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Antecedents to the Global Financial Crisis:

Mandeville, Smith, and Keynes

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Introduction

The Global Financial Crisis (GFC) is a fertile backdrop for introducing students to social economic issues and methods. This paper describes a seminar for first year undergraduates at a liberal arts college in the United States. The course analyzes the moral questions that arise when considering a government's response to mass unemployment, and the moral justifications for financial deregulation that began in the 1980s in the United States. Financial institutions and shadow banks eventually took on highly leveraged risks, imposing systemic costs with moral implications for inequality and sustainability of the economic system.

Primary readings in the history of economic thought are an innovative approach to teaching about the GFC. The historical moral underpinnings for collective social action in time of economic depression, and the rationales for financial market regulations, engage students in debates that continue today. Earlier economists are often social economists, and provide insights into human nature and behavioral economics; these ideas are seemingly ignored in the design of financial market liberalization. Historical figures in the canon of economic thought help students broaden their thinking about the world and one's moral responsibilities within it.

Using an historical approach, the class begins by analyzing and debating the familiar classical economic themes that unemployment is voluntary, that “greed is good,” and that markets self-regulate leading to widespread prosperity. Next, it explores evidence from the Great Depression and Keynesian models to explain the data. The course then addresses other history of economic thought debates and confusions about *laissez faire*. Using mainly primary sources, students learn that these debates arise out of ethical controversies that predate Adam Smith, such as in the work of Bernard Mandeville. Students come to question whether the standard interpretation of the invisible hand correctly presents Smith’s ethics, and the institutional and policy pluralism that arises from it. To allow for Socratic discussion, university rules cap seminar enrollment at 16 students per section. Classes meet for 75 minutes, twice a week for 14 weeks. The course has no exams but a large writing component including an essay and a research term paper. While some students have taken principles of economics prior to the class, that is not a requirement in this interdisciplinary seminar.

Literature review

Amidst the large and growing literature on the causes and consequences of the GFC, teaching about the crisis is also receiving attention. Shiller (2010) notes that students are deeply dissatisfied with the standard economic approaches that fail to address important policy problems. Shiller counsels that “Teachers can encourage such recognition and best serve their students if they refer regularly and respectfully to the history of economic thought, conveying the reasons for the theoretical constructs of other times and the tentativeness of current theories” (p. 403). Gärtner, Griesbach, and Jung (2013) surveyed a large number of macroeconomic instructors in Europe and the United States on how their teaching is evolving as a result of the

GFC. They received over 250 responses. The respondents show a modest move toward revising their teaching by emphasizing the short run Keynesian model. While slightly more than a third of respondents have never used history of thought in teaching macroeconomics, 14 percent of respondents in Europe say they have increased their coverage in this area, compared to 9 percent in the U.S. Meanwhile, 5 percent in both areas have reduced coverage of history of thought, perhaps because they are devoting more time to economic history, case studies, and public debt. Madsen (2013) surveyed macro textbooks and found few changes, even though he calls for greater historical emphasis.

In 2014, Granter and Tischer provide a primer on teaching about the crisis taking a sociological and political economy approach. They use historical figures such as Marx, Durkheim, and Weber, and 20th century figures like Minsky and Kindleberger, to weave a story for students about the inherent instability of capitalism. Similarly, in making sense of complex events, Zouboulaki (2017) argues that studying history, psychology, and sociology in the classroom helps students overcome the biases that undergird methodological individualism, and which separate economics from its sister disciplines.

These accounts from the literature demonstrate a modest move towards reconsidering how to teach about the crisis, and in several cases emphasize the role of history of thought in doing so.

The ethics of unemployment

The GFC that began in 2008 revived contested debates about the political economy of government intervention in the macro economy. To understand the moral antecedents of these events, a large amount of class time (3-4 weeks) is spent examining historical macro models, and

evaluating the ethical justifications for, and against, government interventions that arise from these models. To begin, students learn about the Classical model from the 18th and 19th centuries, and its claim of well-functioning labor markets. In this world, rational actors respond to real wage incentives that change behaviors and clear labor markets, producing full employment. At a macro level, supply creates its own demand (Say's Law), so a deficit in aggregate demand can never persist. While recessions occur over short periods, the main moral take-away is that long-term unemployment arises only when workers refuse to work for equilibrium real wages. Such "unemployment" is really just disguised choice optimization—people voluntarily quitting the labor market when their preferences for leisure outweigh their preferences for income. In such situations, government handouts to the "unemployed" are immoral and create incentives for idleness. The best government action in this context is no action.

While President Herbert Hoover is sometimes depicted as an advocate for *laissez faire*, his administration undertook public works to raise employment during the early 1930s, and where "circumstances and ill fortune" leave someone bereft, he advocates for relief agencies to help. Fundamentally, however, Hoover embraces the view that assistance should rely on the private social bonds in communities and the "spirit of mutual self-help through voluntary giving." The justification comes from a Christian appeal: "'Am I my brother's keeper?' No governmental action, no economic doctrine, no economic plan or project can replace that God-imposed responsibility of the individual man and woman to their neighbors" (Hoover, 1931).

Students go on to study Keynes' social philosophy as motivation for his theory of federal responsibility, and explore primary sources from the Great Depression. A key difference reveals itself in his final chapter of *The General Theory*, where Keynes writes "The outstanding faults of the economic society in which we live are its failure to provide for full employment and its

arbitrary and inequitable distribution of wealth and incomes" (1936, 372). Inequality is equally important when discussing the GFC and the bailouts for Wall Street, with no lifeboats for Main Street. The GFC accelerates the march of wealth concentration: the top 1% of Americans own 39% of wealth in 2016, up from 34% in 2007 (Podkul, 2018).

Students then consider facts about the Great Depression, in which official unemployment rates soar to 25 percent, and stories of suicide and starvation roil the nation. Photojournalists like Dorothea Lange provide moving portraits of working people in desperate poverty. "Migrant Mother," for example, is the iconic 1936 photograph of Florence Owens Thompson, a Cherokee Native American. She is shown in a stark black and white image sitting on her doorstep at an agricultural labor camp with three of her seven children clinging to her. Lange's subjects often face the camera with quiet dignity after exerting backbreaking efforts in the fields picking peas and cotton—hardly the deadbeats and freeloaders sometimes depicted by dependency views in Classical economics memes.

Students compare job openings with unemployment rates (the Beveridge curve) and observe that workers in a recession typically are not leaving the labor market voluntarily (creating job openings), but rather the reverse. The Keynesian labor market model offers an alternative to the classical view, in that wages and prices in some markets respond slowly for a variety of reasons. This could relate to the transaction costs of hiring, training, and firing heterogeneous workers, the need for firm-specific skills, the existence of long term labor contracts, money illusion, or other factors. If a Keynesian labor market better reflects the reality of job losses in a downturn, the moral implications of this are profound: mass unemployment is to some large degree *involuntary.* If this suffering can be alleviated by reasonable government

policy, then a claim can be made that it is immoral to sit idly by and do nothing, or to mainly rely on private philanthropy, as did Hoover.

Students analyze readings by John Maynard Keynes that argue this point. The first is his essay on "The Great Slump of 1930," in which Keynes argues that central banks, working together, have the power to restore full employment:

> In every way the more effective remedy would be that the Central Banks … should join together in a bold scheme to restore confidence to the international long-term loan market; which would serve to revive enterprise and activity everywhere, and to restore prices and profits, so that in due course the wheels of the world's commerce would go round again (Keynes, 1930).

By 1936, when Keynes publishes *The General Theory of Employment, Interest and Money,* it is clear that two new problems have arisen. The first is that central banks fail to take the necessary strong action to restore banking confidence. Thus a financial panic on Wall Street spreads into the real sector on Main Street, causing a general depression. The second problem is that a liquidity trap weakens the central bank's powers to expand aggregate demand. In this situation, Keynes recommends that an activist fiscal policy stimulate investment spending. Students read the concluding chapter to *The General Theory* and write a short essay on whether Keynes advocates for a socialist state. The evidence for, and against, this claim makes for an appropriate critical thinking exercise in social economics. Keynes does aver, "a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment," and argues also for higher taxation of wealth. On the other hand, he argues that his system will preserve and protect individual liberty and private initiative, which otherwise may give way to something more dangerous:

> [T]he enlargement of the functions of government … would seem to a nineteenth-century publicist or to a contemporary American financier to be a terrific encroachment on individualism. I defend it, on the contrary, both as the only practicable means of avoiding the destruction of existing economic forms in their entirety and as the condition of the successful functioning of individual initiative (Keynes, 1936, p. 380).

Indeed, the political context for Keynes' *General Theory* is the rise of totalitarianism in the Soviet Union, the rise of Hitler in Germany, and the rise of communist movements in the UK and the US in the 1930s. High involuntary unemployment is not just an economic concern, but also a social and political malady. Keynes anticipates that high unemployment rates can lead to international conflicts, as nationalistic leaders blame other countries' policies for their own workers' woes. Far better, he argues, for each country to achieve full employment using its own policy tools, and enjoy the higher wealth and efficiency afforded through international trade (Keynes later moves away from this view).

One justification for activist fiscal policy is that instincts drive human nature and can supersede logic when it comes to investments. In Chapter 12 of *The General Theory,* students read Keynes's observation that investors have no incentive to think long term, because uncertainty reduces the accuracy of long run projections. As a result, speculators use gut instincts about the "state of confidence" that outweigh sober judgments in the formation of expectations. "Animal spirits" sway decisions and panics ensue when investors run for safety. Keynes notes that long run investment decisions "cannot depend on strict mathematical expectation," because socially contagious optimism or pessimism matter. Ultimately, long-term investments rely on "whim or sentiment or chance," and hence rely to some large degree on irrational forces (Ibid., p. 163).

Keynes maintains, paradoxically, that *politicians* suffer no such myopia; in his view, the political leaders of the state are forward-looking and able to take the rational "long view." This provides the justification for fiscal policy investments during depressions: "I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment" (Ibid., p. 164)

The United States Congress formally adopts Keynesian economics in 1946 when it declares, "it is the continuing policy and responsibility of the Federal Government to use all practicable means ... to promote maximum employment, production, and purchasing power" (Employment Act, 1946). The change from *laissez faire* to federal macroeconomic responsibility coincides with higher growth rates and greater stability. From 1860 up to World War II, recessions come frequently and last about 21 months on average. Under activist monetary and fiscal policies from 1946-2010, the average downturn lasts only about half as long, 11 months. Average GDP growth rates are higher (1.9% compared to 1.5%), and growth volatility is substantially lower (standard deviation of 2.4 compared to 5.6) (data calculated from Williamson, 2016). The correlation of better macroeconomic performance with Keynesian policies does not prove causality, but this evidence, along with sound theory, suggests that collective social action can help ameliorate negative macroeconomic events such as the GFC.

By the 1980s, however, Keynesian economics gives way to rational expectations and efficient market theories. Stagflation in the 1970s makes people leery of thinking that macroeconomic variables can be manipulated easily, because rational economic actors can predict and take steps to counteract government actions. Nevertheless, policy makers at the Federal Reserve continue to rely on Keynesian theory and policy, albeit with limits and

reservations (Krugman, 2009). Support for unemployed workers, via transfers, direct government hiring (such as in the Civilian Conservation Corps), and fiscal investment spending, may not lead inevitably to the vice of indolence and dependency, nor to rampant inflation; rather, it may provide opportunities for self-fulfillment, the strengthening of labor force participation rates, and the development of capabilities.

To ensure that students engage in critical thinking about these issues, opposing views are brought forward. Students read Friedrich Hayek's Nobel Prize address, "The Pretense of Knowledge," in which he argues that economists fool themselves into thinking they have sufficient information to fine-tune the economy (Hayek, 1974). They also watch a video of an imagined debate between Hayek and Keynes (Papola and Roberts, 2010). Students come to appreciate that while a small Board of Governors at the Fed easily controls the levers of monetary policy, fiscal policy shows up with long lags, and must overcome political hurdles in Congress and the White House. While Keynes calls for a balanced budget over the business cycle (deficits during recessions, surpluses during booms), asymmetry exists in terms of the difficulty of enacting each. Historically, it is easier for politicians to increase rather than decrease government spending—giving rise to mounting public debts, the financing of which could threaten to crowd out private investments. Even so-called fiscal conservatives in Congress show a willingness to run up large deficits through stimulatory tax cuts when the economy is near full employment (as happens with the Tax Cut and Jobs Act of 2017). The pragmatism of Keynesian fiscal policy can also be criticized on socio-economic grounds as assuming too much long term goal orientation on the part of politicians, as well as too much civic virtue in doing the right thing for the country at large; Keynesian policy may require excessive knowledge and rationality on

the part of economist-advisors. The excessive reliance on economic "experts" can lead to a weakening of democracy, according to Levy and Peart (2016).

The invisible hand

According to neoclassical economics, humans are motivated by self-interest and typically do not constrain their utility functions with overarching deontological or virtue ethic principles. Rather, moral hazards that arise in economic exchange are overcome with enlightened self-interest. In this view, the desire for repeat business in competitive markets compels business people to treat others with respect and honesty. In seeking profit, business people are forced by the circumstances of rivalry to behave in ways that mimic duty and virtue ethics approaches. The first fundamental welfare theorem in neoclassical economics thus states that under ideal assumptions, competitive markets will always lead to an efficient outcome. This is called the "invisible hand" theorem because it is argued that, in an idealized world, agents pursuing their own aims, free of government regulation, generate the greatest possible social benefits, even though every agent concerns himself with satisfying only his own individual preferences.

As a primary historical marker for this view, students read an excerpt from Bernard Mandeville's *The Fable of the Bees,* published in various editions in the early 18th century. This manuscript provides an extreme version of *laissez-faire*, in which, according to the subtitle, *Private Vices [yield] Publick Benefits.* The poem starts in a free-for-all beehive economy in which greed and other so-called vices are conducive to enriching the public's welfare:

Millions endeavouring to supply

Each other's Lust and Vanity…

Thus every Part was full of Vice,

Yet the whole Mass a Paradise… (Mandeville, [1732] 1988).

Mandeville finds no virtue in the hearts of humans; every altruistic act seemingly arises from a selfish motive. Yet the lack of virtue counter-intuitively turns into a veritable gold mine: greed and vanity spur the economy!

Fraud, Luxury and Pride must live,

While we the Benefits receive.…

So Vice is beneficial found….

When the beehive residents convince their god to endow them with contrition and virtue, an economic depression ensues: without crooks there are no jobs for police or judges or courts; without lust there are no prostitutes; without pride there are no vanity or status purchases. Markets collapse and mass unemployment follows. The message is clear:

[T]hey, that would revive

A Golden Age, must be as free,

For Acorns, as for Honesty" (Ibid.)

wherein acorns are a metaphor for crass materialism over saintly virtues.

Students read Mandeville for two reasons. He is a pre-Keynesian who foresees the potential for a lasting macroeconomic disequilibrium with mass unemployment. More importantly, Mandeville provides jocular justification for the 20th century dictum that "Greed is good" for society at large. Ayn Rand (1905-1982), the influential philosopher, picks up this theme after experiencing totalitarianism and collectivism as a young woman in the Soviet Union. In contrast to the collective public responsibilities implied in Keynesian economics, Rand celebrates the highest form of individualism leading to ethical egoism in novels such as *The Fountainhead* and *Atlas Shrugged*. Rand's philosophy sways the thinking of notable policy

makers such as Alan Greenspan (Chairman of the Federal Reserve from 1987-2006), Senator Rand Paul, and House Speaker Paul Ryan (who also ran for the Vice Presidency in 2012). Ivan Boesky echoes her sentiments when he exhorts business school graduates that: "[G]reed is healthy. You can be greedy and still feel good about yourself (Investopedia 2018)." Boesky subsequently confessed to insider trading and received three years in prison and a $100 million fine. Nevertheless, many economists extol a world of business without virtue: Arrow and Hahn assume that "greed" is the essential motivation for achieving economic efficiency (1971, p. vii).

Many 20th century authors contend that this insight into motivation goes back to Adam Smith, who asserted the "dignity" of greed (Lerner, 1937, p. ix). A quote from *The Wealth of Nations* is often used to make this point:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantage ([1776] 1981, pp. 26-27).

The assertion that Smith's notion of self-interest is synonymous with greed receives widespread condemnation by modern historians of economic thought (e.g., Otteson, 2002, McCloskey, 2007, Evensky, 2005, and Young, 2009). Rather than rely on secondary sources, students read lengthy passages in which Smith himself condemns such a view, calling out Mandeville for spreading the "fallacy" that every motive is selfish. He excoriates Mandeville's "sophistry…that private vices are public benefits." Mandeville's model, Smith writes, yields a "façade" of truth, but is "absurd and ridiculous" in light of our own experiences. Smith observes that "the desire of doing what is honourable and noble, of rendering ourselves the proper objects of esteem and approbation, cannot with any propriety be called vanity." ([1759] 1982, p. 309). Smith's model of

socialization relies less on rationality—the conscious and logical pursuit of means toward ends—and more on innate drives. Instincts, Smith proposes, are a more reliable mechanism to create behaviors needed for survival and propagation:

> But though we are in this manner endowed with a very strong desire of those ends [survival and propagation], it has not been entrusted to the slow and uncertain determinations of our reason, to find out the proper means of bringing them about. Nature has directed us to the greater part of these by original and immediate instincts (Ibid., pp. 77-78).

Smith is thus an early behavioral economist who would not assume for humans the mantle of rationality or *homo economicus*.

For greater depth, students read the academic novel, *Saving Adam Smith: A Tale of Wealth, Transformation, and Virtue* (Wight, 2002) that uses Smith quotes from *The Theory of Moral Sentiments* and *The Wealth of Nations* to bring forth Smith's socio-economic approach. Rather than selfish individualism, Smith's model relies on the social construction of meaning and identity. Without social interaction and fellow feeling, individuals have no springboard for learning right from wrong, for making mistakes, and for learning self-control. Vernon Smith notes that "…far from championing the individual's pursuit of self-love, [Adam] Smith [sees] the individual as not even defined except in a social context. There is no cognitive individual psychology except as it is born of a person's social circumstances, out of the 'social psychology' of his environs…." (2013, p. 288).

The conflation of self-interest with greed is a misreading of Smith's model. This means that the interpretation that greed is essential for the working of the invisible hand is also incorrect

(Wight, 2007). The most familiar version of Smith's invisible hand appears in *The Wealth of Nations*, where Smith explains why entrepreneurs prefer to keep their capital closer to home. He notes that a merchant

> intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an *invisible hand* to promote an end which was no part of his intention" ([1776] 1981, p. 456, emphasis added).

This does not mean that the merchant who intends his own gain operates without regard to social and ethical contexts. In fact, a few lines earlier, Smith makes clear that one of the key reasons merchants believe there will be greater security in domestic transactions is that "He can know better the character and situation of the persons whom he trusts. . . " (Ibid., p. 454). Trust can be based on enlightened self-interest, as depicted in the neoclassical model, but it is much stronger when based on internal motivations born out of ideals of justice and forged into character through conviction and habit. Smith's use of the word "character" identifies that a key ingredient in the invisible hand is the instinct for fellow feeling that gives rise to the love of virtue for its own sake. When a merchant believes a supplier is honest by principle and character, not by calculation, that reduces the transactions costs of trade and opens greater opportunities for mutually advantageous wealth creation.

Application to Financial Markets

Discussion now leads into a second fallacy: that Smith and the invisible hand rely on the credo of *laissez faire*. This doctrine rests on the claim that market forces can be trusted to correct any moral hazards that may arise, and government intervention is both unnecessary and

counterproductive. Alan Greenspan, the Federal Reserve Chairman from 1987-2006 during a period of bank consolidation and deregulation, argued strenuously that self-interest would dependably lead financial markets to self-regulate their own behaviors and reduce excessive risk-taking. After the GFC, when Greenspan is debriefed by a Congressional oversight committee, he admits that his *laissez faire* ideology has a "flaw," which distresses him greatly: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief" (Andrews, 2008).

With support from deregulation advocates, the Commodity Futures Modernization Act of 2000 outright banned the regulation of derivatives. While some derivatives serve a vital role in reducing risk, more than two-thirds of credit default swaps in the GFC are transacted for reasons of pure speculation. Such "naked" trades do not arise from the ownership of a financial asset that needs hedging through insurance; rather, people are speculating that the mortgage-backed securities owned by *others* would fail. Wiser heads like Warren Buffett call derivatives "financial weapons of mass destruction" (quoted in Blinder, 2013, p. 279). Financial market leaders, policy makers, and politicians ignore the warnings, and argue that market discipline can take care of any problem, even those driven by greed; no oversight or regulation is desirable.

Adam Smith, by contrast, is a realist who worries about excessive speculation in financial markets and he supports regulations to curb risky behaviors. To many this sounds contradictory, because Smith is a noted enthusiast of Dr. Francois Quesnay, the French Physiocrat, who promotes the notion of *laissez faire*. Yet in *The Wealth of Nations* Smith explicitly distances himself from Quesnay's "speculative" approach. Smith makes fun of the idea that a system of perfect liberty is practical, and he endorses regulations if he believes they pragmatically advance the goals of growth and justice. Jacob Viner observed that, "Adam Smith was not a doctrinaire

advocate of *laissez-faire*. He saw a wide and elastic range of activity for government, and he was prepared to extend it even farther if government, by improving its standards of competence, honesty, and public spirit, showed itself entitled to wider responsibilities" (1928, pp. 153–54).

Smith explicitly addresses problems of speculation and excessive risk in financial markets. Recall that Smith does not think people are always rational, and he supports regulations for reducing the scope of bad private choices that today we would call paternalistic. The operation of Smith's invisible hand requires appropriate institutions that align personal interests with social interests. Smith is aware of financial market crises (the South Bubble of 1720, the Mississippi Bubble of 1720, and the Scottish banking crisis of 1772) whose noxious effects might have been reduced with simple regulations. In *The Wealth of Nations,* Smith thus advocates for government controls that would reduce speculation and improve capital allocation. First, Smith supports imposing an interest rate ceiling of 5 percent on loans that would deliberately create a shortage of funds ([1776] 1981, p. 357). Since bankers are constrained by lower returns, they would seek to engage in financial triage, allocating credit only to the most "sober" and trustworthy borrowers, and eliminating loans to "prodigals and projectors," whose riskier private tastes are not in keeping with society's objectives.

Second, Smith advocates regulations that prohibit banks from issuing paper notes in denominations smaller than £5—equivalent to about $835 in 2018 (Nye, 2018). The enormous sum of £5 would make it hard for poor people to acquire and gamble on the value of such notes. Circulation would be limited to wealthier speculators, and this paternalism prevents the poor from suffering 'a very great calamity' in the case of bank failure ([1776] 1981, p. 323). Smith's regulations clearly violate the modern principle of Pareto optimality and his objectives align with economic justice and long-term growth, rather than with equilibrating market supply and

demand. Further, Smith did not accept the view that greed and *laissez faire* always lead to society's good, and in this case rejects the view that private vices produce public benefits.

Reducing regulations and enhancing the freedom of workers to pursue their own aims is a key tenet of *The Wealth of Nations*. Yet as a realist, Smith is an ethical pluralist—switching goals and methods as needed. Smith is not willing to let financial markets regulate themselves using the forces of competition and enlightened self-interest alone. For self-regulation to work there must be an alignment of personal incentives with social outcomes. Smith finds that missing in this case because of excessive risk taking by speculators.

In one assignment, students write an essay comparing and contrasting Smith's views with Keynes'. Specifically, students analyze the question of whether Smith would approve of Keynesian economics. On the surface, there are strong arguments that he would not, for example, because Smith, as a Classical economist, focuses on the long run, and Keynes on the short run. The concerns run deeper, however. The goal of this assignment is to get students to grapple with issues arising from a social economic perspective. There are a number of remarkable coincidences in this regard:

- Smith and Keynes are both economic reformers and share the goal of improving the lives of working people. Both experience fellow-feeling with the suffering of the poor and the idea that changing institutional rules could play an important part in enhancing wealth for those at the bottom.
- In Smith's model, institutions (such as laws and policies) evolve with the moral imagination. Smith would understand and possibly support changes to fiscal and monetary policies if he could be convinced of the pragmatism of the Keynesian approach.

- Smith and Keynes share similar views of human nature, and have doubts about the rational powers of market participants. In particular, both argue that humans are capable of miscalculations and over-confidence. These concerns play a role in the kinds of policies they would endorse.
- Smith and Keynes share the view that markets do not allocate capital in the best possible way. Smith, as noted earlier, does not trust bankers to make the soundest long run loans. Likewise, Keynes notes, "There is no clear evidence from experience that the investment policy which is socially advantageous [geared to the long run] coincides with that which is most profitable" (Keynes, 1936, p. 157).
- Smith and Keynes both support government regulations in financial markets that reallocate capital away from riskier to safer endeavors. Smith endorses the policies outlined above, and Keynes supports a substantial transfer tax on stock transactions. This makes it more costly to speculate, but would not harm investors who buy and hold for the long term.
- Smith and Keynes thus share a long run perspective, even if Keynes' policies specifically address short run deficiencies in aggregate demand.

Students are asked to think critically and explore ideas on both sides of the issue. From a Hayekian perspective, Smith likely would worry about the unintended consequences of larger government and the tendency for ever-larger budget deficits. He would be appalled by the use of social resources for the bailout of perceived elites on Wall Street, even if most loans are eventually repaid (Blinder 2013).

Applications to the GFC

Students apply these historical ideas and concepts to study the GFC using primary sources such as the *Financial Crisis Inquiry Commission Report* (2011) and a textbook by Alan Blinder, *After the Music Stopped: The Financial Crisis, The Response, and the Work Ahead* (2014). They also visually and emotionally experience the crisis through documentaries and movies such as *House of Cards* (2009), *Inside Job* (2010), *Too Big to Fail* (2011), and *The Big Short* (2015). Students go on a field trip to a financial trading floor and meet with brokers and bankers to discuss the regulations on conflicts of interest, leverage, proprietary trading rules, and other requirements of the Dodd-Frank Act of 2010.

While the GFC began in the United States, students are early given assignments on the European Union and beyond to demonstrate the global nature of this and other crises. They read excerpts from Reinhart and Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (2011) and they read in its entirety Bernanke's 2007 Berlin speech (just prior to the collapse) raising alarm about the global savings glut and the interconnectedness of world financial markets. They briefly study the East Asian financial crisis of 1997 and the Latin American debt crisis of 1982. About two-thirds of students do their final research paper on how the GFC affected markets and peoples outside the U.S. While students explore the GFC as an economic event, it has profound social and political consequences, and their ten page research papers can approach the topic from any academic discipline, including the arts and humanities. Final paper topics include, "Racism and Predatory Lending in the GFC," "Gender Inequality in the GFC," "The Impact of the GFC on the Catalan Independence Movement," "Unemployment and Mental Health: An Analysis of the GFC on the Psychological Well-Being of Americans," "The GFC and Its Effects on Youth," and other topics on Germany, Argentina, Mexico, Russia, South Korea, China, and other countries.

Learning Outcomes and Student Comments

In the most recent version of the course (spring 2018), 28 out of 30 students completed a course evaluation (response rate of 93%). The evaluations are anonymous and seen by faculty only after the submission of final grades. Two questions address content and learning. Question 9 asks students to rate the statement: "The course stimulated my critical thinking and analytical thinking." Seventeen students "strongly agreed," 9 "agreed," 1 felt "neutral," and 1 "strongly disagreed." Question 10 asks students to rate the statement: "The course significantly increased my knowledge of the subject," to which 16 "strongly agreed," 9 "agreed," 2 felt "neutral," and 1 "disagreed." For some students the class provides a springboard into more advanced courses in economics and finance. One student says the class is a "joy," another that it is "truly enlightening," and another that it is "informative" and "changed my viewpoint on a lot of things."

This should not suggest that all students are pleased. A number of students complain that although the class is open to any student without economics prerequisites, the difficulty and level of some topics is "too advanced" and "stressful." Several feel intimidated by the material, particularly relating to oral reports. Although the overall results indicate that most students appreciate the critical thinking component, some feel that the instructor shows bias toward a particular viewpoint. One of the controversial issues discussed in the course is whether "greed is good" for society. Students are exposed to principles texts and popular literature that seem to misinterpret Smith's invisible hand, and students read Smith's own words to reach a conclusion on this issue. Students are asked to identify the different kinds of market structures needed to support the proposition on greed propounded by Mandeville and Rand—namely, perfect competition, good information, transparency, no externalities, stable preferences, a rule of law,

and so on. There are plenty of counter examples, in which financial markets with asymmetric information create moral hazards, which inevitably lead to disaster. As a consequence, ethical and social mores evolve over time to elevate concern for *fiduciary duty* as an element needed to make financial markets more efficient. Self-interest is still present, as financial advisors vie with others to gain control of assets, but that is tempered by self-control and the elevation of another's interests. Some students insist that "greed is good" without offering a defense grounded in logic or literature; these students accept the phrase axiomatically or ideologically, but cannot come up with a justification beyond a gut instinct; to them the course's grading mechanism that requires more than this is unfair and subjective.

Another area in which faculty bias may appear is with regard to the efficacy of Keynesian fiscal and monetary policy compared to classical laissez faire. Students are provided data on recessions, growth rates, and deviations from growth from the 19th century to the present that show a marked improvement in the Keynesian era. Students also learn of the different outcomes resulting from the United States' and the European Union's different responses to the crisis. The U.S. central bank adopts a Keynesian viewpoint that coincides with a faster recovery than in Europe. Critics of the Keynesian view argue that major monetary expansions inevitably cause inflation; this did not materialize in the years after the Great Recession of 2008 for reasons that the Keynesian model can explain; the classical model view of a recession becomes harder to support using logic and facts. As discussed in class, there are numerous other reasons *not* to support Keynesian policy, but as with the issue of greed, some students seem to accept an anti-government viewpoint on ideological grounds, and at times struggle to articulate the reasons for this instinctive distrust. To some students there are easy "right/wrong" absolute answers to life's big policy questions.

A nuanced student ably compares Smith's to Keynes' philosophy, noting that circumstances matter for policymaking:

> Smith favored small roles for government and would foresee that it would be difficult to wean people off of government spending once it has already began. Special interest groups would lobby for continued big government and the government would never return to its limited role as a small government. Smith would also be wary of the potential for institutional corruption in government. In order for the invisible hand to promote society's interests, Smith argued that the institutions of justice and self-control were needed. If those institutions were missing in government and the politicians only focused getting re-elected in the short term, Smith would see that implementation of Keynesian economics as only hurting society and the poor.

This student develops a coherent argument based on the unintended consequences of Keynesian economics, using critical thinking to reach her own conclusions. It is essential to create a learning environment in which students receive rewards for thinking for themselves.

Conclusion

Social economics offers important insights into the existence of market bubbles, and provides guidance on policies that may reduce financial crises and periods of prolonged unemployment. In particular, the history of economic thought exposes students to pluralist conceptions of human nature, pluralist conceptions of the economic goal, pluralist conceptions of economic methodology and policies, and pluralist conceptions of the kinds of ethical frameworks operating in markets—particularly expanding notions of duty and virtue that reduce transactions costs in

trade. By reading primary sources including Mandeville, Smith, Keynes, and Hayek, students form conclusions about the strengths and weaknesses of government interventions, both to fix, and to prevent, major recessions and depressions.

Additional social economic issues arise in class, including the pervasive psychology of greed that leads unemployed home buyers to take on adjustable rate loans, predatory lending (deceptive or fraudulent practices arising from rampant asymmetric information), conflicts of interest in credit rating agencies, and potential gender differences in the formation of financial bubbles (Eckel and Füllbrunn, 2015). Given the complexity and global nature of the crisis, no single cause can, or should be, attributed, (Lo, 2012).

Primary texts from the history of economic thought contribute to pedagogical practice by exposing students to pluralist perspectives in which there is no one right answer. In the context of this class, the readings serve as a backdrop for exploring the moral underpinnings of collective social action and government regulation. At issue are the elements of human nature explored in social economics and the moral lessons of Adam Smith's invisible hand. Readings from Mandeville, Smith, Keynes, Hayek, and others, usefully engage students in debates about the GFC and its aftermaths.

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