Walsh University

Morality's Alpha:

A Case Study Determining Whether Morality Must Be the Basis of Capitalism

A Thesis by:

Ian Stroud

Finance

Submitted in partial fulfillment of the requirements for a

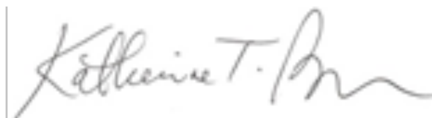
Bachelor of Arts with University Honors

April 2020

Accepted by the Honors Program

Bradley Beach, Ph.D. Date : April 16, 2020

Steven Edelson, Ph. D Date: April 17, 2020



Katherine Brown, Ph.D., Honors Director Date: April 20, 2020

Abstract

Many believe that capitalism is inherently immoral, a system designed by the rich, for the rich. Events like the 2008 financial crisis seem to point to a conclusion of this sort as well. However, delving deeper into the roots of capitalism and its founder, Adam Smith, paint a different picture, with different intentions. The Theory of Moral Sentiments predates and provides the foundation for the Wealth of Nations. In both the timing of the books, and in their content, morality is clearly shown to be the bedrock upon which capitalism was built. Having proved this, one must then look to the 2008 crisis through the previously constructed lens, and evaluate the actions that led up to it. If they were immoral, as this thesis claims them to be, then the theory that morality is the basis of capitalism is given practical application.

Introduction

September 15th, 2008, near midnight; this night will be remembered as the spark of the Great Recession; the night that Lehman Brothers filed for bankruptcy. Overnight, Americans lost billions from the collapse of the individual bank, and trillions over the next few months from the broader market implosion. Retirement accounts were obliterated, college funds cut in half, jobs lost, and millions of families were put out on the streets (Cassidy et. al, n.d.).

This is not what the American Dream promises. We were promised riches; we were given rags. The nature of America, its economic soul, capitalism, is clearly flawed, correct? Should we not be led to believe this after such a massive collapse, very nearly plunging the nation into a darker time than the Great Depression? What system, functioning correctly, could allow such a financial demise?

One may be inclined to doubt the goodness of capitalism after asking these questions. However, though the fall of the financial system in 2008 was a tragedy, this thesis aims to prove that it was not a fault in capitalism, rather a feature that has been neglected by economists since its founding by Adam Smith. Economists are quick to point out the power of the invisible hand in correcting the markets, but forget the foundation on which the hand rests: morality. The immoral actions of bankers and lenders and the greed of the American people led to the financial collapse because of this lapse in memory. This work will contain a review of the beginnings of capitalism and ethics, along with a brief history of the beginnings of the Great Recession. The content is intended to first increase the reader's understanding of morality,

Adam Smith's two most notable works, and the Great Recession, and while I will draw my own conclusion, the content affords the reader with the ability to come to their own.

Aristotle, Adam Smith, and the Great Recession

Economists have long taken Adam Smith's most famous work, the *Wealth of Nations*, as an island, isolated from any other work or any kind of exegesis. Any theologian could explain the issues of taking one book out of context, and yet many economists continue to do so when referencing some of Smith's ideas. As a moral philosopher first and foremost, the father of capitalism wrote the *Theory of Moral Sentiments* decades before writing his magnum opus, the *Wealth of Nations* (Smith, 1986). This causes one to wonder if capitalism, in its most pure form, must have been designed to have roots in morality.

The *Theory of Moral Sentiments* and the *Wealth of Nations* are not only connected by timing, but by content. The *Wealth of Nations* is built on and, more importantly, relies on the *Theory of Moral Sentiments* as a foundation and a guide. However, before delving into the *Wealth of Nations'* foundation, a prudent academic exercise would be to examine the bedrock upon which the foundation is built. To discontinue the metaphor and write plainly, I will be first evaluating the *Nicomachean Ethics*, by Aristotle. This is the work that Adam Smith would have studied and built his ethical work from, standing on Aristotle's shoulders (Thomas, 2019). Then, I will evaluate the main themes of the *Theory of Moral Sentiments* and the *Wealth of Nations*, as many of them are similar. Finally, I will connect the ideas of the Theory of Moral Sentiments and the Wealth of Nations, proving them to be connected and that latter is reliant on the former.

Nicomachean Ethics

As Adam Smith was a self-proclaimed Aristotelian, the Nicomachean Ethics serve as a basis by which to explain morality and on what Smith would have based his moral theory (Thomas, 2019). The Nicomachean Ethics can be interpreted as Aristotle's roadmap to happiness. He begins by noting that there is general agreement that happiness is the highest of all human goods, but no general agreement as to what produces happiness. Aristotle defends this by showing that wealth, or honor, both strong candidates for the highest human good, are chosen both for themselves and for the sake of something else. This is because wealth is pursued for the sake of something else, and honor depends on others bestowing it upon us. However, happiness is that which is an end in itself. Therefore, happiness must be the highest human good because it is the ultimate good – the Summum Bonum (Aristotle, 1975).

Happiness itself can be dissected and analyzed, and should be so. There are two definitions of happiness: The ancient form of happiness, or the ethical form of happiness, and what could be called the modern form. The ancient form of happiness, as Aristotle described it, is achieved by "being good," or living a good life. A good life is one that seeks and acquires all real goods, in the right order. Aristotle called this *eudaimonia*, which is simply Greek for happiness. Generally, when referencing this form of happiness, one would use eudaimonia, to distinguish it from the modern understanding of happiness. The modern form of happiness focuses on the emotions and desires of the mind. Essentially, it is a subjective state of mind, as one feels "happy" when laying on the beach. The ancient form of happiness, reasonably, must

be the correct end goal, because it betters the soul, betters society, and betters the self. The psychological form merely makes a mirage of true happiness, the reflection of the shadows in Plato's Allegory of the Cave (Aristotle, 1975).

In order to be sure that the ultimate goal, happiness as defined in the ancient sense, is achieved, one needs to have in place the correct plan. Socrates once said, "the unexamined life is not worth living (Apology, Plato, par. 38a)." Aristotle furthered this idea, credited with saying, "the unplanned life is not worth examining." Aristotle believed that it was not enough to simply have a plan for one's life; it was necessary to have the right plan, aimed at the right ultimate end: Happiness. This plan is one that has the individual seek and acquire all real goods, in the right order (Aristotle, 1975).

In order to live by the right plan, one must act virtuously, according to Aristotle. All actions are performed by previously deciding, or choosing, to perform it. These performed actions are always done because the agent sees the action as good, and beneficial to the self or others. Actions are performed purposefully, always aiming at a desired goal. Some actions may be used as means only, simply stepping stones to an end. These ends may be collectively intermediate, aimed at the ultimate goal. The ultimate goal, for all humans, is happiness. At the end of the line of questioning "why" an action is performed, one comes to conclusion that ultimately, it was done so that the agent could be happy. Certain actions may be uncomfortable, or inherently undesirable, but they are good if they will lead to happiness (Aristotle, 1975).

Any action performed is seen by the agent performing it as good, and leading to happiness, but this is not always true. Goods can be separated into two categories; virtue, and

external. These virtue goods are those that satisfy our natural desires, or the "needs" in our lives. These natural desires may not be conscious thoughts, but are there, nonetheless. External goods satisfy our acquired desires, or "wants" that we may find ourselves having. These appear good to those who desire them. One may think of virtue goods as those we ought to desire, and external goods are things that one consciously desires. There may be overlap between the two (Aristotle, 1975).

The unacceptable can be clearly defined, reasonably following from the proceeding statements: anything that hurts, harms, or hinders ourselves or another from living a good life is immoral. This is to say that performing an action, aimed at fulfilling an apparent good while in reality is hurting, harming, or hindering one from living a good life by following the right plan is immoral. Living a virtuous life, according to Aristotle, is the way to achieve happiness, and living in an unplanned fashion or without the right goal is unacceptable (Aristotle, 1975).

Theory of Moral Sentiments

Adam Smith, as an Aristotelian, endorses many of the same ideas as Aristotle, with a number of exceptions to be outlined. Smith believes that a good person is a virtuous person, and a virtuous person is working to live a good life. However, Smith has a bit of a different way of explaining virtue than Aristotle. Smith's views rely heavily on the idea of natural empathy, and the unseen spectator (Smith, 1986).

Empathy, according to Smith, is how we as humans dictate our actions. We flinch when we see someone about to be struck, and we share in the happiness of others. He defines this as sympathy. Yet there are limits. We sympathize only when the doings of others and their

corresponding emotions seem appropriate to their circumstance. We do not sympathize with excessive emotions that we regard as damaging, because we see them as misplaced or wrong (Smith, 1986).

Smith argues that we gauge and temper our emotions when compared to others, because when others view us with emotions less passionate than theirs, they will feel distressed by the discord and restrain their emotions in order to bring themselves more into line with our view of their predicament. Smith, then, brings up the idea of the invisible spectator, a precursor to the invisible hand of the market later penned in his magnum opus, *The Wealth of Nations* (Smith, 1986) (Smith, 1910).

Smith argues that we learn to temper our emotions and actively perform in a beneficial way to others because we know that an impartial spectator would approve, and we derive pleasure from that.

> "And hence it is, that to feel much for others and little for ourselves, that to restrain our selfish, and to indulge our benevolent affections, constitutes the perfection of human nature; and can alone produce among mankind that harmony of sentiments and passions in which consists their whole grace and propriety (Smith, 1986)."

Morality, for Smith, is a system of behaviors, a state of equilibrium, in which individuals are expected to control their emotions. Morality comes from the human ability to empathize and sympathize with other human beings, and realizing that one's ego must be kept in check to see oneself as the rest of society does. Humans aim to temper emotions, to keep them in check, so as to more harmoniously live with others (Smith 1986).

This idea of acting in accordance to what others deem acceptable is another cornerstone in the foundation of the *Wealth of Nations*. The invisible spectator, which

guides the individual's temperament of their emotions, is the same theoretical entity as the invisible hand of the market. Individuals would not act in unsatisfactory ways because of their own conscience, and because they would be dissatisfied with the idea that an invisible spectator would not sympathize with their actions or emotions. In the *Wealth of Nations*, the invisible hand is the metaphorical, self-regulating force that guides the markets and allocates resources and value to what is desirable, and from what is not desirable it takes resources away. Understanding the basis of Smith's morality is imperative to understanding the *Wealth of Nations*, and to performing in a manner that allows capitalism to function properly (Smith, 1986).

Smith references government, and how government should act to keep laws in accordance with human nature. Rewards and punishments are important for encouraging the social passions and discouraging the unsocial. Intention, rather than only the outcome, should determine our approval of an act, because a "good" act done for the wrong, or immoral, reason becomes immoral itself. This falls in accordance with Aristotle, and his theory on moral culpability (Aristotle, 1975). This would not cure violence, as some still choose to do wrong, but working to shape the character into one that intentionally does actions for the good, out of beneficence, would create a self-regulating society. Smith claims that unmerited and unprovoked violence or malice should be restrained through punishment, and that nature has given us as humans strong instincts to guide us. However, since we cannot look into the intention, as unless it is stated explicitly it cannot be known, we must punish only when the action causes harm. The motive behind the action cannot be punished (Smith, 1986).

Smith writes about government in a different setting as well. He makes a distinction between two virtues: justice and beneficence. Beneficence is the benevolent activities of doing good for others without any expectation of reciprocity. Justice, as he defines, protect the negatively defined rights of individuals to be free from harm, and to life and liberty. Institutions of justice, according to Smith, are those informal social norms and formal laws that allow us to live together in civil society. A society can exist without beneficence, but justice is necessary to a society's existence. The reason Smith says this is very important. A society without beneficence is one that may not be very nice to live in, but just, nonetheless. A society without justice, by necessity, is one that is unjust, and therefore impossible to live in. Because of this, Smith argues that the most important role of government is to protect those negatively defined natural rights, and to provide the rules and laws that uphold a system of justice. However, any governmental interference in beneficence is unnecessary and positively harmful, he would argue, because it would crowd out any more beneficent behavior on the part of individuals. This is all grounded in the idea that the human is a social being, and we as humans strive for sympathy and mutual sympathy, and we are disciplined by the idea of the impartial spectator that eventually shapes us into a habitually virtuous person, acting always for the good (Smith, 1986). This is Smith's vision of a free society living together peacefully and harmoniously, and this idea ties strongly into his vision portrayed in the *Wealth of Nations* Smith, 1910).

Wealth of Nations

The *Wealth of Nations* is indisputably one of the most influential books on economics of the past few centuries, and though the book itself is celebrated, few know the book as the

origin for many of the commonly accepted ideas of modern times. Concepts such as GDP, the law of supply and demand, the invisible hand of the markets, and most notably capitalism, all find their origins in this response to the prevailing economic system of the day, mercantilism. Mercantilism, to Smith, was inherently flawed and did not truly measure the wealth of nations, or allow them to fully prosper. The idea that only the seller benefited from a transaction, and that gold and silver were the only way to measure a country's wealth did not make sense (Smith, 1910).

The first of Smith's groundbreaking theories was that of job specialization. As he describes in the *Wealth of Nations*, the key to economic efficiency is job specialization. At the time of its publishing, it was common for farmers to need to tend to their livestock, crops, and land, but also make their own household items. Smith argues that a famer who could focus his time and energy on tending to his specialty would be far more efficient. This notion of specialization was a novel idea. However, Smith goes further, suggesting that whole countries could specialize into exporting the few items they made best and importing that which they needed.

> "The greatest improvement in the productive power of labour, and the greater part of the skill, dexterity, and judgement with which it is anywhere directed, or applied, seems to have been the effects of the division of labor (Smith, 1910)."

There are mutual gains from this exchange, such as each person being able to specialize in their own craft and buy what they need from selling their excess. This increases the productivity of all and drives down prices. Smith says that it is not from the sheer benevolence of the butcher or baker that we would expect our dinner, but from their regard to their own interest. Since we are able to give them something they need, they will give us something we

need in return and out of their own self-interest. In the *Theory of Moral Sentiments*, Smith calls this prudence, the idea that concern for our own welfare is entirely natural and proper. Justice, identified as the virtue of not harming others in the *Theory of Moral Sentiments*, is fundamental to a human society since it establishes trust (Smith, 1986). The exchange, then, is facilitated by both parties' prudence and justice (Smith, 1910).

The world Smith lived in was not a barter economy, but one in which goods were traded for money, much like our own. However, only money was regarded as wealth, and therefore only the seller could have benefitted from the exchange since they were the only one receiving money. Smith negates this by showing that the benefit of exchange is indeed mutual, and in doing so argues that the restrictions of the day disallowing some trade in order to prevent money from leaving an area were unnecessary (Smith, 1910).

Smith shows great sympathy for the common working people of the time, and little for the employers. Because of his idea of free markets and free trade, many assume that he must be on the side of the employers. On the contrary, Smith believes the most efficient way to spread wealth is through free and competitive markets. Efforts of politicians and corrupt businesspeople to diminish competition and freedom should therefore be resisted, as it mainly harms the common person. This is worth mentioning as a facet of his belief in morality since many assume capitalism is a system designed by the wealthy, for the wealthy, so that they may continue to be wealthy. People also assume capitalism is an inherently immoral system, however, it was not intended this way. Smith actually encourages the "combinations of workers", or unions, to compete against the combinations of employers, who he sees as attempting to rig the markets to benefit only them. Rather than seeing employers as entirely

malicious, he does acknowledge that they provide employment and wages above those of ordinary financial stature, however willingly or unwillingly they do so (Smith, 1910).

Another central theme of the *Wealth of Nations* is Smith's view on a country's future income. This income depends upon future capital accumulation, because that leads to deeper specialization and further capital accumulation. Smith describes it as a "virtuous circle". Specialization results in the accumulation of capital, and from it more capital is gained, leading to further specialization. He qualifies how he describes wealth: money itself is not wealth, but wealth is what that money can buy. The accumulation of capital, money, allows for a greater amount of products to be acquired, which translates to wealth. The accumulation of capital, then, is necessary for the survival of a nation. To mistake simply the having of money as a good rather than the ability to spend said money as a good will leads to a nation's downfall (Smith, 1910).

Smith continues to detail various policies and restrictions specific to his era, even having a section on colonial trade restrictions. He cautions the British to allow freer trade in the colonies, though unfortunately, his advice comes too late. The American colonies rebel and declare independence, beginning the Revolutionary War. He outlines how governments should act, defend, and protect various rights to keep the socio-economic system stable. Smith's last theme, though he allows government must have the duty to protect and defend, is that the system he has described is automatic, or without need of governmental interference. Where resources are scarce, people are prepared to pay more for them. There is more profit in supplying scarce resources, so producers invest more capital to produce them. Industry will remain focused on the nation's most important needs, without need for government

intervention. In fact, Smith directly argues against any kind of government intervention. The system, he says, will be automatic only when there is free trade and competition. Governmental subsidies or monopolies to favored producers, sheltering companies behind tariffs, or any other intrusion in the market disallows normal competition and can affect prices. The poor suffer the most from this, taking the brunt of higher costs. The government, according to Smith, has the duty to keep order, maintain defense, build infrastructure, and promote education. It has also the duty to keep the market open and free, any attempts to distort the market must be met with resistance (Smith, 1910).

Many of Smith's ideas in the *Wealth of Nations* follow closely from the foundation he laid in the *Theory of Moral Sentiments*. The person ought to be self-regulated through virtue, as they are the better person, and similarly a better market is one that is self-regulated by its participants through virtue. This benefits both the individual, as they would become wealthier through job specialization and mutual exchange, and society as a whole since more would be virtuous. Since the system is designed to be kept open and free, though regulated minimally by the government to ensure justice in the system, capitalism without morality would be unsuccessful. Excessive intrusion from the government, especially when the government attempts to force beneficent actions, would upset the balance and lock shackles on the invisible hand (Smith, 1910). Morality, then, must be the bedrock from which capitalism was built upon, for without it, the system crumbles.

The Great Recession

Conflicting conclusions have been drawn as to what the original causation of the 2008 financial crisis might have been, though the general consensus is that sub-prime mortgage loans, covered by credit default swaps, precipitated the financial crisis (Duignan, 2019). This section will serve to provide the general themes of the financial crisis, as well as how the proceeding research will connect the crisis to the Smith's views. An important note is that the 2008 financial crisis was supremely complicated, something that could be written about (and has been) on its own. This section serves only to provide the general themes of the crisis without probing too deeply into the minutiae.

Mortgage-backed securities, or thousands of mortgages bundled together and sold as a security, began selling in the 2000s. They were the product of investors' desire to better the roughly 3% annual return on treasury bills, while keeping the same safety of investment. The housing market had been booming throughout the early 2000s, and because of this, real estate and mortgage-backed securities were viewed as steady and safe investments. Originally, this perceived safety was the reality, because only those with good credit ratings could qualify for a mortgage. However, "sub-prime" loans, or mortgages given to those with poor credit histories, began to normalize with mainstream financial institutions, unbeknownst to investors. Often, predatory lending practices were used, allowing individuals with poor credit histories to procure loans with incredibly high interest rates (Uhlig, 2018).

Originally, and most prevalently in the time before 2007, an individual could not get a loan without proving their creditworthiness and ability to pay the interest on their loans. This created a limited supply of people both willing and able to buy houses and pay for their mortgages. These people were judged on their credit score, or their relative risk. Those with

lower scores were given higher interest rates, to compensate the banks for their risk, and those with higher scores were given lower interest rates since they were safe investments. Those with credit scores that were too low, generally below 600 (Akin, 2019), were simply denied a mortgage since they were considered too risky to loan money to. However, the demand for the mortgage-backed securities grew faster than the number of “prime” people did, so mortgage brokers began to give “sub-prime” people loans. These people were very unlikely to pay their mortgages back, so the bank saddled them with adjustable-rate mortgage loans, to try and compensate the banks for their risk while enticing the sub-prime borrowers to take out a mortgage instead of simply renting. An adjustable-rate mortgage has an interest rate that is fixed for a period of time, and then can be adjusted on a yearly or even monthly basis. Generally, when the sub-prime borrower’s fixed period ended, they defaulted on their mortgage. This happened to a vast number of people very quickly in 2008 (McArthur & Edelman, 2017).

Collateralized Debt Obligations, or CDOs, began to sell in this era as well. CDOs are essentially mortgage-backed securities bundled together into a larger pool of loans and other assets. For the same reasons as mortgage-backed securities, these received great ratings since the housing market was in such a bull phase. However, these were often made up of the massively risky sub-prime mortgages. The rating agencies could still point to historical data, from before sub-prime mortgages began to sell, which invariably supported the buying of mortgage-backed securities. Inevitably those given the sub-prime mortgages defaulted, and the sub-prime lenders were left with the real estate. Eventually, enough people had defaulted on their loans that the lenders were left with too many houses, and the lenders were forced to

declare bankruptcy. This was the first domino in line to fall, and led to massive financial institutions also declaring bankruptcy, and the popping of the housing bubble (Ramskogler, 2015).

The last major component of the Great Recession were the ratings of these previous investment vehicles. The major rating services, such as Moody's, Standard and Poor, and Fitch Ratings, are responsible for the accurate credit ratings of debt securities, including government bonds, corporate bonds, collateralized securities such as CDOs, and mortgage-backed securities. Despite this charge, the rating services failed to adjust the ratings of the CDOs and mortgage-backed securities even when the underlying mortgages began to default. When the underlying mortgages in these two debt securities begin to default, it restricts the cash flow to the brokers and, ultimately, to the banks holding the mortgages. The next level of the process was already described, with the lenders being forced to declare bankruptcy. The ratings agencies should have begun to downgrade the debt securities once the mortgages began to default, yet they did not, underestimating the riskiness of the securities to investors. This, in turn, is the reason so many lives were affected by the housing crisis in 2008. Pension funds, retirement accounts, even endowments were invested in these AAA rated debt securities, because they offered a relatively reliable return and low risk, according to S&P, Fitch, and Moody's. S&P was sued by the Department of Justice for their role in the financial crisis, and ratings agencies as a whole are roundly criticized for both their failure to warn investors of the dangers of mortgages at the time, but also for benefiting by not pointing out deficiencies. For reference: when Lehman Brothers declared bankruptcy, their debt was still considered the best, or investment-grade (Ramskogler, 2015).

These four factors are interconnected. The bundling of mortgages into securities, CDOs, sub-prime loans, and the ratings of the first two were equally dangerous in creating the situation that led to the financial meltdown of 2008. These things are not hypothetical; they are historic fact that have been widely credited with being the causes of the crisis. Michael Blurry, the famed investor who is credited with being among the first to discover the impending crisis, accused the ratings agencies of being just like the investment banks during the dot-com bubble, "… money-grubbing and sorely in need of an ethical compass (McLean, 2007)." As a point of information, the way that Blurry discovered that the mortgage-backed securities were so dangerous was by going through the thousands of mortgages in each of the top securities, one by one, and finding that many of the mortgages were either in danger of defaulting or had already defaulted. This method is also how the ratings agencies would have rated the securities, by going through each and evaluating the risk. The ratings agencies, investment banks that created the mortgage-backed securities, and the brokers who sold them created a dangerous environment that, eventually, had to implode.

A Step Back

Before continuing to the main thesis of this work, a step back to evaluate the bigger picture is necessary. This study looks to draw the works of Adam Smith together, showing that there is a relationship between the two and he did indeed wish for the two previously mentioned writings to connect, and that the 2008 financial crisis is a direct result of immoral, and therefore non-capitalistic, actions by bankers, brokers, and lenders.

In order to show that the two books must be connected, a method of discovery would be to simply identify shared themes in both. Famously, and most obviously, the idea of the invisible hand and the impartial spectator are connections. Smith's notion of the invisible hand of the market forces is one that closely relates to the impartial spectator. Both are unseen forces that guide the actions of individuals. The impartial spectator is an unbiased voice, directing our feelings toward virtue, and applies to how individuals behave. The invisible hand guides resource allocation to that which people desire and need most, out of both self-interest and interdependent exchange. This connection goes deeper than simply the unseen nature of the two forces, however. Smith intended the Theory of Moral Sentiments to be a road map to "happiness, goodness, and self-knowledge" according to Russ Roberts in his book *How Adam Smith Can Change Your Life*. The impartial spectator was to show how our internal self-interest is governed in a way that stops us from harming others, and if we harm others, we are also hurting our own self-interest. The impartial spectator would disapprove of the intentional harming of another human being, and therefore so would most other people. The invisible hand, understood through this impartial spectator, is not then a rationale for unfettered capitalism in which the "corrupt" corporations are rewarded. So often these corporations cause harm to others rather than add value, as Smith's original system intended. This study will examine the mortgage-backed collateralized debt obligations (CDOs) in a later section, in order to see if the abuse of these were a direct result of the invisible hand operating without regard for the impartial spectator.

Self-interest is another common theme between the two Smithian works. This theme is generally attributed to the Wealth of Nations, as even those with an elementary understanding

of capitalism know that individuals are rewarded when acting in a way that benefits themselves. However, this theme finds its roots in the Theory of Moral Sentiments. Smith recognizes that self-interest is a universal trait, shared by all. However, this self-interest governs us to treat others in a way that benefits them, because this has a reflection on us (Smith, 1986). This is a selfish way of viewing altruism, some may argue, but this is a theory of why humans treat each other well. Smith, in a parallel argument, says that riches will not make us happy. "Trinkets of frivolous utility," as he calls them, instead act as a burden and are opposed to our true self-interest (Smith, 1986).

Claim

The crux of this thesis is to prove that morality and capitalism are connected and were intended to be so by Adam Smith. Doing this would necessarily facilitate a change in the way we think about capitalism. Instead of simply a system by which the wealthy manipulate the downtrodden and lower classes into growing their wealth, capitalism would be a system that rewards moral actions. The "good" individual and the smart businessperson, if both acting in a morally upstanding manner, could both profit in a capitalistic system. This, of course, is not to say that one does not need to be smart to succeed in capitalism, as it is still an inherently competitive system. Smith intended his two works, The Theory of Moral Sentiments and The Wealth of Nations, to be connected. More than that, Smith intended the second work to be built upon the first. Once this connection has been proven, the next step will be to evaluate the 2008 financial crisis through the newly formed lens of capitalism needing a base in morality, and determine if the collapse was due to immorality.

Part One

The proof for the claim that the two works are connected can be found in the numerous connections between the two works, most obviously the unseen nature of both the spectator from the Theory of Moral Sentiments and the hand from the Wealth of Nations. The unseen spectator is nominally a metric that we use to judge our actions. If the action is good, the unseen spectator will be pleased; if it is bad, the unseen spectator will be displeased. Humans ought to base moral actions on consciously thinking, "what would others think of this action", before becoming habituated into acting good (Smith, 1986). The invisible hand acts much in the same way, though referring to voluntary trades in the free market producing widespread benefits. It is a metaphor, much like the unseen spectator, about how individuals act in a system of interdependence (Smith, 1910). Morality, in this sense, is a precursor to capitalism. For individuals to participate in a system of interdependence, such as capitalism, they must all act in a way that is objectively good, something that could be measured by the unseen spectator, to establish trust. Therefore, for a system of interdependence like capitalism to function, it must be grounded in a moral framework.

The connection between the invisible hand and the unseen spectator presupposes another connection: self-interest. Smith argues that self-interest is a good, natural, and moral. The unseen spectator assumes that people will act in a way that brings them the most happiness. To attain eudaimonia, as Aristotle described it, one must strive for excellence in their thoughts and actions, which requires practice (Aristotle, 1975). Smith exemplifies the eventually habitual aspect of Aristotle's teachings with the unseen spectator, showing that individuals have to originally work on their morality to perfect it, before it becomes a part of

character. People will act out of their own self-interest to be virtuous in life, and individuals will undertake job specialization and mutual beneficial exchange in the markets, relying on the self-interest of others to establish trust, according to both Aristotle and Smith. Trust, then, built on morality and self-interest, is integral to capitalism.

Part Two

The last aspect of this thesis is to determine if the 2008 financial crisis was caused by immoral behavior in the markets. The main four components of the crisis that were examined were the mortgage-backed securities, collateralized debt obligations, sub-prime loans, and the ratings agencies. Each one of these, taken alone, would likely have had some impact on the economy, but all together they resulted in the collapse of the housing market.

If the previously made claim that capitalism must have a basis in morality to function is true, then using the 2008 financial crisis as a case study will show that it must have been caused by immoral actions. The bundling of mortgage-backed securities, as a practice, was not inherently bad. In fact, mortgage-backed securities still sell today. However, when lenders began giving mortgages to non-creditworthy individuals, the mortgage-backed securities became deceptively risky, despite being considered a very safe investment for the past decade (Duignan, 2019). This sub-optimal lending practice, these sub-prime loans, were the catalyst for the crisis that few could see coming. The collateralized debt obligations fell prey to this practice as well, since the CDOs were essentially bundled-up mortgage-backed securities (Ramskogler, 2015). While profitable in the short term, these dubious practices ultimately led to the market collapse. It would have been in the mortgage brokers' self-interest to have withheld loans from the sub-prime borrowers, as they could not be reasonably to pay back their loans. This placed

the financial well-being of all those invested in the bank at risk, from shareholder to stakeholder.

The ratings agencies made a number of errors that can be attributed to nothing but negligence, and possibly active disregard. The ratings agencies have a very specific role: to correctly evaluate the risk of debt securities. They constantly update these ratings, due to the changing nature of the debt securities. However, the ratings agencies did not downgrade the risk of billions of dollars of debt securities until long after the mortgages began to default. This signaled to investors that they were still a very safe investment, and many investors continued to invest in them, doomed to lose whatever they put in (McLean, 2007). Additionally, they profited from their own negligence. Since credit-rating agencies are paid by the companies that issue debt, companies will continue to be customers with the agencies that will rate their debt well. This directly contributed to the downfall, and was actively immoral. It would have been in the best self-interest of the agencies to downgrade the debt, despite the possible loss of customers, because if they had, the financial crisis may have been averted. Instead, due to their willing negligence, millions of people lost jobs, retirement funds, the failure of many, many businesses resulted.

If the participating individuals had been acting in a way that would have pleased the unbiased, unseen spectator, this would not have happened. Negligence on the part of the ratings agencies would have been checked, greed on the part of the mortgage brokers would have been reigned in, and the selling of sub-prime loans may never have occurred, at least not without the vigilant ratings necessary. With a moral component remembered in the market, the 2008 financial crisis may have never been.

To say that we can eliminate market fluctuations and recessions by introducing morality is irrational, because often people do not act in ways that are moral, and often some act in ways that are irrational. People will still fall prey to investing in failing companies, and losing their money, companies that cause scandals like Enron would still exist, and corrupt politicians would still exist. However, consciously acting in a way that is striving for virtue, for *eudaimonia*, is just. It would reduce crime, and interference in the markets. It would spread wealth more effectively. It would be more in line with the vision of the father of capitalism: a system, built upon morality, dependent on others, for the good of all.

THANK YOU

I would like to take a short postscript to say thank you to a number of people. Firstly, my Honors class. Speaking of a system of interdependence without giving a concrete example would be ridiculous. We all relied on each other to finish these theses on time. Often, I had some of my closer friends just come to my apartment and we would all write together. We bounced ideas off of each other, argued with each other, and sharpened each other. Thank you to you all.

Next, my family, particularly my dad. My dad read a very early version of my thesis, and was completely lost. He had no idea what I was trying to say. He felt as if that didn't help me, but on the contrary his confusion helped me more than any other comment I received throughout the course of my thesis. I was able to sharpen my thesis, because if a medical doctor with a Master's in Business Administration could not understand what I was trying to say, then something must be wrong. I'm not making my work accessible, and inaccessible work is worthless. You helped me make my work meaningful, thank you.

Lastly, my advisor and reader, Dr. Beach and Dr. Edelson. You both know what you did to help me. Without you I would have been directionless, and most likely, late. I appreciate so much the pushes you gave me to stay focused, passionate, and driven on my work. Truly without you both I would not have nearly as strong a thesis. Thank you both.

References

Akin, J. (2019, October 25). What Does Subprime Mean? Retrieved from https://www.experian.com/blogs/ask-experian/what-is-subprime/

Aristotle, H., & Rackham, H. (1975). *The Nicomachean Ethics*. Cambridge, MA: Harvard University Press.

Cassidy, J., Packer, G., & Lemann, N. (n.d.). The Real Cost of the 2008 Financial Crisis. Retrieved from https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis

Duignan, B. (2019, September 26). Great Recession. Retrieved from https://www.britannica.com/topic/great-recession

McArthur, C., & Edelman, S. (2017, April 13). The 2008 Housing Crisis. Retrieved from https://www.americanprogress.org/issues/economy/reports/2017/04/13/430424/2008-housing-crisis/

McLean, B. (2007, August 21). Ratings agencies under fire. Retrieved from https://money.cnn.com/2007/08/20/magazines/fortune/ratings_agencies.fortune/index.htm

Plato, & Helm, J. J. (2009). *Apology*. Mundelein, IL: Bolchazy-Carducci Publishers, Inc.

Ramskogler, P. (2015). Tracing the origins of the financial crisis. *OECD Journal: Financial Market Trends,2014*(2), 47-61. doi:10.1787/fmt-2014-5js3dqmsl4br

Smith, A. (1910). *The Wealth of Nations*. London: Dent.

Smith, A. (1986). *The Theory of Moral Sentiments*. Düsseldorf: Verlag Wirtschaft u. Finanzen.

Thomas, C. (2019, November 20). Adam Smith and Aristotle. Retrieved from https://www.adamsmithworks.org/life_times/adam-smith-and-aristotle

Uhlig, H. (2018, May 1). Mortgage-Backed Securities and the Financial Crisis of 2008: A Post Mortem. Retrieved from https://bfi.uchicago.edu/insight/research-summary/mortgage-backed-securities-and-the-financial-crisis-of-2008-a-post-mortem/