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To the editors,

I would like to add something missed by Benjamin M. Friedman in his article "The Failure of the Economy & the Economists" regarding "animal spirits" and the Credit Default Swaps. Friedman does a good job in describing how some human behaviors are beyond those used in the mainstream economics mathematical models and the difference between economic actions which have no costs (financial "bets" which an equality of winners and losers) and those that carry real costs to the economy. In the case of CDSs, the reason that the real losses didn't have to be suffered by those that took the bets is because the financial institutions knew that, in the end, they would be bailed-out by the Fed and/or the Treasury. The institutions which traded these swaps with each other just stopped trading them because they did not want to suffer the losses, then knowing these losses would be passed along to the taxpayer. This is called the "unintended consequences" of government policy. In economics (or more widely defined most human interaction) incentives matter. It is the incentive structure created by the Federal Reserve Bank's "too big to fail" doctrine, and the 100% government guarantees of the underlying mortgage-backed bonds which formed the basis of the CDSs, which passed along the real costs to those who would not have profited by the real gains had the banks, AIG and other CDS traders had incentives to continue trading, absent the anticipated bailouts. It was government policy in this case which drove the "'animal spirits." These policies, however well-intended, create private gain and socialized risk.

Thank you,

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