Can Economists Learn?
The Right Lessons From the Financial Crisis

Alan S. Blinder

Is it acceptable for a reviewer to complain about a book’s title? I hope so, because this one is pretty misleading. A number of valuable lessons can indeed be gleaned from the two and a half dozen essays that compose this quite interesting volume, but the book’s subject is described far more accurately by the title of the April 2013 International Monetary Fund conference that spawned it: “Rethinking Macro Policy II: First Steps and Early Lessons.” (Yes, there was a “Rethinking Macro Policy I,” which resulted in an earlier MIT Press volume.)

The two subjects are related, of course. But readers expecting the insights of 31 prominent authors on what economists should have learned from the crisis may come away disappointed. For example, the book’s index does not even contain the words “bubble,” “subprime,” “Lehman,” or “AIG,” and there is only one reference to derivatives. Still, readers looking for wisdom on how to rethink monetary, fiscal, macroprudential, and other policies will be richly rewarded, for this fine volume is bristling with it.

The five essays written by the editors are alone worth the price of admission, and the other 25 include the often provocative thoughts of such luminaries as Sheila Bair, former chair of the Federal Deposit Insurance Corporation; Stanley Fischer, former governor of Israel’s central bank and current vice chair of the U.S. Federal Reserve; Mervyn King, former head of the United Kingdom’s central bank; Jean Tirole, the French expert on markets and regulation who won the 2014 Nobel Prize in Economics; Janet Yellen, the current Fed chair; and many more.

Not every essay in this volume is a gem. But some of them are. I particularly liked the Berkeley economist David Romer’s ruminations on what he calls “deeper solutions,” such as imposing much higher capital
requirements on banks, creating a simpler financial sector, legislating stronger automatic stabilizers, and replacing inflation targeting with a new monetary policy framework. Unfortunately, such large topics are barely touched on elsewhere in the book—which is precisely Romer’s point.

Policy wonks will be captivated by the reflections on the budding field of macroprudential policy from the Bank of England’s Andrew Haldane and the Bank for International Settlement’s Claudio Borio, as well as the accounts of what Israel and South Korea have already done in this domain by their former central bank heads (Fischer and Kim Choong-soo, respectively). Tirole also contributes an insightful essay on financial regulation.

And who wouldn’t want to read what Yellen has to say about conducting monetary policy at the zero lower bound? Because she is chair of the U.S. Federal Reserve, her every word on monetary policy is now parsed like Holy Writ, so it is interesting to learn that in April 2013, she wrote approvingly of the Columbia University professor Michael Woodford’s essay in this volume, which suggests, as she put it, “that the [central bank’s] policy rate should, under present conditions, be held ‘lower for longer’ than conventional policy rules imply.” At the time, the Federal Open Market Committee had not yet adopted the Woodfordian prose that it subsequently offered in its December 2013 statement and then modified in March 2014 to read: "The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

Those words from the committee are consistent with Woodford’s view that mere forecasts by a central bank of its own future actions are not enough. As Woodford writes in his contribution to this volume, “If a central bank intends to conduct policy later in a way that is different from what people in the markets would already expect, then it should seek to communicate that intention by talking directly about how future policy decisions will be made.”

THIS TIME IS DIFFERENT

Still, the question suggested by the book’s title nags: What should economists and policymakers have learned from the crisis and its aftermath? I have seven personal favorite lessons, the first of which is that Hyman Minsky was right.

Minsky, who died in 1996, may have had the highest ratio of importance to influence of any economist in the twentieth century. He argued for years that financial fragility and recurring cycles of boom and bust (rather than equilibrium) should be the central concepts in theorizing about financial markets and the macroeconomy. Instead of assuming that markets are efficient and expectations are rational, he wrote, economists should assume that markets regularly go to extremes and that people forget. When the profession was being swept by the efficient-market tide, this was deeply contrarian thinking, but I think he was basically correct.

The financial world envisioned by Minsky is different in every respect from the one posited by the efficient-market hypothesis. As long as the good times roll, people lose sight of the bitter lessons of the past, claiming that “this time is different.” Financial excesses grow more severe as bubbles progress, creating greater vulnerability to shocks and more damage when the bubbles finally burst. The crashes
themselves always seem to come as surprises, after which sentiment swings radically in the other direction: people shun risk, pessimism rules, and the economy struggles. This all sounds like an accurate description of what happened in the United States and elsewhere between, say, 2000 and 2010. But Minsky is barely mentioned in this volume.

A second lesson is that “Reinhart-Rogoff recessions” are worse than “Keynesian recessions.” In a Keynesian recession, one or more components of spending (say, homebuilding) sag, perhaps because the central bank has raised interest rates to fight inflation. Once inflation is back under control, monetary policy reverses course, interest rates fall, the housing market recovers, and growth resumes. Even the monstrous U.S. recession of 1981–82, which was called the Great Recession in its day, fit this pattern.

But what I now call “Reinhart-Rogoff recessions” (after the work of Harvard’s Carmen Reinhart and Kenneth Rogoff) are creatures of a different sort. Reinhart-Rogoff recessions destroy portions of the financial system and leave much of the rest reeling. Having been preceded by huge buildups of debt, they leave a painful legacy of deleveraging, which makes the recession deep and long and the recovery tepid and slow.

Reinhart and Rogoff emphasize the importance of sharp buildups of public debt, stemming, for example, from bank bailouts and recessions, which may drive up interest rates, limit the ability to use fiscal stimulus, turn fiscal policy procyclical, or even threaten sovereign default. If fiscal expansion is blocked by a large public debt and monetary expansion is blocked by zero interest rates, recovery from a Reinhart-Rogoff recession (unlike a Keynesian recession) may require unorthodox debt-reducing policies, such as explicit debt forgiveness or implicit debt repudiation through inflation. These radical remedies are far from the usual Keynesian prescription—and, like Minsky, they are almost entirely absent from this volume.

FOOL ME ONCE

A third lesson is that self-regulation is an oxymoron. “Self-regulating organizations,” a legal creation of U.S. securities law, are private (but presumably public-spirited) institutions to which, say, the Securities and Exchange Commission delegates authority for detailed rule-making and enforcement. One quintessential example is a stock exchange. Self-regulating organizations can bring great technical expertise to bear on certain regulatory issues, but they can also be like foxes guarding chicken coops. I have long been skeptical of them due to obvious conflicts of interest, and that skepticism has been deepened by how they performed in the run-up to the recent crisis. The lesson here seems painfully simple: regulators must regulate, not delegate.

The fourth lesson is that fraud and near fraud can become so prevalent that they can have macroeconomic effects. “Fraud” is a legal term, and it is hard to prove. What I call “near fraud” is a moral term, and it is much easier to identify. Near frauds were rife, for example, in the way the financial industry dealt with borrowers and investors during the U.S. mortgage boom of 2003–6. Until the financial volcano erupted, however, virtually all economists, myself included, thought that fraud and near fraud, bad as they might be, could not rise to the level of macroeconomic significance.

Wrong again. It is now clear that a veritable epidemic of deception in the home mortgage market, especially in subprime lending, helped fuel the housing bubble, with disgracefully bad mortgages pumping
up the demand for low- and medium-priced houses. Wall Street then turned these awful mortgages into horrible securities, many of which were subsequently blessed with AAA ratings by pliant rating agencies. Derivatives built on these dodgy securities multiplied the breadth and depth of exposure to the toxic mix, and when the day of reckoning finally arrived, the entire economy was affected. Who knew? We do now.

A fifth lesson (one that is actually mentioned in the book) is that excessive complexity in finance is both anticompetitive and dangerous. *Homo economicus*, an efficient, rational, calculating machine, never worries about complexity. But *Homo sapiens* is an entirely different creature. We humans are poor and biased calculators. We regularly succumb to fads, fancies, and passions. We can be fooled.

All this means that in the real world, extreme complexity can undermine competition by making it harder for buyers of financial instruments to comparison-shop effectively—or even to know what they are buying. When investors don't understand the risks they are taking—as many did not during the bubble—big mistakes can be made. Losses in the subsequent crash can be larger than anyone imagined, and markets can freeze up because no one knows what complex securities are worth. Complexity per se can thus be a source of financial fragility.

In his essay, Romer writes that “it is not immediately clear that the benefits of the financial innovations of recent decades have been on a scale that warrants [the] costs [they imposed].” Amen. He wonders whether “a much simpler, 1960s- or 1970s-style financial system [would] be better than what we have now.” It would have been great to read the ruminations of some of the conference’s experts on this excellent question.

A sixth lesson is that go-for-broke incentives will induce traders to go for broke. In the years before the crisis, commercial banks, investment banks, and hedge funds often compensated their traders in ways that offered fabulous riches for success but comparative slaps on the wrist for failure. Such skewed compensation systems created powerful incentives to take huge risks. To make the situation even worse, many traders were smart, young, risk-loving, and avaricious. So they acted just as one might have expected, gambling furiously. As long as the boom proceeded, successful traders became as rich as Croesus. But when the bust came, others bore the brunt of the losses.

The problem with such skewed incentives should have been obvious to anyone who paused to think about them before the crisis. Apparently, few did. Now many have, and compensation practices have changed. But, like Minsky, I worry about what will happen over time as people forget.

**ILLIQUID OR INSOLVENT?**

The seventh and final lesson is that illiquidity looks a lot like insolvency. Economists and financial experts are accustomed to drawing a sharp distinction between being short on cash (illiquid) and having negative net worth (insolvent). If you’re a financial business, illiquidity is the flu. A truckload of borrowed cash will enable you to recover from it, probably quickly. But insolvency is fatal; you are headed to bankruptcy court. The nature and severity of the two financial ailments are generally considered to be different, as are the classic remedies for them.
Fischer’s interesting essay in this volume takes this traditional distinction a step further, suggesting it as a way to demarcate the proper domains of central banks versus finance ministries in a crisis. “So long as a financial institution needs only liquidity assistance, the [central bank] can handle the problem on its own; but as soon as the insolvency of a financial institution has to be dealt with, the Treasury has to be involved.”

This sounds sensible; after all, dealing with potential insolvencies may have fiscal consequences. But is the distinction between illiquidity and insolvency truly clear, or even relevant, in a crisis? During a panic, news or even rumors that a financial institution may have suffered large losses (and hence may be in danger of insolvency) can create a liquidity squeeze by precipitating a run on it. And the process operates in reverse: a run on a financial institution with positive net worth can destroy the firm unless someone comes to the rescue with a large loan.

Several essays in the volume take up this issue, and on balance, they recognize that the line between illiquidity and insolvency can be blurred or even erased. For example, the New York University economist Nouriel Roubini writes that if there is a run and no lender of last resort, “you may end up in a situation in which a liquidity problem leads to insolvency.”

The cases of Bear Stearns and Lehman Brothers, and the different reactions of the Federal Reserve and the U.S. Treasury to them, illustrate just how important these issues can be in practice, and just how difficult they are to address. In March 2008, Bear Stearns was bleeding cash. The Fed acted to save it, justifying its highly unorthodox actions by arguing that the firm was illiquid but solvent. But does anyone doubt that Bear Stearns would have died absent the Fed’s intervention?

Six months later, Lehman Brothers showed remarkably similar symptoms: a liquidity squeeze brought on by the prospect of large losses. But this time, the Fed refused to intervene, basing its decision on a judgment that Lehman did not have enough good collateral to cover what might have been a short-term bridge loan. Deemed insolvent, Lehman was dispatched to bankruptcy court.

But were the two situations really so different? Regardless of where one comes down on the decision to save Bear but let Lehman go, the two cases, taken as a pair, deal a fatal blow to the allegedly sharp distinction between illiquidity and insolvency.

Whatever the drawbacks of this volume, the thinking on policy issues presented in it make it a must-skim for people seriously interested in macroeconomic policy. It’s not really a book, except in the physical sense: no story holds the various pieces together, no voice creates a single coherent point of view, and one can read the essays in any order. But it offers a bountiful and delicious smorgasbord from which readers can graze according to taste, returning until they are sated. So I’m delighted to keep a copy close by, the misleading title notwithstanding.
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