Friedman, Jeffrey, ed. *What Caused the Financial Crisis*. Philadelphia: University of Pennsylvania Press, 2010.

In my graduate and undergraduate courses on money and banking, we spend at least one week of the semester discussing the 2008 financial crisis and the factors that may have caused it. My approach is to supply students with reading materials expressing multiple perspectives on the primary causes of the crisis so they might form their own opinions through debate and discussion. Despite my efforts, Jeffrey Friedman's *What Caused the Financial Crisis* provides a fuller and more informed guide to the events contributing to the crisis than any set of works I have managed to assemble. It includes essays with multiple perspectives on the crisis, each of which is clearly explained and replete with data. This book would be an excellent read for anyone seeking to familiarize themselves with the financial crisis and for experts seeking new information or divergent opinions. As the chapters cover a variety of positions and topics, I will discuss each individually and conclude with some general thoughts and comments.

This volume, edited by Friedman, begins with a chapter by Friedman himself summarizing an array of data regarding the years leading up to and including the crisis. It follows with eleven chapters of essays by academic experts and an afterword by Richard Posner. Friedman's introductory chapter walks the reader through some pre-crisis history and summaries of several of its potential causes. References to the later chapters are given where relevant, but the tone is to lay a factual foundation upon which the competing theories can be judged.

Friedman begins with statistics showing the increased origination and securitization of subprime mortgages, a change he attributes mostly to flawed U.S. housing regulations. The Federal Reserve's interest-rate policy appears to have played a significant role, since subprimes were almost exclusively adjustable-rate mortgages (ARMs). Deregulation of the commercial banking industry may also have contributed to some degree, especially the risk-based capital regulations based on the Basel Accords, which had the devastating effect of encouraging banks to hold large volumes of mortgage-backed securities (MBSs). Indeed, "all banks' MBS exposure seems to have been acquired in pursuit of capital relief" (pp. 26-27). The securities rating agencies further contributed to this problem as they were protected from competition and, therefore, had little incentive to provide legitimate evaluations.

Buried within his mountains of evidence, Friedman unearths the informational and analytical biases to which financiers and officials may be predisposed. Bankers and regulators alike appear to have been ignorant of the individual and systemic riskiness of securitized assets. However, Friedman

Reason Papers 34, no. 2 (October 2012): 222-228. Copyright © 2012

notes that ignorance by the regulator often poses a greater danger than that of the banker, since bad regulations necessarily lead to systemic risk. He finds an ideology of "economism," the faith that economists and regulators put in their ability to prevent risk "based on what academic economists judged to be the best economic theories" (p. 51). This characterization is reminiscent of Friedrich von Hayek's "scientism," a term coined to describe overconfidence in the predictive power of social-scientific theories as though they can be applied to the real world as is done in the physical sciences.[1] "Given the regulators' ideology, it will not do to blame the crisis on capitalism" (p. 53). Additionally, the challenge of operating within a social democracy inhibits effective regulation. Public officials must focus on the issues of the day and have little understanding of the potential long-term side-effects of their actions. The notion that regulators acted in ignorance and with hubris is a consistent theme discussed in several of the later chapters. Friedman ends the chapter by acknowledging the difficulty of operating within a multi-tiered legal structure of unknowable complexity and proposing research on the effect of mark-to-market accounting regulation.

The contributed essays begin with two chapters on "The Crisis in Historical Perspective," the first being "An Accident Waiting to Happen: Securities Regulation and Financial Deregulation," by Amar Bhidé. Beginning with the theory and history of securities regulation since the 1930s, Bhidé describes how securities regulation "fosters antagonistic, arms-length relationships between shareholders and managers" (p. 73). This separation aggravates manager/owner relations and inhibits the sharing of information, thereby magnifying principal-agent problems. These problems have been further exacerbated by "defective regulation" of the banking industry. Bhidé criticizes the American free-banking systems of the nineteenth century, which he (mis)characterizes as "inherently unstable" and in need of regulation (p. 85).[2] According to Bhidé, early regulations such as Federal Deposit Insurance Corporation (FDIC) deposit insurance created stability in the banking system that was eventually undone by increases in asset securitization and deregulation during the late-twentieth and early-twenty-first centuries. It was this combination of increased financial innovation and reduced monitoring

[1] See Friedrich von Hayek, "Scientism and the Study of Society," *Economica* 9, no. 35 (August 1942), pp. 276-91.

[2] Despite the common perception that nineteenth-century banking was filled with turmoil, most studies have found that the banking industry was not inherently unstable. The banking crises of that period are generally thought to have been caused by prohibitions on interstate banking rather than by the absence of regulation. See Arthur Rolnick and Warren E. Weber, "Causes of Free Bank Failures: A Re-examination," *Journal of Monetary Economics* (1984), pp. 267-91. See also George Selgin, William D. Lastrapes, and Lawrence H. White, "Has the Fed Been a Failure?" *Journal of Macroeconomics* (2012), accessed online at: http://dx.doi.org/10.1016/j.jmacro.2012.02.003.

that "led to the implosion of the world economy" (p. 106). Ironically, Bhidé does not worry that FDIC deposit insurance creates a separation between depositors and managers (the same effect as separating owners and managers, which he demonizes in regard to securities regulation). Bhidé shares Friedman's concern that bankers and regulators were prone to overlook obvious risks due to their overconfidence in mathematical models. However, Bhidé contends that regulators "were more concerned than bank executives" about the systemic risks of financial innovation, but eventually "succumbed to the idea" (p. 100).

The next chapter is by Steven Gjerstad and Vernon L. Smith, "Monetary Policy, Credit Extension, and Housing Bubbles, 2008 and 1929." The authors begin by discussing the experimental evidence of assets bubbles, a phenomenon whose pattern is easily identified but whose root causes are not. They contend that the 2008 housing bubble was sparked by mortgage-tax exemptions instituted in the late 1990s and fueled by the Federal Reserve's easy monetary policy. Indeed, they provide evidence that "the years 2001-2004 saw the longest sustained expansionary monetary policy in half a century" (p. 114). The increased use of subprime lending and ARMs furthered the dependence on interest rates, thereby ratcheting up the bubble effect. The authors draw interesting parallels between the recent crisis and the market crash of 1929. I was interested to learn that the banking collapse of the early 1930s was, in many respects, caused by the bursting of a real-estate bubble that devalued bank assets and constrained liquidity in the financial system. Although this explanation is consistent with the analysis of Milton Friedman and Anna Schwartz,[3] Gjerstad and Smith differ by suggesting that in both 1930 and 2007 the Federal Reserve Bank was unable to stem the financial crisis because the underlying problem was insolvency, not liquidity. The chapter closes with a now-familiar refrain that overconfident regulators, or in this case central bankers, were unable to recognize important risks or implement effective policy.

Joseph E. Stiglitz leads off Part II, "What Went Wrong (and What Didn't)?" with his essay, "The Anatomy of a Murder: Who Killed the American Economy?" Although Stiglitz believes the causes of the crisis to be many and multifaceted, he argues that "blame should be centrally placed on the banks (and the financial sector more broadly) and the investors" (p. 140). U.S. commercial banks were responsible, according to Stiglitz, for excessive leverage, short-sighted risky behavior, and ignorance of the risks of asset securitization. Stiglitz adds the ratings agencies, whose analyses were unreliable, and mortgage originators, who tended to "prey on innocent and inexperienced borrowers" (p. 142), as accomplices to these crimes. Many of these factors are the same as those discussed in Friedman's introductory chapter, but come from a different perspective. While Friedman links the

[3] Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, NJ: Princeton University Press, 1963).

housing-price bubble to government policies, including those of Fannie Mae and Freddie Mac, Stiglitz exonerates policymakers for any wrongdoing. Friedman attributes the banks' risky behavior to poor regulatory incentives. Stiglitz instead blames the "powerful and wealthy" bankers, yet he provides little data in his "search for whom to blame for the global economic crisis" (p. 139). Indeed, the relative weakness of Stiglitz's analysis makes Friedman's point appear even more convincing.

The next chapter is "Monetary Policy, Economic Policy, and the Crisis," by John B. Taylor, in which he argues that "government actions and interventions caused, prolonged, and worsened the 2008 financial crisis" (p. 171). Taylor begins with his theory that through the early 2000s, the Federal Reserve erred by lowering their funds rate to a level below that dictated by the Taylor Rule. Although low interest rates are not themselves indicative of loose monetary policy (since banks might still choose not to lend), Taylor summarizes a 2007 study showing that housing starts were, in fact, linked to low interest rates and that following a Taylor Rule would have minimized the bubble.[4] International evidence is consistent with this hypothesis, since "housing booms were largest where the deviations from the rule were the greatest" (p. 155). The crisis was worsened by U.S. housing policies, which encouraged securitization and the use of subprime mortgages. It was prolonged by government policies that provided liquidity without addressing the fundamental problem of mortgage insolvency. One counter-theory is that loose money in the United States was caused by a "global savings glut" from abroad. However, Taylor shows that net savings rates were not increasing over the period, since increased investment by foreigners was counteracted by lower domestic savings.

The sixth chapter is "Housing Initiatives and Other Policy Factors," by Peter J. Wallison. He finds that "[t]he crisis had its roots in the U.S. government's efforts to increase home ownership, especially among minority, low-income, and other underserved groups" (p. 172) through the Community Reinvestment Act (CRA), the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, and other tax and regulatory policies. Wallison concedes that CRA loans did not lead to higher default rates, but contends that they caused a reduction in underwriting standards that "spread rapidly to the prime market and subprime markets, where loans were made by lenders other than insured banks" (p. 175). Wallison provides evidence that lending standards declined drastically from 1997 to 2007 due to increased demand from the GSEs who held and securitized more low-quality mortgages.

The impact of GSE mortgage securitizations is explained by Viral V. Acharya and Matthew Richardson in "How Securitization Concentrated Risk

---

[4] John B. Taylor, "Housing and Monetary Policy," presented at the "Housing, Finance, and Monetary Policy: A Symposium" conference, Jackson Hole, WY, August 20-September 1, 2007, accessed online at: http://www.kansascityfed.org/publicat/sympos/2007/pdf/2007.09.04.Taylor.pdf.

in the Financial Sector." They begin with the same logic previously discussed by Friedman, namely, that risk-based capital regulations encouraged banks to hold MBSs in place of other assets. In addition, banks created "secured investment vehicles" to purchase their subprime mortgages and asset-backed securities, upon which they issued asset-backed commercial paper (ABCP). By holding ABCP, banks could essentially maintain ownership of their risky MBSs while reducing their regulatory capital. The result was that from 2004 to 2007, "in the top ten publicly traded banks, the magnitude of total assets doubled even though the size of the banks' *risk-weighted* assets increased by less than 50 percent" (p. 192, emphasis in original). These big bets on the mortgage market turned disastrous when housing prices began to fall and "effectively brought down UBS, Bear Stearns, and Lehman Brothers" (p. 197). Unlike Friedman, however, Acharya and Richardson place responsibility for these bets on profit-seeking bankers who exploited failed capital regulations rather than on the regulations themselves.

Juliusz Jabłecki and Mateusz Machaj's "A Regulated Meltdown: The Basel Rules and Banks' Leverage" gives a detailed discussion of the perverse incentives in U.S. banking regulation. Similar to prior chapters by Friedman and Acharya and Richardson, Jabłecki and Machaj find that the Federal Reserve's adoption of risk-based capital regulations encouraged banks to acquire MBSs and ABCP. Unlike Friedman, they put greater emphasis on the Basel rules and monetary policy than housing policy as the impetus for excessive subprime lending, stating that "[e]asy money led to low interest rates, which not only contributed to a housing boom, but . . . provided an excellent environment for the development of securitization, and particularly the securitization of subprime mortgages" (pp. 218-19). They also pose an intriguing hypothesis that the liquidity crisis in the banking sector was not a "modern day bank run" in which banks no longer trusted each other. Rather, it was a consequence of the falling values of ABCP which caused banks to move their off-balance-sheet assets back onto their books, an activity requiring that they maintain more of their own liquidity rather than lending it to others.

In "The Credit-Rating Agencies and the Subprime Debacle," Lawrence J. White explains how the regulation of rating agencies led to the propagation of subprime MBSs. In 1975, the Securities Exchange Commission (SEC) declared that only three firms—Moody's, Standard and Poor's, and Fitch—would be classified as "nationally recognized statistical ratings organizations." The change gave these firms a "de facto oligopoly" and caused them to switch from an "investor pays" to an "issuer pays" business model (p. 231). White identifies four ways in which the rating system contributed to the securitization of subprime mortgages: the rating agencies were trusted and respected in the financial community, many firms such as insurance and pension funds were legally required to rely on their ratings, banks could use these ratings to reduce their Basel capital ratings, and ratings were necessary to create ABCP funds.

Peter J. Wallison argues in "Credit-Default Swaps and the Crisis" that, despite common perceptions, credit-default swaps (CDSs) were not to blame for the credit crunch of 2008. Like any financial security, CDSs intermediate risk by transferring it between parties. Wallison does an excellent job of demystifying the mechanics of CDSs, concluding that "the seller of a CDS is taking on virtually the same risk exposure as a lender" (p. 241). Nor did CDSs create systemic risk any further than giving anti-market advocates more "speculators" to demonize. Wallison finds that "there is little evidence that the failed financial institutions were the victims in their participation in credit-default swaps, or that their failure jeopardized their swap counterparties, and thus, the global financial system" (p. 239).

Part III of the book has two chapters on "Economists, Economics, and the Financial Crisis." Daren Acemoglu, in "The Crisis of 2008: Lessons for and from Economists," calls for a balance between markets and regulation. He conjectures that regulators' efforts to reduce aggregate volatility actually increased our exposure to systemic shocks. For example, regulations suppressed reputational mechanisms, which limited market participants' ability to police each other. According to Acemoglu, markets failed because policymakers were "lured by ideological notions derived from an Ayn Rand novel," which "equated free markets with markets unregulated by institutions" (p. 254). He proposes that a regulated market is necessary for economic growth, but provides no new insight into how such a system is achieved. This is particularly ironic considering that, as demonstrated throughout the collection and acknowledged by Acemoglu himself, vague but well-intentioned regulation was the primary cause of the financial crisis. While accusing capitalists of confusing free markets with markets free of institutions, Acemoglu seems to be confusing better institutions with increased financial regulation.

The final chapter, by David Colander et al., is "The Financial Crisis and the Systemic Failure of the Economics Profession." As in prior chapters, the authors propose that economists failed to recognize, and even contributed to, the financial crisis due to an overreliance on quantitative economic theory. Aspects of this failure include simplistic and unrealistic assumptions, overreliance on mathematical rigor, underreliance on empirical testing, and excessive conceptual reductionism.

Richard Posner provides an afterword that hearkens to Acemoglu's call for regulated markets. Posner agrees with earlier authors that the crisis was primarily caused by "unsound monetary policy . . . and inadequate (at times inept) regulation of financial intermediation" (p. 279). Yet despite his acknowledgement that the crisis was a failure of government policy and regulation, Posner claims that "the financial crisis was a failure of capitalism (the title of my first book on the crisis), but it was a failure of the regulatory arm of capitalism" (p. 294). Like Acemoglu, he calls for more and better regulation with no concrete prescriptions on how that goal may be reached. Like Acemoglu, Posner is in danger of confusing the prescription with the disease. He decries inept regulation as the problem yet calls for more regulation as the solution. This solution is no solution at all. Everyone is in favor of fair and reasonable regulation. As Peter Boettke describes in *Living Economics*, "[n]obody in their right mind would argue for unreasonable regulation dominated by interest group politics," but "[w]hat if . . . that set of regulations is a null set?"[5] Without more detail, it is impossible to discern whether Posner's proposed regulations are indeed reasonable. The saying "the devil is in the details" does not imply that one can avoid the devil by omitting the details.

Although all of the chapters provide detailed, data-driven analyses, the collection does have a few shortcomings. Regarding content, one significant limitation is the scant discussion of the "global savings glut" as a potential cause of the crisis. This view is espoused by prominent economists, including Ben Bernanke, Alan Greenspan, and Paul Krugman. In this volume, Stiglitz dismisses it (p. 144) and Taylor provides some evidence against it (p. 154), but a more comprehensive discussion would have complemented the existing chapters. Another problem, common to such collections, is that much of the material is repeated or overlapping. There is also some sense in which the authors are talking past each other. Perhaps it might have been better to have had them read and comment on each other's works rather than making each contribution completely independent.

In summation, Friedman's *What Caused the Financial Crisis* gives detailed accounts from several perspectives of the factors most likely to have contributed to the crisis. It is the best compilation of information on the crisis that I have read to date. The only mild warning that I might give to those considering the purchase of this book is that I hear that Friedman's more recent book, *Engineering the Financial Crisis*, might be even better.[6] Look for a review of that work in a forthcoming issue of *Reason Papers*.

Thomas L. Hogan
West Texas A&M University

[5] Peter J. Boettke, *Living Economics* (Oakland, CA: The Independent Institute, 2012), p. 160.

[6] Jeffrey Friedman and Wladimir Klaus, *Engineering the Financial Crisis* (Philadelphia, PA: University of Pennsylvania Press, 2011).