Response to the referee report.

Any writer receiving such a detailed and thoughtful report is lucky! I thank the referee! Below I reproduce the report and under the sections that I wish to comment on, I give my comment in italics.

Referee report on MS 394

The Crisis and Beyond: Thinking Outside the Box By Claude Hillinger
I recommend that Claude Hillinger's paper "Thinking outside the box" be published. It is an interesting paper full of ideas and suggestions how to reform financial markets. To a subset of his suggestions and reforms I agree, and would therefore like to see them published. To another subset of his theses I definitely disagree. Once published, the scientific community, including myself, would be free to comment and object them.
In the following, I first want to give a fundamental comment and a comment on a structural aspect of the paper. Subsequently, I will comment the text on a more detailed level.
The fundamental comment is that Claude joins the crowd of scholars who know quite a lot of financial markets and the reasons of the current financial crisis. Far from being agnostic, I am skeptical about our state of comprehension. I tend to agree with Dani Rodrik who points out that it is not so clear "Who murdered Wall Street" (Rodrik 2008). So, at one hand, I find Claude's paper too confident regarding our comprehension of financial markets; on the other hand, it is a piece of work that could help inspire some detective work.

This comment is indeed fundamental and is echoed in many of the more detailed comments. At issue is nothing less than the epistemology of the social sciences: How do we know? How confident are we of our knowledge? How do we communicate? Is it possible to reach a consensus on societal issues? Obviously, I cannot discuss these issues here at length, but I will try to indicate where I stand.

I should say that I am not a financial economist. My motivation for writing this paper was that I found the discussions of the crisis to be either shallow or narrowly focused and thought that I could provide a more comprehensive view. Regarding the details, I educated myself in the process. Before I started, I might have thought that a 'naked credit default swap' was a transaction between nudists!

The most dramatic example of the above is deficit financing. I was enraged by the endless repetition of the assertion that there is no alternative to borrowing in order to finance a public deficit. Even a modest amount of thought should convince any reasonable person that this assertion is false. Yet, it is endlessly drummed into the consciousness of the public by the 'authorities'.

Regarding confidence and style: I think that to motivate himself a scientist needs considerable faith in his own judgment and I am immodest enough to admit that I have it! I also think that for the reader this should be irrelevant. I don't want my arguments to be accepted because they are convincing to me, but because, hopefully, they are convincing *to the reader. I believe that discussions are advanced by forceful arguments; let those who disagree argue equally forcefully!*

The most fundamental issue that I can only touch upon: it is the nature and possibility of a consensus on societal issues. The social sciences were founded in the hope that, analogously to the physical sciences, they would provide a growing body of secure, verified knowledge on which such a consensus could be based. This hope has been severely disappointed. I believe that any successful society or civilization has a consensus on basic issues. Western societies, supported by the economics profession, believed in eternally growing material prosperity. That consensus has been shattered and a new one is not in sight.

The structural comment is that the paper, which comprises 34 pages of text, devotes the 13 pages of chapter 5 to “Fundamental reforms”, and the 11 pages of chapter 2 to “Why there will be no fundamental structural reforms”. Given the records of fundamental reform of financial markets, it is understandable when Claude states, “…that the chances of adoption for these proposals are quite remote”. Nevertheless, I think that most readers would prefer to first read his proposals, and then listen to his discussion of what hindrances and obstacles these proposals may meet. At least, I would. However, there is an alternative to restructuring the paper: Chapter 2 could rather easily be rescheduled to setting the scene and giving the wider picture (in terms of time and scope). Most of its content would not be touched by this operation.
Now to the more detailed comments. I give them to rationalize my general conclusion as given above. Moreover, Claude may find some of them useful when going through his manuscript.

Chapter 2.1:
My understanding of the theoretical underpinnings of the Anglo-Saxon variety of democracy is the idea that in parliament, human beings push for the interests of their constituencies. This is in stark contrast to the French concept of a parliament as a place where the volonté général is somehow found (“deducted” when Cartesians do it). The Anglo-Saxon rational for this concept is that its empirical record is satisfycing. No one is forced to buy into this concept. I myself tend to prefer it as it is at least openly stated and pragmatic. If you prefer otherwise, feel free to suggest democratic alternatives. Democratic, however, they should be in a non-cynic sense.

When citing Grünewald: “Values are taken to be relative, so often is truth”. I am curious about the alternative. Provided there are absolute truths, I would be interested in the means to determine them democratically – or scientifically. I would also be curious about the yardstick when it comes to measure the “social and cultural decline”.
“The interests of a society” is an alarming concept to me – in Kantian terms, I would denounce it as real-hypostasis, i.e. stating a non-existing existence. Quite in line with the Anglo-Saxon democratic theory, for me societies do not have interests. In contrast, humans and groups of humans do. You may guess: I am neither French nor an admirer of Rousseau.

Again, it is the deep philosophical questions. I don’t think that the issue is a question of “absolute truth”. I think the real question is do we have a society in which reasonable *people seriously engage in a search for truth and for agreement, or a society in which people distract themselves with trivia and 'arguments' are settled by who can shout loudest.*

Chapter 2.2:

• "Devising incentives which will lead to better social outcomes requires the analysis of rational, not of irrational behavior." This statement is a prefect example for why this paper should be published. I do not yet want to deliver an essay on why I basically agree with Claude on this subject, but have a long list of qualifications…

Chapter 2.3:

• „The laws and regulations at issue were formulated by people who were thinking in a common sense manner about what it takes for institutions to function as intended. It does not require a genius to understand that allowing banks to speculate with their depositor's money is not a contribution to the stability of the banking system. In current debates and in government actions to deal with the crisis this common sense understanding of how institutions function is either lacking, or being deliberately ignored."

Very strong statement. Entails sufficient substance to inspire a scientific debate.

Chapter 2.4:

• A good example for inspiring material and theses. Sometimes, it is the figures, as in the campaign tables of 2.4.1. Sometimes it is these little pieces of information that are so easily missed in academia. I, at least, was not aware of the fact that Lloyd Blankfein was in the room when the decisions whether to bail out Lehman Brothers and AIG were made. And this is a very important information for a social scientist.

Chapter 3:

Chapter 3 is short and crisp, which is good.

Chapter 3.3., however, is a bit too short and not really crisp. What is the ideal from Claude's perspective? Who or what is to be empowered? Is it individuals? What would this mean? Is it groups of individuals? What would be second best when the ideal can't be met? Creating new institutions? Reforming existing ones?

Chapter 4:

"I would have gone one step further: Ideally the principal international monetary authorities should simply have declared all naked CDSs to be void. At one stroke, and at no cost to taxpayers, this would have eliminated the largest chunk of toxic assets in the financial system. The balance sheets of financial institutions would immediately have been greatly improved, since the CDSs had been marked down as assets on the balance sheets of buyers, not as liabilities on the balance sheets of sellers." Here I have three comments:

i) Would declaring naked CDSs to be void be legally possible? I am not an expert in Anglo-Saxon law, but there should be something similar to the European continental principle that contracts are void provided they are against public policy – when the contract was concluded. As CDSs were not supposed to be against public policy when they were issued, declaring them void would imply interfering with written contracts, which would violate basic legal principles. Even if it would be legal by special rules, it may not be a perfect measure to restore trust in the business world.

I am no more a legal expert than the referee. My basic position is that laws are not ultimate—they are made by humans and can be changed by them. The basic issues are *morality and the public interest. Slavery was legal and when it was ended the owners were deprived of property that they had acquired with perfect legality.*

ii) It needs quite some exegetic exercise to construct a line of argument why declaring CDSs to be void would greatly improve the balance sheets of financial institutions. In which scenario would that hold? At the onset of the financial crisis? Before AIG's situation became apparent to the markets? When it had become apparent? The conclusion is very sensitive to the assumed scenario, I presume.
iii) My understanding so far has been that one of the main problems of this financial crisis was that no one was able to quantify the net positions of the companies, due to the complex network of contracts. Given this understanding, no one could have told how specific companies would have been affected by declaring CDSs to be void.

I am unable to see the difficulties that the referee thinks he sees. The deterioration in the balance sheets of financial institutions is due to the fact that the holders of toxic assets have to write them down, while the issuers are unable to do so. Voiding these securities will improve balance sheets regardless of the complexities of cross obligations or of valuation.

• "I had proposed that the values of subprime mortgages as well as the payments on them should be drastically cut, for example by 40 or 50 percent. This would have greatly reduced the burden on the affected home owners and the loss to the issuers would be moderate, since they would still receive half or more of the payments on mortgages that would otherwise default completely."
I am curious about the actual figures. Assuming that I am the CFO of a firm holding subprime mortgages or CDOs, I would maybe not agree that halving their values is a moderate measure. It may be better than total loss, but kill me anyway.

The greatest moral flaw of US policies in the crisis has been that many thousands of families that have been evicted or have abandoned their homes. That concerns me much more than the one or other bank going bust. For most banks it would just be a reduction in profits.

Chapter 4.3.1:
• "A special program initiated specifically to deal with the current crisis provides financial incentives to firms that keep employees on a part time basis rather than laying them off."
Yes and no. Basically, it is not a special program initiated specifically to deal with the current crisis. "Kurzarbeit", i.e. publicly paying for keeping employees on a part time basis is a traditional measure in Germany. Only prolonging the duration an individual is allowed to receive this payment is a specific reaction to the current crisis.

Chapter 4.4. Financing Deficits
• I would love to see this published – very inspiring, much to disagree…

Chapter 5.1:

• The financial markets' "primary function is to channel savings to investments. This function is served when firms issue new equity or debt obligations or when consumers borrow."

This is the Anglo-Saxon perspective. In continental Europe, financial markets give loans to firms. This is in the midst of the current crisis in continental Europe. And even in the US, local banks give loans to SMEs.

This appears to be a misunderstanding: by ‘financial markets’ I means those markets on which financial assets are traded.

On page 23, Claude asks what the social benefit of running huge trading computers is. The mainstream answer would be: Accomplishing the arbitrage business. I find it useful to ask for the reasonable scale and scope, and for the possible limits of arbitrage. But Claude denies any benefit of running these computers. Taking this radical position is a possibility. I would, nevertheless, like to learn more on why Claude takes this position.

I confess to having no direct knowledge of the subject, but I cannot believe that the enormous profits that banks are making from these operations are due to arbitrage. Arbitrage involves little or no risk. It is the common understanding that banks are making huge profits by taking very large risks.

“I suggest that the deepest level cause of this dysfunction is the separation of ownership from management. The shareholder owners no longer decide on hiring, firing and remuneration of ‘their’ managers and they have only a partial control over the allocation of their capital among alternative investment opportunities. The most fundamental reform would therefore be to restore owner control of corporations.”

Fundamental, indeed, it would be – but also beneficial? As far as I understand, it was their owners who managed Sal. Oppenheim. Is this an exception from Claude’s rule? If so, why?

Among successive generations of inheritors of wealth there will be some with poor judgment. Still, it is the common, and I believe correct, opinion that people are more careful if they have to bear the consequences of their actions.

Chapter 5.2:
• “Regulation of the real economy has much to do with genuine science. For example, the approval of drugs is essentially a question of pharmacology.”
The approval of drugs may not be the best subject for exemplifying the regulation thesis. I am aware that this is a controversial issue, but I am member of the crowd that claims that the way western societies deal with drugs is a perfect example of the construction of reality by social interactions. My understanding is that there is convincing scientific evidence that alcohol is a much more dangerous drug than most of the prohibited ones – and it is legal in the west.

Science and public policy is a big and difficult subject. Under neoliberalism too much science has been commercially financed and thus subjected to commercial pressure. Still, there is no question that medicine and pharmacology are science, however imperfect, and no one seriously suggests that drugs should not be tested before being allowed on the market. In my opinion, comparable expertise for regulating financial markets does not exist.

Chapter 5.3 Are there simple solutions?

• After heaving read this chapter, I still do not know the author’s answer. But I am curious about his conclusions.

Not only do I believe that simple solutions exist, I think that they are the only ones! Complex institutions are not the result of complex ideas or designs. They are a patchwork of parts that fit badly together and have never been subjected to a comprehensive design!

Chapter 5.5

• In a first draft of this chapter, Claude wrote about the banking sector. He rewrote the chapter, now using the term payments sector. However, I read parts of the chapter as if the headline would not have been changed, i.e., they lucidly refer to banks, but not to payment systems.

Chapter 5.5.2 Full reserve banking

The text passage on how fractional banking evolved should be reconsidered. It perfectly resonates with the myths of Anglo-Saxon mainstream monetary theory. Unfortunately, it is not in line with mainstream textbooks of economic history. Cipolla condensed in his textbooks written in the 70ies the state of research of the 60ies, including the pioneering work of de Roover on banking in medieval and renaissance Italy. This is still telling and, to my understanding, not challenged by more recent research. It was all there: Credit, paper money, fractional banking – all the financial goodies of our days. This is not to blame Claude. It is telling about our state of economics.

The referee is evidently much better read in this area than I am. I took an account from the internet that seemed both informed and plausible. The referee does not really challenge that account because he does not state where the “goodies” came from; there must have been a beginning.

Full reserve banking is my favourite issue in this paper – I totally disagree with the conclusions. But this is not crucial. I am, however, puzzled when Claude states that he would not know of any arguments in favour of fractional banking. What about the money multiplier? The ability of banks to expand business and finance commercial operations of the real economy that otherwise would not take place? The leverage central banks have by using fractional banking? It is fair to challenge these arguments – but denying their existence? I think that this kind of arguments were the rational why our ancestors invented fractional banking.

The idea, that if the loans that banks make on the basis of fractional reserves were not made, then ditto the related expenditures and the economy would shrink accordingly, has only a surface plausibility. Implied is the idea that an economy cannot find a full employment equilibrium without the continuous creation of new money. I think that when this implication is realized, the plausibility vanishes.

• “Suppose that industry and technology are pretty much as today, but that deposit banking as well as central banking had not been invented, payments being effected by means of paper money or coins.”

Here I disagree about the presumption. To folks like me, this is a contradictio in adjecto. If central banking had not been invented, we would not have industry and technology pretty much as today. Once again: I want to see this published so that I can object!
Claude should nail down what he touches in footnote 2, page 31: The problem is that the reserve obligations had been watered down.

Chapter 5.5.3
• I would love to see how banks could make a business case with FRB. Maybe, it is just a lack of imagination that plagues me, but I can’t help it: I do not see possible business cases.

Part of my proposal was that governments would cease to provide deposit insurance. Then there would be three kinds of accounts: a) full reserve accounts involving a fee, but no risk; b) privately insured partial reserve accounts with a low risk and perhaps a low return; c) uninsured partial reserve accounts with substantial return as well as risk. I think some customers would choose a.

Chapter 5.6.1
• “It is by now common place that the financial crisis was to a large extent caused by the proliferation of complex financial derivatives that were understood by no one.”
This is an example for my general remark regarding the overconfidence of analyst when it comes to explaining the crisis. It may be commonplace, but is it also true? It was commonplace in the early 30ies that cutting wages and prices would be necessary to restore economic prosperity.

Chapter 5.6.4
• I really like the idea of investment cooperatives. I have my doubts that they would flourish. But I would join forces with the author to experiment with them. Who knows? Maybe, they would be one remedy.

Trivia: Complete references will help enjoy the reading.
Reference
Rodrik, Dani (2008) Who killed Wall Street? ww.project-syndicate.org

Thanks again and it would be nice if some readers joined the fray!

Claude