Book Synopsis

From Craig Weightman

Freefall

By Joseph Stiglitz

The Making of a Crisis

- The belief that the market is self regulating and government serves no purpose
- The maintenance of cheap debt to inflate spending coming unnecessarily
- Banks combined with investment firms, yielding emphasis on short term returns
  - High transaction costs yield profits, even for bad loans
  - Problems pushed off to someone else's responsibility
- Culprits (in combination)
  - Mortgage originators
  - Banks and Rating agencies
  - Federal Reserve refusal to raise interest rates
- Market Failures
  - When there are important agency problems and externalities, markets typically fail to produce efficient outcomes.
    - Agency – people handling money and decisions on behalf or others
      - Partnerships watch their own money, corporations have anonymous shareholders and management can run the firm for their own benefit, hence the emphasis on short term returns.
      - Securitization can make transactions less transparent (a goal of most banks, for competitive reasons) and further removes the stockholder.
    - Externalities – situations where a market exchange imposes costs or benefits on others who aren't party to the exchange.
  - Regulations were stripped away and regulators were managed by people from the regulated industries.
- The world economy is undergoing seismic shifts. The Great Depression coincided with the decline of U.S. agriculture, while the U.S. is now moving from a manufacturing to a service economy

A Flawed Response

- A stimulus program in the Keynesian model …
  - It should be fast – Bush procrastinated for months, hoping for a correction
  - It should be effective – each $ spend should give rise to a large increase in employment and output
  - It should address the country's long-term problems – low national savings, huge trade deficits, long-term financial problems for Social Security decaying infrastructure, global warming.
  - It should focus on investment – We are increasing our debt; therefore, we should use that debt to increase our assets – yielding at somewhat of a balance as we move forward.
  - It should be fair – middle-class Americans have faired far worse in recent years, compared to those at the top; therefore, special tax deals for the rich should be avoided.
  - It should deal with the short-run exigencies created by the crisis – states often run out of money in a downturn and have to start cutting jobs, the jobless are left without insurance, mortgages are 'upside down'; therefore, a stimulus has to deal with as many of these issues as possible.
  - The stimulus should be targeted at areas of job loss – if the job losses are likely to be permanent, the stimulus should be directed at retraining workers.
- This is not the first crisis of this type. The Asian financial crisis in the 90's resulted in tremendous failures of the banking systems and greatly increased debt forced on the countries involved by the IMF and World Bank.
- The U.S. crisis was not handled in the same manner; the banks were simply given cash to strengthen their balance sheet – with no restrictions.

- The auto industry was forced to give up ownership and the stockholders lost their investments – unlike the financial firms.

The Great American Robbery

- The success of the financial sector is ultimately measured in the well being that it delivers for ordinary citizens, because either capital is allocated better or risk is managed better.
  - Incentives matter, but there is a systemic mismatch between social and private returns unless there is effective government regulation (the vehicle for enforcing public good in the face of short term gains).
  - If institutions become too big to fail their attitude toward risk is skewed and they will be mismanaged
  - Big banks moved away from vanilla banking to securitization for better returns
  - Commercial banks sought to imitate the high risk-high returns of high finance – given the public insurance underlying these institutions, this is a bad model
  - Too many banks forgot they should be responsible citizens and started preying on the poorest and most vulnerable – a result of the corporate, short-term return philosophy
- The rescue that wasn't – shareholders were rescued and bank management retained
- Why the rescue was doomed to fail
  - It wasn't focused on restarting lending – banks were not required to address the mortgage question; the underlying beginning of the crisis
  - The banks were not taxed, therefore the taxpayers were going to be the ones to ultimately pay for poor banking decisions
  - Incentives were not refocused for the banks (regulations and taxes)
- The Federal Reserve actively resisted exercising any regulation not directly assisting the largest businesses

A New Capitalist Order

- The government must play a central role in restructuring the economy – it will not happen on its own. The misguided attempt to reduce the role of the state has resulted in government taking on a larger role than anyone would have anticipated, even in the New Deal. We will now have to reconstruct a society with a better balance between the role of government and the role of the market.
- Why do we need to restructure the economy?
  - We have been living well beyond our means for many years
  - Our income has stagnated for a decade
  - The US has the largest percentage of its population in prison – up to 10 times as much as many European countries
  - Global warming necessitates a retrofitting of the economy
  - The infrastructure has decayed – i.e. New Orleans's levees
  - Students perform more poorly in science and math than the average of most industrialized countries
- A global context
  - There is a gap between global demand and global supply – the world's productive capacity is being underutilized
  - Climate change – scarce environmental resources are treated as if they are free, distorting prices as a result (more bubbles are coming, if not addressed)
  - Global stability – America is living well beyond its means while others produce more than they consume; creating a growing imbalance of debt
  - Manufacturing conundrum – increasing productivity has reduced the employment requirements, putting more pressure on innovation (education and social contracts)
  - Inequality – growing inequality contributes to the problem of lack of global aggregate demand
- Financial stability – while we have technical and social advances, we feel less secure about our lives today because economic crises have become more frequent, the social compact between employer and worker are much reduced, the safety net has been shredded, the family has become less beholden to its members

Reforming Economics

- The general equilibrium approach – Leon Walras (a mathematician) described the economy as equilibrium in 1874. Conservative economists have used that model to define their theories since that time, believing that rational actions and information flows would always work to maintain that equilibrium.
- Keynesian theory has maintained that there is no scientific basis for the presumption that markets were efficient.
  - Small information imperfections could dramatically change the nature of the market equilibrium
  - It is not true that markets are efficient in determining the ideal amount of spending or the best direction of research (much research has begun with government programs related to social needs or defenses).
  - The human animal does not always work from a rational basis, therefore, the market will not always be driven in a way to maintain a rational equilibrium.
- Failure of the neoclassical model (perfect markets)
  - Presupposes there is no unemployment – everyone can find a job over the long term, i.e. the demand for labor equals the supply (unemployment insurance is counterproductive)
  - There is no such thing as credit rationing. Anybody can borrow as much as they want – at the appropriate interest rate. In other words, nobody stops lending and trust only influences the rate you are charged.
  - Whether a firm finances itself with debt or equity doesn't matter. This ignores the possibility of bankruptcy and the costs associated with it.
  - Each worker gets paid according to his marginal contribution to society. How do we explain a CEO jumping from 40x a workers' pay to 400+x a workers' pay over the last 30 years when the result is an economic crash?
  - There is not such thing as discrimination. If there were a discriminated person, they would be hired; just at a lower rate.
- Consequences
  - Individuals act systematically in an irrational way
    - Smart firms can find profitable opportunities in exploiting irrationalities. People don't read/understand their credit card application, but, once used, they will tend not to move their business to another card.
    - Government is needed, not only to prevent exploitation (usury for example), but also to help individuals make better decisions (how choices are presented to people).

Toward a New Society

- We should take this moment as one of reckoning and reflection, of thinking about what kind of society we would like to have, and ask ourselves, Are we creating an economy that is helping us achieve those aspirations?
- How economics shapes society and individuals
  - Misallocation of our scarcest resources: our human talent. Our best students are going into finance, instead of socially more productive areas
  - How the market has altered how we think and misshaped our values: Too many came to believe in the theory that pay reflected social contributions.
- We concentrate on our freedom, without accepting our responsibility – made easier by increasing the isolation of individuals. This is an extension of our belief in rugged American individualism.
- "I was just doing my job" is not a defense that should allow people to avoid responsibility for their actions.
- What you measure is what you value, and vise versa
  - Measuring GDP is a bad measure of societal well-being, therefore while we were being told things were getting better, we felt ever more insecure and threatened.
  - Measuring median income is far more descriptive than measuring average income.
  - Social safety nets allow people to take risks in innovating products or services.
- The financial market is supposed to allocate resources in the most efficient manner. Since people are not completely rational, there are always imperfections in the information available to different people, and externalities are unavoidable; there is no way for the market to operate efficiently without some oversight. Government evolved to serve this purpose. We citizens have to decide exactly what goals we want for our society and then construct our laws and regulations toward these goals.