Reviews


What caused the 2008 Global Financial Crisis? One popular view is that it was due primarily to greedy bankers who created toxic securities to dupe unsuspecting investors. Another points the finger at politicians – for failing to provide regulators with the necessary tools to combat said greedy bankers, for deregulation of financial markets and for excessive intervention in housing markets. Still another emphasises the role of economics itself – that it not only failed to predict or prevent the crisis but also that its reliance on inaccurate and outmoded models was a primary contributor to the crisis.

In this thoughtful new book, Barth, Caprio and Levine (henceforth BCL) pour varying amounts of cold water on all these ideas and instead focus on the role of the so-called ‘Guardians’ of finance: financial market regulators. The reader is given much to ponder, but the crux of BCL’s argument is that financial regulators demonstrably failed to act in the public interest, that this was not an accident, that it was not the result of unforeseen forces and that it was not due to regulatory gaps. Instead, regulators ‘repeatedly designed, implemented and maintained policies that increased the fragility of the global financial system in the ten to fifteen years before the crisis that shook the world in 2008’. (p. 85) Perverse regulator incentives, a consequent failure by regulators to diligently monitor and a reluctance to enforce existing regulations even when there was clear evidence of the need to do so, combined to produce a systemic collapse of the regulatory system at exactly the time effective oversight was most needed.

BCL carefully assess various decisions of the United States Federal Reserve, the SEC, the ratings agencies, the FDIC, Freddie Mac and Fannie Mae, Congress and their counterparts in Ireland, Iceland and the United Kingdom. Most seem to be wildly at odds with the objective of a stable financial system, and not just with the benefit of hindsight. Some of the cases discussed in detail include regulatory authority failures to respond to (i) massive off-balance-sheet migration of bank assets; (ii) dramatic substitutions of credit default swaps for equity capital; (iii) unprecedented growth in bank assets; and (iv) various problems highlighted by their own staff. BCL emphasise that regulators were aware of all these phenomena at the time they occurred, and yet, inexplicably, failed to act. Just a nodding acquaintance with financial economics, including the much- (and wrongly) maligned efficient markets hypothesis, should have alerted them to the dangerous road on which they were travelling.

Why did regulators ignore such obvious signals? Many commentators have pointed to conflict-of-interest issues created by the revolving door between regulatory agencies and financial institutions, but BCL downplay this argument. Instead, they suggest several other reasons. First and foremost, social norms cause regulators to suffer from a ‘home team’ bias: forced into such close collaboration with financiers, regulators come to identify with them and their interests. Second, to the extent that regulators remain able to distinguish between financier and public interests, the lobbying power of the financial services industry inevitably makes it difficult for regulators to prioritise in the public interest.

BCL also consider the role of another form of regulatory ‘capture’ – the adherence by some regulators (notably Alan Greenspan) to Ayn Rand philosophy and a consequent belief in the self-correcting nature of markets, even when prevailing incentives imply precisely the opposite. But such beliefs have no grounding in conventional economics – so to the extent that regulatory failure is attributable to ideology, this failure occurred in spite of economics, not because of economics.

Current reform efforts – such as Dodd-Frank and Basel III – that ignore the problems of regulator incentives and capture, and instead simply offer more of the same, therefore seem doomed to fail. To provide necessary support to these reforms, BCL propose the formation of a ‘Sentinel’ – a group of expert economists, lawyers, accountants, regulators and bankers whose
sole role would be to provide regular public assessments of the state of financial regulation. It would, in short, regulate the regulators, albeit informally and with no statutory power. To ensure its independence, the Sentinel would have guaranteed and stable government funding, and its members would be barred from post-Sentinel employment in the financial and lobbying industries for a significant period of time after leaving. To ensure its expertise, Sentinel members would be paid a market salary, and would have the power to acquire whatever information they deem to be necessary.

BCL’s diagnosis of the problems with financial regulation is compelling, but their proposed solution is slightly less persuasive. Although the theoretical case for an agency such as the Sentinel has obvious merit, and follows logically from the authors’ diagnosis, some practical doubts remain. First, identifying and putting together a multidisciplinary team that is both expert and independent is not likely to be all that easy, even in a large country like the USA. In much smaller countries – such as Australia and New Zealand – it may be well-nigh impossible. Second, an agency such as the Sentinel will inevitably feel obligated to adopt a somewhat critical tone in its reports on the regulatory system. Because crises occur relatively infrequently (fortunately), these reports are likely to eventually acquire something of a ‘cry-wolf’ reputation, making it inevitable that the Sentinel will be ignored or undermined at precisely the times when its warnings are most needed. To this reader at least, the Sentinel proposal looks suspiciously like one of those highly elegant and general models that, when it comes to practical implementation, require knowledge of several unobservable parameters.

But this is a minor quibble. BCL have produced a study that is not only clear, readable, thorough and convincing, but also one that puts to bed many of the popular misconceptions about the crisis that began in 2008. Anybody interested in the causes of that crisis, the complexities of financial regulation or just economics and finance generally, should read this book. In the language of finance, it will be an investment that yields supernormal returns.

GLENN BOYLE
Department of Economics and Finance
University of Canterbury


Economics is not an infallible science. The Global Financial Crisis (GFC) has only too well shown that many of the main themes in economics in recent times have to be revisited and seen in a critical light. I am one of many members of the tribe of economists arguing that a good understanding of economics (theory) helps to understand better what we actually know and where we need to be cautious with our recommendations. Gilbert Rist presents an outsider’s view on our failures. He takes the perspective of an anthropologist and then moves between critically looking at economists’ set of ideas with an anthropologist mindset (that is at least my impression) and presenting an anthropological study of the tribe of economists. Unfortunately, both jobs are – in my eyes – done very superficially. Nonetheless, Rist gives the economist reader a good idea of how other social scientists and maybe many members of the public see economics, economists and their ideas. This may help an interested reader to learn better where economists need to do a good job to explain what we know and what we do not know.

To go into detail: The Book starts off with placing Economics somewhere between History and Anthropology. The main argument here is that economics can only look at historical data and it tries to describe how a society organises its relationships. Indeed, most economists would have no trouble to agree that economics indeed overlaps with many other social sciences. Most of us, I guess, disagree with Rist’s judgement that economists deem themselves as superior to other social scientists.

The next six chapters (more than half of the book) claim that economics is a failed scientific ambition. After a general introductory chapter, individual chapters look at the concepts of Homo Economicus, Exchange, Scarcity, Utility and Equilibrium. These chapters are at best questionable; I could not stop thinking that they were written by someone who never read more than a first-year textbook. Almost all the comments are such that I would expect them from one of my best first-year students. These students critically identify all the heroic assumptions made in a first-year course work, but have not yet heard about Externalities, Asymmetric Information, Public Choice etc., not even to mention Behavioural Economics.