bank estimated there had been 117 systemic banking crises in 93 countries between the late 1970s and the end of the twentieth century; all this before the current round of bank failures. Martin Wolf, reflecting on this astronomical total, noted that 'to have had one crisis may have been a misfortune; to have had 117 was surely the result of extreme carelessness' (2008, 32). But to chalk these crises up to 'carelessness' is itself flippant. Instead, the pervasiveness of these crises suggests a structural problem in the global monetary and banking framework at least since the end of Bretton Woods.

In fact, the Bretton Woods system fared no better. By the effective adoption of fixed-exchange rates in Europe in the late 1950s, growth of the U.S. balance-of-payment deficit with Europe and the consequent rise of a euro dollar market had already undermined the system. Nor, despite its obvious romantic appeal, did the era of the 'gold standard' prove more stable.[8] In the United States between 1873 and 1913-from the moment of the demonetization of silver to the founding of the Federal Reserve-the country experienced major banking crises in 1873, 1884, 1890, 1893, 1896, and 1907. Each crisis obviously has its own proximate causes, dynamics, and consequences that are case specific. Nevertheless the pervasiveness of these crises across time cries out for a broader explanation.

The starting clue is that most financial crises, and a large number of more general macroeconomic ones, are correlated with bank failures. This is because banks are very peculiar financial institutions. In the case of stocks, bonds, and commercial paper, money is transferred between borrowers and lenders. These financial markets and institutions mediate an existing stock of money. These are properly termed financial intermediaries. By contrast, fractional reserve banks-banks that receive deposits but keep only a fraction of them on hand, investing the rest in loans and securities-use withdrawable deposits placed with them by savers as a basis for extending new money to borrowers. In this case, money at the bank is now available both to savers with deposits and to borrowers with loans. Banks thus create money through their financial dealings (Bossone 1999). According to most estimates, banks create 97 percent of the monetary media conventionally labeled M1 through their asset and loan practices, while government-issued currency accounts for just 3 percent (Hutchinson et al. 2002; Mishkin 2008).[9]

Banks, of course, are not autonomous actors. Banks make loans- and thereby manufacture money-in response to demand from the nonbank public. But banks have an incentive to minimize their reserves of non-interest bearing cash and maximize their holdings of higher-yielding investments. The problem is that such business cyclical lending exacerbates downturns and aggravates speculative booms. In the twentieth century, central banks have been constructed to temper this dynamic through countercyclical, open market operations. But there are limitations on the efficacy of such operations, and these operations can generate their own damages.

Adam Smith's account of massive Scottish banking failures around the time of the publication of Wealth of Nations in 1776 elucidates the danger.[10] For Smith, the Scottish banking crisis was ultimately traceable to the unscrupulous borrowing of 'projectors,' the eighteenth-century term for what we today more approvingly call 'venture capitalists.' According to Smith, 'Had every particular banking company always understood and attended to its own particular interest, the circulation never could have been overstocked with paper money. But every particular banking company has not always understood or attended to its own particular interest and the circulation has frequently been overstocked with paper money' ([1776] 1976, vol. 1, 320).[11]

In response to the crisis, the moneyed interests in Scotland founded the Ayr Bank in 1772 to assume many of the responsibilities we associate with a central bank, principally standing ready to advance notes to Scottish banks as a 'lender of last resort.' However, as a result of the high demand placed on it by Scottish banks to underwrite their nonperforming assets, the Ayr Bank was itself required to draw on foreign funds at increasingly high interest rates, eventually to the ruin both of the Ayr Bank and the Scottish banking system. 'In the long run, therefore, the operations of this bank increased the real distress of the country which it meant to relieve' (Smith [1776] 1976, vol. 1, 333).

Today the Federal Reserve and the Treasury are courting disaster in much the same way. The monetary base has doubled since heightened government intervention in the money markets to resolve the financial crisis. The increase in the money supply has been accomplished through Treasury's issuing new government debt-in other words, through an increase of public arrears that Smith worried would oppress and, in the long run, ruin states.[12] To make matters worse, the sale of debt to foreign investors only further aggravates America's balance-of-payments deficit.[13]

One possible solution to prevent this now recurrent cycle of crises involving private banks, followed by equally intolerable reactions on the part of public authorities, is to move to a system of so-called narrow banks, or banks where demand deposits are backed by a 100 percent cash reserve. In such a system, government alone would have the power to create money, thus making coinage a public institution as Smith himself advocated ([1776] 1976, vol. 1, 245-46, 342). The two distinct functions that present banks combine-the safekeeping of deposits and the issuing of money based on those deposits-would then be separated, generating the efficiency gains from specialization Smith ascribed to such division of labor.[14]

In a full reserve system, banks would profit and compete by charging consumers for their warehouse facilities, payment services, and debit card transactions. Banks could even continue to lend funds acquired in the form of non-checking accounts, such as certificates of deposit that are not redeemable on demand but are transparently lent to the bank for a specified period. What banks would not do is distort the money supply and profit from the private production of money.

Within the current banking architecture, depositors are (largely unknowingly) underwriting the speculative purchase of interest-bearing assets by banks. Although many of these are short-term assets with ordinarily liquid markets such as Treasury bills and commercial paper, the glut of these assets on the market during financial crises forces banks to sell them at a deep discount from their book value unless there is intervention by the central bank. What banks consider 'adequate capitalization' is therefore a shifting historical category that is the stuff of cultural fiction. In the final analysis, the present banking system is guaranteed by government.

In ordinary times we privatize bank profit, and in extraordinary ones nationalize their losses through deposit insurance. As Shy and Stenback wryly note, 'The cost of bailing out failing banks falls on the shoulders of taxpayers who also happen to be the depositors. This is somewhat paradoxical in the sense that the deposit insurance sys- tem is designed precisely to protect these depositors!' (2008, 2). In a full reserve banking system, the enormously expensive system of deposit insurance could be abolished, and the integrity of currency restored.

While moving to a 100 percent reserve system would encounter some practical difficulties, the long-run benefits that would accrue because of the greater stability it would give the banking system are well worth short-term troubles. To effect such a transition, the Fed, for instance, could lend banks the amount of reserves equal to their current deficiency from 100 percent reserves on all accounts subject to immediate withdrawal, including so-called savings accounts, which today are basically as liquid as demand deposits.[15] These new reserves would appear as a credit to banks' accounts with the Federal Reserve on the asset side of their balance sheet, and simultaneously as official loans on the liabilities side. Unlike the current bank capitalization plan, these new monies would be required to stay on account with the Fed. Repayment of the loan could occur over an extended term (for instance, over forty years) at an interest rate indexed to inflation, so that the debt could be retired through institutional growth over time or raising of capital, thereby preventing the immediate liquidation of loans or fire sale of other assets simply to meet the 100 percent reserve requirement (see McLane 1980).

While Smith did not explicitly mention a 100 percent reserve system as an ideal, this was because he presupposed that this was how banks operated in reality. In his praise of the Bank of Amsterdam as a model for how banks should operate-as a 'public utility and not revenue was the original object of this institution' ([1776] 1976, vol. 1, 512)'smith writes 'that [the Bank] keeps in its repositories all the money for which there are receipts in force . . . cannot well be doubted' (ibid., 511).

Mutualize Finance

Being the managers rather of other people's money than of their own, it cannot be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. - Smith ([1776] 1976), vol. 2, 264-65

In recent debates about whether banks should be private or public enterprises, the category 'private' is usually shorthand for an investor- owned firm whose shares are traded on an exchange. The conflation of privatization with joint stock companies, however, conceals a variety of possible organizational forms, such as partnerships, producer cooperatives, nonprofits, and, of particular significance in the history of the banking and financial sector, mutual firms owned by their subscribers.

The conflation of a private banking system with investor-owned banks is intelligible only when seen within a broader intellectual context that celebrates this particular organizational model above all others. In particular, the last twenty-five years have witnessed an elevation of the discourse of 'shareholder value' as best practice among firms (see Ezzamel et al. 2008). This discourse claims that the overall efficiency of the economy is improved when managers of companies implement policies that maximize stockholder return; or, more specifically, policies such as employment and benefit cuts that are interpreted as 'good' in the imagination of investors and that will supposedly garner greater future dividends or capital gains for shareholders as a result.

But recent events call into question the triumphalism of the shareholder value discourse in particular and the investor-owned firm more broadly. Consider the now infamous case of Northern Rock. When in 1999 Northern Rock converted from a mutual building society to a publicly traded bank, it put a capstone on the building society movement that had been responsible for providing homes for the majority of people in the United Kingdom. Tracing its origin to the 1850s, the Rock also played an integral role in the northeast England economy as the single largest private-sector employer. However, in the 1990s, along with other building societies such Abbey National and Halifax, Northern Rock demutualized. In the process, its corporate governance altered. The view of the bank as a complex social institution with multiple stakeholders shifted to a view of the 'bank' as a nexus of contracts and cash flows-a conception consonant with the view of businesses promoted by the discourse of shareholder value (Davis and Stout 1992).

Since Northern Rock's collapse, a number of factors have been cited for its failure. The most frequently discussed is that its business model depended too extensively on sources of funds from wholesale markets, and on -originating to distribute? mortgages as securitized assets to investors. When these markets tightened up, Northern Rock in particular was adversely affected.[16] But while this explanation may be correct as regards the immediate cause, it ignores the underlying

shift in ownership structure, which arguably made such a business model necessary to satisfy the profit ideals of stockholders and investment analysts. Had Northern Rock remained a mutualized society in the business of making mortgages instead of a corporation selling its stock, it may not have pursued such a reckless course that helped feed a speculative real estate boom and now will cost British taxpayers an immense sum.

Smith's antipathy toward joint stock corporations is well documented.[17] He was among the earliest to recognize what we now call the 'principal-agent problem'; or, as the problem is ordinarily exemplified, the potential misalignment of interests between the management and shareholders of a company. Smith did not mince words, claiming that such companies frequently suffered from the 'negligence, profusion, and malversation' of their corporate boards ([1776] 1976, vol. 2, 278). That said, he believed banking to be one of the few trades amenable to the joint stock form.[18]

Smith's position, however, hinged on his view that the banking trade should be 'reducible to strict rule and method' ([1776] 1976, vol. 2, 281). Smith did not imagine, nor would he have endorsed, the increased emphasis of banks on so-called off-balance-sheet activities, such as financial derivatives trading and investment banking services. Applying Smith's perspective to the present, the banking model of financial conglomeration fostered by the deregulatory efforts of the 1980s and 1990s should give way to more decentralized and specialized subsectors.

One further recommendation suggests itself. Smith eloquently articulated a principle of subsidiarity on the issue of ownership. According to Smith, the individuals most intimately connected to a specific property will manage it better than those more distant from direct concern with its stewardship. From a Smithian perspective, the whole current debate about the nationalization'privatization of banking thus needs reframing. What both nationalization and privatization of banks concretely mean is their formal control by abstracted ownership. Ideally, financial institutions should be run more directly by their stakeholders, particularly employees and customers.

The usual case against mutual firms and for investor-owned firms in finance, as elsewhere, is that the latter are imagined as having better corporate governance because of their ownership structure. For example, so-called agency theorists have argued that mutual companies are inferior to exchange-traded companies because the latter are disciplined by concentrated share holdings into more efficient management, and because positive incentives exist for managers when their pay is linked to share price (Fama and Jenson 1983).

But the critique is mistaken. In the first place, ownership of banks today is so widely dispersed that investors are practically incapable of effectively disciplining management. In addition, the present crisis suggests that linking executive compensation to share price encourages, rather than mitigates, risk-taking because the constant turnover of high-ranking employees in the financial sector incentivizes strategies that maximize share price in the short term at the cost of the long-term health of the firms they run.

Historical experience instead supports mutual firms as the best organizational model for banks. For example, in 1933, the worst year of the Great Depression for banks, 27.7 percent of all investor-owned banks failed, but only 0.8 percent of savings and loans associations, nearly all of which were mutual firms. More recently, during the 1980s, the failure rate among investor-owned savings and loans was significantly higher than among mutual savings and loans because of the tendency of investor-owned firms to pursue more speculative ventures with the monies entrusted with them by depositors (Hansmann 1996, 256-57).

Credit unions and mutual societies foster the safe, democratic, and downsized financial order I believe Smith would support. As he counseled, 'A bank which lends money, perhaps, to five hundred different people, the greater part of whom its directors can know very little about, is not likely to be more judicious in the choice of its debtors, than a private person who lends out his money among a few people whom he knows' ([1776] 1976, vol. 1, 337)

Restrict Speculation on Intangibles

The sole use of money is to circulate consumable goods. -Smith ([1776] 1976), vol. 1, 361; emphasis added

Arguably no writer has made the case more strongly for the potentially productive role played by speculators in commercial society than Smith.[19] In book 4, volume 2, of Wealth of Nations, Smith defends two speculative activities-forestalling and engrossing-common in the eighteenth-century corn trade. Forestallers acquired corn at low prices to resell at times of scarcity while engrossers profited from geographic differences in corn prices. Smith argues that -the popular fear of engrossing and forestalling may be compared to the popular terrors and suspicions of witchcraft? ([1776] 1976, vol. 2, 41). In fact, Smith argues, the interests of these speculators and 'that of the great body of the people' are 'exactly the same' (30).[20] But speculation on corn is one thing. Speculation in, say, Dow Jones Index derivatives is another. Very broadly: eighteenth-century speculators took ownership of a tangible commodity; present-day ones cannot own what they are trading because it does not actually exist or they do not own it.

Consider credit default swaps. A credit default swap is a financial agreement in which one contracting party makes periodic payments to the other for a payout should the underlying asset default. The trick is that neither of the parties in a credit default swap need own the underlying asset. Although frequently referred to by the financial press as forms of 'insurance,' they have little to do with the insurance a consumer carries on cars, house, and life they actually own. Instead they are better thought of as bets, no different than when two friends wager on the outcome of a basketball game in which they play no part. Thus instead of spreading risk as insurance does, they amplify it. For example, the proximate cause of the recent problems of AIG and many other troubled financial companies can be traced to the unscrupulous use of these contracts.

There are an estimated $55 trillion in credit default swaps outstanding, larger than the combined gross domestic product of every country on Earth. These sorts of speculative bets on money, for money, would surely be repugnant for Smith. Smith pejoratively refers to money as 'dead stock,' claiming that it 'makes no part of the revenue of the society to which it belongs' ([1776] 1976, vol. 1, 309). For these reasons, Smith preferred a properly regulated paper currency to a metallic one. By such a substitution, a society could transfer its labor resources away from the mining of dead stock and 'convert, as it were, a great part of its highways into good pastures and cornfields, and thereby increase very considerably the annual produce of its land and labour' ([1776] 1976, vol. 1, 341).

But, according to Smith, paper money-while offering 'a sort of wagon-way through the air?'contained a danger. It was quite possible that a society would lose the sure footing it had when it traveled 'upon the solid ground of gold and silver' ([1776] 1976, vol. 1, 341). Today that danger has been realized in the inversion of a means as an end. Money, designed to facilitate exchange, has itself become the most heavily exchanged commodity in the world. In light of the current financial crisis, the variety of financial derivatives and currency trades permissible deserves careful scrutiny. This may sound old-fashioned-eighteenth century even-but contracts written on undeliverable objects, such as financial indices, should not be legal.

Conclusion

Money is neither a material to work upon, nor a tool to work with. -Smith ([1776] 1976), vol. 1, 313

An event appears as a 'crisis' only if it assaults and threatens the continuity of values and relationships central to a particular culture. What defines a crisis is therefore not pre-given in the events themselves. Rather, an event emerges as a crisis because a culture so interprets it. There is certainly no shortage of events today that might be categorized as crises in our country: millions of health-care uninsured, continuing racial segregation, and pervasive gerrymandering, to name a few. None of these, however, elicited such a swift and generous response on the part of government, or such uproar from its citizenry, as the current financial 'crisis.' What then does this say about the character of our culture?

In the United States, perhaps more than in any other commercial society, labor in the formal sector consumes much of our daily life and mediates our access to the security of a money income and, if we are lucky, pension and health-care benefits. When the government magically manufactures $2 trillion without reference to this fundamental relationship, we quite understandably feel affronted.

Adam Smith appreciated these sentiments. As is well known, Smith drew a distinction between the market price of commodities, as determined by supply and demand, and their natural price, determined by the cost of their production calculated by the labor time they entailed. Smith attempted to reconcile these two determinations of commodity prices in asserting that, although market prices might deviate from natural price, the natural price was a statistical mean toward which market prices gravitated over the long run.

Although subsequent efforts to link natural prices with market prices have consistently failed to be empirically compelling, this is perhaps less a scholarly failing than a social one.[21] For Smith, like Locke, Ricardo, and other Enlightenment writers, believed people were (and should be) rewarded by their labor contributions. Today, however, it is clear that wealth and work are profoundly decoupled.[22] As documented in Challenge, a number of metrics suggest -reduced if not completely severed relationships between labor productivity gains and real-wage gains at the national and state levels- (Sum et al. 2008, 58). The entitlement and earning of our most important legally sanctioned right, money-the idiom through which we conceptually convey worth and allocate material resources-has less to do with thriftiness and labor than it does with privileged access to IPOs and interest-bearing financial securities or, most recently, a government bailout. If we feel this is wrong, it is because we are, for better or worse, products of the same culture as Adam Smith.[23]

Notes

1. Also, to seek the wise counsel of Smith does not entail treating him as messiah. On a number of registers, Smith's analysis is found wanting. For example, Smith advocated that banks lend by discounting bills of exchange. This is what later writers refer to as the 'real bills doctrine.' According to the real bills doctrine, if banks issue credit (loans) against trade bills that indicate a real economic transaction (for example, an advance of a wholesaler to a retailer), then banks cannot over-issue money and cause inflation. Later writers have shown the problem with such lending criteria. For instance, a single commodity may be sold a number of times, with each sale giving rise to a trade bill. After a time, there may still be several bills outstanding to represent one commodity, and therefore banks may issue credit many times more than the commodity is worth. For a fuller discussion, see Mints ([1945] 1965).

2. As Laidler notes, 'More space in the Wealth of Nations (1776) is devoted to monetary matters than, say, to the division of labour' (1981, 186). Yet it is for the latter that Smith is famous, to the detriment of an appreciation of his whole corpus.

3. Such economists are sometimes termed neoclassical. In fact, as Maurice Dobb perceptively noted, they are better termed 'counter-classical' (1973, 248). Arguably the most important divide between the classical political economists and present economists hinges on the basis of value and price determination. Classical economists focused value and price analysis on

the production process, while current economists derive them from exchange, in particular consumer demand within a theory of marginal utility.

4. It is also not uncommon for heterodox economists to read Smith as the father of today's orthodoxy. For instance, Whalen summarizing Minsky's views about Smith in a recent issue of Challenge, depicted Smith as a proto-equilibrium theorist, where it is only 'forces external to the market process' that generate disequilibrium (2008, 95). This is not entirely accurate. For example, it was Smith, not Marx, who first claimed that, all other things equal, there will be a tendency in a free market for the rate of profit to decline as capital accumulation increases. This sets up a perverse relationship between the interests of capitalists and the interests of society as a whole. According to Smith, both wage laborers and landlords benefit from increasing productivity and its result, capital accumulation. Workers will benefit because their real wage'measured in the 'trinkets and baubles' available for consumption-increases, as will demand for their service. Landlords also benefit, both as consumers and because rents increase as more land is demanded to carry out production. The exception among the 'three great classes' is capitalists: the profits of capitalists decrease in circumstances of real economic growth and a free market, both because of diminishing marginal productivity over time and because increased competition in a free market limits the opportunity for price gouging.However, according to Smith, it is the capitalists who are most likely to prevail in politics in a commercial society. This is because the laborer in such a society 'is little heard and less regarded' on account of his position that 'leaves him no time' to assert his interests in public deliberation; and because landlords, as a result of 'the ease and security of their situation' are rendered 'incapable of that application of mind which is necessary in order to foresee and understand the consequences of any public regulation' ([1776] 1976, vol. 1, 277). This leaves the residual, the capitalist class, 'whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it' ([1776] 1976, vol. 1, 278). It is therefore plausible to interpret Smith as claiming that endogenous processes are at work within a commercial society because of its class structure, which will generate disequilibrium or less than optimal economic growth.

5. It was Hayek who was interested in so-called spontaneously self-generating forms. For examples, see Hayek (1991).

6. These proposals are suggestive rather than exhaustive. There are no doubt additional proposals that might be generated applying Smith's ideas in the present. For example, one of the major focuses of Smith's effort was imagining ways of reducing the 'inconveniences' and 'vexation' caused to people, or what economists today term 'transaction costs' and 'transparency.' Indeed, a major problem with the structure of the current financial system is the inefficiencies caused because of a lack of transparency. As is well documented, because of the process of securitization, mortgage borrowers did not know until recently that their mortgages had been sold off the books of banks to investors. This has reduced the contractual rights of borrowers to renegotiate the terms of their mortgages.

7. This passage concludes a section in which Smith lays out the case for the prohibition of bank note issues with nominal face values of less than £5. Smith argues that small notes are more risky than large notes because the ability to issue small notes encourages 'many mean people' to become bankers, and because people are not as careful about accepting small notes issued by persons of doubtful credit (Gherity 1994, 435).

8. The 'gold standard' is among the most enduring fictions in social science. My own archival research at the Bank of England, for example, shows that only about 2 percent of notes were backed by gold in the late nineteenth century, at the supposed apogee of its functioning. With a gold standard like that, who needs a fi at currency?

9. As Schumpeter noted, 'Banks no longer . . . 'lend their deposits' or 'other people's money' . . . they . . . manufacture money rather than act on behalf of their depositor. What the banker does with money cannot be done with any other commodity' ([1954] 1996, 320).

10. The summary of Smith's account of these failures presented here is heavily indebted (pardon the pun) to the excellent summary presented by Gherity (1994).

11. Incidentally, this indicates that Smith did not believe people or institutions always act according to their rational self-interest. (See also Smith [1776] 1976, vol. 2, 402.) In general, Smith's endorsement of selfishness was more ambiguous than it is among today's philistines. Writes Smith: 'All for ourselves, and nothing for other people, seems, in every age of the world, to have been the vile maxim of the masters of mankind' ([1776] 1976, vol. 1, 432). Moreover, what Smith meant to convey by the category of self-interest is different from how that category is conventionally interpreted today. It is more accurate to say that Smith conceptualized humans as self-regarding or vain. The reason people are vain is that they care

about what others think of them and desire their approval. For Smith, 'self-interest' is irreducibly social in its source and its definition. See his Theory of Moral Sentiments ([1759] 2005).

12. See [1776] 1976, vol. 2, 446.

13. On the surface, it might seem Smith would not care about the current U.S. current account deficit, since he frequently chastised his contemporaries for an un- warranted obsession with 'the balance of trade' (see especially [1776] 1996, vol. 1, book 4). This is because Smith believed in the 'price-species mechanism' classically articulated by David Hume. The price-species mechanism held that in the long run, trade balances reach equilibrium. If country A is running a deficit, the outflow of gold to country B to pay for those commodities will eventually result in an increase in the price level in B, coupled with a decline in the ability to pay on the part of A. For example, Ben Bernanke, among others, argues that the financial crisis has its origin in a so-called global savings glut, especially in China. This attribution is correct as regards the immediate cause. What it ignores is the underlying structure of productive relations that generated the crisis in the first place. An adequate response to this crisis would include renewed international efforts to promote regulation on Chinese labor practices that have brutally purchased China's 'economic miracle.'

14. This is also the sort of banking system Hume and Ricardo supported. As Hume famously quipped, 'No bank could be more advantageous than such a one that locked up all the money it received, and never augmented the circulating coin'

([1752] 1970, 36). The first Chicago school of economics also defended a plan for full-reserve banking. See Philips (1995).

15. The net reserve deficiency for an individual bank would be calculated by subtracting from its gross transactional deposit accounts inter-bank deposits and items in the process of collection; vault cash; and money already on reserve at the Fed and invested in Fed stock and FDIC insurance.

16. Many of the details provided here about Northern Rock are from Walters (2008).

17. For example, see Muthu (2008).

18. The other trades Smith mentions are insurance and canal and water management ([1776] 1976, vol. 2, 279).

19. As this essay demonstrates, however, Smith was clearly not an apologist for the merchant class. Consider the following: 'Our merchants and master-manufacturers complain much of the bad effects of high wages in raising the price, and thereby lessening the sale of their goods both at home and abroad. They say nothing concerning the bad effects of high profits. They are silent with regard to the pernicious effect of their own gains. They complain only of those of other people' ([1776] 1976, vol. 1, 110).

20. Consider forestallers. If forestallers purchased corn on the expectation of a rise in its price, and the price of corn instead fell, the only damage done was to them. On the other hand, if forestallers were correct and prices did rise because of shortages, then they and the citizenry benefited. 'By making them feel the inconveniences of a dearth somewhat earlier than they otherwise might do, he prevents their feeling them afterwards so severely as they certainly would do' (Smith [1776] 1976, vol. 2, 41).

21. For Smith, the realm of the 'natural' refers to propositions derived by rational deduction. But the extent to which the natural is empirical is a point on which Smith oscillates. Regarding price, it is clear that Smith thinks the natural price is an abstraction from the complexities of everyday market prices that is, nevertheless, a long-run mean toward which prices tend. At other points in Wealth of Nations, however, the natural is a purely normative category, equivalent to the Scholastic notion of the 'just,' against which Smith is writing. In these cases, what is natural may not have ever corresponded with the actually existing. For example, in book 3, vol. 1, chapter 1, Smith writes that in 'the natural course of things,' commercial society should have arisen first by improvements in agriculture, allowing for domestic manufacture, and eventually leading to foreign commerce. In fact, Smith writes, the history of Europe is 'inverted,' 'unnatural,' and 'retrograde.' It was participation by Europeans in the carrying trade (foreign commerce) that introduced 'trinkets and baubles' from the East to the Continent; that stimulated demand for domestic manufacturers; which led to the overturn of feudal relations and the transformation of agriculture.

22. The collapse of the housing market is more an effect than a cause of the current economic crisis. The stagnant real incomes of households had until recently been compensated by the growth in consumer indebtedness, in large part financed

through mortgage liens and home equity lines of credit.

23. Criticism within this culture can therefore be authored in two ways. First, within its meaningful parameters, our culture can be critiqued for its empirical failure to live up to its own ideals; that is, we should demand that there exist some relation between wealth and work. For example, proposals traceable to Proudhon [1849] for labor-time-based money fall within this category. Alternatively, the cultural boundaries can themselves be called into question. This would entail that access to wealth is mediated by a guiding principle besides work, such as citizenship in a community or, more justly, proportional to needs and contribution to innovation and virtue.

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