Keep the Casinos Open

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In the storm of politician and pundit pique over financial regulatory reform, brought to a crescendo by conveniently-timed SEC charges against Goldman Sachs[1], one refrain is repeated again and again in different forms. Paraphrasing a few:

- Wall Street is just a casino.
- Over-the-Counter derivatives like the Goldman Sachs' CDOs are just "side bets" and should be banned, or at the very least we should regulate the bejesus out of them.
- These "bets" aren't "real investments".
- We should not let people "gamble" in this manner.

However ubiquitous, and now verging on the conventional wisdom, this is still just silly talk.

First, almost all derivatives are side bets. Even the exchange-traded, clearinghouse-blessed plain vanilla ones that the love-to-regulate crowd supports are still side bets. The simplest S&P 500 futures contract is a bet between the long investor and the short investor that is settled up without any stocks changing hands. Even contracts that, in theory, have physical delivery at their end almost never do, and even if they did are still a side bet between the long party and the short party. So, unless you're planning to ban all derivatives, including these plain vanilla exchange-traded clearing-housed beauties, please don't complain about side bets and casinos.[2,3]

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[1] At no point in this essay do I address the question of whether Goldman perpetrated a fraud in this transaction by not disclosing material information. That is a completely separate issue from whether we should listen to the hysterical mass of punditry and politicians and ban what they consider to be "gambling." Believers in limited government like myself believe civil courts adjudicating fraud are one of the few proper functions of government (as opposed to, say, taxing soft drinks to pay for "cash-for-clunkers").

[2] One prominent legislative proposal would ban all OTC derivatives, save those issued by Native Americans. Yep, if you're 1/16th Chippewa you can issue customized, naked CDS without requiring margin.

[3] I made up the prior footnote. I know you were 95% sure of that, but isn't it a little scary that you were even 5% unsure?

OK, now why are these side bets good for the world? Well, first, I don't think I need to prove that. To "ban" something (a word statists really love), you need to show it does a lot of harm to those that are not a party to the transaction. Otherwise, again, be quiet and let free people transact (including betting) with each other as they see fit. But, luckily, I don't need to rely on just my fellow Americans' love of liberty here. These side bets are indeed generally good for the world.[4,5]

This is all fairly standard economics so I won't spend much time on it. Any time you have a transaction, including a side bet, which both sides enter into voluntarily, both sides must think they are being made better off. In the case where one side is a speculator and the other a hedger (or better, two offsetting hedgers) both can be made better off before and after the fact. The speculator, by making money, the hedger by reducing a risk he feared (e.g., if you buy fire insurance on your home you are not made worse off by your home not burning down). The tough case seems to be speculator-on-speculator side bets. In this case somebody will win and somebody will lose. First, I appeal again for the rights of free people to put their money where their opinions lie. Just because somebody will be wrong doesn't reduce this right. But, second, this activity still makes society itself better off. If these "side bets" encourage more research, more time and energy, into figuring out whether the current price is too high or too low, they themselves can make prices more accurate.

Consider of course the case of John Paulson and the now infamous Goldman Abacus deal. Now imagine that instead of just John Paulson and only a few others, many people realized how ugly the real estate bubble was going to be, and realized it a few years earlier than when it was actually experienced. If they all tried to put on "side bets" that real estate would fall (and mortgages would default), they would have moved prices. They would have had to entice people to take the other side. The way this enticement works in a free market is by prices changing. In other words, if more people tried to do this earlier, real estate prices never would've gotten so high, and mortgage yields never so low. Put simply, a more vigorous, more liquid, more active market for "side bets" like John Paulson's would likely have made the real estate / credit bubble a less, not more, dangerous event.

Consider the recommendations of Professor Robert Shiller, famed for predicting both the technology stock and real estate bubbles. Shiller has long advocated a

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[4] By the way, and for the record, government loves betting, it just doesn't love free people betting amongst themselves without government wetting its beak. Government loves Powerball. Government loves OTB. Government loves legalized casinos that pay big taxes. So please, don't tell me it's a moral thing about gambling, or about government protecting us from ourselves. It's a power and revenue thing where the government wants it all.

[5] For fun, let's talk about Powerball some more. Government monopolizes and promotes about the most regressive scheme in history (let's make a giant number of poor people a little poorer to make one poor person super-rich) and this causes them no shame whatsoever. But, at least after selecting each Powerball winner the government has one new "fat cat not doing his fair share" to demonize.

futures market on economic news. These derivatives would give us the ability to bet on how strong GDP will be, how high or low unemployment comes out, whether inflation is climbing back, etc. Furthermore, every one of these is a "side bet". He doesn't advocate these side bets as he cruelly wants to feed people's gambling obsessions, or wants to create a new vehicle on which Wall Street can charge commissions. He advocates for these contracts because he knows that legitimate hedgers and speculators, facing economic risk themselves and wanting to reduce it (hedgers), or holding economic opinions and wishing to profit from them if correct (speculators), will use the contracts to make their worlds, and the World, a better place. Risk would be reduced for those who wish it, and through the research of speculators we would gain valuable insight into where the economy is heading (I promise no forecast will be as good as the net of those betting their own money). The "side bets" Shiller advocates here are worthwhile, but no more so than "side bets" on the state of the real estate and mortgage world back in 2007. And they are all worthwhile for the same reasons.

Of course, another knock on complex OTC derivatives is that they threaten the world's stability through a giant web of "interconnectedness." This is certainly possible, though I tend to think this worry is considerably overdone, particularly if some very reasonable small steps are taken. A combination of reducing the pernicious application of too-big-to-fail, the root of so many of our problems, increasing demands that securities be marked-to-market, and simply focusing more energy on the before-the-fact mechanics of unwinding a large derivatives trader in bankruptcy, should suffice to make the system far more robust. If you still worry about disaster, then advocate all you want for exchange trading and clearinghouses. Again, that is a separate issue from the demonization of "betting", the topic I address here.[6]

A lot of the moralistic yelling against casino-like "side bets" is simply the old prejudice against short-selling rising up again in slightly altered form.[7] These "side bets" I defend have both a long investor and a short investor, and thus presuppose the legitimacy of going short. Of course, short-selling is actually a very good thing. Since asset prices rise over the long-term, unless short-sellers are right unusually often, on average the shorts are doing the rest of the world a favor by losing money so we can all be a little more net long. And, from the tech bubble to Enron *et al*, to the real estate / credit crisis, the shorts help (if obviously insufficiently) to rein in bubbles. So, logically we should all embrace short-sellers, and establish rules to make their activities cheap and easy, as they are either transferring money to the rest of us, making our prices more accurate, or both. But, through an almost atavistic prejudice we just hate their guts. When

[6] Irrespective of government action, I'd be shocked if more or most derivatives did not move to exchanges and clearinghouses naturally. Both business and government can and do make horrible mistakes. But, businesses really do learn from their errors. Government promotes theirs to higher office.

[7] Holman Jenkins writing in the Wall Street Journal on 4/21/10 in "The War on Shorts, Cont." makes this point well.

you hear someone ranting about the Wall Street “casino” it’s a good bet that misguided bias against short-sellers is behind it.

One closely related canard is used to target credit default swaps (CDS) particularly. Countless commentators have informed us that you should not be allowed to purchase CDS as a “bet” against a company, unless you have an insurable interest (money at risk if the company defaults) in that firm. Each and every one of these geniuses have quite independently made the analogy to existing law stopping you from purchasing fire insurance on your neighbor’s house but only allowing it on your own. We are supposed to nod at the deftness of this analogy and “ban” yet another thing that people who like banning things want us to ban (ok, I’m not proud of that sentence). In this case, we’re supposed to ban CDS unless you already own the company’s bonds, in which case the CDS is near useless as you probably should just sell some of the bonds.

The problem is that the fire insurance analogy for CDS is a terrible one. The reason you are prohibited from purchasing fire insurance on your neighbor’s house is not that there is anything inherently wrong with “betting” on such a thing as a bystander. The problem instead is that if you bet on such a thing you would have too much incentive to light the fire yourself. We prevent this type of bet because it introduces a drastic and clear incentive to work actively towards burning your neighbor’s house down. Now, there are indeed tales of “bear raids” by short-sellers and purchasers of CDS -- active attempts of short-sellers to bring companies down for profit. The difficulty is that these are just tales. Nobody has ever come close to proving any large bear-raid conspiracies, let alone showing that they are any more prevalent than the possible fraud and intentional rumor-mill that may occur on the “long” side.[8] Like in our other examples, giving investors incentive to root out companies whose credit is worse than it appears, by allowing them to profit, or lose if they are wrong, from this bet is a worthwhile economic activity. If the short-sellers (CDS purchasers) are right the problems really exist, and it’s always better to discover problems now, not later.

Stepping back, nowadays the popular narrative is that this economic crisis was caused by Wall Street and derivatives. It was not. It was a real estate bubble caused by government, countless individual people, indeed Wall Street, and a bevy of other economic agents like mortgage and real estate brokers and a government-created oligopoly of underperforming rating agencies. Government was a prime culprit through the creation of disastrous GSEs, implementing politically correct social policy that warped the housing market, enacting land use restrictions in the bubble’s worst epicenters and, of course, promoting 20+ years of too-big-too-fail when it was not at all needed, including pursuing exceptionally easy monetary policy for years after the “dot com” bubble. Individuals contributed mightily through a get-rich-quick mentality (who doesn’t know somebody who quit a real job to flip houses?), over-spending, and short-

[8] Remember, in both the long and short cases we can and should prosecute fraud.

sightedness. Financial firms of all types clearly pitched in as they tried to ride the bubble until it burst all over them.

Had Wall Street acted more soberly we would still have had a bubble (but maybe a smaller one, which I agree would've been better!). But had government not built a bonfire and thrown gasoline on it, I'm not sure we'd have had any problem at all. This can be argued in a circle forever and, admittedly, rational people can disagree how to apportion blame. But, to solely blame Wall Street, as has become the popular narrative, and use that as an excuse to bring yet more of the economy under the federal thumb, is sordid.[9] Government is using a disaster it had a primary role in creating as cover for further takeovers in a cloud of class warfare and lies. That just sounds wrong to me

To review, government, including many of the same legislators who brought us Fannie Mae and took VIP loans from Countrywide, is pinning the full blame for this mess on Wall Street, and concluding we should give government much <u>more power</u> going forward. Its idea of reform is not to commit to ending too-big-to-fail, but to plan for it in perpetuity. Its idea of reform is to give government unspecified but exceptionally puissant abilities to prevent and to fix all problems in the future through bureaucrat-determined arbitrary taxes, open-ended takeover powers, and unprecedented resolution powers that ignore a century of well-developed bankruptcy law (making the corruption carried out in the Chrysler bankruptcy now the law of the land). I've exhausted even my ability to be sarcastic here. Please ridicule government amongst yourselves.

OK, back to the point. All derivative contracts are side bets. They serve a useful economic purpose and our base case should be to let free people who want to make contracts with each other do so. The reviled Goldman transactions did not cause, or even inflate, the real estate bubble, it just made one financial institutional (Paulson) a bigger winner, and another a bigger loser. It was a bet each wanted to make, and was by definition considered a fair one by each party at the time. How do we know this? Easy, it was voluntary.[10] Now government wants to rewrite history and say that this type of fair bet caused all our problems, and they'll never bother us again if we just give them much more power, again. Do you believe them?

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[9] The political reasons for this narrative seem clear. Those in government can either blame themselves, those who vote for them, villainous bankers, or the most accurate, some combination of the three. Which would you guess they'd choose?

[10] Unless, of course, as the SEC alleges, one side's consent was obtained via fraud. In that case, as a fraud, it is covered under existing law. We don't need new laws to prevent it but simply enforcement of the existing ones.

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